LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

PEGS, POLITICS AND PETRIFICATION: EXCHANGE RATE POLICY IN ARGENTINA AND BRAZIL SINCE THE 1980S

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A thesis submitted to the Department of International Relations of
the London School of Economics and Political Science
for the degree of
Doctor of Philosophy in International Relations

2009

AUTHOR DECLARATION

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ABSTRACT

Pegs, Politics and Petrification:
Exchange Rate Policy in Argentina and Brazil since the 1980s

Currency crises have long constituted one of the most important sources of politico-economic instability across middle-income emerging markets, with exchange rate pegs having been identified as key culprits. Given pegs' propensity for boom-bust-cycles, it is thus puzzling that governments insist on implementing such constraining regimes and, more importantly, that they tend to postpone exchange rate flexibilisation until a disorderly exit becomes inevitable. This thesis addresses as its core puzzle exchange regime choice in middle-income emerging markets in Latin America, and especially the phenomenon of 'exchange rate petrification', by examining the tumultuous exchange rate history of Argentina and Brazil. Adopting a qualitative approach and using comparisons between periods and countries, it traces the process of exchange rate policymaking on the basis of participant interviews and archival and media research over a period ranging from re-democratisation in the early 1980s, through the decade of structural reforms under nominal exchange rate anchors in the 1990s until the crisis exits to inflation-targeting under 'dirty floats' in the new millennium.

The study shows that existing studies, which narrowly focus on electoral opportunism, credibility-building motivations or structurally-determined interest group pressures derived from OECD contexts, fail to capture the reality of emerging market exchange rate politics, their distinct economic structural context and the inter-relationship between exchange rate policy and executives' structural reform endeavours. Instead, the analysis suggests that only a model of exchange rate politics that centres on intra-executive dynamics, but incorporates their interplay with societal cleavages and the role of international financial institutions, can account for the countries' divergent exchange rate policy and especially the differential severity of 'exchange rate petrification'.

Using the cases of Argentina and Brazil as a backdrop, the thesis offers an explanation for the problematic nature of exchange rate pegs that goes beyond the analysis offered by the economics literature, and instead highlights their inherently political nature insofar as national governments conceive of nominal pegs as coalition-building devices in the context of politically controversial structural reforms. Aside from structural factors, such as liability dollarisation, it is governments' reluctance to surrender this political instrument that perpetuates 'exchange rate petrification'. As 'exchange rate petrification' presupposes the absence of sustained exchange rate politicisation, the thesis also refines the literature's exchange rate politicisation hypothesis by incorporating several intervening variables, such as the institutional structure of organised society, the nature of the political system and ideational factors, which may mute calls for exchange regime change and thus generate permissive circumstances for exchange rate pegs to petrify.

ACKNOWLEDGEMENTS

What we call the beginning is often the end.
And to make an end is to make a beginning.
The end is where we start from.

T.S. Eliot (1888-1965)

The end of a thesis is the beginning of a desperate attempt to account for the huge debts one has amassed in the completion process. Above all, I would like to thank my supervisors, David Stasavage and especially Daphné Josselin, for accompanying me during the past years. I would also like to thank the LSE's Department of International Relations for I could not have imagined a more intellectually stimulating environment to work in.

With all its advantages and disadvantages, this project's inherently interdisciplinary nature forced me to cross (often rather arbitrary) departmental divisions. Although intimidating at first, I came to appreciate being able to tap into the incredible wealth of knowledge at the LSE. Special thanks are due to Waltraud Schelkle at the European Institute. Similarly, I extend my thanks to Andrew Walter, Chris Alden, James Mayall and Francisco Panizza for sharing insights, which greatly contributed to my thinking, and to Neil McLean at the *Teaching & Learning Centre* for accompanying me on my PGCertHE.

During my research, I have had the unique opportunity to spend more than a year in Argentina and Brazil. The list of friends and colleagues who made this organisational challenge a truly unforgettable experience is long. In particular, I would like to thank Andrea and Juliana Oelsner, Pamina Firchow, Ryan Gawn, Ann-Marie Nguyen, Alexandre Roig and Samuel Keifman for making my stays in Buenos Aires not only very pleasant but also productive and intellectually rewarding. Similarly, my fieldwork in Brazil – divided between Brasília, Rio de Janeiro and São Paulo – would not have been as stimulating without the friendly help I received from Alfredo Saad-Filho, Bruno Saraiva, Carlos Pio, Marco Bonomo and Maria Rita Loureiro. Special thanks go to Claudia Shima and Wagner Alves, Braz da Costa Baracuhy, Malena Rehbein Rodriguez, Aurimar Nunes, Itamaraty's SQS411 Bloco H, my *'família brasileira'* Magda, Grace and Bruno Tanno, Luis Malheiro, Jurandir Leto, Evelina Bertranou and Veronica Valles, who have turned my passion for the Southern Cone into a professional commitment to the region.

Tantas pessoas, tantas palavras amáveis, tantos gestos de solidariedade, camaradagem, amistade e altruísmo que, por mais que eu faça, jamais conseguirei retribuir na justa medida. A todas essas pessoas, colegas e amigos, minha eterna gratidão.

Muchas personas, muchas palabras amables, muchos gestos de solidaridad, camaradería, amistad e altruismo que, no importa quanto tentaría, nunca lograría retribuir en la medida justa. A todas estas personas, colegas e amigos, mí gratitud eterna.

During my fieldwork, I have had the great fortune of encountering staff at libraries, archives and other organisations that consistently went beyond their call of duty. Their assistance was invaluable with a view to locating documents and interviewees, arranging meetings and organising travel to obscure interview locations. Similarly, I was overwhelmed by the positive responses to my interview requests and would like to express my sincere gratitude to all interviewees for their time, openness and interest in my research.

Financing fieldwork-driven research at a university in one of the world's most expensive cities is challenging, and I am very grateful to the *Economic and Social Research Council* (ESRC) for funding my studies. In addition, I have been fortunate to benefit from generous departmental funding via the *Montague Burton Award* (2003), various *Research Studentships* (2004-2007) as well as *Travel* and *Conference Grants* (2004-2008). Equally, I would like to thankfully acknowledge the *Travel Grant* (2005-2006) extended to me by the *Central Research Fund* of the *University of London*.

Over the past few years, London has become 'home' thanks to an amazing group of friends. In particular, I would like to thank Karen Barnes and Jill Stuart as well as Alexandra Dias, Stacy Closson, Douglas Bulloch, Robert Kissack, Stephanie Carvin, Marco Vieira, Målfrid Braut-Hegghammer, Faisal Muhamad, Jafri Abdul-Jalil, Kenny Chitranukroh, Nicola Casarini, Sotiria Theodoropoulou, Alex Apostolides, Tamer Douara, Adil Mawani, Goor Moshe, Tia Raappana, Juliet Walker, Obidike Chinyere-Ezeh, Alan Holm and Sokratis Papafloratos for making me laugh, for acting as sounding boards whenever my own vision got murky and for making my PhD experience a whole lot less lonely.

Special thanks go to Sebastian Drutschmann. Only he knows how great his contribution has been to enabling me to complete this project whilst opening the next chapter of life as a diplomat. He has encouraged me to keep things in perspective, to see the bigger picture whenever I got caught up in details and was always ready to bring a smile back to my face.

Finally, I am deeply endebted to my parents and family for their (not only financial) support. Especially Birgit, Wolfgang and Kristina continue to be an inspiration to me in more ways than they will ever realise. They provided me with an anchor whenever I felt lost somewhere in the Anglo-Italo-German triangle, and their patience and unwavering belief in me as well as their ability to keep me going when the going got tough are the reason I am sane at this project's conclusion. This thesis is dedicated to them: *Ich danke Euch von ganzem Herzen*.

Berlin/Singapore – February 2009

AB

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ACRONYMS AND ABBREVIATIONS

ABA	*Asociación de Bancos de la Argentina*	Association of Banks of Argentina
ABA(P)PARA	*Asociación de Bancos Públicos y Privados de la República Argentina*	Association of Public and Private Banks of the Argentine Republic
ABBC	*Associação Brasileira de Bancos*	Brazilian Association of Banks
ABBI	*Associação Brasileira de Bancos Internacionais*	Brazilian Association of International Banks
ABICALÇADOS	*Associação Brasileira das Indústrias de Calçados*	Brazilian Association of Shoe Manufacturers
ABRA	*Asociación de Bancos de la República Argentina*	Association of Banks of the Argentine Republic
ADEBA	*Asociación de Bancos de la Argentina*	Association of Argentine Banks
ANDEFA	*Asociación de Fabricas de Automotores*	Association of Automotive Industry (Argentina)
ANDIMA	*Associação Nacional das Instituições do Mercado Financeiro*	National Association of Financial Market Institutions (Brazil)
ANFAVEA	*Associação Nacional dos Fabricantes de Veículos Automotores*	Association of Automotive Industry (Brazil)
ARI	*Alternativa por una República de Iguales*	Alternativa for a Republic of Equals (Argentine political party)
BACEN	*Banco Central do Brasil*	Brazilian Central Bank
BB	*Banco do Brasil*	Banco do Brasil
BCRA	*Banco Central de la República Argentina*	Argentine Central Bank
BNDES	*Banco Nacional de Desenvolvimento Económico y Social*	Brazilian National Development Bank
CAC	*Cámara Argentina de Comercio*	Argentine Chamber of Commerce
CACEX	*Carteira de Comércio Exterior*	Foreign Trade Council (Brazil)
CEA	*Consejo Empresario Argentino*	Council of Argentine Business
CEDES	*Centro de Estudios de Estado y Sociedad*	Centre for the Study of the State and Society (Argentina)
CEMA	*Centro de Estudios Monetarios Argentinos*	Centre for Argentine Monetary Studies
CEPAL		ECLAC – Economic Comission for Latin America and the Caribbean
CGE	*Confederación General Económica*	General Economic Confederation (Argentina)
CGI	*Confederación General de la Industria*	General Confederation of Industry (Argentina)
CGT	*Confederacón General del Trabajo*	General Labour Confederation (Argentina)
CGT	*Confederação Geral dos Trabalhadores*	General Workers' Confederation (Brazil)
CAN	*Confederação Nacional da Agricultura e Pecuária*	National Confederation of Agriculture (Brazil)

CNC	*Confederação Nacional do Comércio*	National Confederation of Commerce (Brazil)
CNF	*Confederação Nacional das Instituições Financeiras*	National Confederation of Financial Institutions (Brazil)
CNI	*Confederação Nacional da Indústria*	National Confederation of Industry (Brazil)
CPI		Consumer Price Index
CRA	*Confederaciones Rurales Argentinas*	Argentine Rural Confederations
CUT	*Central Única dos Trabalhadores*	United Workers' Confederation (Brazil)
Depin	*Departamento de Operações das Reservas Internacionais*	International Reserves Operations Department (Brazil)
Dipom	*Diretor de Política Monetária*	Deputy Governor for Monetary Policy (Brazil)
Direx	*Diretor de Asuntos Internacionais*	Deputy Governor for International Affairs (Brazil)
DIEESE	*Departamento Intersindical de estadística e Estudos Sócioeconômicos*	Inter-Trade Union Department of Statistics and Socio-Economic Studies (Brazil)
DNU	*Decretos de Necesidad y Urgencia*	Need-and-Urgency Decrees (Argentina)
FAA	*Federación Agraria Argentina*	Argentine Agrarian Federation
Fazenda	*Ministerio da Fazenda*	Brazilian Ministry of Finance
FDI		Foreign Direct Investment
FEBRABAN	*Federação Brasileira de Bancos*	Federation of Brazilian Banks
FENABAN	*Federação Nacional de Bancos*	National Federation of Banks (Brazil)
FIEL	*Fundación de Investigaciones Económicas Latinoamericanas*	Foundation for Latin American Economic Research (Argentina)
FIESP	*Federação das Indústrias [de São Paulo]*	Federation of Industry of the State of São Paulo (Brazil)
FS	*Força Sindical*	Trade Union Centre (Brazil)
FSP	*Folha de S. Paulo*	Daily Brazilian Newspaper based in S. Paulo
FREPASO	*Frente del País Solidario*	Front for a Nation of Solidarity (Argentina)
Gence	*Gerência-Executiva de Narmalização de Câmbio e Capitais Estrangeiros*	Exchange and Foreign Capital Regulation Executive Office (Brazil)
IBGE	*Instituto Brasileiro de Geografia e Estatística*	Brazilian Institute for Geography and Statistics
IDES	*Instituto de Desarrollo Económico y Social*	Institute of Economic and Social Development (Argentina)
IEDI	*Instituto de Estudos para o Desenvolvimento Industrial*	Institute for the Study of Industrial Development (Brazil)
IEO		Independent Evaluation Office (of the IMF)
IFI		International Financial Institution
IMF		International Monetary Fund
INDEC	*Instituto Nacional de Estadística y Censos*	National Institute of Statistics and Censuses (Argentina)
ISI		Import-Substitution Industrialisation
ITDT	*Instituto Torcuato di Tella*	Torcuato di Tella Institute (Argentina)
IPEA	*Instituto de Pesquisa Econômica Aplicada*	Institute for Applied Economic Research (Brazil)
LRF	*Lei de Responsabilidade Fiscal*	Fiscal Responsibility Law (Brazil)
MECON	*Ministerio de Economía/Palácio de la*	Argentine Ministry of Economics and

	Hacienda	Finance
MIA	*Movimiento Industrial Argentino*	Argentine Industrial Movement
MIN	*Movimiente Industrial Nacional*	National Industrial Movement (Argentina)
MRE	*Ministério das Relações Exteriores*	Brazilian Ministry of Foreign Affairs
OECD		Organisation for Economic Co-operation and Development
OESP	*O Estado de S. Paulo*	Daily Brazilian Newspaper based in S. Paulo
PFL	*Partido da Frente Liberal*	Party of the Liberal Front (Brazil)
PJ	*Partido Justicialista*	Peronist Party (Argentina)
PL	*Partido Liberal*	Liberal Party (Brazil)
PMDB	*Partido do Movimento Democrático Brasileiro*	Party of the Brazilian Democratic Movement
PNBE	*Pensamento Nacional das Bases Empresariais*	National Grassroots Business Association (Brazil)
PRN	*Programa de Reorganización Nacional*	Program of National Reorganisation (Argentina)
PSDB	*Partido da Social Democracia Brasileira*	Brazilian Social Democratic Party
PT	*Partido dos Trabalhadores*	Workers' Party (Brazil)
Selic	*Sistema Especial de Liquidação e Custodia*	Special System of Clearance and Custody – Selic rate is the BCB's short-term (overnight) lending rate
SINDIPEÇAS	*Sindicato Nacional da Indústria de Componentes para Veículos Automotores*	Brazilian Association of Auto Parts Manufacturers
SRA	*Sociedad Rural Argentina*	Argentine Rural Society
TSE	*Tribunal Superior Eleitoral*	Superior Electoral Tribunal (Brazil)
UBE	*União Brasileira dos Empresarios*	Brazilian Union of Businessmen
Ucedé	*Unión del Centro Democrático*	Union of the Democratic Centre (Argentina)
UCR	*Unión Cívica Radical*	Radical Party (Argentina)
UIA	*Unión Industrial Argentina*	Argentine Industrial Union
URV	*Unidade Real de Valor*	Unit of Real Value (Brazil's non-monetary currency in 1994)
WB		World Bank

C H A P T E R   I

INTRODUCTION: PEGS, POLITICS AND PETRIFICATION

1.1. Introductory Remarks

Since the 1980s, and especially in the 1990s, currency and financial crises have been identified as perhaps the most important source of politico-economic instability across middle-income emerging markets and thus as a crucial barrier to sustainable development.[1] A common root of many of these crises was the adoption and, more importantly, the petrification of fixed exchange rate regimes, be it in the context of exchange rate-based stabilisation programmes, which exploit the disinflationary benefits of a nominal exchange rate commitment, or as a strategy for building credibility and attracting foreign investment.[2] Few examples highlight the devastating socio-economic and political impact of misguided exchange rate policies and the costs of delayed policy adjustment as clearly as the 2001-2002 crisis in Argentina. Argentina's devaluation-cum-default in the midst of a lengthy recession and after eleven years of sustaining a rigid quasi-currency board pushed the country into economic depression with unprecedented levels of poverty and social conflict.

During the 1990s, both Argentina and its neighbour Brazil had adopted exchange rate-based stabilisation programmes whilst reforming their economies and integrating into the global economy. Although initially widely praised, the costs of this nominal anchor strategy in terms of real appreciation, deteriorating current accounts and growing debt burdens became all too apparent from the mid-1990s onwards. Yet, in spite of a window of opportunity for 'orderly exit' in 1996-1997, both governments held on to their exchange rate stance and ruled out adjustment towards greater flexibility. Eventually, in January 1999, Brazil overcame this

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[1] This thesis uses the term 'middle-income emerging market economy' in accordance with the World Bank's class of 'upper-middle-income countries'. This group of IBRD-eligible borrowers includes countries with 1999 GNP per capita exceeding $2,996. In contrast to low-income countries, middle-income emerging market countries are assumed to have *"reasonably modern financial systems and relatively high degrees of integration into world capital markets"* (Velasco and Céspedes 1999: 3).

[2] The *nominal exchange rate* is defined in domestic currency per unit of foreign exchange (i.e. the US$). Therefore, the terms devaluation, depreciation and weak currency (revaluation, appreciation and strong currency) mean an increase (decrease) in the amount of domestic money paid for one unit of foreign currency. The *real exchange rate* (RER) is defined as the ratio of the price of tradables to non-tradables. Therefore, the terms devaluation or depreciation of the RER (revaluation or appreciation) mean an increase (decrease) in that ratio.

state of exchange rate petrification and floated the *real* amid speculative attacks. Meanwhile, Argentina continued to bear the burden of 'Convertibility' for three additional years until mutually reinforcing spirals of economic and political decline provoked the regime's disorderly abandonment in January 2002.

Given the profound impact of these crises on the one hand, and acknowledging the marked gap between economists' recommendations and actual policy choices on the other hand, political scientists have developed an acute interest in this field. This growing literature has probed exchange rate policy choices both with a view to their embeddedness in international monetary regimes and, more recently, with respect to the role of domestic political constellations, be they institutional, societal or ideational in nature.

1.1.1. Research Questions and the Argument in Brief

Building onto these two broad strands of thought, which have to date primarily focused on OECD experiences, this thesis investigates the question *'What are the political determinants of exchange regime choices in middle-income emerging market economies in Latin America?'*. It does so by identifying and accounting for the dynamics of *'exchange rate politics'* in Argentina and Brazil, as two prominent examples. More specifically, the study is concerned with accounting for countries' tendency to postpone exchange rate flexibilisation until a disorderly exit becomes inevitable.[3] *'What accounts for the wide-spread phenomenon of exchange rate petrification, as witnessed in the cases of Argentina and Brazil in the 1990s?'* therefore constitutes a key sub-question that animates this research. In addition, the impact of emerging markets' growing commercial and financial integration on exchange rate-political dynamics over the last three decades is explored as well as exchange rate policy's interplay with efforts to implement far-reaching market-oriented reforms.

As the literature review in section 1.3. shows, these questions and especially the phenomenon of exchange rate petrification have to date not been satisfactorily addressed. While economic explanations suggest criteria for exchange regime sustainability, they fail to capture the political dimension of exchange rate decisions and are often held back by data problems. In turn, international system-level accounts highlight the role of global constraints but do so at the price of disregarding the relative autonomy domestic executives enjoy in choosing exchange rate arrangements – even in middle-income economies. Domestic

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[3] Between 1990 and 2002, 80 of 139 exits towards flexibility were 'disorderly'. See IMF (2004a), *IMF Executive Board Discusses "Fixed to Float: Operational Aspects of Moving Toward Exchange Rate Flexibility"* IMF. Available from http://www.imf.org/external/np/sec/pn/2004/pn04141.htm. [cited 11th May 2006].

institutionalist approaches, amongst other difficulties, struggle to capture the institutional context in non-OECD countries and – similar to interest-based accounts – exhibit an impoverished vision of executive-society relations, which fails to do justice to the highly strategic use of exchange rate policy decisions by the executive. Yet, institutionalists highlight credibility-building strategies centring on institutional commitments, while interest-based approaches contribute a greater sensitivity to the role of distributional politics to our understanding of exchange rate policymaking. Finally, ideational accounts complement our understanding of interest formation with respect to exchange rate policy. Yet, *per se* they cannot convincingly explain the timing of exchange rate policy changes or indeed wider paradigm shifts. In short, while all four approaches make substantial contributions to our understanding of exchange rate politics, the fragmented literature is afflicted by contradictory assumptions and methodological problems and, to date, remains incomplete with respect to identifying the political determinants of exchange regime choice in Latin American middle-income countries.

Seeking to fill this gap, this thesis addresses the set research questions by advancing the argument that exchange rate policy choices, although constrained by the integration of international financial markets and conditioned by the existence of evolving exchange rate policy paradigms in the international sphere,[4] are primarily determined by inherently political processes at the domestic level. Indeed, exchange rate policy decisions are driven by political-strategic motivations on the part of 'political entrepreneurs' within the executive. Regime choice is therefore decisively affected by four interrelated factors:

(i) intra-executive dynamics that shape decisionmaking processes at the core of the executive;

(ii) executive ambitions with respect to implementing structural reforms, and an evolving understanding among executive actors that depicts exchange rate commitments as useful devices for building and disciplining coalitions of societal actors so to generate a democratic consensus in favour of such reforms;

(iii) the degree to which these coalitional arrangements become increasingly reliant on the continuance of the exchange rate arrangement; and

(iv) the role of international actors, in particular the IMF.

Exchange rate petrification thus is the combined result of the executive's reluctance to surrender this powerful disciplining instrument and risk reform reversal, the relative influence

[4] These constraints have been considerably more potent in earlier times, e.g., during the Gold Standard when exchange regime choice was *"in practice dictated by convention, by internationally agreed rules"* (Cooper 1999:100).

of societal actors whose interests are closely bound up with the maintenance of the exchange rate regime, and the IMF's inability to provide a check on petrification as well as its tendency to further accelerate the petrification process by providing external validation to reformist governments and their chosen exchange rate pegs.

On this basis, this thesis also proposes a critique of the exchange rate politicisation hypothesis advanced by Frieden (2000). Indeed, Frieden's linear depiction of the process by which exchange rate policy becomes a politically salient issue fails to take into consideration a range of intervening variables, such as the institutional structure of organised society, party-political constellations and ideational factors, which – as this thesis and especially its case studies show – all play a crucial role in shaping actors' perception of and interest in exchange rate policy matters.

This chapter proceeds by outlining the significance and motivations behind this study and its core puzzle. Section 1.3. reviews existing research on exchange rate politics and demonstrates its shortcomings in addressing the drivers of exchange rate politics in Latin American middle-income countries and in accounting for the phenomenon of exchange rate petrification. Finally, section 1.4. outlines the methodology underpinning this research and maps out the remainder of the thesis.

1.2. Motivations and Significance of this Study

The motivations for this study's interest in exchange rate politics in middle-income emerging markets in Latin America are fivefold. First, this thesis aims to test, extend and refine the existing literature's theoretical propositions to cover middle-income emerging markets in Latin America. As Chapter II shows, the present body of research on exchange rate politics struggles to capture the contextual and procedural factors, which differentiate middle-income emerging markets and the exchange rate-political dynamics in these countries from those in advanced industrial countries. Moreover, the case studies that form the core of this thesis seek to account for the drivers of exchange rate decisions in the specific cases of Argentina and Brazil, as well as generating more widely applicable insights that shed light at similar dynamics in other middle-income emerging markets in the region. The study thus complements and updates the analysis offered by the two principal text books on exchange rate politics in Latin America to date, Wise and Roett (2000) and Frieden and Stein (2001) as well as constituting the first attempt at tracing in great detail the process of exchange rate policy formulation in Argentina and Brazil in a comparative mode.

Secondly, by tracing the role of exchange rate policy in two middle-income economies from relative closure in the 1980s to their integration into the world economy in the 1990s, this thesis intends to shed light on the literature's politicisation hypothesis. Frieden and others posit that at rising levels of economic integration the distributional impact of exchange rate policy movements grows and therefore the political contest around exchange rate policy decisions intensifies (Frieden 2000: 257; Broz, et al. 2007; Frieden 2007: 345). While this proposition is said to hold true for advanced economies, the level of (future) exchange rate policy politicisation is expected to be even higher in emerging markets given, among other things, the heightened level of price pass-through due to production profiles dominated by standardised goods and primary commodities (Broz and Frieden 2001: 332), and because the exchange rate plays a relatively more prominent role in the transmission mechanism of monetary policy (Vitale 2003: 836 quoted in Setzer 2006: 2). In addition to testing and seeking to refine this hypothesis in reference to the way in which the institutional structure of organised society, the political process as well as ideational and 'framing' factors may constitute an intervening variable with respect to exchange rate politicisation, this study thus equips us with an improved analytical tool set for capturing future dynamics of political contest around exchange rate political decisions in emerging markets.

Thirdly, this study's explicit focus on the *politics* of exchange rate policymaking provides a critical perspective on the as yet inconclusive debate among economists on optimal exchange regime choices, a state of affairs which Naím (1999) provocatively suggests is *"akin to engineers disagreeing about the principles of how to design the structure of a building."* This debate (re-)emerged with the breakdown of the Bretton Woods System and intensified as the 'two-corner debate' in response to the Asian crisis and especially Argentina's currency board experience (Corden 2002; Edwards 2002; Berg, et al. 2003) and divided those scholars, who advocate super-fixed exchange rate systems as a beneficial credibility-building anchor (Calvo and Reinhart 1999; Eichengreen and Hausman 1999), from other economists who view such rigid arrangements as more of *"a straitjacket [rather] than an anchor of salvation"* (Malloy and Conaghan 1994; Mishkin 1998; Sachs and Larrain 1999; Chang and Velasco 2000). While it is unlikely that a politically astute analysis may solve this debate, it does promise to fill the glaring *"gap between exchange rate policy advice and the actual policy environment"* (Fischer 2007: 345) and thus complements the otherwise rich economics literature not only in its efforts to identify appropriate exchange rate regimes but also with respect to estimating policy sustainability in a given politico-economic context.

Fourthly, as the Argentine crisis highlighted, the costs of misguided exchange rate

policy choices have risen substantially. Governments and international financial institutions (IFIs) alike have thus come to see the importance of *sustainable* exchange regimes as an issue of paramount importance for development (Caramazza and Aziz 1998: 2; Williamson 2003a; 2003b; Rodrik 2006: 24-25). As acknowledged by the International Monetary Fund (IMF), for both national policymakers and IFIs it is insufficient to rely exclusively on economic-technical analyses when formulating policy or making policy recommendations. To the contrary, an accurate understanding of the political dynamics shaping exchange rate policy decisions over the course of an arrangement's life cycle is imperative – and is also of growing commercial interest for risk rating agencies and financial market actors (IMF - IEO 2007: 52-53).[5]

Finally, in an entirely original contribution to the literature,[6] this thesis includes in its analysis an evaluation of the role of IFIs in shaping exchange rate policy, and in particular of the IMF's role in Argentina and Brazil. In doing so, this study does not only position itself vis-à-vis the multiple criticisms levelled against the IMF's involvement in client economies, but it also points to some of the problems inherent to the Fund's obligations of exchange rate surveillance, which are likely to persist despite recent reform efforts.

1.3. Exchange Rate Policy Choices in the Literature

Following Henning and Destler's distinction (1989: 11), this thesis primarily analyses *direct* as opposed to *indirect* exchange rate policymaking. In other words, instead of evaluating how fiscal and monetary policy stances affect the exchange rate, the explicit focus of this study is on direct exchange rate policy decisions, such as regime choice, official interventions and changes to exchange and capital controls.[7] Irrespective of the adopted exchange regime and although exchange rate policy decisions tend to only make the headlines when pegs are adopted or abandoned, this thesis conceives of exchange rate policymaking as a political process that accompanies the life cycle of an exchange rate arrangement rather than one, which is dominated by extraordinary decisions about the design, defence and abandonment of regimes as much of the literature seems to suggest.

Based on this reading, exchange *regime* choice is of primary importance as it conditions

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[5] The 1999 World Business Environment Survey covering 10,000 managers in 80 countries concluded that the exchange rate represented a 'nontrivial consideration' for the average firm (Broz et al. 2007).

[6] Odling-Smee (2004: 36) deals with exchange rate policy advice as a side-issue emphasising the *"educational element"* in helping the Russian government identify alternative policies.

[7] As Rodrik (2006: 24) points out, although governments can at best control the *nominal* exchange rate, they have multiple tools at hand to also shape the *real* exchange rate e.g., by restricting/encouraging capital inflows, sterilising interventions, implementing tight fiscal policies and nominal devaluations.

all further instances of exchange rate policymaking. Since the amendment of the IMF's *Articles of Agreement* in 1978 and assuming that countries desire to maintain a domestic currency, governments choose between three ways of determining the monetary linkage between the domestic and global economy: (i) let the value of the currency be determined in international foreign exchange markets ('free float'); (ii) fix its price against a foreign currency or against a basket of currencies (e.g., exchange rate pegs, currency boards and dollarisation); or (iii) they can pursue a so-called 'intermediate' approach, such as 'managed floats' and floats within some pre-determined parameters (e.g., target zones, crawling pegs and bands). Additionally, the adoption of an exchange rate peg or an intermediate regime presupposes a secondary executive decision regarding the level at which the exchange rate is fixed or the width of the fluctuation band.[8]

Acknowledging its critical importance insofar as the chosen exchange regime determines how a national economy responds to shocks (Stiglitz, et al. 2006: 106), the literature has made invaluable contributions to our understanding of exchange rate policy choice. Against the background of surveys of both the economic literature and studies rooted in comparative and international political economy, the subsequent sections aim to contextualise the central research question and highlight the limitations of current research.

1.3.1 Economic Explanations of Exchange Rate Policy Choices

The economic literature on exchange regime choice and performance is vast, and no attempt will be made at providing a complete overview.[9] Rather, I identify those concepts that provided the groundwork for subsequent political economy analyses. Unlike the literature on trade policy, there is currently no reigning theoretical approach to determining an optimal national exchange rate policy (Cooper 1999; Naim 1999; Broz and Frieden 2001: 319). Indeed, economic theory has so far failed to develop a microeconomic base that resembles *"anything that we can properly call a model of the benefits of fixed rates and common currencies"* (Krugman 1993: 3). Even less sophisticated is the literature on *exits* from (fixed) exchange regimes (e.g., Eichengreen 1998; Asiçi and Wyplosz 2003; Asiçi, et al. 2005; Detragiache, et al. 2005).

[8] See table on p. 291 in Appendix IV.

[9] For an overview, see Maurice Obstfeld and Kenneth S. Rogoff (1999), *Foundations of International Macroeconomics* (Cambridge (MA): MIT Press). A more recent contribution is Lucio Sarno and Mark P. Taylor (2003), The Economics of Exchange Rates (Cambridge (UK): Cambridge University Press).

Optimum Currency Area Theories

The classical open economy perspective on exchange regime choice under capital mobility emphasises the trade-offs between the investment and trade benefits of exchange rate pegs and their costs in terms of sacrificing an independent exchange rate and monetary policy to facilitate balance-of-payment adjustment and demand management – the so-called 'impossible trinity' principle (Mundell 1960; 1961).[10] In this view, a country's optimum regime is determined by its economic characteristics. Extrapolating from the literature on 'optimum currency areas' (OCA) pioneered by Mundell, exchange regime choices ought to be determined by considerations including an economy's size and degree of openness, the level of factor mobility and the flexibility of relative price adjustments. In short, the OCA literature[11] examines whether countries entering close monetary relations tend to be subject to asymmetric shocks and if so, whether the existing corrective mechanisms represent an adequate alternative to shock-absorption via exchange rate and monetary policy (McKinnon 1963; Kenen 1969; Fleming 1971).[12]

Argentina's dollar-pegged currency board in the 1990s poses a puzzle to OCA theorists (also Corden 2002: 179): Highly dependent on trade with Brazil, the country conducted on average only 10-15% of its trade with the United States (INDEC 2002), and the asymmetric shock potential was significant.[13] The Argentine case illustrates how economic theories, rooted in a social welfare perspective, commonly fail to account for *de facto* exchange rate choices. Although OCA theory, by directing our attention to economic structural constraints, provides a good starting point, its theoretical foundations are insufficiently conclusive to assess policymakers' choices – even if assuming that policymakers maximise social welfare. OCA theory is removed from real-life policymaking not only insofar as it ignores policymakers' political motives but also because it constructs its analysis around two polar extremes – pure floating and super-fixed exchange rate regimes – whereas policymaking deals with more subtle choices (Joshi 2003: 16-18).

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[10] Many accounts based on the 'Impossible Trinity' concept overstate its predictions by assuming perfect capital mobility, see Joshi 2003.

[11] For the classic optimum currency area literature see Robert A. Mundell (1961), "The Theory of Optimum Currency Areas," *The American Economic Review* 51; Ronald I. McKinnon (1963), "Optimum Currency Areas," *American Economic Review* 53. A more recent treatment is Paul R. Masson and Mark Taylor, eds. (1993), *Policy Issues in the Operation of Currency Areas* (Cambridge (UK): Cambridge University Press).

[12] Recent research shows that OCA criteria should be treated as endogeneous to the (monetary) integration process. They are therefore problematic *ex ante* determinants of regime choice. See Barry Eichengreen (1995), "The Endogeneity of Exchange Rate Regimes," in *Understanding Interdependence*, ed. Peter Kenen (Princeton (NJ): Princeton University Press); Jeffrey A. Frankel and Andrew K. Rose (1996), *The Endogeneity of the Optimum Currency Area Criteria* National Bureau of Economic Research. Available from http://www.nber.org/papers/w5700. [cited 16th June 2004].

[13] Unlike the U.S., Argentina is a commodity exporter and thus subject to volatile world prices. Moreover, levels of factor mobility and price flexibility were low (Cohen 2004: 82).

Rational Expectations Literature: Credibility Considerations

In the 1980s, reflecting the emergence of the rational expectations literature and the dynamics of European monetary integration, the idea of adopting a currency peg to promote credibility was revived, an idea that had already underpinned nineteenth century debates around the Gold Standard (Giovannini 1993: 110). Similar to reforms towards central bank independence, economists regarded exchange rate pegs as useful commitment devices for achieving monetary stability (Barro and Gordon 1983a; Giavazzi and Giovannini 1989). Credibility – i.e. the private sector's belief that pre-announced government policies would be acted upon – had become the key concept of the rational expectations literature, which had compounded monetarists' attack on Keynesianism.[14] In particular, authors emphasised its importance for overcoming the inflationary bias in monetary policy associated with the time inconsistency problem (Kydland and Prescott 1977). Assuming that the maintenance of a highly visible exchange rate peg functions as an automatic rule for monetary policymaking (thus minimising governmental discretion), the private sector would be more likely to treat a government's commitment to low inflation as credible. Private inflationary expectations would therefore adjust accordingly, leading to the elimination of inflationary biases in wage bargaining and price setting. Precisely this characteristic and the prioritisation of domestic price stability over competitiveness is said to be exploited in the context of exchange rate-based stabilisation programmes such as those repeatedly adopted in Argentina and Brazil.

Approaching these insights from a political science angle sheds light on some of the approach's problematic assumptions. In addition to relying on a naïve model of policymakers as benevolent social planners, the studies' validity has recently been put into question for their uncritical reliance on the IMF's classification of exchange rate regimes (Rogoff, et al. 2003). Until recently, IMF reports merely offered a description of the regimes governments *declared* to be following (*de iure*).[15] Yet, as Reinhart and Rogoff (2004) showed, the discrepancy between *de facto* and *de iure* regimes is significant[16] and highlights what many politically astute economists have long acknowledged: Exchange rate policy is not determined by economic

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14 Blyth (2002: 139-147) illustrates how the rational expectations hypothesis created an opening for monetarist ideas insofar as it suggested a politically less costly alternative to conventional monetarism's demand for deflation by emphasising the ease and speed with which actors' expectations adjust if governments *credibly* commit to policy targets.

15 Since 1997, entries in the IMF's *Annual Reports on Exchange Arrangements and Exchange Restrictions* also include commentaries on the *de facto* regime as interpreted by local IMF representatives. See http://www.imf.org/external/np/mfd/er/index.asp [cited 11th May 2006].

16 With respect to the motivations of this discrepancy, see Alberto Alesina and Alexander F Wagner (2003), *Choosing (and Reneging on) Exchange Rate Regimes* National Bureau of Economic Research. Available from http://ssrn.com/abstract=420323. [cited 19th May 2004]; Hans Genberg and Alexander K. Swoboda (2004), *Exchange Rate Regimes: Does What Countries Say Matter?* International Monetary Fund. Available from http://www.imf.org/External/Pubs/FT/staffp/2005/03/pdf/genberg.pdf. [cited 5th May 2006].

structures but is driven by political motivations (Ingram 1969: 97-98; Goodhart 1996: 1084). In the following, the domestic sources of these political motivations will be sketched out.

1.3.2 Domestic-Level Accounts of Exchange Rate Policy Choices

Studies into the domestic politics of exchange rate decisions, in the tradition of comparative political economy, are primarily rooted in, and thus conditioned in their propositions by, industrial democracies.

Rationalist Interest Group Approaches

Paralleling endogenous tariff theory and employing so-called 'open-economy politics' (Bates 1997), one of the most widely quoted approaches to understanding exchange regime choice focuses on the role of domestic economic interests (e.g., Frieden 1991b; 1994; 1997; Hefeker 1997; Oatley 1997; Schamis 1999; 2000; Schamis and Way 2001; Shambaugh 2004). Its main proponent, Jeffry A. Frieden, argues that exchange regime *outcomes* can be derived from the pattern of political divisions generated by actors' diverging exchange rate policy preferences (as stipulated by economic theory). In its most simplistic form, groups are expected to position themselves along a 'stability vs. flexibility' trade-off depending on the extent of their involvement in international trade and payments. Hence, exporters, foreign direct and portfolio investors are said to be more sensitive to currency fluctuations than to the implications of sacrificing monetary autonomy. They would thus favour (and lobby for) a stable exchange rate. Non-tradables producers and import-competing producers, on the contrary, greatly value monetary autonomy as a precondition for demand management and domestic macroeconomic stability. Based on these hypotheses, scholars account for exchange regime choice *ex post* (**Table 1**).

In addition to its parsimony, one of the major advantages of Frieden's interest-based account is its adaptability insofar as it can be applied to non-OECD countries without fundamental theoretical modifications. His Inter-American Development Bank (IDB) study on the political economy of exchange rate policy in various Latin American countries (Frieden and Stein 2001) is a case in point, as is his recent contribution 'Globalisation and Exchange Rate Policy' (2007). So far, it is this approach, which dominates the rather circumscribed literature of political economy analyses of exchange rate politics in emerging markets and developing countries (also Wise and Roett 2000; Hall 2005; Walter 2007).

Table 1: Exchange Rate Policy Preferences, Given Capital Mobility

<table>
<tr><td rowspan="4">Preferred Level of the Exchange Rate</td><td colspan="3">Preferred Degree of Exchange Rate Flexibility / National Monetary Independence</td></tr>
<tr><td></td><td>High [floating rate]</td><td>Low [fixed rate]</td></tr>
<tr><td>Low [more depreciated]</td><td>Import-Competing Traded Goods Producers</td><td>Export-Competing Traded Goods Producers
Frieden (2002): Ability to pass on ER fluctuations divides exporters into those who prefer flexible rates (high 'pass-through') and others who prefer fixed rates (low 'pass-through', e.g., specialised manufactured goods).</td></tr>
<tr><td>High [more appreciated]</td><td>Producers of Non-Tradables</td><td>International Traders and Investors
Shambaugh's 'capital-specific' preferences (2004):
• Foreign commercial bank lenders & domestic borrowers both prefer fixed rates.
• FDI investors' align with the preferences of the target sector.
• International portfolio investors prefer fixed rates, whereas domestic recipients of portfolio investments prefer floating rates.</td></tr>
</table>

Source: Adaptation from Frieden 2000, 2002; Shambaugh 2004.

Limitations of Rational Interest Group Approaches

The limitations of this conceptualisation of exchange rate politics are equally considerable. First, largely driven by their quantitative methodology, interest-based studies rarely attempt to trace the exchange rate policy *process*. Instead, they point to *what* and *who* the important factors and actors are without offering a convincing account of *how* they matter and influence decisionmaking (Oatley 1997: 17). Studies' use of problematic proxies and the non-consideration of non- or hardly-quantifiable factors are equally rooted in their reliance on cross-sectional quantitative methods which prioritise parsimony over explanatory complexity.

Secondly, there is substantial scope for refining the predictions of the strength and quality of actors' exchange regime preferences (and hence their lobbying incentives). Some inroads have been made by studies, which incorporated the degree of product diversification and specialisation, which determines actors' ability to accommodate currency changes by passing on prices to their consumers and thus reflects actors' sensitivity to currency volatility (Goldberg and Knetter 1997; Frieden 2002). On this account, import-competing producers of highly specific products (e.g., automobiles) with reduced channels for price 'pass through'[17] are expected to lobby intensely for stable exchange rates. Lobbying incentives will also be

[17] 'Pass-through' refers to the extent to which exchange rate movements are reflected in product prices. Standardised goods sold in competitive markets (e.g., commodities) exhibit very high pass-through, i.e. market prices reflect exchange rate changes almost immediately, whereas highly differentiated goods prices are less responsive (Goldberg and Knetter 1997; Frieden 2002: 839).

shaped by the availability of 'private solutions' to manage exchange rate risk (Cleeland Knight 2007). Moreover, scholars like Shambaugh (2004) have considered the exchange rate's balance sheet effects on the nature of actors' exchange rate policy preferences (also Hall 2005; Kinderman 2005; Woodruff 2005). Unlike Frieden, this adaptation recognises that currency mismatches expose actors to exchange rate movements in a way that may reinforce or indeed contradict the competitiveness effect (also Walter 2007).[18] In short, non-tradables producers with sizable dollar-denominated liabilities see their preference against a depreciated exchange rate reinforced whilst also becoming more accepting of greater limitations on national monetary independence for the sake of exchange rate stability. Conversely, for tradables producers the presence of large dollar-denominated liabilities may mute or even outweigh their preference for a depreciated exchange rate. As Chapter V will show, this extension of interest-based accounts is crucial for contrasting the political dynamics around the Argentine 'Convertibility regime' with those in Brazil in the late 1990s and makes a substantial contribution to our understanding of exchange rate petrification.

Thirdly, interest-based accounts tend to misrepresent societal interests' behaviour and their lobbying effectiveness due to a lack of engagement with collective action dynamics in this field.[19] Foreshadowing the case studies, vibrant lobbying on exchange rate matters represented the outright exception. This chimes with studies that observe that the exchange rate only becomes a rallying point under crisis conditions rather than in the context of wider economic policy debates (Keohane and Nye 1977; Odell 1982: 126; Gowa 1988; McNamara 1998: 41) and with analyses that highlight exchange rate policy changes' public good characteristics given that, unlike in trade policy, non-lobbying groups cannot be excluded from enjoying the benefits of policy change (e.g., Gowa 1988; Broz and Frieden 2001; Josselin 2001).[20] More importantly, the nature of the political organisations that represent different groups ought to be examined with greater priority, as Duckenfield (2006) has done with respect to business and EMU. Given that actors tend to look to their representative associations for policy advice and active lobbying on their behalf, corporatist organisations represent an influential intervening variable that has largely been overlooked. In particular, business associations' internal structure, the composition of their membership, the procedure by which competing interests are weighed in order to develop policy positions, the availability

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[18] Walter (2007: 9) argues that a group's exchange rate policy preference is not only determined by its competitiveness and balance-sheet vulnerability but also by the severity of speculation and the policies needed to maintain the exchange regime.

[19] These accounts barely engage with the rich literature on interest group behaviour, e.g., Frank R. Baumgartner and Beth L. Leech (1998), *Basic Interests: The Importance of Groups in Politics and Political Science* (Princeton (NJ): Princeton University Press).

[20] Similarly, given the close substitutability between exchange rate policy changes and trade protection, some of the lobbying resources may be channelled into petitions for trade relief.

and quality of in-house technical expertise and, crucially, their historical relationship to the executive and state bureaucracy may strongly affect a sector's *de facto* policy influence in a way not captured by Frieden (also Hall 1986: 15). As aforementioned, these factors may greatly distort the politicisation process by muting some and empowering other interests.

Fourthly, one of the reasons actors consult their representative associations on exchange rate policy matters is because *"groups … [have] trouble formulating and thus acting on a fixed and compelling preference"* (McNamara 1998: 37). This observation suggests that Frieden's underlying model of actor cognition is overassuming (Odell 2002). Considering the *ex ante* uncertainty about the size and distribution of gains from exchange rate policy choices and the fact that exchange rate policy is often perceived as technical in nature, it seems to be an audacious step to derive lobbying stances and policy *outcomes* from theoretically stipulated *preferences* without allowing for the interference of judgment biases, framing and persuasion – and without providing empirical evidence (Krasner 1978: 65; Giovannini 1995; McNamara 1998: 37 + 59; Blyth 2002: 247).[21]

Altogether, contrary to Frieden's original aim, the interest-based literature stopped short of proposing a theory of exchange rate *politics,* that is an explanation of *how* interests achieve their preferred policy outcome, or *why* they fail in other cases. Instead, politics is reduced to distributional struggles within pre-defined conceptual boundaries. The organisational, institutional and ideational framework within which actors identify and pursue their interests is largely disregarded (Sikkink 1991). This impoverished vision of politics partly stems, as Bearce (2003: 374) points out, from the literature's simplistic pluralist model of the state, which paints executive policy as totally reflective of society's demands and reduces the process of interest translation into public policy to one where a sector's political strength is determined by its relative economic weight without paying attention to political institutions. Even a superficial glance at the insulated position of executive policymakers and their relative autonomy in shaping the 'Convertibility Regime' and the 'Real Plan' suffices to unveil these assumptions as misleading.

Indeed, as several studies show, one cannot make sense of interest group behaviour in such an executive-dominated field, fraught with collective action problems, in the absence of an analysis of governments' strategic behaviour and the institutional context (Krasner 1978; Pastor 1980; Evans 1985; 1992). By selectively granting access and actively facilitating the organisation and mobilisation of interests, governments strongly influence the effectiveness of

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[21] As Oatley (1997:17-18) and Blyth highlight, interest-based approaches fall victim to the *ergo proptor hoc* fallacy as they argue that *"because they wanted to do it, they did it, and because they did it, they showed that they wanted to do it"* (Blyth 2002: 247).

particular pressure groups (e.g., Schmitter 1971; 1995; Schneider 2004). Moreover, difficulties in the process of interest identification arguably open a secondary channel for influencing societal interests and thus partially reverse the relationship suggested by interest group accounts. By means of its official discourse, the purported means-ends relationships presented by government-sponsored economic analysis and offers of compensation, governments may be able to intervene in the process of actors' interest identification and thus mediate societal behaviour (Bauer, et al. 1972: 373-374; Pastor 1980; Odell 2002). The nature of societal influence on exchange rate policy thus has to be understood as shaped by a process of strategic interaction, in which policymakers have the 'last word'. Ultimately, this interactive process has to be assessed through the lens of the executive in order to understand why one group prevailed over another.

Rationalist Institutionalist Approaches

The motivation of rationalist institutionalist approaches to exchange rate politics, so far largely applied to industrial democracies, is to relativise interest groups' influence by embedding them in an institutional context, *"whereby politicians make decisions on the basis of incentives created not only by constituency pressures but also by extant political and electoral structures"* (Bernhard, et al. 2002: i). In short, institutionalists model institutional constraints on the interaction of 'policy demanders' (i.e. interest groups and the wider electorate) and 'policy suppliers' (i.e. policymakers)(North 1990: 4-5). The question that drives their research is: 'What makes exchange rate regime X an appealing choice for executive policymakers?'

Policy Suppliers: Policymakers in Government

The centrality of the government and its responses to institutional constraints and opportunities are at the core of the political business cycle (PBC) literature (Clark 2000; Schamis and Way 2001; Clark 2002b). These contributions serve as a starting point for rectifying the disregard for government's political agency inherent to the interest-based approach. From this perspective, exchange regime decisions are evaluated against their implications for policymakers' 'survival', i.e. winning elections and retaining office in the context of competing political demands expressed by societal interests (Bernhard and Leblang 2002; Clark 2002a). By implication, and based on the assumptions of the 'impossible trinity', exchange rate decisionmaking is depicted as the result of *ex ante* cost-benefit calculations of sacrificing monetary policy as an electoral instrument. In particular, PBC studies deepen our understanding of the *temporal* dimension of exchange regime decisions by emphasising the use

of exchange rate pegs for the generation of pre-election consumption booms, whereas devaluations tend to be postponed to post-election periods (Edwards 1996a; Schamis and Way 2001; Schamis and Way 2003).

Institutionalists' conception of the executive as a political agent, while more sophisticated than that of interest-based approaches, remains determined by distributional pressures and institutional constraints. Although acknowledged as supreme decision-makers, policymakers are accorded remarkably little leeway. Typical for rational choice-based institutionalism (as opposed to historical institutionalism (e.g., Thelen and Steinmo 1992; Thelen 1999)), the focus is on policymakers' preferences for political survival. No reference is made to more substantive aims (see Ames 1987; Sikkink 1991).

Policymakers' Preferences: Partisan Factors

Attempts to model preferences that could be considered to be substantive in terms of partisan factors have largely been unconvincing due to contradictory results and inconclusive empirical evidence. Some authors expect partisan differences to emerge due to the fact that rightist parties (as a function of their ideology and constituencies) have anti-inflationary preferences and thus would be eager to adopt stabilising exchange rate pegs (Simmons 1994; Bernhard and Leblang 1999; 2000; Bearce 2007). In contrast, others have argued that leftist parties adopt exchange rate commitments precisely in order to acquire greater credibility and to improve their reputation in international markets (Bodea 2004; Setzer 2005). Bearce (2003: 373-374; 2007), in turn, utilised partisan explanations to bridge the gap between societal interests and state institutions by arguing that political parties transmit their principals', i.e. societal groups', preferences to determine policy outcomes in exchange rate matters. Bearce's 'party-as-agent' framework possesses some explanatory power in the context of industrial economies but faces significant obstacles when applied to emerging markets. In particular, its assumptions concerning the principal-agent relationship between societal interests and political parties fail to capture the nature of party systems (Shambaugh 2004). In Latin America, applying the traditional right-left partisan spectrum as a structuring device for determining which parties represent which societal groups remains problematic (e.g., Hibbs 1977). Argentina's Peronist Party (*Partido Justicialista* – PJ) defies this kind of classification altogether due to its personalistic heritage and considerable shifts in the party's policy programme over the decades. Brazil's PMDB is similarly difficult to categorise (e.g., Coppedge 1997; Rosas 2005: 839). Although the introduction of political parties as transmitters of societal preferences represents a worthwhile first step, it thus remains of limited use for this thesis.

The Institutional Context as an Intermediating Variable

According to institutionalists, a wide range of institutions is assumed to condition exchange regime choice: the political regime (democracy vs. authoritarian regime) (Leblang 1999; Broz 2002); electoral (majoritarian vs. proportional representation), legislative (degree of committees' inclusiveness) and party systems (Bernhard and Leblang 1999; Clark 2000; 2002); state structure (unitary vs. federal) (Hallerberg 2002); as well as the degree of central bank independence, the structure of the financial system and fiscal regime, and wage-bargaining structures (Fernández 2005). This institutional background is assumed to influence exchange regime choice in two ways: First, institutions determine the political costs to policymakers of giving up monetary autonomy as an electoral tool for the sake of exchange rate stability. Thus, in majoritarian electoral systems with weak, non-inclusive legislative committee structures policymakers are expected to be more reliant on the use of monetary policy in order to ensure their electoral survival and policy influence. Secondly, institutional structures represent the essential social underpinning of exchange rate commitments as they determine a country's ability and political willingness to hold on to a peg once adopted (e.g., the resolve to achieve fiscal solvency). Some authors assume that these secondary considerations enter exchange regime decisionmaking in an *ex ante* fashion (Simmons 1994). That is, governments with sufficient 'political capacity' to maintain a peg (i.e. facing a low number of veto players in fiscal policy and enjoying relative autonomy) would employ exchange rate pegs as transparent credibility-enhancing commitment devices to manage inflationary expectations and interaction with private economic actors.

Central Bank Independence and Exchange Rate Pegs: Solutions to the Same Problem?

One of the institutions, whose interplay with the exchange regime is at the centre of recent institutionalist investigations, is the central bank (Bernhard, et al. 2002). Within the rationalist institutionalist paradigm, some argue that the decision to grant the central bank (greater) independence and the adoption of an exchange rate peg are policy solutions to the same problem – that is, governments' inability to credibly commit (Bernhard, et al. 2002: 693). However, the literature so far has remained inconclusive as to whether independent central banks and exchange rate pegs are substitutes, or whether they aim to solve very different policy problems (Broz 2002; Keefer and Stasavage 2002). Given the wave of central bank reforms in the 1990s, the interesting issue is no longer which *one* of the two alternatives is chosen but rather the way in which an independent central bank and thus arguably empowered central bankers condition governments' exchange regime choices (O'Mahoney

2004). For instance, how did the fact that the *Banco Central de la República Argentina* (BCRA) gained independence in 1992, whereas the *Banco Central do Brasil* (BCB) continues to be formally subject to the executive, affect the respective exchange rate policymaking processes?[22] This question remains largely unaddressed by the institutionalist literature, which despite its rapid evolution has so far presented us with a rather fragmented and at times even contradictory image of the determinants of exchange rate policy (e.g., Bernhard, et al. 2002). Moreover, unlike interest-based accounts, its applicability to non-OECD contexts remains questionable once the stark differences in historical trajectories and socio-economic and institutional structures between OECD countries and emerging markets are acknowledged.

The Veto Player Approach

Some institutionalists regard further abstraction as a solution, and seek to conceptualise institutional constraints in terms of 'veto players'. This approach, pioneered by Tsebelis (1995; 2002), has been used in some of the literature (e.g., Hallerberg 2002; Keefer and Stasavage 2002).[23] Derived from the notion of 'checks and balances' and employed for the analysis of 'policy stability vs. change', veto players are defined as those actors, institutions, or occupants of institutional roles whose consent is essential for any change in the policy stance in question. Veto player accounts contribute to this study's aims insofar as they provide a lens for understanding the expected durability of exchange rate pegs or the likelihood of changes in a country's exchange rate policy (*petrification).* Yet, the application of this approach is not straightforward: In many countries, the decision to adopt and abandon an exchange regime can be taken by the executive – and in many cases by the president – alone. Strictly speaking, in many countries' exchange rate politics veto players thus do not exist.[24] Yet, in practice, an executive's ability to maintain an exchange regime (especially a peg) depends on its success in implementing the appropriate measures in other fields (e.g., fiscal policy) where veto players abound. Regime maintenance is subject to a veto by the legislative and provincial governments but also by extra-institutional actors such as business interests and labour unions (i.e. 'policy players' according to Armijo Elliott, et al. 2004). These interconnections thus undermine the parsimony of the veto player approach.

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[22] Cukierman's (1992) Index of Central Bank Independence ranked the BCRA highest in South America, whereas the BCB is classified below regional average.

[23] Keefer and Stasavage (2002) and Edwards (1999) hold that the number of veto players affects a government's ability to push through the necessary policy adjustments in order to maintain the exchange rate peg and this, as *ex ante* consideration, shapes exchange regime decisions.

[24] Note that the Argentine Convertibility Regime represents an interesting exception here as it removed the power to devalue the currency from the executive and placed it with Congress in 1991, therefore creating a veto player in the process of adopting and abandoning the quasi-currency board.

1.3.3 International System-Level Accounts of Exchange Rate Policy Choices

The shortcomings associated with applying CPE approaches beyond their original context and the reality of currency hierarchies, high crisis propensity, debt developments and asymmetric adjustment pressures suggest that analyses that disregard global systemic characteristics are bound to remain partial at best. Indeed, policymaking in emerging market countries in Latin America is strongly constrained, if not determined, by countries' mode of insertion into the global economy and the limited size of domestic markets (Sikkink 1991: 19). Hence, domestic politico-economic processes ought to be analysed within the wider international context.[25]

Foreshadowing a discussion of these international structural constraints in Chapter II, four aspects should be highlighted: First, emerging market currencies in Latin America are inherently weak monies that stand in intense competition with other currencies – even for internal transactions (Sgard 2002; Cohen 2004b). Secondly, the impact of currency competition operates, among other things, via strict limitations on local currency-denominated debt issued, which heightens the risk of currency mismatches (Eichengreen and Fishlow 1998; Starr 2001; Eichengreen, et al. 2003; IMF 2004e; Franco 2006: 573-575). Thirdly, the logic of debt sustainability often runs counter to the requirements of export-led growth and development with respect to exchange rate policy (Eichengreen, et al. 2003; Eichengreen and Hausmann 2005). Caught in this dilemma of having to service dollar-denominated debt, while a depreciating exchange rate would enhance a country's trade performance, emerging markets often manifest a 'fear of floating' and resist currency swings either way (Calvo and Reinhart 2000). Finally, given the persistence of inflation, exchange rate policy is strongly affected by stabilisation goals, which render the 'debt sustainability vs. competitiveness' trade-off even more complex and force national authorities to weigh the costs and benefits of exchange regimes within the tensions of this policy trilemma.

International Agency: Bilateral Relations and International Financial Institutions

Although commonly constructed as passive constraints, there is scope for their instrumentalisation on the part of international actors. For instance, the costs and benefits of currency policy strategies are heavily conditioned by the 'currency market leader' (Cohen

[25] IPE investigated exchange rate politics through the lens of the international monetary system, regimes and monetary cooperation. On 'hegemonic stability theory', see Charles P Kindleberger (1987), *The World in Depression 1929-1939* (Hardmondsworth (UK): Penguin). On the systemic effects of financial deregulation, see Geoffrey R D Underhill, ed., (1997), *The New World Order in International Finance* (Basingstoke (UK): Macmillan); Susan Strange (1998), *Mad Money* (Manchester (UK): Manchester University Press).

2004b: 89-90).[26] Hence, for Argentina and Brazil, U.S. economic policies (and in particular the Federal Reserve's interest rate policy) greatly alter the relative costs of retaining national currencies, pegging to the U.S. dollar or even dollarisation, as well as attempts at monetary integration within MERCOSUR (Seidel 1972; Drake 1989; Jameson 1990: 530; 2007).

The United States' Role as Currency Market Leader

In addition to the unintended consequences of domestically motivated interest rate policy, the *Omnibus Trade and Competitiveness Act of 1988* explicitly stipulates a role for the U.S. government in evaluating and, if necessary, responding to third countries' exchange rate policies if they are deemed to *"prevent effective balance of payments adjustments"* or aim at *"gaining unfair competitive advantage"* (US Treasury 1988: Sec 3004 (b); U.S. Treasury 2006; 2007).[27] To date, no country has been identified on these terms. Thus, although U.S. interest rate policy (may) affect exchange rate policy considerations and despite the existence of, to date unused, provisions for exerting pressure on third countries, bilateral relations by no means determine exchange rate choices. Indeed, contrary to considerable bilateral pressure regarding debt management, commercial reforms and privatisation, exchange rate policymaking represents a curious exception with little conclusive evidence of *decisive* bilateral pressures.[28]

International Financial Institutions and Exchange Rate Policy Choices

Industrial countries may prefer to indirectly exert influence in exchange rate policy matters, e.g., via intermediaries such as IFIs, which they dominate through voting rights and financial contributions (e.g., Chwieroth 2005; Woods 2006). *Prima facie*, however, the IMF seems to be similarly reluctant and, in most cases, ineffective in exerting explicit pressure in this area (IMF - IEO 2007).[29] This is surprising considering that exchange rate surveillance, i.e. ensuring consistency with country circumstances and the international system, is part and parcel of the IMF's *raison d'être* (IMF 1944 (1992): Article IV, Section 3 b); also see IMF 2004d; de Rato 2007a; 2007c; IMF 2007). Yet, the IMF has failed to live up to this promise of

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[26] The adoption of the 'Mack Bill' on seigniorage-sharing might have encouraged further dollarisation throughout Latin America (Cohen 2004: 89-90).

[27] The *Semi-Annual Report on International Economic and Exchange Rate Policies* reviews trading partners' exchange rates, foreign exchange reserves and exchange restrictions. The report does not cover Argentina, but Brazil has recently been included.

[28] Very explicit diplomatic pressure, e.g., on China in 2007, still constitutes an exception but might become more commonplace once the U.S. dollar appreciates again, given that the *Currency Exchange Rate Oversight Reform Act of 2007* put 'new teeth into U.S. currency policy'. See U.S. Senate (2007), *Currency Exchange Rate Oversight Reform Act of 2007*. Available from http://www.senate.gov/~finance/sitepages/leg/LEG%202007/Leg%20110%20061307.pdf. [cited 20th June 2007].

[29] This passive attitude motivated the U.S. to propose the strengthening of IMF surveillance, see Timothy D. Adams (2006), *Working with the IMF to Strengthen Exchange Rate Surveillance - Remarks by Treasury Under Secretary for International Affairs Timothy D. Adams at the American Enterprise Institute on 2nd February 2006* US Treasury. Available from http://www.treas.gov/press/releases/js4002.htm. [cited 11th May 2006].

'firm surveillance' or to acting *"as an independent arbiter of what constitutes a fair exchange rate"* (Woods 2006: 188).[30] Since the mid-1980s, when devaluations of soft pegs were part and parcel of structural adjustment conditionalities (Bird 1998), it has rarely, if ever, made use of its coercive powers in influencing members' exchange rate policies, e.g., by including exchange regime recommendations among loan conditionalities (Cohen in IMF 2004e; IMF - IEO 2004). Indeed, as the IMF's IEO acknowledges, in the *"absence of a widely agreed economic theory to analyse many exchange rate issues"* and limited in its influence by members' freedom of exchange regime choice enshrined in its *Articles of Agreement*, IMF *"[s]urveillance has largely evolved into a form of policy dialogue between the Fund and its members"* (IMF - IEO 2006; 2007). The IMF

> relies largely on persuasion and peer pressure to influence national policies, using different channels – bilateral discussions at the staff level, review at the [Executive] Board level, national and international policy debate, and through the disciplining role of the markets (IMF - IEO 2006: 5).

Although open pressure is largely inexistent, the influence of IFIs on exchange rate policymaking should not be underestimated. Both institutions, the IMF and the World Bank, as well as regional development banks such as the IDB, have considerable scope in influencing policymaking through non-coercive means, such as policy statements, technical assistance (Biersteker 1995: 184; Killick 1996: 226; Woods 2006: 66), research publications or by training economists who later take on decisionmaking responsibility (Hirschman 1987: 31; Finnemore and Barnett 1999: 707-710; Biglaiser 2002; Leiteritz forthcoming). It is through these channels that policymakers are exposed to new 'policy currents' (Maxfield 1990: 18-19), providing them with new cognitive frameworks for understanding their countries' economic realities and thus strongly condition their policy choices (Granovetter 1992). Thus, from advocating floating exchange rates in the 1980s in reflection of neoclassical ideas (Quirk, et al. 1987; Quirk 1994; Harrigan 2006: 212), persistent high inflation and macroeconomic instability in many 'client' states led to the reappraisal of hard pegs as anchors (Giavazzi and Giovannini 1989).

Another example is the emergence of the 'bipolar view' in response to the Asian

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[30] Since 1977 it has been the IMF's task to surveil the international monetary system and appraise members' exchange rate policies – a complex task, which the Fund has repeatedly sought to clarify. In April 2007, a *Consultative Group on Exchange Rate Issues* was formed, which as the *"first major revision in the surveillance framework in some 30 years and the first-ever comprehensive policy statement on surveillance"* adopted new exchange rate policy guidelines: i) the avoidance of exchange rate manipulation; ii) a commitment to intervene to counter disorderly conditions; iii) the consideration of spillover effects; and iv) the avoidance of policies that provoke external instability (de Rato 2007b; IMF 2007). Despite these efforts, the Fund's policy influence remains circumscribed given that *"the Fund can advise, but [it] cannot and should not dictate to [its] members on the choice of their exchange rate regimes, their intervention policies, or their exchange rate levels"* (de Rato 2007a).

crisis, which delegitimised the adoption of intermediate regimes due to their crisis susceptibility and encouraged policymakers to move towards either super-fixed or floating regimes (Eichengreen 1994; Obstfeld and Rogoff 1995; Council of Foreign Relations 1999; Summers 1999; Eichengreen 2001). Although the IMF at no point formally adopted a policy preference, the tone of its publications and recommendations pointed to a prevailing conviction that emerging markets ought to impose discipline by means of super-fixed exchange rate regimes until they had reached the necessary level of institutional maturity for the adoption of market-determined exchange rates (see e.g., Andrews and Willett 1997; Fischer 2001; Bubula and Otker-Robe 2003; Odling-Smee 2004: 36).

The implications of this type of 'soft power' and the profoundly catalytic effect of IMF pronouncements on international financial markets have largely been disregarded in analyses of exchange rate policy choices and in accounting for exchange rate petrification. Yet, IFIs' external 'stamp of approval' for exchange rate regimes may constitute an important factor in enabling and providing incentives for governments to postpone exchange regime flexibilisation.

1.3.4 Ideational Accounts of Exchange Rate Policy Choices

The inclusion of an ideational dimension may not only capture the role of IFIs as transmitters of policy paradigms but also remedy deficiencies in accounting for the dynamics of interest group formation and political mobilisation as well as shedding light on the nature of executive decisionmaking processes by conceptualising policymakers' perceptions of societal and institutional pressures and of structural economic constraints.

Bounded Rationality

Rational choice-based approaches to exchange rate politics prevalent in CPE rely on the assumption that actors choose among the given alternative courses of action that one which is expected to yield the greatest possible utility given their coherent and stable set of preferences as well as costs and other constraints. This conceptualisation of decisionmaking has been contested by Simon (1957), who coined the term 'bounded rationality'. 'Bounded rationality' describes human choice as conditioned by the agent's 'cognitive limitations' and the 'structure of the environment' (Gigerenzer and Selten 2001). In contrast to other social science approaches that reject individual rationality, 'bounded rationality' thus retains the individual as unit of analysis but redefines the concept of 'rationality' to attain greater fit with empirical findings. For instance, actors are known to conduct only limited searches for

alternative courses of actions. Rather than optimising choice, they *satisfice*. Thus, while choices depend on actors' utility functions, they are also critically affected by *external* factors via actors' *"representation of the world in which they live, what they attend to in that world, and what beliefs they have about its nature"* (Simon 1985: 300). Without such conceptual framework of what constitutes and orders the (economic) world, actors would find it impossible to act in an overwhelmingly complex environment (Hall 1997: 184-185). This need for cues and 'guiding flashlights' is accentuated even further during crises when actors are unable to assign subjective probabilities to different outcomes and systematically fail to reduce uncertainty to risk (Knight 1921; McNamara 1998: 58; Blyth 2002: 32). Assuming this 'thin' rationalism thus creates scope for including pre-conceived cognitive maps, such as policy paradigms, as relevant factors in policy decision, while staying within the broad scientific parameters of positivist political economy (Hassdorf 2003: 83).

Drawing on Blyth (1997; 2002), McNamara (1998) and Odell (2002), the mutually constitutive relationship between material interests and economic ideas deserves further attention. Assuming 'bounded rationality', cognitive models of the functioning of the economy are necessary to give substance to and allow for action on the basis of (economic) interests. Indeed, *"[r]egardless of the structurally given interests one assumes agents to have, such structures do not come with an instruction sheet"* (Blyth 2002: 251). Other than representing an essential pre-requisite for the identification of interests at the individual level, actors' bounded rationality opens an additional explanatory dimension to accounts of collective action. Indeed, actors' inability to clearly identify and act on their interests in the absence of conceptual models and exchange rate policy's presentation as a highly technical field renders actors more susceptible to persuasion through means-end 'knowledge' purported by the government or other self-appointed 'economic experts' (Bauer, et al. 1972: 373-374; Odell 2002). In this sense, economic ideas may *"act as coalitional glue to facilitate the cohesion of particular groups"* (Goldstein and Keohane 1993: 12) and constitute a means for empowering and mobilising actors and redefining existing interests (McNamara 1998: 59). As Blyth (1997: 246) states, *"[e]conomic ideas can thus create the basis of a mutual identity between differently located economic and political agents"*.

A bounded rationality conception also highlights how economic ideas and ideological affiliations frame executive decisionmaking by skewing the way in which policymakers understand and ultimately react to economic reality and its inherent risks, problems and opportunities by providing invaluable 'cognitive maps' (McNamara 1998; Kirshner 2003a: 14). Indeed, the executive's constraints and opportunities generated by societal pressures, institutional rules and economic structures *"do not exist outside of individual cognition; rather, they are*

perceived by policymakers based on their conceptual frameworks" (Sikkink 1991: 19). Or, as Adler (1991: 53) puts it, *"the environment [itself] does not 'instruct' policymakers, it challenges them"*. Allowing for bounded rationality, executive agency is no longer limited to 'survival politics'; instead policymakers are seen to influence the process of interest formation by means of framing policy choices in powerful ideological discourses using particular models of economic reality (e.g., Yee 1996). In this sense, policymakers may directly shape interest group pressures, for instance, by masking distributional conflicts or legitimating alternative policy preferences (Odell 2002: 183).

Ideas and Exchange Rate Politics

Monetary matters and currency policy lend themselves to ideational analysis for two reasons. First, money is itself a social construct whose value depends solely on inter-subjective agreement, and monetary policy is strongly affected by agents' beliefs (see Hahn and Solow 1995: 150). Secondly, the continuing lack of consensus on what constitutes a 'correct' macroeconomic policy programme, ambiguities over micro-level distributional effects, data collection complexities and difficulties in interpreting macroeconomic data with regards to policy effects in an *ex ante* fashion all make exchange rate policy a field in which conceptual frameworks have a significant impact on actual decisionmaking (McNamara 1998: 57-58; Hay 2002: 57 + 202-204). The mechanism through which ideas affect exchange rate choices both directly (by shaping executive decisionmaking) and indirectly (via their effect on societal actors' perceptions of economic interest) can be summarised as one that operates through beliefs about causal relationships, ideas about 'appropriate' behaviour, and via *"the unique link between ideas and 'market sentiment' in money matters, and the overwhelming influence of that sentiment on the ability to practice macroeconomic policy"* (Kirshner 2003b: 262-264).

This reading suggests that policymakers' exchange rate decisions are informed by their beliefs about the nature of the domestic economy and the goals and instruments of monetary policy (McNamara 1998: 56). Thus, the international norm of liberalised capital accounts combined with the 'causal belief' in Mundell's model of the '(un)holy trinity' (1960) meant that policymakers increasingly understood exchange rate policy as a structurally determined choice between an independent monetary policy and stable exchange rates (Widmaier 2004). In conjunction with the rising importance of the concept of 'credibility' since the 1980s, this conceptualisation arguably introduced a bias towards exchange rate pegs (Andrews and Willett 1997: 492). Similarly, this approach captures the impact of policymakers' non-material goals, such as national reputation and prestige, on exchange regime decisions (also Habermas 1990).

Indeed, given that national currencies have been *"one of the hallmarks of state sovereignty"* (Woods 2000: 14) and constitute a crucial *"source of political authority"* (McNamara 2005: 3) and because money is *"among the most important identity markers in people's daily lives"* (Risse-Kappen 2003: 488), national currencies play a crucial role in national political developments (also Kindleberger 1970; Camdessus 1992; Helleiner 1998; Towers and Borzutzky 2005: 42). Indeed, it was partly the motivation not to lose *"the symbolic value of a national currency, which is an aspect of cultural identity and of autonomous decisionmaking"* and *"together with the language and the [national] flag has a fundamental agglutinating function,"* that led Brazil's government to oppose a greater role for the U.S. dollar in 1993-4 (Cardoso 2006b: 175+208). Moreover, these non-material concepts frame exchange rate choices asymmetrically insofar as devaluations are seen as instances of 'defeat' with the according electoral implications for incumbents (e.g., Polanyi 1944: 24; Edwards 1996b; Leblang 2005), whilst appreciation is often (mis)represented as synonymous with the attainment of a higher development status. This conceptualisation, therefore, provides a handle on understanding not only the widespread opposition to dollarisation but also the reluctance to flexibilising exchange regimes that had created a sense of international prestige by generating a currency that was 'as good as the dollar'.

Summary

This preliminary literature overview showed that the fragmented body of existing research cannot account for exchange rate policy choices in middle-income emerging markets in Latin America, nor can it provide a comprehensive explanation of the phenomenon of exchange rate petrification. Several questions remain unresolved. For instance, if credibility considerations drove exchange rate policy in the 1990s, why did Brazil successfully stabilise on the basis of a significantly more discretionary exchange regime than Argentina? Although more flexible, why did Brazil risk exchange rate petrification in the late 1990s, and what motivated the authorities to repeatedly postpone exchange rate flexibilisation? Why was Argentina victim to such an extreme case of exchange rate petrification during 1997-2001? And, if institutional factors were key, why could they be sidelined to implement devaluation-cum-default in the midst of crisis in 2001-2002, but not previously? The aim of this thesis is to bring together insights from the reviewed literature so as to provide an executive-focused explanation of policy choices in Argentina and Brazil since the 1980s, which sheds light on the core research questions: *'What are the political determinants of exchange regime choices in middle-income emerging market economies in Latin America?'* and *'What accounts for the wide-spread phenomenon of exchange rate petrification, as witnessed in the cases of Argentina and Brazil in the 1990s?'*.

1.4. Methodological Remarks

1.4.1 Comparative Case Studies and Process-Tracing

The key argument shall be assessed on the basis of a comparative qualitative study of exchange rate politics in Argentina and Brazil as representative cases of middle-income emerging markets in Latin America. Given this thesis' primary interest in the drivers of exchange rate choices, the study aims to trace and elucidate the decisionmaking *process* in this field in the context of these two case studies spanning the 1980s and 1990s, each divided into two sub-cases. According to Bennett and George, the purpose of process-tracing is

> to generate and analyse data on the causal mechanisms, or processes, or events, actions, expectations, and other intervening variables that link putative causes to observed effects (1997: 5; also Van Evera 1997: 62-64; George and Bennett 2004: chapter 10).

In other words, having identified the puzzle of exchange regime choice, the decisionmaking process is traced back to find the causal factors. By engaging in this endeavour in four sub-cases, this thesis seeks to square two in-depth case studies with a comparative approach, that is it aims to capture complexity whilst preserving its ability to produce generalisations (Peters 1998: 5)(**Table 2**). This set-up facilitates both cross-country and cross-temporal comparisons, as well as an investigation of the evolution of exchange rate politics over the past thirty years.

Table 2: The Four Comparative Cases - Argentina and Brazil, 1983-2003

	1980s	**1990s**
Argentina	**Chapter IV** *Plan Austral (1985-1986) and Plan Primavera (1988)*	**Chapter V** *Plan de Convertibilidad (1991-2002)*
Brazil	**Chapter VI** *Plano Cruzado (1986) and Plano Collor (1990-1991)*	**Chapter VII** *Plano Real (1994-1999)*

The period of analysis runs from the onset of the (re-)democratisation processes in Argentina and Brazil (1983 and 1985, respectively) to the year 2003, i.e. into the aftermath of the currency crises in 1999 and 2002, respectively, amidst which both countries adopted a flexible exchange rate under an inflation-targeting approach. The time frame is divided into two comparative periods by the hyperinflationary crisis of 1989 in Argentina and 1991 in the case of Brazil. In addition to contrasting the unsuccessful attempts at stabilisation in the 1980s with the arguably successful exchange rate-based stabilisation programmes and structural

reforms of the 1990s, this periodisation mirrors the evolution of various structural effects on middle-income countries: The constraints on exchange rate policy rooted in the external debt crisis of the early 1980s and the subsequent 'lost decade' can be contrasted with the effects of regional integration (MERCOSUR in 1995) and economic globalisation, which resulted in countries' increasing integration into global capital markets and thus accentuated their dependency and exposure to potentially volatile capital inflows in the 1990s and beyond.

In terms of methodology, this case study approach, reliant on 'thick description' of interactions between executive decision-makers and actors rooted in organised society as well as IFIs (Geertz 1973), was selected based on the realisation that large-n cross-national studies of exchange rate regime choice, although of great value for theory-building and constituting the dominant share of the current literature on exchange rate politics, are afflicted by two sets of data-related problems. First, studies rely on the *'pretty meaningless'* official IMF classification (Corden 2002: 6). Secondly, crucial socio-economic phenomena, such as coalition-building efforts among interest groups and the symbolic role of the exchange rate, are disregarded due to difficulties with respect to quantification (Manzetti 2003: 323). In this light, Jameson (2002: 129) suggested that *"exchange rate determination may be too complex for the quantitative approach"*. Moreover, as Odell (2001: 170) points out, *"large-n statistical studies tend to bias theory away from processes"*, i.e. away from the core interest of this thesis. Although refraining from utilising statistical methods, in drawing up the four case studies this thesis exploits insights generated by both qualitative and quantitative-statistical studies so to allow for a theory-driven but historically detailed examination of exchange rate policymaking processes.

Table 3: The Southern Cone and the Latin America and Caribbean (LAC) Region

	GDP in US$ billions	*GDP per capita in US$*	*GDP as % of SC*	*Population in millions*	*Population as % of SC*
Brazil	**452.4**	**2,592.55**	**71.08**	**174.5**	**73.66**
Argentina	**102.2**	**2,696.57**	**16.06**	**37.9**	**16.00**
Chile	64.2	4,115.38	10.09	15.6	6.60
Uruguay	12.3	3,617.65	1.93	3.4	1.44
Paraguay	5.4	981.82	0.84	5.5	2.32
Southern Cone (SC)	636.5			236.9	
LAC Region	1,700.0			524.9	

Source: World Development Indicators Database 2003. Available at http://www.worldbank.org/data. [cited 7th March 2004].

Table 4: Argentina and Brazil – Evolution of Average Unweighted Tariffs, 1987-2004

in %	**1987**	**1990**	**1991**	**1992**	**1995**	**1997**	**1998**	**2001**
Argentina	27.0	20.5	12.2	11.8	10.5	11.3	13.5	11.6
Brazil	51.0	32.2	25.3	21.2	11.1	11.8	14.6	12.9

Sources: Author's calculation based on data derived from databases of the WTO and the IDB.

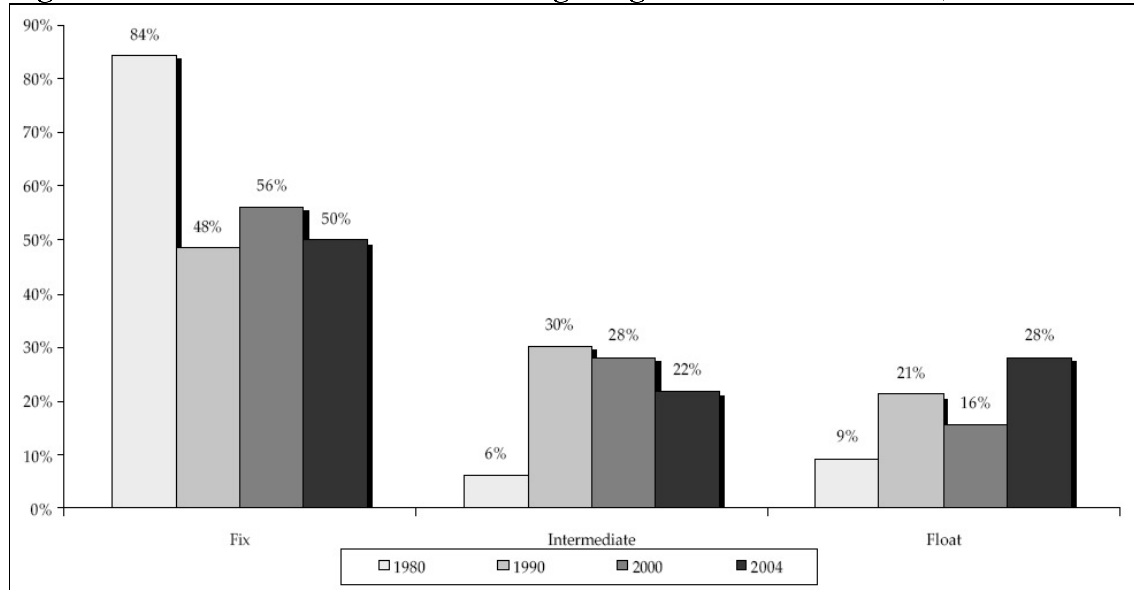
The Cases: Argentina and Brazil

Constructing a comparative study around Argentina and Brazil is a relatively common choice (e.g., Kaufman 1988; Sikkink 1991; Packenham 1994; Pang 2002; Weyland 2002). As the two largest economies in the Southern cone and as founding members of the MERCOSUR project, developments in these two countries are crucial to an understanding of politico-economic dynamics in South America (**Table 3**)(Carranza 2003; Phillips 2004; Gomez Mera 2005). Moreover, the two countries are highly suitable case study candidates not only because they are sufficiently akin to their wider peer group but also because the two economies themselves are sufficiently comparable. Although exhibiting some crucial differences, important parallels can be drawn with respect to their respective socio-economic histories (i.e. their developmental paths until the mid-1970s, the timing of the re-democratisation process in the early 1980s and the shift from an inward-looking to a neoliberal economic model in the 1990s). Both societies are structured around the tensions between an influential financial-industrial business class and a politically important popular sector, which are intermediated by a comparatively professionalised state apparatus (Kaufman 1990: 65). A comparison between Argentina and Brazil also allows to minimize the influence of divergent degrees of trade liberalisation on exchange rate politics (e.g., Fernández 2002). Indeed, although tariff regimes diverged in the 1980s, both countries liberalised their trade regimes during the 1990s within MERCOSUR (**Table 4**)(Ernst 2005: 1-3). Finally, this comparison usefully highlights exchange rate outcomes' disruptive impact on regional integration efforts (e.g., Carranza 2003: 87-88).

The Cases and Exchange Rate Policy Trends in Emerging Markets

How representative are Argentina's and Brazil's exchange rate choices for middle-income emerging markets in Latin America? IMF data shows that during the 1980s, governments throughout Latin America pursued a wide array of regimes (**Figure 1** und **Table 5**). Yet, by the late 1990s, there was a clear trend towards flexible regimes – the notable exceptions being dollarised Panama, Ecuador, El Salvador and Argentina (Berg, et al. 2003; Levy-Yeyati 2005). While Argentina's commitment to the currency board constituted a 'deviant case', Brazil exemplified this regional trend when it moved from a relatively rigid crawling band to a float embedded in an inflation-targeting regime in January 1999. In turn, although Argentina's decision to hold onto its rigid regime until January 2002 diverged from its neighbours' strategies, it provided a core case on the basis of which the 'bipolar view' gained strength.

Figure 1: Distribution of *de facto* Exchange Regimes in Latin America, 1980-2004



Source: Levy-Yeyati 2005: 33. Based on a classification that can be downloaded at http://www.utdt.edu/~ely/papers.html.
Note: This sample distinguishes itself from global trends by an increase in the share of floats and a fall in pegs in the 2000s.

Table 5: Exchange Rate Regimes in Selected Latin American Economies, 1985-2002

	1980-4	1985-89	1990-4	1995-9	2000-02
Argentina	Adjustable Peg	Managed Float	Currency Board (1991)	Currency Board	Currency Board, Managed Float (2002)
Bolivia	Peg	Managed Float	Managed Float	Managed Float	Managed Float
Brazil	Mini-Devaluations	Managed Peg	Managed Peg	Crawling Band	Float (1999)
Chile	Crawling Peg	Crawling Peg	Crawling Peg	Crawling Band	Float (1998)
Colombia	Crawling Peg	Crawling Peg	Crawling Peg, Crawling Band	Crawling Band, Float (1998)	Float
Ecuador	Multiple Exchange Rates	Dual Exchange Rate System	Dual Exchange Rate System	Dual Exchange Rate System	Dollarisation (2000)
Peru	Peg	Peg	Float (1990)	Float	Float
Venezuela	Peg	Multiple Exchange Rates	Managed Peg	Peg, Band, Crawling Band	Crawling Band, Managed Float (2002)
Mexico	Managed Peg	Managed Peg	Crawl. Peg, Float	Float	Float

Sources: Own elaboration based on IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions*, 1980-2002. 1985 and 2002 data from Berg, et al. 2003: 25.
Note: Predominant regime in each period. Classification based on IMF staff views. Hard pegs include arrangements without separate legal tender, currency unions, currency boards. Intermediate regimes include horizontal bands, crawling pegs/bands.

Research Strategy

With a view to tracing the process of exchange rate policymaking over the course of the last three decades in Argentina and Brazil so as to identify key determinants of exchange rate policy choices, this thesis makes use of a wide range of data forms and sources. First, I exploited the rich secondary literature's qualitative-historical and quantitative-statistical studies to reconstruct both the micro- and macro-context of exchange rate policymaking and to

identify the key actors relevant to my research. Based on these studies and on the insights of UK-based experts I designed my multi-phased field research in Argentina and Brazil.[31]

These stays provided me with access to the second source of data: interviews with almost 90 key personalities, focusing on executive decisionmakers but also consulting a wide range of politicians, economists, businessmen, labour representatives, journalists and diplomats in the two countries.[32] These so-called 'elite interviews' (Lilleker 2003) can be divided into case-specific interviews with actors that were closely involved with exchange rate decisions and/or lobbying activities, and interviews, which aimed at establishing a wider historical overview over the issue area. Each interview started with the interviewee's own assessment of the respective country's record of exchange rate policy since democratisation and the implications for the interviewee's line of business or policymaking institution. I followed these questions with a more detailed set of open-ended questions on the drivers, implications and perceptions with respect to key exchange rate political decision.

I chose interviews as the key methodology for this research because they would allow me to gain insights on events, such as decisionmaking behind closed doors and notoriously secretive lobbying activities, on which little public knowledge is available (as also noted by Hall 2005: 14), and because interview-derived evidence would enrich this thesis' sense for the inner workings of the exchange rate decisionmaking process. The decision in favour of interviews was made in the acute awareness of this methodology's inherent weaknesses with respect to its time-intensive nature and especially in terms of the trustworthiness of the collected oral evidence. Cautious about exaggerations and falsehoods and aware of some interviewees' desire to 'rewrite history', interviews thus were carefully triangulated with one another, against the secondary literature and against journalistic reports and official documentation (Stake 2000: 437; Lilleker 2003: 211). A secondary problem, more acute in Argentina than in Brazil, was to gain the trust of and hence access to key personalities due to the controversy inherent to recent politico-economic crises. In many but not all cases, this lack of trust could eventually be overcome by establishing my academic integrity vis-à-vis other interviewees, who then established contact to their former colleagues and/or friends on my behalf. Once arranged, many interviewees would emphasise the sensitivity of

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[31] In 2003, preparing my doctoral research, I spent three months working for the Economics section of the German Embassy in Buenos Aires. Subsequently, I arranged two two-month research stays in Buenos Aires in April-May and September-October 2005. My field work in Brazil, divided between Brasília, Rio de Janeiro and São Paulo, was conducted between October 2005 and February 2006.

[32] The interview data was collected during my stays in Argentina and Brazil. Some email and phone interviews were also organised in London and Oxford in 2006 and 2007. In total, 41 interviews were conducted in Argentina and 47 in Brazil. In exceptional cases pledges of confidentiality were made so that only descriptive, non-identifying terms will be used in referencing these interviews. All other interviewees, in addition to biographical information, are listed in Appendix 1.

the information provided. Hence, although almost all interviews were recorded on tape or in notes, some information was obtained on the condition that it was 'non-attributable'.[33]

As a third source of data, I gathered evidence from written government documents, memoirs and journalistic reports and consulted relevant works from the local academic literatures, which are too often – and at great cost – neglected in the English-speaking world.[34] In addition to local academics, a wide range of business associations, research institutes, policymakers and political parties in Argentina and Brazil publish material on issues related to exchange rate policy, their policy preferences and policy implications for particular sectors of the economy.[35] I had access to congressional archives as well as the archives of several business associations, which allowed me to trace the evolution of internal policy positions. I also extensively used local press reports, (auto-)biographies and newspaper articles to gain an insight into actors' policy preferences and their role in exchange rate policy decisionmaking.

1.4.2 Structure of this Thesis

This thesis, broken into three parts, proceeds as follows. Part I outlines the primary shortcomings of the existing explanations of exchange rate politics in emerging markets (Chapter II) and then constructs a theoretical framework of exchange rate politics (Chapter III), which will guide the subsequent empirical analyses of exchange rate policymaking in Argentina and Brazil. Against this theoretical backdrop, Part II accounts for exchange rate political decisions in the context of four case studies covering the period between 1983 and 2003. Chapter IV and Chapter V investigate exchange rate politics in Argentina in the 1980s and 1990s, respectively. In turn, Chapters VI and VII present the empirical evidence of exchange rate politics in Brazil. The third part, Chapter VIII, re-states the refined argument against the background of the preceding case studies and with a view to more recent developments in both countries. It then highlights this thesis' implications for the literature and policymaking prior to concluding with an outlook on avenues for further research.

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[33] In twelve cases, interviewees requested full transcriptions of the interviews, which they amended before issuing approval.

[34] Most interviews and documentary evidence were in Spanish and Portuguese. Quotes were translated and checked with native speakers prior to their inclusion into this thesis.

[35] This evidence was also exploited for articles, e.g., Annika Bolten (forthcoming in 2009), "Special Interests in Action: The Unión Industrial Argentina and the Exit from the Convertibility Regime," in *Interest Groups & Lobbying: Volume Three - Latin America, Africa, the Middle East, and Asia*, ed. Conor McGrath (Lewiston (NY): E. Mellen Press).

C H A P T E R I I

OUT OF CONTEXT? THE LITERATURE'S SHORTCOMINGS IN EXPLAINING EXCHANGE RATE POLITICS IN MIDDLE-INCOME EMERGING MARKETS IN LATIN AMERICA

2.1. Introductory Remarks

As the introductory chapter showed, the scholarly literature has not yet resolved the puzzle posed by governments' exchange rate policy choices in emerging markets. While making important contributions from a variety of theoretical and methodological angles, established arguments cannot compellingly account for policymakers' decisions to adopt heavily constraining exchange rate regimes, or explain the timing of exits from such arrangements. Nor do they shed sufficient light on the typical emerging market phenomenon of exchange rate petrification.

Preceding the thesis' conceptual framework of exchange rate politics in Chapter III, this chapter's aim is threefold. First, it highlights a key shortcoming that runs across the existing political economy literature: Its (almost) exclusive focus on exchange rate politics in industrial democracies at later stages of development. A critical engagement with the literature shows that its unqualified application to the emerging market context generates a distorted picture that disregards key motivations. In particular, this chapter shows how exchange rate decisions in Latin America are affected by executive goals with respect to macroeconomic stabilisation, debt management and the promotion of structural reforms. This critique highlights the need for theory-building above and beyond the existing literature's insights so to satisfactorily address the key question – *What are the political determinants of exchange regime choices in middle-income emerging markets in Latin America?* The second aim is to provide a conceptualisation of the structural context within which exchange rate politics in these middle-income emerging markets evolve and of the way policymakers have come to understand the constraints on exchange rate policy decisionmaking. Thirdly, the discussion of policymakers' framing of these structural constraints highlights the rise of the concept of 'credibility' in academic and policymaking circles, based on institutionalists' framing of the exchange rate dilemma as a choice between credibility and competitiveness with exchange rate commitments – be they pegs, currency boards or outright dollarisation – constituting

credibility-enhancing devices. The chapter's third aim thus is to investigate the notion of 'credibility' and the conceptualisation of exchange rate policy as driven by the aforementioned trade-off. In doing so, I emphasise institutionalists' narrow understanding of credibility as a core driver of exchange rate policy choice and suggest that the mechanism by which exchange rate pegs enhance the credibility of a country's economic policy agenda differs from that stipulated by institutionalists. Rather, foreshadowing Chapter III, this thesis argues that policymakers regard exchange rate commitments as means for enhancing a wider form of political credibility thanks to their use in building and stabilising reformist support coalitions.

2.2. Exchange Rate Politics in Middle-Income Emerging Markets in Latin America

The 1997-1998 Asian Crisis, with its offshoots in Eastern Europe and South America, revealed how little we still know about workable exchange rate policies for developing countries.

Velasco and Céspedes (1999: 1)

Economic structuralists, OCA theorists and development scholars have long emphasised that systemic conditions in middle-income countries vary considerably from those in developed nations (e.g., Bowles and White 1994: 257; Phillips 2004: 22-28; Stiglitz, et al. 2006: 52-62). Indeed, while disagreement persists as to whether these differences warrant a distinct approach in *all* matters of economic policy, ever since the Asian Crisis consensus among economists has grown that policy recommendations with respect to monetary and exchange rate policy have to be redefined to reflect the stringent constraints faced by emerging markets and other developing nations under conditions of heightened capital mobility (e.g., Sachs 1996; Eichengreen and Hausman 1999; Velasco and Céspedes 1999; Eichengreen, et al. 2003; Williamson 2003a; 2003b).

2.2.1 The Economic Structural Context

Middle-income emerging market economies in Latin America, i.e. developing countries with reasonably modern financial systems and relatively high degrees of integration into world capital markets, are commonly characterised by relatively weak fiscal accounts, shallow domestic capital markets, vulnerable banking systems and feeble regulatory institutions, in addition to inflation and scarred government reputations. The exchange rate policy environment in these countries thus differs from OECD contexts along three

structural characteristics, which heighten their exposure to external shocks and considerably complicate exchange regime choice: Emerging markets in Latin America do not only continue to be deeply reliant on foreign capital inflows and are subject to the 'original sin' problem, but they also exist in conditions of inherently fragile macroeconomic stability with persisting growth concerns. Worse, for these (primarily) commodity exporters, the logic of debt sustainability and exchange rate-based stabilisation runs counter to the requirements of export-led growth.

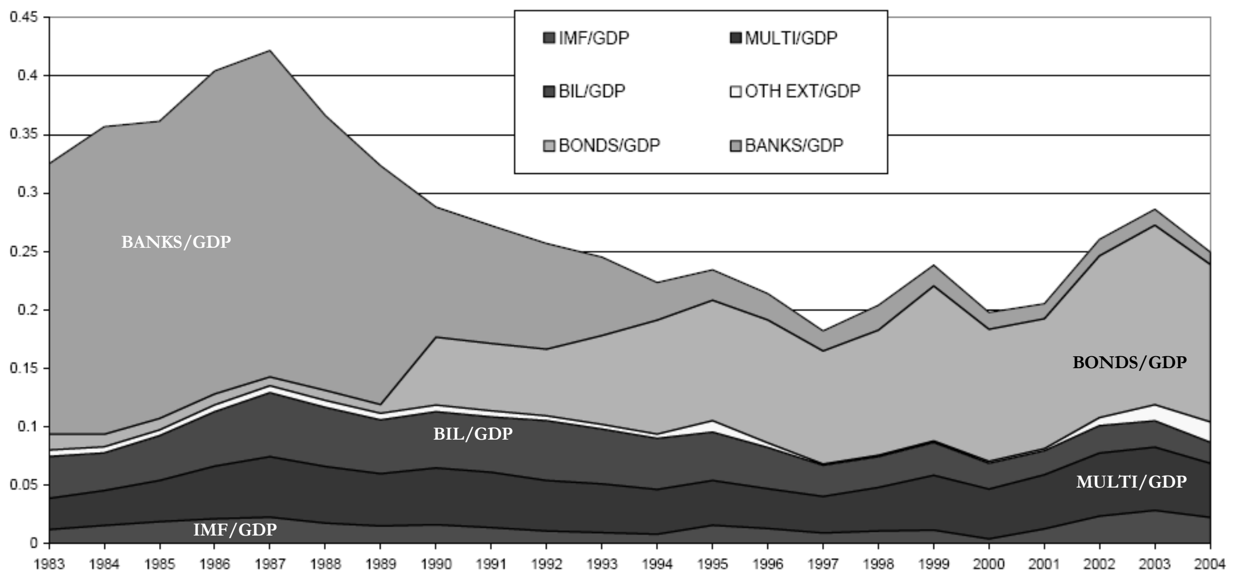
Debt Dynamics and the 'Original Sin' Problem

As relatively capital-scarce economies with low domestic savings rates, Latin American middle-income economies are structurally reliant on capital inflows to finance government and balance of payment deficits, to make debt service payments and, more generally, as a boost to aggregate demand, investment and growth (Rodrik 2002: 2; Shambaugh 2004: 283). By implication, these countries are exposed to financial market-determined factors, such as the changing nature of foreign capital inflows (**Figure 2**). The shift from commercial bank loans to international bond finance (so-called securitisation) in the early 1990s had particularly far-reaching consequences. First, the growing importance of bond markets put a premium on satisfying investors' expectations and on maintaining a positive image among investors so as to pre-empt the threat of capital flight, which had become significantly more immediate due to investors' improved mobility and shortened time horizons (Armijo Elliott 1999). Investors' demands therefore gained in political weight (e.g., Haley 1999; Mosley 2003b). Secondly, countries became more profoundly exposed to exogenous factors. The impact of events beyond national governments' direct control (e.g., changes in OECD interest rates) on capital flows repeatedly forced governments to cut back on investment and spending, undermining attempts at extending policy horizons and achieving greater predictability (Calvo 1998; Maxfield 1998: 70-73; Ghosh 2001: 151-152; Rojas-Suarez 2003; Stiglitz, et al. 2006: 181-182).

Given the key role exchange regimes play in shaping the impact of external shocks on the domestic economy, an assessment of the nature and severity of these constraints flows into exchange rate policy decisions and generates a different set of decisionmaking parameters than those confronted by OECD policymakers. Debt considerations are of particular importance given that the prevailing level of exchange rate volatility is known to significantly influence the *volume* and *composition* of capital flows. Exchange rate policy's implications for the public (and private) sector's ability to take on and service debt hence affect policymakers'

exchange rate policy stances. More generally, exchange rate developments, such as speculation against a peg, are known to constitute a root cause of capital flow reversals and 'sudden stops' (Calvo 1998; Goldstein 2003; Shambaugh 2004). Governments will therefore very carefully weigh which exchange rate decision sends the desired signal to market actors so to maintain investor confidence and steady capital inflows.

Figure 2: Composition of Sovereign External Debt in Latin America, 1983-2004



Source: IDB. Available at http://www.iadb.org/res/publications/pubfiles/pubWP-577.pdf. [29th March 2007].
Note: Includes Argentina, Brazil, Chile, Colombia, Ecuador, El Salvador, Mexico, Peru, Uruguay and Venezuela. IMF/GDP = IMF lending. BIL/GDP = bilateral lending. MULTI/GDP = multilateral lending. BOND/GDP = bonded debt. BANKS/GDP = bank lending. OTH EXT/GDP = other external debt.

A second interactive effect between exchange rate policy and debt dynamics lies in the 'original sin' problem, which describes the *de facto "inability of a country to borrow abroad in its own currency"* (Eichengreen and Hausman 1999; Eichengreen, et al. 2003: 5 + 12). The religiously-laden label seeks to convey that this financial market characteristic is not exclusively rooted in affected countries' policies (e.g., histories of inflation and defaults) but that it *"has something to do with the structure of the international system"* (Eichengreen and Hausmann 2005: 6).[1] This constraint on smoothing domestic consumption by means of international borrowing is compounded by difficulties to borrow at extended maturities even domestically (Starr 2001; IMF 2004e; Franco 2006: 573-575).[2] While the roots of these borrowing limitations are complex, their implications for borrowing behaviour and portfolio structures are straightforward and well-documented: The 'original sin' problem heightens the risk of

[1] The use of this religious metaphor also suggests that nothing can be done to address this condition other than to *"sit back, pray and ask for forgiveness"* (Interview Keifman). Yet, Brazil's 10-year *real*-denominated bond, issued in September 2005, and issues by Colombia and Uruguay suggest that the 'original sin' problem may be surmountable.

[2] Most domestic bond issues tend to be indexed to the exchange rate and thus are conceptually indistinguishable from foreign-currency denominated issues (Eichengreen et al. 2003: 32).

currency and maturity mismatches as countries have to borrow either short-term, or in foreign currency (Stiglitz, et al. 2006: 122) and is therefore at the root of a second source of emerging market vulnerabilities (Jonas 2003). This exposure may be deepened depending on the choice of exchange regime. While highly volatile exchange rates provoke the drastic fluctuation of the domestic currency value of external debt, an exchange rate peg may function as an implicit guarantee, which discourages economic actors from hedging currency risk and thus stimulates the accumulation of dollar-denominated debt (Shambaugh 2004: 285). Once significant currency mismatch exists, be it on the part of private actors or the public sector, exchange rate policy options are severely constrained insofar as instances of exchange rate depreciation or outright devaluation would drastically increase debt service costs – and the likelihood of bankruptcies and sovereign default (Fernández 1987; Jonas 2003). On average, governments in emerging markets in Latin America thus face strong incentives to minimise exchange rate movements by means of regular foreign exchange market interventions to stabilise what are officially 'market-determined' exchange rates – an attitude Calvo and Reinhart (2000) refer to as 'fear of floating'. In turn, when dollar-denominated debt has been accumulated under a peg, policymakers tend to persevere with the regime leading to exchange rate petrification (Genberg and Swoboda 2004; Reinhart and Rogoff 2004).

Finally, Latin American emerging markets exhibit a high level of 'debt intolerance', i.e. financial market actors consider emerging markets to be unable to manage levels of external debt relative to GDP which they would very much trust developed nations to handle. Indeed, emerging markets' credit ratings fall significantly more rapidly as levels of external debt increase than in OECD economies (Reinhart, et al. 2003). Together with currency mismatches, this combination is 'deadly' insofar as debt levels can rapidly become unsustainable as a result of exchange rate depreciation or devaluation, as the Argentine devaluation-cum-default in 2002 illustrated (Rojas-Suarez 2003: 136).

Macroeconomic Stabilisation and Growth Concerns

Another factor that affects exchange rate policymaking in Latin America consists in recurrent (hyper-)inflationary dynamics (e.g., Frieden and Stein 2001: 25-26). As Hirschman (1984: 247) described, inflation became *"all-enveloping, prolonging itself over a long period, in such a way that today, it seems familiar and almost 'normal'"*. The persistence of inflation is often explained with reference to a process by which *"inflation replaces politics"* (Palermo and Novaro 1996: 40). Indeed, in the absence of other institutionalised conflict-resolution mechanisms and given state structures that lack the strength and autonomy to bypass sectoral interests, Latin

American governments tend to resort to expansionary and (often) inflationary policies and income transfers between sectors as a short-term pressure valve. Depending on a country's state organisation, distributional conflict fuels inflation through two principal channels. First, 'cost-push' inflation refers to the notion that well-organised labour unions and businesses in non-competitive markets succeed in obtaining higher wages and product prices, which are then – often via indexation mechanisms – translated into across-the-board price rises. The second mechanism centres on governments financing budget deficits generated by excessive spending in response to sectoral demands and (international) debt service through money creation (e.g., Haggard and Kaufman 1992: 273-274). This dynamic evolves against the backdrop of states' inadequate tax systems (Lledo, et al. 2004: 11-25), which fail to extract sufficient resources from society in order to cover their contractual obligations vis-à-vis the former. Fiscal insolvency, in turn, exacerbates the fight for sectoral shares of national wealth by further shortening agents' time horizons and fuelling their inflationary expectations.

Especially since the emergence of the monetarist paradigm in the early 1960s (e.g., Friedman 1956), the socio-economic costs of inflation have become widely acknowledged (e.g., Lucas and Rapping 1969; Barro and Gordon 1983b; Lucas 2000). In addition to recognising the administrative costs associated with ever-changing prices, monetarists contended that high and volatile inflation rates are fundamentally at odds with growth and full employment as continuous increases in the general price level erode the price system's signalling effectiveness and market-clearing mechanism and, by generating uncertainty, encourage short-termist behaviour at the expense of investment. Moreover, given that government policies – i.e. excessive spending and deficit-financing via the central bank – are usually at the root of inflationary episodes, public trust is known to be detrimentally affected to the extent that high inflation is regarded as a catalyst of profound politico-economic crises and even regime change (Przeworski 1991; Haggard and Kaufman 1992; 1995; Weyland 2002; Biglaiser and DeRouen 2004: 575).

While policymakers' awareness of the (political) costs of inflation is illustrated by recurrent stabilisation attempts, until the late 1980s the reduction of inflation rates tended to be subjugated to growth targets (Bird 1998; Cardoso 2006b: 143).[3] Indeed, it was only in response to the neoliberal emphasis on the importance of macroeconomic stability for growth and full employment and under circumstances of severe economic crisis that the reduction and, ideally, the elimination of inflationary dynamics became a central objective for middle-

[3] Policymakers' awareness of exchange rate effects on inflation are illustrated by developing countries' historical opposition to IFI advice, which in 79% of cases foresaw devaluations as a solution to balance of payments problems (Bird 1998: 255).

income governments. Gradually, and at speeds that varied across countries, policymakers thus began to evaluate alternative exchange rate policy options with respect to their anti-inflationary utility (Andrews and Willett 1997; Bird 1998; Rojas-Suarez 2003: 147).

The prevalence of inflation has significant implications for exchange rate policymaking. For one, inflationary inertia undermines exchange rate pegs via real appreciation. If inflation is not sufficiently quickly reduced to international rates, pegs hurt export and import-competing sectors and therefore the balance of payments and the country's ability to generate hard currency required for debt service (Edwards 2001; Frieden and Stein 2001). Inertia is also at the root of the boom-bust-cycles associated with pegs introduced in the context of disinflation-cum-liberalisation programmes (Franco 2000: 32-33; Schamis and Way 2001; Gala 2004: 6). More generally, past inflation and episodes of dramatic currency debasement and volatility created structural realities that strongly constrain exchange rate policy, such as the widespread use of indexation and foreign currencies (Leblang 2003; Arida 2006). As a result, currencies like the *peso* and the *real* are best described as 'peripheral monies' (Falção Silva 1999: 91-92; Ghosh 2001: 151-152) or 'permeated currencies' (Cohen 2004b: 14) at the bottom of the 'hierarchy of competing currencies' (Sgard 2002).

These competitive pressures lead some analysts to posit that eventually weak-currency countries will substitute their currencies for a stronger one (the 'contraction contention'). Yet, especially in larger Latin American middle-income emerging markets, such as Argentina and Brazil, currency substitution is rare. Instead, foreign monies co-exist with the domestic currency. Especially the U.S. dollar is intensively used for internal transactions, borrowing and saving and thus plays a crucial role in the public perception of economic developments (Cardoso in Pompeu de Toledo 1998: 80; Cohen 2004b). In these circumstances, the exchange rate constitutes a natural focal point for inflationary expectations as well as providing a widely reported external check on governmental policy.

Table 6: Trade Shares and Openness of a Selection of Middle-Income Countries

in %	**1998 Trade Share**		**1998 Trade/GDP**
	with USA	**with Euro Area**	
Argentina	**14.2**	**20.0**	**10.2**
Brazil	**21.7**	**24.8**	**8.2**
Chile	18.8	17.9	27.1
Mexico	77.8	5.9	25.0
Venezuela	43.0	10.8	20.3
Czech Republic	2.1	54.9	60.9
Hungary	4.0	65.5	60.8
Poland	2.3	59.2	27.5
Malaysia	18.1	9.0	115.5

Sources: IMF World Economic Outlook Database, Direction of Trade Statistics and Oppers 2000: 17.

Trade Relations and Export Profiles

Together with debt dynamics and notorious macroeconomic instability, Latin America's trade patterns and export profiles constitute another source of external vulnerability as well as a dilemma, which has to be addressed by exchange rate policy. Although middle-income countries have progressively diversified their export base during the past fifty years, their economies are still sensitive to terms-of-trade shocks due to their dependence on commodity exports (**Figure 3**)(e.g., Balassa 1982; Williamson 2003b; Gala 2004; Phillips 2004: 22; Williamson 2008). Emerging markets' trade-related exchange rate policy dilemma, especially acute for Argentina and Brazil, derives from their trade patterns: Although the U.S. dollar plays a crucial role with respect to debt denomination and, in the case of Argentina, also with respect to domestic transactions and represents the likely nominal anchor, the U.S. are not the countries' primary trading partner. Instead, for Argentina and Brazil, trade with the 'Eurozone' dominates commerce with the U.S..[4] Thus, when determining the anchor currency, considerations about retaining competitiveness in core markets pull in a different direction than (largely) dollar-denominated financial relations, the logic of debt sustainability and, last but not least, dollar-conscious public perceptions (Eichengreen, et al. 2003; Eichengreen and Hausmann 2005). The severity of this trade-off is conditioned by the size and openness of the economy in question. As **Table 6** shows, openness varies greatly throughout Latin America. For countries like Brazil and, to a lesser extent, Argentina with large and rather closed economies and a sizeable share of trade with Europe rather than the U.S., the risks for competitiveness associated with dollar pegs are non-negligible and yet may be inescapable given the currency structure of their debt portfolios.

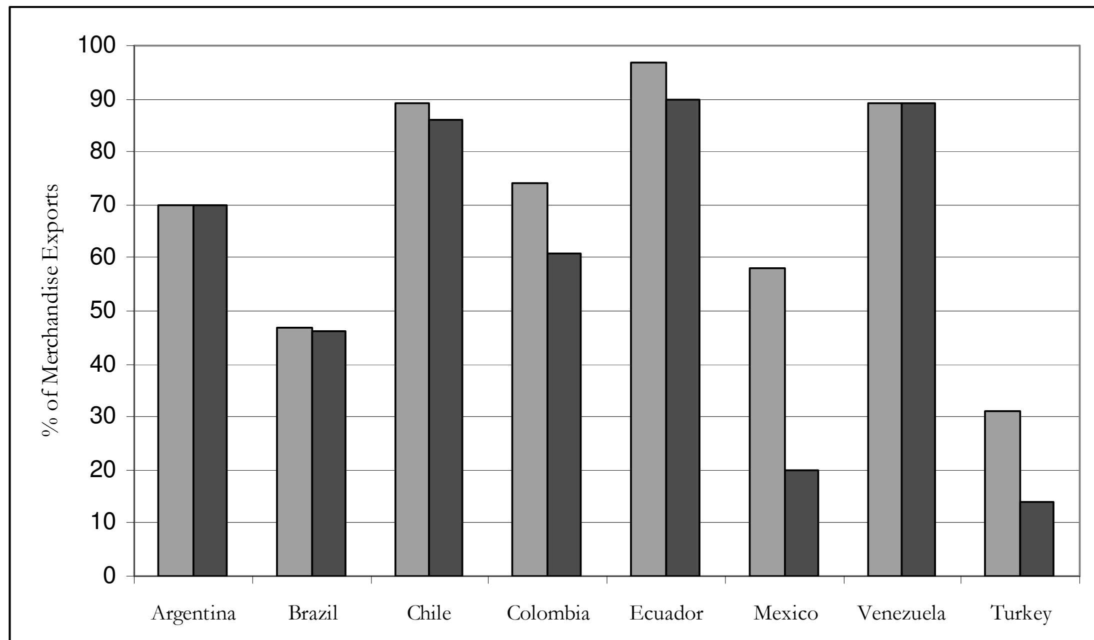
Table 7: Argentina vs. Brazil – Trade Relations, 1990-2005

in % of total exports and imports	**Imports from**				**Exports to**			
ARGENTINA	**1990**	**1996**	**2002**	**2005**	**1990**	**1996**	**2002**	**2005**
Latin America and Caribbean	33	31	37	47	27	48	42	40
North America	20	21	21	16	14	9	12	12
EU	27	31	25	20	31	20	20	17
Asia	12	13	13	13	10	17	18	20
Rest of the world	8	4	4	4	18	6	8	11
BRAZIL								
Latin America and Caribbean	18	22	18	17	11	24	19	26
North America	20	25	24	19	25	21	27	21
EU	22	29	31	26	32	29	27	24
Asia	11	19	21	28	17	20	20	21
Rest of the world	29	15	6	8	15	6	5	8

Source: UN Comtrade.

[4] Note that although trade with the U.S. is not dominant, most other commercial contracts tend to also be in U.S. dollars.

Figure 3: Commodities as a Percentage of Total Merchandise Exports, 1990 and 2004



Source: World Bank, World Development Indicators 2006.
Note: 1990 = light colour; 2004 = darker colour. Fuel exports constitute a significant share of commodities, e.g., Argentina (16%), Colombia (38%), Ecuador (54%), Mexico (12%) and Venezuela (85%) in 2004.

The Economic Structural Context: Credibility Deficits and the Need for Structural Reforms

The structural environment of exchange rate policy in emerging markets in Latin America is thus rather distinct from OECD contexts.[5] More important for decisionmaking than this structural reality *per se*, however, has been policymakers' evolving interpretation of these constraints. Indeed, since the rise of neoliberalism in the mid-1980s the totality of these structural circumstances has come to be understood as sharing a root cause: insufficient *policy credibility* (e.g., Blackburn and Christensen 1989; Rodrik 1989; Dornbusch 1991; Brunetti and Weder 1994).[6] Based on this diagnosis, neoliberals advocated finding *institutional* solutions to these credibility concerns.

Against the backdrop of neoliberalism's *'tempered template of Monetarism'* (McNamara 1998; 1999), over time this also led to a new framing of exchange rate policy choice on the part of emerging market policymakers.[7] Indeed, the rise of the concept of credibility meant that the traditional depiction of exchange rate policy choice as a two-dimensional trade-off consisting of the core dilemma of 'exchange rate stability vs. flexibility' and a secondary choice regarding the nominal value of the exchange rate (Frieden 1997) – for emerging

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[5] Bearce (2007: 136) acknowledges the OECD-centrism of core research on exchange rate and monetary policy to date.

[6] Indeed, 'credibility theory' provided a politically convenient interpretation of the failure of neoliberal reforms in the 1970s and early 1980s insofar as blame was apportioned to the domestic (institutional) environment without problematising the reforms' fundamental goals nor systemic obstacles to development (Blackburn and Christensen 1989:29).

[7] McNamara (1998: 67-69) distinguishes between 'academic monetarists', who subscribed to floating rates, and 'pragmatic monetarists', who regarded fixed rates as paramount for reinforcing disinflationary efforts. Also see Bearce 2007: 80-83.

markets and developing countries – was collapsed into a dilemma of 'credibility vs. competitiveness' (Frieden and Stein 2001: 5-6). This approach suggests that policymakers have to choose between a very fixed exchange rate whose strong anti-inflationary signalling effects help to overcome the time inconsistency or credibility problem at the expense of giving up monetary autonomy, and a more flexible currency that tends to depreciate and therefore allows for the maintenance of local price competitiveness. While there are substantial grounds for criticising this conceptualisation insofar as *"credibility seems to be a prerequisite for flexibility to be useful"* rather than an alternative policy objective for emerging markets (Velasco and Céspedes 1999: 25), and given that an exchange rate peg *per se* does not eliminate incentives for time-inconsistent behaviour (Hefeker 2000: 162), what is of importance here is policymakers' framing of exchange rate policy choice in these terms from the late 1980s onwards.

Preparing the ground for the conceptual framework, a critique of the concept of 'credibility' in the context of exchange rate politics as well as an account of its emergence and consolidation as one of the most powerful cognitive frames driving economic reform design more generally and exchange rate decisions in the 1990s in particular is warranted. The questions addressed in the next section thus are: How did policymakers' understanding of 'credibility' evolve as domestic economies became increasingly integrated into global markets and pressures towards the implementation of structural reforms intensified? And, to what extent were exchange rate policy choices shaped by this evolving understanding?

2.2.2 Framing Exchange Rate Policy Choices: 'Policy Credibility'

Credibility, in short, is founded on politics, not metaphysics.

Grabel (2003: 41)

Since its rise in neo-classical macroeconomic theory in the 1970s in conjunction with the rational expectations hypothesis, the concept of 'credibility' has become a much-used but increasingly fuzzy buzz-word (Ho 2003: 162). The loss of rigour in its use is problematic not the least for its tautological tendencies (Grabel 2000). Indeed, in much of the political economy literature on policy reforms in transition and developing economies identifying 'credible' economic policies has become tantamount to referring to successful policy reforms whereas unsuccessful reforms – almost by definition – lacked credibility (see, e.g., Starr 1997; Pastor and Wise 1999; Starr 1999; Borner and Kobler 2002). Moreover, economists have found it difficult to converge on a single definition for 'credibility' (Blackburn and

Christensen 1989: 2; Blinder 1999: 4). Interpretations range from reputation-building and learning models to enhance disinflationary efforts (Backus and Driffill 1985), the precision of inflation control and the speed with which economic actors realise a shift in policymakers' inflationary preferences, to the likelihood of a government honouring its debt contracts (Stasavage 2003: 23). The most widespread definition understands 'credibility' as

> the extent to which beliefs about the current and future course of government policy are consistent with the program originally announced by policymakers (Blackburn and Christensen 1989: 2).

The notion's heritage lies in the rational expectations hypothesis, which theorises the way in which individual forward-looking agents make decisions and then act on the basis of perfectly informed expectations derived from a singular economic model (Grabel 2000: 3). Economic agents, however, are conceived of as unable to *know* whether policy commitments are ultimately enforced because governments are simultaneously the *"main potential villain and the ultimate enforcer"* of the policy (Cottarelli and Giannini 1997: 16). Private economic agents, thus, are expected to act as envisaged by the policy design and therefore ensure the policy's successful implementation if, and only if, they believe that the government will follow through with its policy promise.[8]

Prima facie, policymakers are thus expected to strive towards the formulation of credible policies. However, according to neoliberal critics, only few governments in emerging markets seem to be able – or willing – to make the necessary sacrifices. Indeed, as long as governments pursue expansionary monetary policies in the vain hope of stimulating demand and employment (i.e. as long as they act in a time-inconsistent manner), they predict that rational economic actors will pre-empt these actions leading to a welfare-inferior outcome at higher levels of inflation and lower growth and employment rates. Instead, neoliberal prescriptions posit that governments have to credibly establish in the eyes of economic agents that they will *not* engage in such inflationary surprises or in policy reversals more generally. But what distinguishes credible policies from others?

A policy's credibility is arguably determined in a complex two-way interactive process between policymakers and economic actors – at home and crucially also abroad. Conventionally, policy commitments are defined as 'credible' if they are offering reasonable grounds for being believed, are worthy of confidence and more generally plausible and

[8] This conceptualisation explains why economists conventionally use the market interest rate on long-term loans as a measure for credibility. If lenders believe the authorities lack credibility and therefore expect inflation to occur in the future, they will demand compensation via an interest rate premium (Bannock et al. 1998: 86).

reliable. In democracies, policies therefore do not only have to be economically *and* politically feasible in terms of the legislative and subsequent implementation process, but private actors have to be convinced that policymakers will not break their commitment in response to short-term temptations. Game-theoretic accounts further tighten these criteria: By pointing to the strategic attributes of this interaction, policies are considered to be credible if, and only if, policies announced *ex ante* also have *ex post* optimality in the eyes of policymakers. In other words, policymakers may not have any incentive for breaking their promise at a later stage (see Kydland and Prescott 1977). Moreover, attributing an important role to information flows and asymmetries, strategic accounts make an invaluable contribution to our understanding of credibility dynamics by pointing to, first, the communication of policymakers' preferences and, secondly, the establishment of infringement observation mechanisms (Persson and Tabellini 1991; Keefer and Stasavage 2002: 751). In short, policymakers have to convey what their policy preferences are, i.e. they have to turn private information about their intentions into public knowledge by means of adopting a commitment device that emits an unequivocal *policy signal*. The adoption of this device must come at a cost to the policymaker. Moreover, private actors have to be capable of observing and disentangling the causes of potential policy failure and distinguish between exogenous factors (e.g., data reliability and external shocks) and policymakers' meddling with economic variables (Blackburn and Christensen 1989: 30).

Exchange Rate Pegs: Solution to the Credibility Deficit?

The concept of credibility has twofold implications for exchange rate policy. First, paralleling other areas of economic policy, exchange rate policy in and beyond Latin American emerging markets is seen as subject to a credibility problem as exemplified by recurring speculative attacks (Leblang 2000; 2003). The credibility problem associated with the maintenance of soft exchange rate pegs and bands, characteristic of the 1970s and 1980s in Latin America (Levy-Yeyati 2005), and the threat of speculative attacks lies in the information asymmetry regarding policymakers' willingness *and* ability to defend a peg (Leblang 2003: 534). If private actors expect the peg's abandonment, due to the government's unwillingness (or inability) to formulate sufficiently restrictive monetary and fiscal policies, a speculative attack will be launched resulting in, if successful, significant costs in terms of exchange rate volatility and inflation, reduced domestic consumption and investment and a loss of credibility of the wider economic agenda (Eichengreen and Rose 2001).

Secondly, hard exchange rate pegs are purported to offer a solution to credibility

problems affecting monetary (and, to an extent, fiscal) policy. They are presented as a commitment device that solves the time inconsistency problem on the basis of a similar logic to the one that led Homer's Ulysses to tie himself to his boat's mast allowing him to listen to the sirens' songs without being tempted to abandon his long-term objective to sail home (Elster 1979; Leblang 1999: 600-601; Broz 2002; Santiso 2003: 25). As mentioned in the previous chapter, this conceptualisation represents an economic formalisation of an idea that had already been voiced in the 1912 Cunliffe Committee in Great Britain (Giovannini 1993: 110). Having emphasised the importance of macroeconomic stabilisation efforts and the necessity of implementing and sustaining structural reform efforts, this second aspect is especially prominent in the limited existing academic literature on exchange rate policy in these countries (e.g. Willett 1988; Falção Silva 1999; Leblang 1999; Wise and Roett 2000; Frieden and Stein 2001; Schamis and Way 2001) as well as in policy papers that emerged from international financial institutions, such as the IMF, since the 1980s (Frenkel 1982; e.g., Fischer 1985; also see Andrews and Willett 1997: 493).

Through the prism of this emerging neoliberal policy consensus and institutionalist approaches the exchange rate is seen to constitute a valuable nominal anchor in the stabilisation of domestic economies by imposing discipline on domestic monetary policy (McNamara 1998). Money supply in any economy represents the sum of foreign exchange reserves (reflecting the balance of payments) and domestic credit (reflecting domestic monetary policy). In turn, the adoption and maintenance of an exchange rate peg requires the subordination of domestic monetary policy insofar as domestic credit growth in excess of money demand would otherwise put pressure on the balance of payments, deplete foreign exchange reserves and ultimately disable central bank intervention efforts in foreign exchange markets to maintain the pegged value of the exchange rate (Corden 1994; McCallum 1996: 135-140). By implication, monetary policy must be fully directed at the attainment of the objective 'exchange rate stability'. This provides (some) assurance to economic actors that the government will not engage in inflationary policies (Leblang 1999: 601) However, it also implies that monetary instruments are no longer available for attaining goals such as output stabilisation in the face of exogenous shocks, which instead have to be accommodated by radical market-led and therefore socially costly adjustment. As Ulysses said, *"if I beg you to release me, you must tighten and add to my bonds"* (Homer quoted in Elster 1979: 36).

Confronting institutional weakness and the structural lack of credibility generated by past institutional failures, hard exchange rate pegs and 'hypercommitment mechanisms', such as currency boards and dollarisation, were therefore seen as offering a policy solution to this

problem by the mid-to-late 1980s (Bird and Helwege 1997: 37; Bird 1998: 256; Levitsky and Murillo 2005: 280-281).[9] They were conceived of as valuable devices for signalling[10] governments' anti-inflationary policy intentions and a welcome *"commitment technology that national authorities can employ – if they choose – to tie their own hands and thereby gain credibility"* (Isard 1995: 198). In response, economic actors would adjust their inflationary expectations more rapidly and therefore the costs of disinflation in terms of unemployment and output could be reduced. Secondly, pre-commitment by means of exchange rate pegs is arguably strong due to the incurred opportunity costs. Abandoning governmental discretion in monetary (and fiscal) policy and thus giving up on its ability to generate pre-electoral booms (Blackburn and Christensen 1989: 30; Clark 2002b) and to accommodate different (sectoral) political pressures by means of inflation-financed government spending (Haggard and Kaufman 1992; 1995), the government of the day accepts to follow a rules-based policy path with a strict reputational constraint embodied in the exchange regime (Edwards 1995b: 303-304). In addition to these qualities, exchange rate pegs also fulfil the third condition that solutions to credibility problems have to satisfy: Exchange rate pegs are policy rules that exhibit an elevated level of transparency, that is a relatively high level of *"ease with which the public can verify and punish government misbehaviour with respect to an institutional commitment"* (Broz 2002: 172-173 also see Canavan and Tommasi 1997; Cottarelli and Giannini 1997). Information about exchange rate developments is more immediately available and accessible through a variety of low-cost information channels than, for instance, monetary data, which is usually time-lagged by seven to ten days and can be removed from general public view. Hence, changes in the exchange rate imply an easily detectable and low-cost indication for the government's failure to adhere to a certain constrained set of policies, which in turn may be punished by private actors (Collins 1996: 119; Shambaugh 2004: 284-285). In summary, and meeting growing acceptance in policymaking circles from the 1980s onwards, exchange rate pegs were perceived to be *credible* anchors signalling government commitment to price stability (Giavazzi and Pagano 1988; Giavazzi and Giovannini 1989; Canavan and Tommasi 1997).[11]

Critique of Institutionalist Theories of Credibility-Building

The institutionalist literature posits that exchange rate pegs present valuable

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[9] In the Southern Cone, 'soft' pegs had been used in the context of the 1970s neo-conservative policy failure. It was not until the early 1990s that nominal exchange rate anchors re-gained prominence (Bird and Helwege 1997: 37).

[10] 'Signalling' refers to the provision of new information about non-observable characteristics. Exchange rate pegs are understood to provide market actors with new information about the government's policy intentions.

[11] Hefeker (2000: 160-163) challenges proponents of exchange rate-based stabilisations to clarify *"what the usually cited 'political' costs should be and why they are higher than in the case of an internal money-stock growth rule"*.

institutional remedies to addressing inflationary dynamics originating in credibility deficits (Neut and Velasco 2004). Indeed, this assumption is fundamental to the policy trade-off between 'credibility vs. competitiveness', which the literature stipulates for exchange rate policymaking in emerging markets (Frieden and Stein 2001). This thesis suggests that this conceptualisation of exchange rate politics is open to two kinds of criticism: It is over-assuming with respect to institutional stability, and the mechanism by which credibility is generated remains underdetermined.

First, institutionalist theories of executive self-restraint – largely due to their origins in industrial economies – tend to assume that the executive expects this institutional instrument to endure so that short-term sacrifices in terms of policy discretion pay off mutually beneficial long-term gains. These assumptions, however, do not capture policymakers' reality in most emerging markets. Here, policymakers' time horizons tend to be short and they rarely expect institutions or 'the rules of the game' to last. Hence, this critique suggests that the motivations, which institutionalists highlight as driving the adoption of exchange rate pegs and other forms of commitment devices, do not correspond to the true determinants of regime choice. To the contrary, acknowledging how short policymakers' time horizons are and that their motivations for adopting an exchange rate peg may not consist primarily of the long-term payoffs but rather, as Murillo and Levitsky (2005: 277) put it, of a desire to *"maximise their short-term discretion and power,"* opens an interesting new perspective on the drivers of exchange regime choice. For instance, preliminary evidence from Argentina suggests that there is a temporal dissonance between the 'credibility dividend' from very hard pegs, which policymakers may reap in the short run, and the real constraints of such institutional commitments, which are only felt in the longer run. Furthermore, especially arguments for very hard pegs, such as currency boards and dollarisation, in terms of their credibility-generating characteristics may initially sound convincing. Yet, they presume that once such regime is in place, a country will adhere to it forever – an assumption that is, as Zarazaga (1995b: 6) puts it, *"as unrealistic and naïve as the belief that a wedding ring guarantees an everlasting marriage."*

Secondly, I do not dispute that exchange rate pegs (or other forms of 'hypercommitment') may generate greater *institutional credibility* in the short run. However, this takes place at the cost of governments' capacity to accommodate evolving politico-economic conditions and therefore provokes negative externalities in other policy areas. In a democratic setting, this may eventually undermine the stability of the economic framework itself – and therefore also its credibility (also Levitsky and Murillo 2005: 281). Hence, I contest the

mechanism by which 'credibility' is generated. Rather than being merely the result of a peg's anti-inflationary utility and its intrinsic characteristics as a 'commitment device', as institutionalists argue, I hold that exchange rate pegs' instrumental value in strengthening the government's policy credibility entails a much more political and complex set of dynamics, which is closely related to the government's ability to legislate and implement structural reforms demanded by influential economic actors. Indeed, as Wise (2000: 118) notes, *"credibility […] can be a moving target"*. In the longer run, credibility presupposes the preservation of discretionary space for policymakers in order to successfully contain evolving distributional struggles and prevent polarisation within the political system.

In this respect, exchange rate pegs understood exclusively as 'institutional solutions' simply transfer the credibility problem from the monetary to the exchange rate policy area – rather than solving it by addressing the underlying political tensions. This is also acknowledged by the IMF, which in its discussion of Argentina's quasi-currency board notes that *"there was strong support for the currency board but not for the other policies needed to make it work"* (IMF 2004c). This illustrates that in the absence of complementary measures aimed at strengthening the legitimacy of the wider economic agenda, exchange rate pegs are little more than transitional fixes at great potential cost. Hence, the ability of an exchange rate peg to generate long-term price stability and growth, rather than cycles of recurring 'boom and bust', in democratic or democratising societies will depend on a more encompassing form of credibility and crucially (democratic) legitimacy of the economic agenda, which institutional accounts invariably cannot accommodate nor conceptualise. Indeed, building credibility in democratic societies presupposes more than quick institutional fixes or declarations of commitment. It has to be *"earned the old-fashioned way (through monetary and fiscal restraint)"* (Andrews and Willett 1997: 493) and sustained throughout a *"messy, complex and time-consuming"* process that often thwarts rapid reforms but *"at least provides an imperfect and rudimentary form of political accountability"* (Cohen 1998: 66; Woods 2006: 82 + 183). It is only in contexts where exchange regimes receive widespread societal support that the political costs of abandoning the peg are sufficient to transform the peg into a disciplinary device.

The following section draws out the different implications for exchange rate policymaking of these two understandings of 'credibility'. While pegs may enhance the credibility of a country's economic agenda, the argument is that this does not happen for the reasons stipulated by institutionalists. Instead, it is due to the instrumental use of exchange rate pegs for politico-strategic purposes in the context of building reformist coalitions, i.e. by

generating *political credibility*, that overall policy credibility and politico-economic stability are strengthened.

Institutional vs. Political Credibility

Institutionalists' solutions to credibility deficits hint at their understanding of the sources of emerging markets' credibility deficit (e.g. Keohane and Milner 1996). Credibility problems are conceived of as rooted in weak institutional structures, i.e. in a policy environment that generates excessive incentives for policymakers to renounce on policy promises without imposing sufficient constraints on policymakers' freedom to do so. Changing the 'rules of the game', i.e. the institutional structure of an economy, in order to insulate decisionmakers from influences that encourage a policy reversal and to reduce policymakers' room for manoeuvre to act upon such external pressures thus seems to be an obvious solution (Broz 2002: 171-172). Supposedly, *institutional* credibility thus emanates from ideal-type institutions that ensure that economic policy is formulated within a rules-based framework that allows for little or no discretion. Advocating the depoliticisation of policymaking, this line of thought presents *"'politics' as a negative force in comparison with allegedly 'sensible' or 'sound' policies followed by 'non-political experts"* (Bowles and White 1994: 240). It overlooks the fact that *"the depoliticisation of economic policy-making is itself a political act"* (Bates 1999) – particularly in polities undergoing democratisation or democratic consolidation.

Institutions' credibility, in turn, is assumed to be revealed by the fact that economic actors (and particularly international investors) display a certain level of confidence by investing in the country in question. This assumption, however, fails to distinguish between 'credibility' and 'confidence', which are closely related, but not interchangeable. Greater confidence in a policy is rationally justified if the policy promise itself is deemed to be credible. Yet, it remains a leap of faith to assume that the inverse relationship also holds. Thus, increased international investment *per se* seems to be insufficient evidence for being able to conclude that the *ex ante* policy announcements were necessarily *worthy* of confidence or credible. Rather, echoing Grabel (2003: 41-42), I argue that the level of 'credibility' of e.g., an exchange rate-based stabilisation and reform programme is in actual fact 'generated' rather than revealed by investors' and multilateral agents' decision to invest in the country in question. Increased levels of capital inflows may temporarily dampen distributional conflict, thus lessening the need for inflationary financing. In some cases, capital inflows to countries undergoing reforms even have the effect of covering up the domestic actors' doubts with respect to government credibility and reform sustainability by compensating for the continued

flight of domestic capital (e.g., Aizenman 2005: 968). It is therefore problematic to interpret the successful attraction of foreign capital as 'revealing' credibility improvements given that inflows *per se* do very little, if anything, to address the root causes of discretionary politics.

This perspective suggests an alternative conceptualisation of policymakers' difficulties to credibly commit to a policy path. Ignoring the political embeddedness of institutional solutions (Acheson and Chant 1972; Granovetter 1992), institutionalists stop short of addressing the true sources of emerging markets' credibility deficit by limiting their analysis to institutions. Following this line of reasoning, economic institutions do not exist 'above' or 'outside' politics, but are embedded in *"a complex matrix of political forces which transcends the conventional divide between polity and economy"* (Bowles and White 1994: 240). By implication, *"institutions […] are not inherently credible"* (Grabel 2003: 41-42). Instead, they are understood to be able to 'generate' credibility if they enjoy sufficiently strong support and legitimacy in the wider polity. In other words, any institutional structure ultimately depends in its autonomy and effectiveness on a wider social consensus (Blackburn and Christensen 1989: 4; Velasco and Céspedes 1999: 25). Moving away from an exclusively institutionally determined understanding of 'credibility', Stasavage (2003: 3) proposes that *"democratic compromise [in the form of coalition-building] may provide commitment even in the absence of constitutional checks and balances."* This line of argument suggests that *only* under circumstances like these, that is against the background of a wider political consensus in favour of the institution in question, can the former in fact attain a level of credibility, which is more fundamental than the narrowly defined 'institutional credibility' (World Bank 2004: 48-49). This form of credibility will be referred to as 'political credibility'.

Applying this reasoning to exchange rate politics under a pegged exchange rate adopted for anti-inflationary purposes, the regime's 'political credibility' depends on the underlying consensus in favour of low inflation and structural reforms, which render the regime sustainable, and on the existence of relatively stable multi-issue support coalitions, which also bind anti-peg interests (Haggard and Kaufman 1992: 19-20; Amann and Baer 2000; Baer 2002; Stasavage 2003: 3). Paralleling Goodhart's (1995: 67; also Rodrik 2006) remarks on central bank independence, a peg will only retain credibility so long as it can maintain a broadly based political coalition in support. Moreover, the extent to which policies in one economic area are credible tends to be a function of the credibility of the overall macroeconomic policy program. Quick institutional fixes exclusive to one field of economic policymaking will thus constitute but an ineffective piecemeal effort to address the lack of trust in economic policies more generally. Indeed, as Blinder (1998: 65) points out, credibility

"is not normally created by incentive-compatible compensation schemes nor by rigid commitment" but rather *"it is painstakingly built by a history of matching deeds to words"*. By disregarding this reality, institutional accounts exhibit a naïve optimism when they propose hard pegs, currency board arrangements and dollarisation as remedies for countries with weak political and irresponsible fiscal institutions, only to acknowledge in the event of catastrophic failure that – *hélas* – the maintenance of such institutional solutions requires – and indeed presupposes – 'high-quality institutions and the rule of law' especially in fiscal policy and banking (Haggard and Kaufman 1992: 19-27; Velasco and Céspedes 1999: 18 + 27-29).

There are thus grounds for believing that the eagerness with which international advisors and academics advocated hard pegs in the 1990s springs from a deep-seated cynicism and scepticism about developing countries' ability to build institutions and govern them(selves) soundly under conditions of democracy. Whereas the mere act of delegating policymaking to technocrats at independent central banks seems to generate confidence in industrialised economies, this 'commitment device' on its own seems to be insufficient for winning their trust in emerging market, thus pushing policymakers to accept ever more constraining arrangements (see Velasco and Céspedes 1999: 26-27).

Furthermore, international actors' preference for institutional arrangements with which they are familiar has provoked a trend of mimicking institutional structures prominent in advanced industrial countries – sometimes referred to as 'institutions substitution' (Santiso 2003: 17). By repeatedly emphasising institutional means for achieving 'credibility', the institutionalist literature in its quest to solve emerging markets' credibility problem has pushed forward precisely this agenda of emulating 'OECD-style' institutions, which foreign investors recognise and trust: independent central banks, data publication standards (Mosley 2003a), accounting methods and so on. This approach, which assumes that *"idealised versions of Anglo-American institutions are optimal development instruments regardless of level of development or position in the global economy"* has been caricatured as 'institutional monocropping' (Evans 2002: 10). It reduces development to *"a process of organisational change"* rather than emphasising capital accumulation and differential environments (Hoff and Stiglitz 2001: 389; Rodrik 2007a). It seems that only after severe crises do international market actors realise that their trust in advanced industrialised nations derives from largely path-dependent circumstances. However, these political systems, which contain distributional conflicts by moderating competing claims within a reasonably transparent and, more importantly, predictable framework and institutions with much more subtle and indirect links to the economic sphere (e.g., the transparency of judicial procedures and party structures) cannot easily be recreated elsewhere.

2.3. Concluding Remarks

In sum, this chapter fulfilled three aims. It highlighted the distinct economic structural contexts within which exchange rate politics takes place in Latin American emerging markets and industrial democracies and described the particular constraints affecting Latin America in this regard, which are often disregarded in the existing literature. In particular, it showed that these contextual features have since the mid-to-late 1980s become increasingly framed by credibility considerations, which therefore have come to play a crucial role with respect to exchange regime choice. The chapter continued its critical engagement with the literature by pointing to institutionalists' problematic use of the concept of 'credibility' in analysing exchange rate choices. More importantly, it showed how this 'credibility prism' itself, by depicting exchange rate anchors as credibility-enhancing devices, affected policy choices insofar as it powerfully framed policymakers' understanding of the exchange rate dilemma in the 1990s. Having questioned the literature's reasoning on credibility-building, Chapter III proposes an alternative explanation for exchange rate pegs' credibility-enhancing characteristics by highlighting the executive's use of exchange rate policy for building pro-reformist coalitions.

C H A P T E R I I I

A CONCEPTUAL FRAMEWORK FOR EXCHANGE RATE POLITICS IN LATIN AMERICAN EMERGING MARKETS: EXPLAINING EXCHANGE RATE PETRIFICATION

3.1. Introductory Remarks

Having devoted my attention to Latin America's distinct features, this chapter proposes an explanatory framework for exchange rate politics. The assumption that underpins this model is that policymakers' exchange rate decisions are not fully determined by the economic structural context; the choice among 'economically feasible' exchange rate options remains an interpretive act driven by strategic political calculations (Kirshner 2003b: 262-264; Cardoso 2006b: 384). The framework thus combines insights from the literature with the original notion of governments' using exchange rate policy for distinctly strategic political purposes, especially for fostering structural reforms. In particular, I make the case that exchange rate commitments facilitate the building of reformist coalitions and hence generate democratic consensus in favour of ambitious reform agendas, which are consequently perceived as credible and sustainable. Addressing the guiding research question, I argue that coalition-building motivations with respect to structural reforms complement and sometimes even supersede the explanatory drivers proposed by the literature, such as electoral opportunism and short-term disinflationary efforts. Moreover, emphasising the importance of evaluating the entire lifecycle of an exchange arrangement, this coalition-building argument does not only capture the initial exchange regime choice but also sheds light on the puzzle of exchange rate petrification: It argues that governments – or decisive actors within the executive – delay exit because they are reluctant to surrender this powerful disciplining instrument and risk reform reversal.

This alternative explanatory model centres on the role of strategic interaction between the executive and societal interests in driving exchange rate choices. In doing so, the analysis synthesises insights from rationalist institutionalist readings (especially Bernhard and Leblang 1999; 2002; Stasavage 2003), which are at the forefront of the research agenda on the political

economy of exchange rate policy, and rationalist interest group approaches, which dominate the exchange rate policy literature on Latin America (e.g., Wise and Roett 2000; Frieden and Stein 2001). Additionally, this framework allocates a role to international factors – especially the IMF – in shaping executive exchange rate choices, an aspect commonly disregarded in the literature. In short, this analysis seeks to answer Jameson's (2002: 127) call for the integration of domestic political demands, international pressures and executive motivations in order to capture the complexity of exchange regime choice in Latin America.

The chapter starts out by reiterating the centrality of the executive in section 3.2.. Complementing a conceptualisation of policymakers' exchange rate preferences as exclusively driven by political survival objectives, the instrumental use of exchange rate policy with a view to structural reform ambitions is introduced. Similarly, emphasis is put on the role of executive decisionmakers and on the nature of intra-executive relationships between the presidency, relevant cabinet members and technocrats as well as relations to other state actors, such as the legislative. Employing this more encompassing conceptualisation of executive behaviour, section 3.3. outlines exchange rate policy's instrumental attributes with regards to coalition-building processes. It is this coalition-building aspect of exchange rate pegs that enhances 'political credibility' but also harbours the risk of a petrification in the exchange rate stance. Section 3.4. weaves into this analysis the role of external agents, especially with respect to fuelling exchange rate petrification by exerting pressure in favour of structural reforms, intellectually supporting governments' exchange rate strategies and rubber-stamping their decisions vis-à-vis markets. Section 3.5. concludes.

3.2. The Executive in Exchange Rate Politics: Opening the 'Black Box' of Executive Motivations

This thesis shares its starting point with institutionalists insofar as it examines the political implications of a particular exchange rate regime for the government of the day and directs its primary analytical spotlight at executive policymakers at the procedural core of exchange rate decisionmaking (e.g., Bernhard and Leblang 1999; 2002; 2002b; Clark 2002a). The executive's centrality stems from the fact that in most countries an exchange regime's adoption and abandonment flows from a decision by the head of government,[1] usually in consultation with relevant cabinet members. Strictly speaking, the executive therefore does not confront any

[1] Given this thesis' focus on two presidential systems and for reasons of simplicity, I will hitherto refer to the 'head of government' as president.

formal veto players (Tsebelis 2002).[2] Yet, contrary to institutionalists who regard executive behaviour as largely pre-determined by institutional constraints and electoral pressures, I emphasise the role of political entrepreneurship, i.e. policymakers' ability to *"change the direction and flow of politics"* (Schneider and Teske 1992: 737). Opportunities for political entrepreneurship are opened up by the government's unrivalled agenda-setting power, its privileged but notably not autonomous position between the international and domestic arenas, and its role as a mediator between domestic socio-political actors (Haggard and Kaufman 1992: 18; Leblang 1999: 603).

This understanding of executive policymakers as political actors, who maintain a considerable degree of autonomy in this field and whose behaviour is shaped but not determined by societal or institutional factors, moves beyond the 'new institutionalism' (Callaghy 1989; Evans 1992). It accepts that *"institutions influence both the capacity of the government to act and the range of societal interests that are represented"* (Haggard and Kaufman 1992: 18) and that institutions *"provide the base from which individuals operate to effect outcomes in politics and economics"* (Thies 2004: 598) but refrains from reifying institutional constraints or granting them distinct explanatory power. Institutions thus matter only insofar as policymakers regard them as constraints.[3]

By locating executive policymakers at the centre of my analysis and acknowledging the government's privileged position in the exchange rate policymaking process, and its 'embedded autonomy' vis-à-vis societal interests (Evans 1992: 165), I also distance myself from traditional interest-group approaches (e.g., Frieden 1994; 1997; Schamis 1999: 243; 2000; Frieden and Stein 2001; Pascó-Font and Ghezzi 2001; 2002). Yet, unlike the other extreme, i.e. 'state autonomy' approaches (e.g., Przeworski 1991; Nelson 1994; Simmons 1994; Remmer 1998), this framework grants societal actors a significant, albeit indirect, explanatory importance. First, the executive is conceived of as continuously interacting with societal agents and strongly involved in organising and disorganising them (Murillo 2001; Schneider 2004: 5-15; Acuña, et al. 2006). Secondly, these groupings – as voters but also e.g., as providers of scarce hard currency – significantly constrain the executive's ability to maintain an exchange regime. Additionally, recurrent encounters inform policymakers' interpretation of politico-economic reality and policy trade-offs, enhance their awareness of the implications of policy choices and therefore impinge on executive preferences and affect decisions.

Executive policymakers thus exist as relatively autonomous actors embedded in a

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[2] The case of the Argentine Convertibility Regime between 1991 and 2002 represents an exception given that the decision to exit from the regime was formally removed from the executive and located with Congress, therefore creating a veto player.

[3] This chimes with Levitsky and Murillo's (2005) criticism of the literature's focus on formal institutions.

strategic environment shaped primarily by domestic actors and institutions. Yet, especially since the onset of structural change, or 'globalisation', and the tightening of international economic relations and growing capital mobility, this environment is also increasingly affected by international factors, be it in the form of new economic paradigms that introduce new theoretical prisms to exchange rate policy choice, of international market pressure and threats of capital flight or of actions on the part of third countries or international (financial) institutions. The next sub-sections investigate these dimensions of the executive's strategic environment and their consequences for governmental motivations.

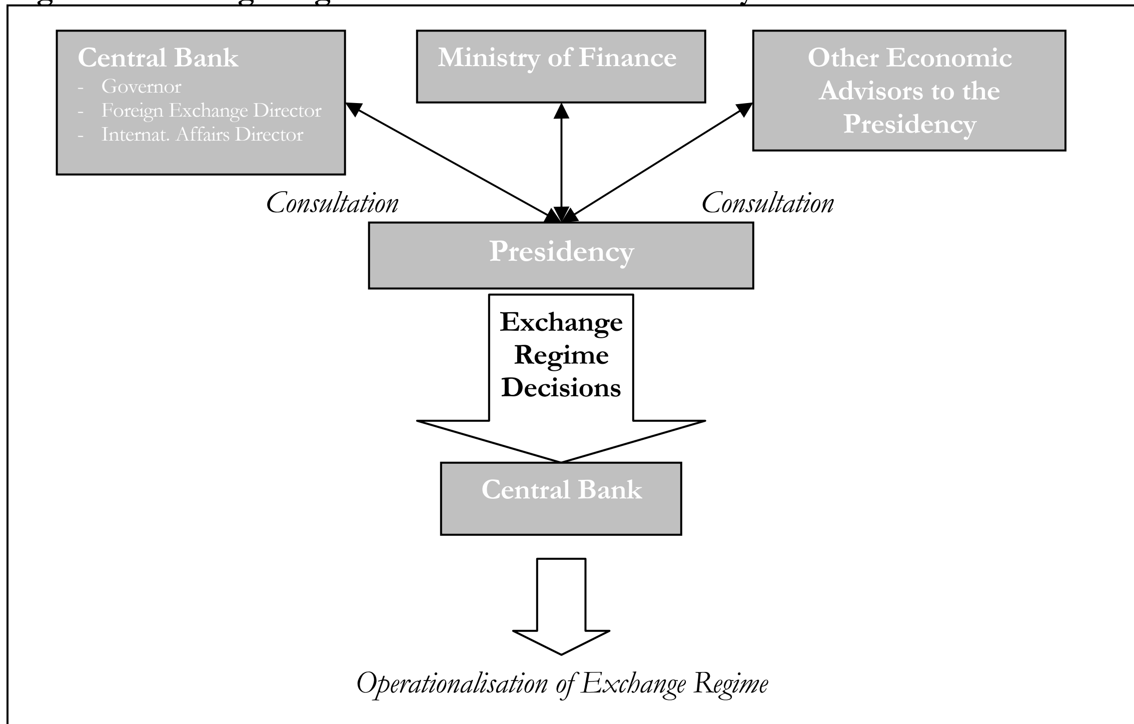
3.2.1 Intra-Executive Relationships

First, I seek to elucidate relationships *within* the executive. Although institutionalists focus on executive factors, they concentrate on degrees of executive insulation in explaining exchange rate outcomes and have – at great cost – refrained from opening the 'black box' of actual exchange rate decisionmaking within the executive. Indeed, especially in a highly technical field such as exchange rate policy, characterised by the joint involvement of such diverse actors as ministerial and central bank technocrats, economic advisors and non-expert policymakers, decisionmaking hierarchies and procedures within the relevant branches of the executive do not only shape policymakers' understanding of economic reality but also determine the timing, nature and outcome of policy decisions (**Figure 4**).

From a formal-constitutional perspective, in most countries – including Argentina and Brazil – the presidency can adopt and abandon exchange rate regimes in absolute discretion.[4] Yet, in practice, presidential exchange rate initiatives rely on information, expertise and advice provided by the president's key interlocutors in this field, namely the ministers and civil servants at the Finance Ministry and at the central bank. Indeed, rather than developing independent exchange rate policy positions, presidents merely select from, and at most suggest amendments to, pre-packaged policy options prepared by their so-called 'economic teams'. In short, exchange regime choice presupposes presidential assent to a policy stance, which itself is a product of input from and intense negotiations among economic experts at the central bank and the Finance Ministry.

[4] In such single veto player environments commitment remains low. The veto player literature argues that commitment and therefore policy credibility and economic performance can be enhanced by introducing additional veto players (North and Weingast 1989). Yet, in exchange rate policy the presence of multiple veto players represents a double-edged sword as Argentina's experience illustrates: Although its currency board's credibility and investor and consumer confidence were much strengthened by granting veto powers to Congress, Argentina's experience of exchange rate petrification also shows that a *"high level of commitment is another way for saying inability for political response"* (Tsebelis 2002: 204; also MacIntyre 2001).

Figure 4: Exchange Regime Choice: Intra-Executive Dynamics



The Relationship between Politicians and Technocrats

This relationship between elected politicians and technocrats[5] and especially the rapport between the president and his 'economic team', as well as the make-up and the intellectual-ideological convictions of this group of economic experts are crucial for understanding the dynamics that govern exchange rate policymaking. This intra-executive focus chimes with an extensive literature on technocrats' particular impact on economic policy outcomes (e.g., Collier 1979; Palermo 1990: 364; Haggard and Kaufman 1995; Dominguez 1997; Corrales 2004). Observing the growing technocratisation of public policy, this literature emphasises the interplay of these two distinct groups of executive actors. Contrasting politicians' responsiveness to particular constituencies and electoral timetables with technocrats' relative insulation and highlighting technocrats' specialist expertise and rational long-term vision, this research agenda emphasises the dynamic nature of the rapport between technocrats and their political superiors (e.g., Haggard and Kaufman 1995; Williams 2002). Whilst politicians lead, delegate and protect their economic experts from political pressures, technocrats possess considerable agenda-setting power thanks to their role in designing and implementing exchange policy strategies. These unelected executive agents may thus become what Dominguez (1997: 44) has referred to as 'technopols', that is policymakers

[5] Technocrats are *"individuals with a high level of specialised academic training which serves as a principal criterion on the basis of which they are selected to occupy key decisionmaking or advisory roles in large, complex organisations – both public and private"* (Collier 1979: 403).

who combine a technocratic background with a politician's understanding of the need and the ability to develop alliances and political support. Technocrats thus are potentially decisive political agents driven by interests and convictions that overlap but are not necessarily congruent with those of their political superiors.

This perspective sheds light on a potential source of conflict in exchange rate policymaking, which institutionalists fail to acknowledge, namely intra-executive tensions between economic team members and policymakers, including the presidency. This relationship is marked by a complex interplay between actors' interdependencies in a hierarchical setting. Technocrats' specialist expertise, their connections to other influential experts worldwide (Woods 2006: 66) and their central role in designing policy proposals turn them into potentially decisive political actors (e.g., Grindle and Thomas 1991). Moreover, they are delegated the day-to-day management of the exchange regime and thus interpret and implement the policy guidelines approved by the presidency at varying degrees of autonomy. This process-generated autonomy – combined with politicians' fear of destabilising the market and undermining policy credibility by challenging the appointed experts – grants technopols considerable leverage. Yet, in the medium and long run, elected policymakers prevail and, as aforementioned, face no formal veto players in this field (also Teichman 1997; Tsebelis 2002). In addition, the presidency controls technocrats' appointment and carefully selects experts' institutional status and hence influence within the ministerial hierarchy – and it will remove the expert(s) if deemed (politically) desirable.

Hence, the experts' influence remains, first, strongly conditioned by their position in the institutional matrix, as determined by their political superiors, and dependent on the sustained support of their political superiors (Bates and Krueger 1993). Secondly, technocrats' weight in determining policy solutions is shaped by the nature of their personal ties to the country's political class and by the political relevance of their professional networks. Especially connections to IFIs may enhance technocrats' autonomy vis-à-vis executive actors, as section 3.4. shows. Thirdly, the degree of personal and professional cohesion within an 'economic team' and the team's degree of institutional unity affects its members' policy influence. Indeed, politicians might exploit the team's vulnerability to politically or ideologically-motivated internal conflicts or disperse team members across executive institutions to limit their ability to act coherently and thus reduce their political influence.

Intra-Executive Relationships: The Finance Ministry and the Central Bank

Technocrats' location within the institutional matrix conditions their rapport to

executive politicians. As **Figure 4** illustrated, the relationship between the presidency and the Finance Ministry and the central bank is of particular importance with respect to shaping executive motivations in exchange regime choice.[6] In principle, this relationship is highly hierarchical: It is dominated by the presidency that is able to simply replace the minister and/or the central bank governor with more loyal representatives in case of disagreements.[7]

However, the first-best option for any president is a consensual rather than a confrontational policy solution, reached on the basis of continuous negotiations with and supported by officials at the Finance Ministry and at the central bank. Indeed, confrontation in the form of (public) disagreements and, at the extreme, removals is by no means costless. The replacement of these highly-respected officials and the overriding of their advice are likely to entail reputational damage and may incite financial market turbulences and reprovals from IFIs. In some cases, a loss of investor confidence may be minimised by nominating a personality equally (or even more) respected by market actors. Yet, even with an ideal replacement, some delay and therefore uncertainty and speculation are unavoidable. Worse, internal conflicts made public may undermine the sustainability of the new exchange regime from the outset.[8] Thus, even the institutionally subordinate Finance minister and the directorate of a *dependent* central bank command significant influence over exchange rate decisions thanks to their technical expertise and unique standing vis-à-vis financial markets.

Under central bank *independence,* this influence is further accentuated but not fundamentally different. Indeed, although central bank reforms have traditionally entailed operational independence in monetary policy matters, even the German Bundesbank, the archetype of an independent central bank, has in its days been circumscribed in its exchange rate policy operations by the federal government's guidelines. Thus, although the potential for disruption is considerably higher if exchange rate policy disagreements emerge between the executive and an independent central bank, central banks usually struggle to act as formal Tsebelian veto players in exchange rate policy, i.e. they cannot derail or implement policy when acting alone even when formally independent. Overall, their role is better captured by Armijo Elliot's 'policy player' concept (2004: 16-17): Policy players are in a position to shape the policy process and are consulted about prospective policy shifts. As members of broader coalitions, they are capable of imposing substantial costs on executive policymakers, which

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[6] In exceptional cases, the Planning Ministry may also play a part in the policy-making process. However, especially since the 1980s, economic policy functions have been centralised in the Finance Ministries – especially in Argentina and Brazil.

[7] While the Finance minister and the governor are both subordinate to the presidency, the Finance minister benefits from relatively greater political influence thanks to his privileged role as a cabinet member and main responsible for the wider economic policy agenda. In many cases, the central bank is also institutionally subordinated to the Finance Ministry.

[8] Taking the Brazilian case, this is why there has only been one *formal* removal of a BCB Governor since 1994 (i.e. Fraga's replacement with Meirelles in 2003). Officially, all other personnel changes were 'resignations' (Interview Arida).

may eventually entail policy revision. Strictly speaking, no traditional *veto* players are thus involved in exchange regime choice. However, several *policy* players, such as officials at the central bank, have a crucial input into decisionmaking.

The context of exchange rate policymaking with respect to the *maintenance* of a chosen regime markedly differs from that of *regime choice*. This is because regime maintenance is highly interdependent with other veto player-rich policy fields, such as fiscal policy. Indeed, whilst the decision to adopt/abandon a regime ultimately lies in the hands of the presidency, the successful maintenance of a particular exchange regime presupposes the acquiescence, if not assent, of several actors with varying degrees of obstructive potential. Especially an exchange rate peg is strongly conditioned by the executive's ability to push through e.g., fiscal reforms and to maintain an adequate central bank stance. In addition to a cooperating central bank, the government therefore relies on the cooperation of non-executive state actors, such as the legislative, and on the acquiescence of non-state actors, including business interests and labour unions, to uphold the chosen regime.

Relationships to Non-Executive State Actors: The Legislative

Given that the successful maintenance of an exchange regime is dependent on, among other things, a consistent fiscal policy, the executive especially relies on the cooperation of the legislative in passing adequate budgets and subscribing to a policy course that maintains the regime's credibility (e.g., to avoid large sales of a country's currency). This insight has motivated some proponents of the veto player approach to conceive of governmental exchange regime choice as the product of an *ex ante* estimate of the difficulties they may encounter in maintaining the regime once adopted (e.g., Simmons 1994; Hallerberg 2002; Keefer and Stasavage 2002).

This line of thought, together with the 'policy player' concept, allows us to conceptualise those institutional actors, which have veto player status in these related policy areas, in terms of being 'policy players' vis-à-vis exchange rate policy. Indeed, the legislative can obstruct the executive's exchange rate political course and significantly raise the costs of maintaining, for instance, a peg. Yet, ultimately, it is the executive's (un)willingness to bear the politico-economic consequences of such (legislative) opposition that determines the final policy outcome. Frieden (1997) reminds us that even under an inconsistent fiscal regime, governments can, in the short run, always rely on monetary instruments by, for instance, unilaterally raising interest rates so as to reverse pressures on the currency. Yet, in practice, such government *"would soon cease to hold office"* (Frieden 1997: 82).

Relationships to Other Policy Players: Societal Interests

Similarly, executive actors – especially in societies undergoing democratic deepening – are acutely aware of the disruptive potential of organised societal actors, which operate outside state institutions (Levitsky and Murillo 2005).[9] The channels through which these actors, especially labour unions and business interests, express their opposition and affect governmental decisionmaking are multiple. In addition to their ability to mobilise street protests and strikes, some groups can activate close historical ties to political parties and thus also exert pressure via legislative institutions. Moreover, business actors control essential resources, such as foreign exchange earnings and decisive patronage, which grants them non-negligeable leverage over governmental actors. Other politically relevant resources wielded by these non-state policy players include funds for campaign finance and especially business' ability to generate credibility with foreign investors (Acuña, et al. 2006).

The executive and the economic team at its core therefore confront a complex landscape of policy players of different strengths and disruptive potentials within and beyond state institutions, which they have to carefully manage in order to maintain political support and hence office. Bringing these two levels of political interaction – intra-executive relationships and dealings with various policy (and possibly even veto) players – together, the preliminary hypothesis here is that the executive's decision to adopt an exchange regime will depend on its perception of the constellation of these actors, whom it will have to confront in other policy areas in order to render the regime sustainable.

More importantly, the executive led by the economic team may comprehend exchange rate policy – and especially exchange rate pegs – as a means *per se* for more effectively managing this complex political setting. Indeed, turning the logic of the preceding sections on its head, governmental emphasis on an exchange rate peg's demanding economic policy requirements (e.g., a prudent fiscal policy, the liberalisation of capital accounts and labour markets to enhance the markets' ability to adjust to shocks without exchange rate adjustment) may persuade legislators and societal interests alike to join the executive in pushing for a reformist policy agenda so to prolong the disinflationary discipline imposed by the regime. In short, exchange rate discipline may itself be understood as a powerful instrument for facilitating the implementation of a wide range of structural reforms.

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[9] Tsebelis (2002: 35-36) himself focuses on institutional and partisan veto players but allows for the possibility that the army, the bureaucracy, societal interests and even foreign actors also be considered.

3.2.2 Strategic Considerations and the Structural Reform Agenda

Before outlining these reformist motivations and their repercussions for exchange rate policy, let me briefly recap the literature's two sets of exchange rate policy incentives in emerging markets. First, as sections 1.3.1 and 2.2.2 argued, the desire to establish credibility and to signal government commitment to price stability are important drivers of exchange regime choice (e.g., Leblang 1999; Frieden and Stein 2001; Broz 2002; Santiso 2003). Given persistent inflationary pressures and the government's desire to distance itself from past policy performances, exchange rate pegs are of particular appeal given their strong reputational impact, which generates market confidence, mediates inflationary expectations and thus rapidly reduces inflation.

A secondary set of motivations relates to governments' electoral opportunism and the timing of exchange rate decisions so as to maximise electoral support (e.g., Clark 2002a; Schamis and Way 2003). This modified political business cycle argument points to a peg's tendency to fuel a consumption boom in inflationary settings (via an appreciation of the real exchange rate and a fall in the real interest rate). Unlike credibility accounts, this latter reading does not exclusively focus on the *adoption* of an exchange regime but also addresses the political dynamic throughout its lifecycle. These accounts acknowledge policymakers' complex and often contradictory incentives given that pegs' short-term politico-economic advantages coexist with an awareness of, first, the inherent risks of exchange rate-based stabilisations, such as balance of payments crises, and secondly the politically costly steps necessary for rendering such rigid regime sustainable in the long run. Schamis and Way (2003) focus on policymakers' rationale for adopting exchange rate pegs despite these known risks. Yet, they remain silent on the phenomenon of exchange rate petrification and fail to explain why governments (and indeed the wider society) continue to support a rigid exchange arrangement once its economic appropriateness has waned.

One reason why these accounts fail to fully capture exchange rate political decisions is their narrow understanding of executive preferences, which are limited to political survival considerations shaped by the domestic electoral cycle. Against the background of this chapter's more encompassing understanding of the role and composition of the executive, an additional, complementary set of executive motivations is introduced. According to this reasoning, executive decisions are also driven by reformist ambitions. In times of globalisation where pressures on emerging market governments in Latin America and beyond emanate from their domestic constituencies as well as from international financial markets and their relations with IFIs and third countries, governmental politicians have developed an acute

interest in being seen to advance structural reforms, be it as a result of intrinsic ideological convictions, pragmatic considerations about their medium and longterm hold on political power, efforts on the part of reform-minded technocrats or in response to outright pressure by international creditors. Democratic governments are thus aware of having not only to construct electoral coalitions but also to manage and ensure the political cohesion of wider governmental coalitions so as to legislate and successfully implement reform measures in areas ranging from privatisation and deregulation to commercial reforms and financial liberalisation.

One political instrument with which executive agents may attempt to generate such wider political reform support is exchange rate policy and especially the policy discipline imposed by an exchange rate peg. The argument holds that policymakers – often on advice from influential technocrats – understand exchange rate pegs as ideal 'disciplinary devices' for complex and often anti-reformist political systems. They believe that the very fact that

> [t]he peg would only survive if and only if you adopt the so-called structural reforms, and the broad coalition of well-disposed interests [towards maintaining the peg] due to stabilisation would help you to move forward with the implementation of the structural reforms. So, the argument goes, pegging the exchange rate would create a *de facto* situation which would force the political system to move forward (Interview Arida).

In the short run, fear of losing the benefits of disinflation and other financial losses associated with a devaluation after a successful exchange rate-based stabilisation may propel the political system to pass reform legislation and persuade societal actors to be acquiescent if not outright supportive towards the reforms. Exchange rate discipline and the heightened exposure to external shocks under a fixed exchange rate may also allow the executive to overcome political complacency once a first round of reforms has successfully been implemented (Naim 1994; Pastor and Wise 1999; Wise 2000; Nava and Velasco 2003).[10] Indeed, examples abound where governments constructed these recurring crises and pressure on the exchange rate regime so as to 'scare' political and societal actors into accepting wide-ranging 'emergency packages' and new rounds of reforms. The political appeal of using the rhetoric of essential reforms so as to maintain market confidence and ensure the peg's survival is considerable in the eyes of policymakers and especially technocrats. By using a policy area that is largely

[10] Argentina and Brazil displayed such complacency when the scope and speed of the 'second generation reforms' were reduced in the mid-1990s.

beyond the influence of societal interests and traditional political actors as a proverbial 'thumbscrew', technocrats and executive policymakers possess a policy instrument that – at least in the short and medium run – enhances their reformist influence and allows them to manage and maintain reformist coalitions. The next section introduces the key element of this argumentative framework, namely a novel perspective on policymakers' choice of exchange rate pegs with a view to building such wider reformist coalitions. This approach synthesizes the importance of societal pressure groups and the centrality of government actors in exchange rate politics and thus offers a new take on the concept of 'policy credibility'.

3.3. Coalition Building and Exchange Rate Policy Choices

The political game can be seen as one of coalition-making.
Di Tella (2001: 48)

Contrary to the trade policy literature (e.g., Schattschneider 1935; Rogowski 1989), research into coalitions in the context of exchange rate regimes, their constitutive elements and internal dynamics has amounted to little more than parenthetic comment. Thus, while the relationship between exchange regimes and the associated cleavages between different real economic interests is well-researched (e.g., Frieden 2000; 2002), very little and often disjointed analysis of the interactions among different interest groups and the way in which their policy preferences are ultimately translated into public policy is currently available. Except for Maxfield (1990) and Bearce (2003; 2007), there has not been any attempt to integrate government behaviour into this coalitional analysis. Encouraged to engage in an analysis of coalition-building and management in exchange rate policy matters by trade policy research (e.g., Hiscox 2001; 2002; Lusztig 2004), I also take my cue on the importance of coalitions for strategic interaction among state and societal actors in emerging market contexts from numerous works on economic reforms in Latin America (Maxfield 1990; Gibson 1997; Schamis 1999; Diniz 2000; Etchemendy 2001; Murillo 2001; Schamis and Way 2001; 2002a; 2003) and from Bates' work on Africa (e.g. 1981; 1997).

3.3.1 Coalitions and Coalition-Building in Comparative Political Economy

Coalitions are sets of individuals with shared policy preferences that are expressed in some form of political activity aimed at influencing public policy, such as electoral voting, traditional lobbying, public protest or indeed the threat to engage in any of these activities. As

Hiscox (2002: 35) points out, in democratic systems the primary channels for influencing public policy are political parties, (peak) business associations, labour unions and lobbying groups. Coalitions have traditionally been conceived of as resulting from a particular constellation of electoral and policymaking institutions, such as the width of the franchise (e.g., Duverger 1954; Alt and Gilligen 1994). In contrast, Hiscox' work on trade policy (2001; 2002: 6-11) suggests that while such variables explain some of the evidence for changing coalitional patterns, it is ultimately economic structural forces, notably factor mobility, that shape societal cleavages and therefore coalitions.

Table 8: Forms of Coalitions

Electoral Coalitions	Voters who unite behind a party or candidate
Legislative Coalitions	Legislators who unite behind a programme, policy or candidate
Governing Coalitions	Societal actors (especially business representatives and unions) who unite behind a programme or policy
Distributional Coalitions	Societal actors united in the struggle over the allocation of wealth and income, often in the context of rent-seeking

Coalitions: Party-Political vs. Societal Coalitions

In spite of these disagreements, these studies share a focus on *party-political* coalitions, such as electoral pacts or legislative coalitions. Yet, it appears unnecessarily restrictive to conceptualise the process of hammering out a coalition for economic policy changes without reference to the influence and preferences of at least some societal actors above and beyond the party system and the state apparatus. This is particularly the case given that much of the literature on Latin America has emphasised the extent to which national political systems are best characterised as games with shifting rules, including formally specified procedures *and* informal behavioural norms, which are shaped by actors including the representatives of important socio-economic groups as well as other corporate interests, including the military and the church (e.g. Chalmers 1977; Wynia 1990; Di Tella 2001; Levitsky and Murillo 2005).

Such more inclusive approach to coalitions is at the centre of the so-called 'market-oriented reforms' literature. Here, broader societal coalitions that support government policy, termed 'governing coalitions' by Kingstone, have gained growing importance as explanatory variables for the nature of reform processes. Kingstone (1999: xxi) derived this term from the Brazilian context where he juxtaposes 'governing coalitions' to both 'electoral coalitions', that is *"networks of disparate voters who unite politically behind a party or candidate"*, and 'legislative coalitions' understood to be *"legislators uniting behind a programme or policy"*. Governing coalitions do not only contribute to the incumbent government's successful policy initiative and implementation and therefore indirectly to its electoral success, but they may also be

sufficiently broad in terms of numerical strength to ensure the incumbents' re-election.

Governments Constructing Coalitions

Maxfield (1990; 1991), Etchemendy (2001; 2003; 2005), Treisman (2004) and Schamis (1999; 2002a; 2002b) have deliberately employed the terms *building* or *constructing* as well as *maintaining* or *managing* coalitions, illustrating the change in emphasis from a purely societal-driven process of coalition formation among 'naturally aligned' interests *à la* Hiscox to one that emphasises the pro-active role of the government and statesmanship in the process of building wider coalitions and therefore ensuring governability (Sola and Kugelmas 2006: 88-89). Similarly, Bates illustrates how African governments use the market as *"an instrument of political control"* that generates political resources, which are then distributed *"to build organised support for the political elites and the policies they propound"* (1981: 6-7 + 121). Others emphasise that governments *"manipulate the level of available rents"* and *"can also alter the incentive structures for those within the producer population"* (Lusztig 2004: 10). Thus, in contrast to the models put forward by Hiscox (2001; 2002) or Frieden (1991b; 2000; 2002), Lusztig argues that one cannot conclusively predict the nature of coalitions based exclusively on structural parameters. Instead, the constellation of coalitions and their respective characteristics are determined by governmental strategies. State actors are thus seen to be in a position from which they can organise and disorganise societal coalitions (Schneider 2004) and set the agenda to which interest groups then respond (Woods 2006: 80). Pointing to this complex relationship between policymakers and societal interest groups and allowing for the occurrence of 'reverse lobbying' (Shaiko 1998), as well as the granting of privileged access to otherwise institutionally relatively insulated technocrats and compensatory deals (Etchemendy 2005), policymakers are understood to intervene in the process of coalition formation by employing a variety of instruments at their disposal.

Coalitions and Exchange Rate Policy

The role exchange rate policy plays in this process of coalition formation has not yet been assessed. Indeed, when the 'economic reform' literature itself addresses exchange rate politics, it presupposes a particular exchange rate arrangement and then investigates *ex post* coalition-building, that is the deliberate government-led construction of a coalition supporting the adopted regime via a variety of compensation payments and pay-off deals (Etchemendy 2001; 2003). This approach sheds light on only two of three kinds of exchange rate decisions. It explicitly suggests an interesting dynamic characterising government behaviour aiming at

maintaining an exchange rate peg – and therefore exchange rate petrification and policy inertia – and it implicitly points out that in the absence of such compensatory arrangements and of determined government efforts to manage a support coalition backing the peg (or when indeed such efforts become too costly), the *abandonment* of the peg is very likely. In these two respects, Etchemendy's line of thought suggests an interesting take on the *political* requirements for sustaining exchange rate pegs over time, which exceed the mere economic prerequisites for maintaining a fixed regime. Yet, these readings fail to problematise the *adoption* of the exchange regime. Where do exchange rate pegs fit into the coalition-building rationale, and how do pegs – as one kind of policy instrument in the process of coalition-building – affect the different actors involved? Under which circumstances do governments find the adoption of a peg beneficial with a view to their coalitional objectives? Which executive players are particularly likely to pursue this strategy, and what determines their success in superimposing this logic onto the official exchange rate policy agenda?

3.3.2 Executive Entrepreneurship: Using Exchange Rate Policy for Coalition-Building

Exchange rate pegs arguably exhibit several characteristics of interest to policymakers and politically astute technocrats concerned with building coalitions in favour of structural reforms: They are useful for converting an electoral coalition into an effective governing coalition supportive of liberalising economic policies (Malloy and Conaghan 1994; Sola and Kugelmas 2006: 88). To show how, I will expand on Bernhard and Leblang's (1999; 2002) account that links pegs to party-coalitional dynamics. The argument is that policymakers view pegs as valuable political instruments for the construction and maintenance of 'governing coalitions' in circumstances of legislating and implementing structural reforms due to five interrelated characteristics. First, an exchange rate commitment provides members of a coalition with a standard for assessing the executive's macroeconomic policy performance, thus addressing the problem of asymmetric information between the executive and other coalitional actors (Herrendorf 1999: 33; Keefer and Stasavage 2002: 760). The inherent transparency of exchange rate pegs and the public's ability to monitor this commitment and (if necessary) to punish failure to abide by it, play a crucial role in this conceptualisation (Bernhard and Leblang 1999: 76; Broz 2002). Committing to an exchange rate peg builds trust among members of the governing coalition as it provides a baseline against which the executive's macroeconomic policy choices can be judged and against which the latter can be held accountable. Hence, it provides a formidable source of information about the degree to

which policy intentions and promises, on the basis of which actors joined the governing coalition in the first place, are kept to. It thus increases policy predictability (Sachs 1996: 149).

Secondly, an exchange rate peg, to some extent, also determines the economic policy *content* in that it limits the range of policy paths consistent with a peg. As insights drawn from the Mundell-Fleming model illustrate, the maintenance of an exchange rate peg under conditions of relatively high levels of capital mobility forces governments to stick to a rather constrained, rules-based policy path and thus radically reduces governmental discretion (Mundell 1960; Fleming 1962). An exchange rate commitment thus frames and cements agreement on a certain economic policy agenda. Arguably, this reflects a common denominator on the basis of which coalition members are willing to cooperate. Consequently, conflicts among sections of the coalition in the fields of monetary and – to an extent – fiscal policy are depoliticised or even taken off the agenda. The adoption of a peg thus reduces the likelihood of the (re-)surfacing of politically destructive conflicts in these fields within the governing coalition. This aspect is of particular importance if, as is often the case in the context of neoliberal reforms, the relevant governing coalition relies on cooperation among interests such as labour and industrial interests, which have historically been confronting one another in distributional struggles with (hyper-)inflationary consequences. Given the well-known costs of the collapse of the peg, the costs of not abiding by these constraints by implementing policies that e.g., undermine the government's fiscal control, are heightened, presenting the government with an, albeit risky, opportunity for 'bullying' legislators into passing reforms.

Thirdly, exchange rate commitments can also be employed for justification purposes for the legislation and implementation of otherwise politically difficult policy initiatives, such as budget cuts or interest rate hikes. While authors such as Bernhard and Leblang (2002) and Oatley (1997: 42-43) primarily refer to this role in the context of monetary integration in Europe, this function is of even greater benefit to policymakers in the aftermath of exchange rate-based stabilisation in countries with (hyper-)inflationary track records. The widespread fear of re-emerging inflationary pressures, in conjunction with the (perceived) stability benefits for society as a whole, legitimises an exchange rate peg's maintenance at the expense of other politico-economic considerations. Indeed, its use as a justification and legitimation instrument feeds back into the depoliticisation argument above. In contexts where the common interest in price stability seemingly prevails over particular interests and where a fixed exchange rate regime enjoys a heightened level of political legitimacy, exchange rate and monetary policy choices become inherently depoliticised to the extent of becoming a political

taboo, pushing conflicts of interest within the governing coalition into other policy areas where, ideally, compromises in line with the exchange rate peg must be found.

From policymakers' point of view, this third characteristic implies that in post-stabilisation contexts they can create political leverage in favour of pushing through further structural reforms by means of appealing to the requirements of and the constraints imposed by the exchange rate peg and to the losses that would follow from its abandonment in terms of, for instance, the return of inflation and the bankruptcy of the domestic banking system. Hence, labour reform is put on the agenda based on the argument that the labour market needs to become more flexible to allow the economy to accommodate the rigidities of the peg; enterprises are squeezed through trade liberalisation and exchange rate-related competitive pressures so to engage in productivity-increasing measures rather than rely on competitive devaluations; privatisation schemes are proposed and implemented to introduce market dynamics into the provision of utilities such as telephone, gas and water. All in all, reforms are implemented and justified in their implementation with respect to the maintenance of the exchange rate regime, the policy instrument that had brought stability and growth once again to the country. The effectiveness of this *modus operandi* on the part of reform-oriented governments rises with the (perceived) costs of abandoning the exchange rate regime. For instance, it is particularly effective if significant dollar-denominated debt has been accumulated by private actors throughout the economy as this acts to diffuse actors' real economic interests. Even tradables producers who are detrimentally affected by an appreciating exchange rate will reconsider their exchange rate preferences when confronting large dollar-denominated debt burdens or indeed anticipating the inflationary repercussions of devaluations.

The need for policy compromise points to another rationale for adopting exchange rate pegs, which is particularly relevant during this process of constructing coalitions for neoliberal reforms in middle-income countries. Looking back at the wave of reforms in the 1990s in Latin America, it is evident that in order to build successful reform coalitions, policymakers have had to persuade factions of traditionally opposed interests – especially labour unions and business interests – to coalesce on the basis of a radical reform agenda. During processes such as these, exchange rate pegs may provide the different groupings with a crucial 'focal point' that serves as a baseline for the solution of other conflicts of interest that arise within the coalition during the course of the liberalisation process (Oatley 1997: 43; Bernhard and Leblang 1999: 76; 2002: 807). In these recently democratised countries with significant shares of the population living in poverty the tendency of exchange rate pegs

towards overvaluation has electorally interesting distributional effects, traditionally associated with 'economic populism' (Sachs 1991; Dornbusch, et al. 1995; Gala 2004). Aside from the positive impact of declining inflation, a strong domestic currency significantly increases the purchasing power of wages at the lower end of the income spectrum and therefore has the potential to mobilise a significant share of the national electorate (e.g., Leitão 2006; Mendonça de Barros and Miguel 2006). This effect on real wages (to the extent that it does not negatively affect employment among unionised labour) may also present a bargaining chip in the difficult reform negotiations with labour unions.

Finally, as many observers have noted who distance themselves from Bernhard and Leblang's conception of exchange rate choice as one *"between the use of monetary policy or no policy to manipulate the economy"* (Hallerberg 2002: 90), a peg under conditions of capital mobility allows policymakers to target specific constituencies through fiscal policy measures as well as boosting the economy as a whole (Clark 2002b; Hallerberg 2002; 2003). This strategy for fostering coalitional cohesion would not be open to governments under flexible exchange rates. Under emerging market conditions, the ultimate constraint to this form of government-led coalition-building through targeted fiscal expenditure is the absolute level of public debt and financial markets' perception of its sustainability.

The above ideas are contained in the following two propositions:

Proposition 1:

For coalition-building purposes, policymakers find exchange rate pegs useful as these pre-determine the economic policy agenda and therefore serve to dampen distributional struggle around other aspects of economic policy via their depoliticisation.

Proposition 2:

Once adopted, reform-oriented policymakers use exchange rate pegs as disciplinary, legitimating and rhetorical instruments to push through those market-oriented reforms that are presented as necessary to preserve the exchange rate peg.

These propositions will be assessed empirically in the four case studies of Argentina and Brazil in Chapters IV to VII. With a view to the empirical verification of these propositions, the composition of these reform coalitions and their internal dynamics need to be addressed. That is, who are the actors that governments believe have to be included in a coalition capable of ensuring the legislation *and* the implementation of reformist policies as well as the survival of the adopted exchange rate arrangement?

Building Reformist Coalitions around Exchange Rate Pegs: Aggregating and Re-Defining Interests

Any successful structural reform effort presupposes the existence of a minimum reformist coalition. The composition of such governing coalition depends upon the country-specific nature of state-society relationships, and in particular on their institutional intermediation and historical evolution. Any successful governing coalition however has to include, by definition, all potential veto players and must be supported, or at least tolerated, by the relevant policy players at two stages of the policy process (Gibson 1997; Starr 1997; Kingstone 1999; Etchemendy 2001; Murillo 2001; 2003; Acuña, et al. 2006): It requires control over key veto points in the legislative process, e.g., a favourable partisan composition in the lower and upper houses of the legislature. And, for a governing coalition to be successful, legislated economic policy reforms have to be implemented so to give rise to policy outcomes in accordance with earlier policy promises, thus satisfying public expectations. Paraphrasing Diniz (2000: 29), this implies that the political viability of the policy in question has to be guaranteed by means of articulating alliances and coalitions so to instil a cooperative attitude on the part of policy players, among others but especially, labour unions and business actors (also Grindle and Thomas 1991).

For a government to assemble this kind of broad-based reformist governing coalition in the context of (hyper-)inflation, polarised distributional struggles, fluid (not to say frail) party identities typical of countries in the process of democratisation, not to mention the public's fragile trust in national politico-economic institutions and significant external pressure from international creditors to adopt a market-oriented reform package, requires the adoption of a complex and actor-specific strategy (Murillo 2001: 199). As the previous section showed, an exchange rate peg is regarded as a highly valued instrument in this context of building and maintaining coalitions. Therefore, proposition 2 can be refined as follows:

Proposition 3:

In particular, reform-oriented policymakers use exchange rate pegs as useful devices for building and disciplining coalitions of societal actors (so-called governing coalitions) in order to facilitate market-oriented reforms.

During the coalition-building process, governments pursue strategies that exceed the mere aggregation of interests and instead push forward an agenda that also involves the re-definition or even creation of new reformist interests as bound up with the exchange rate regime. Societal interests that on aggregate benefit from market-oriented reforms and/or that

are so-called 'classic' supporters of fixed rate regimes as stipulated by Frieden (2000: 259), such as competitive exporters, international traders and investors, represent the 'natural' core components of the reformist coalition premised on the exchange rate peg. However, a successful governing coalition has to be more encompassing. Therefore, government actors will try to co-opt, buy off or compensate other less naturally aligned policy players, while structurally weakening or even neutralising those societal actors that are (politically) too costly to integrate into the wider reformist governing coalition.[11]

Other than managing the coalition and ensuring its internal cohesion by these means, governments will also seek to mobilise actors on an ideological basis. Due to the perceived highly technical nature of exchange rate policy, societal actors in an effort to identify 'their' economic interests in this policy matter are particularly vulnerable to governmental and other forms of discourse, which present them with seemingly apolitical means-end 'knowledge' (Bauer, et al. 1972: 373-374; Odell 2002). This may involve invoking images of national *grandeur* and success from the past as associated with the strength and stability of the national currency and its nominal equality with developed country currencies (especially the U.S. Dollar)(Kindleberger 1970) as well as the polar opposite, that is fear-mongering by juxtaposing the status quo to previous episodes of (hyper-)inflationary crises and national misery. In the Latin American context, this residual fear of the return of inflation is sometimes referred to as a 'hyperinflationary scar' on the collective memory of, especially, the urban middle class (Gerchunoff and Torre 1998: 121).

In turn, the re-definition of interests through cooptation and compensation proceeds largely through two channels. Other than through direct fiscal targeting, the liberalisation process puts governments in a position where they can buy off a variety of different socio-economic interests by offering privatisation deals on special terms and conditions and allocate rents in new or yet protected markets. The logic of these compensatory deals relies on the permanence of the peg. Indeed, the exchange rate peg presents the crucial context to privatisation deals and to the re-negotiation of contracts and concessions and, as such, strongly influences the profit calculations of the businesses and sectors involved. A secondary mechanism, not initiated but consolidated by determined government action, for diluting opposition from sectors detrimentally affected by the accompanying exchange rate appreciation consists in encouraging the dollarisation of contracts and assets within the domestic economy, which neutralises actors' interest in depreciation.

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[11] In the language of veto and policy players, this aspect of the governmental strategy amounts to revoking actors' status as policy players turning them into non-specific actors within civil society.

Support for the coalition and its overall reform agenda can also be expected to be rewarded by less hawkish liberalisation attempts and therefore the preservation of rents in sectors of interest to coalition members. This leads to a curiously uneven pattern of liberalisation, as illustrated by developments in Argentine and Brazilian labour markets (Schamis 1999; Etchemendy 2001; 2002b; 2003). However, governments' reliance on such deliberately constructed pro-reformist coalitions will eventually constrain the reform agenda itself, especially with regards to so-called 'second generation reforms' (Pastor and Wise 1999; Wise and Roett 2000; Etchemendy 2001; Bambaci, et al. 2002). Ultimately, the resulting patchwork of liberalised sectors and 'illiberal enclaves' provokes two contradictory trends that increase the likelihood of a crisis collapse of the exchange regime: First, the postponement of a flexibilisation of the exchange rate arrangement and, secondly, the growing untenability of the status quo exchange regime in the face of political complacency and hence growing budgetary pressures and factor inflexibility.

The Risk of Petrification

The petrification of exchange rate pegs, that is governments' reluctance to revise their policy even in the light of deteriorating politico-economic circumstances (e.g., external shocks) that render the regime economically suboptimal, is indeed common in emerging markets that underwent exchange rate-based stabilisation (Eichengreen 1998). This phenomenon and its underlying political dynamics are also captured by the above coalition-building argument. The reasoning suggests that in addition to seeking to avoid the high (short-term) *economic* costs of devaluation in terms of contractionary effects, market volatility, heightened debt servicing costs and inflationary pressures, governments – or decisive actors within the executive – opt to delay exit from a peg for *political* reasons.[12] More precisely, executive actors are seen to be unwilling to surrender the peg, this powerful disciplining instrument with which they managed reformist coalitions, for fear of risking reform reversal.

As alluded to previously, especially technocrats, whose attitudes to their country's political landscape and class tend to be marked by great scepticism or in some cases by outright anti-democratic sentiment, regard this logic as an appealing means for disciplining a multitude of political actors within the domestic political system, to reorient the political system towards reforms and hence to credibly commit the country to a reformist, disinflationary path and to maintaining the exchange regime underpinning these efforts. Moreover, given technocrats' privileged role and their process-derived autonomy, the

[12] Studies show that leaders are considerably more likely to lose office after a devaluation (e.g., Cooper 1971; Frankel 2005).

commitment to exchange rate discipline equips these experts with a powerful instrument for influencing economic policy developments well beyond their normal sphere of influence. Acknowledging that technocrats' interests and convictions overlap but are not necessarily congruent with those of their political superiors, this reasoning also enables us to identify a political dynamic by which – at least in the short run – technocrats may even hold formally superior policymakers 'hostage', and demand further reformist advances if an outright currency crisis is to be avoided.

In addition to this deliberate tabooisation of exchange regime change, exchange rate petrification also results from the aforementioned methods for ensuring the survival and cohesion of the reformist governing coalition insofar as the underlying logic of deals and compensatory measures relies on the maintenance of the exchange rate regime (e.g., price agreements contained in contracts underpinning privatisation deals). A devaluation would profoundly damage support from core coalition members. These political motives lead executive actors to indefinitely postpone exchange rate flexibilisation. Whilst exchange rate discipline may initially allow the excutive to push through emergency packages by exploiting the threat of currency crisis, in the longer run these measures rarely, if ever, amount to the deep structural reforms that would sustainably solve the problem of peg sustainability by providing the necessary adjustment flexibility required by a rigid exchange rate regime. Instead, unless governments succeed to generate a true societal consensus in favour of reforms by building relatively stable multi-issue coalitions that also bind anti-peg interests, the strategy eventually fails. Indeed, the political costs of artificially generating support and obtaining congressional consent for legislation necessary for the maintenance of the peg gradually increase whilst the executive's ability to manage the exchange regime's growing vulnerability to external shocks decreases. *Per se*, exchange rate pegs therefore represent an instrument that gradually loses its initially appealing effectiveness with respect to building and managing reform coalitions and obtaining reformist success. Yet, whilst elected policymakers gradually become aware of the inherent limitations of this method of generating reformist consensus in the polity – also because eventually it is them who have to face the political consequences of such risky exercise –, technopols tend to be more reluctant to revert to more traditional, time-intensive processes of negotiating credible reforms and to relinquish the priviledged and influential policy position they hold under a rigid exchange regime. This reasoning generates proposition 4:

<u>Proposition 4:</u>

Exchange rate petrification is the combined result of the reluctance of the

> executive – and especially of technocrats at the core of the executive – to surrender the exchange rate peg, this powerful disciplining instrument, and to risk reform reversal by destabilising coalitional arrangements that have become increasingly reliant on the continuance of the arrangement.

In sum, this reasoning concurs with institutionalists in that governments adopt exchange rate pegs as institutional short-cut solutions to the credibility problem that affects macroeconomic policy. However, the accounts diverge in their views on the mechanism by which this credibility is 'generated' with the present chapter arguing for a more 'political' understanding of credibility that takes into account the socio-political constellations of interests and the longterm importance of notions such as (democratic) legitimacy.

3.3.3 Coalitions and 'Political Credibility' in Exchange Rate Politics

> *The tightness of such self-imposed straitjackets has been obviously highly dependent on the country's coalition games, economic conditions and needs for external funds.*
>
> Santiso (2003: 26)

Before moving onto the external dimension of this argument in section 3.4., let me briefly touch on the implications of this argument for our earlier excursus into the credibility requirements of economic policies and exchange rate pegs. The argument is that the origins of enhanced policy credibility lie in the (initial robustness of the) coalitional structures that are constructed around the exchange rate peg and thus precisely in the way in which the government acts on the basis of its (remaining) political discretion. Understanding socio-political coalitions as crucial for the establishment of credibility implies a more encompassing understanding and thus stands in stark contrast to credibility being solely associated with institutionally-insulated technocratic and non-discretionary decisionmaking. Moreover, against the background of a political history of formal and informal 'pork and barrel' deals that have marked Latin American politics for centuries, the institutionalist scenario of establishing greater credibility by means of adopting institutions that depoliticise and insulate the policy process almost 'over night' must be judged to be utopian.[13] Ultimately, the survival of institutions themselves, such as an exchange rate peg, presupposes wider political support in the citizenry and an underlying consensus in favour of low inflation and the continuation of the regime, and the existence of relatively stable multi-issue coalitions of political support,

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[13] Note the curious convergence of technocrats' (mis)interpretation of exchange rate pegs as quick fixes to the complex political constellations they confront in their reformist endeavours with institutionalists' reading of exchange rate policy.

which for one reason or another also successfully bind anti-peg interests (Haggard and Kaufman 1992: 19-20; Amann and Baer 2000; Baer 2002; Stasavage 2003: 3). The degree to which this consensus has to be engineered or 'bought off' as opposed to being a reflection of the economic interests of a wider range of societal players will ultimately determine the duration of the exchange regime itself. Indeed, in the long run, 'true' consensus and credibility can only be achieved if underlying distributional conflicts are moderated within a reasonably transparent and predictable political system that has consistently matched deeds to words.

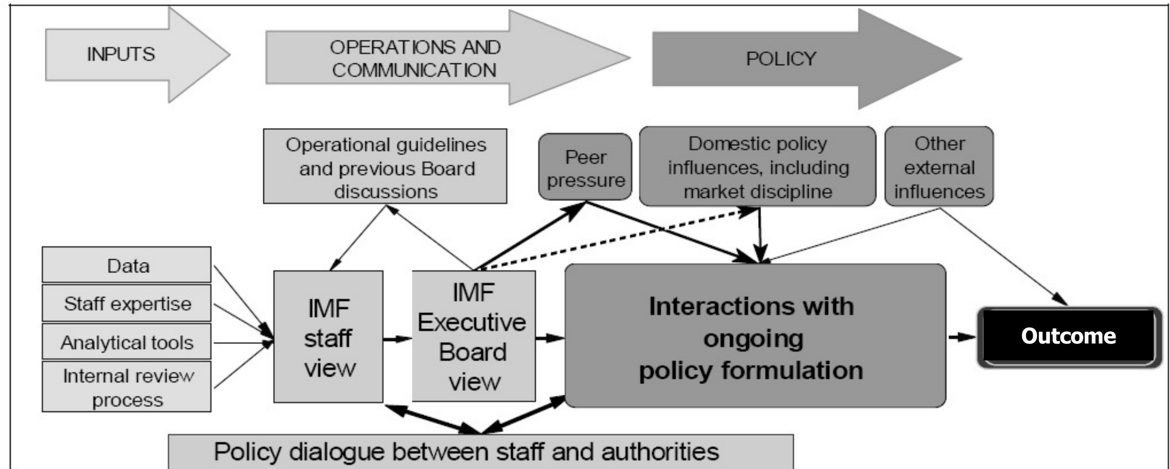
However, coalitional consensus should not be misunderstood as stasis or be equated with the absence of conflicts. To the contrary, distributive struggles will arise over policy always and everywhere. Thus, while no one expects interests to converge at a fundamental level, the long-term sustainability of an economic regime or an exchange rate peg ultimately depends on a certain convergence in thinking about fundamental means-ends relationships in the economy and about how to contain these conflicts in a way that is perceived as legitimate (Haggard and Kaufman 1992: 36). Especially in countries that have only recently (re)turned to democracy and where the trust in political institutions remains weak, coalitional arrangements above and beyond party alliances are thus of utmost importance for generating legitimacy as they enable a wide variety of interests to participate in the national policymaking process. And legitimacy is crucial for the longterm survival of any institutional arrangement (Armijo Elliott, et al. 2004: 10).[14]

3.4. The Role of External Actors in Exchange Rate Politics

This final section addresses the international dimension of the coalition-building argument. In doing so, it seeks to integrate the role of external agents, especially with respect to their part in executive efforts to build reform coalitions around exchange rate pegs and in fuelling exchange rate petrification. On the basis of section 1.3.3., this analysis draws special attention to the IMF, that is the one international institution that is formally charged with exchange rate surveillance (IMF 1944 (1992)), and one whose role in national exchange rate policy choices and with respect to exchange rate petrification has hitherto been largely disregarded. Seeking to further develop this chapter's argumentative line, this section shows how interactions between the IMF and national governments may reinforce the coalitional dynamic that shaped exchange rate politics in emerging markets and how, additionally, the IMF's public stance may further strengthen the tendency towards exchange rate petrification.

[14] Participation here refers to inputs into the policy process rather than *de facto* participation in policy outcomes.

Figure 5: 'How IMF Views Connect to Exchange Rate Policy Outcomes'



Source: IMF - IEO 2007: 43.

Before accounting for the IMF's role in the coalitional dynamic, let me briefly acknowledge the organisation's 'soft power', which complements its limited coercive influence in exchange rate matters. In the understanding of the IMF's IEO, its influence in exchange rate policy matters is primarily deployed in the context of a 'policy dialogue' undertaken by IMF staff (Biersteker 1995: 184; Killick 1996: 226; Woods 2006: 66). As **Figure 5** shows, during this negotiation process the fund can serve as a 'conveyor belt' for new 'policy currents' right to the core of the country's economic team (Maxfield 1990: 18-19). Policy dialogue thus represents one of several avenues by which the fund is able to transplant new policy paradigms into the core of domestic policy institutions and thus shape the exchange rate political agenda. Indeed, against a background of peer pressure and threats of financial market discipline, national policymakers and especially local technocrats may embrace the IMF's policy convictions as new cognitive frameworks for understanding economic challenges and drafting policy responses (IMF - IEO 2006: 5). Similarly, albeit evolving over a longer time horizon, the IMF's *de facto* influence results from training young economists within its ranks, who later on take on decisionmaking responsibility in their home countries. Sympathetic to IMF reasoning and a market-driven ideology as a result of their experiences and personal ties to IMF staff, such technocrats tend to constitute loyal anchor personalities during policy dialogues and other more informal interactions (Hirschman 1987: 31; Finnemore and Barnett 1999: 707-710; Biglaiser 2002; Chwieroth 2007b; Leiteritz forthcoming). It is via these channels that convictions, such as the one that emerging market governments ought to impose discipline via super-fixed exchange rate regimes, emerged among emerging market executives towards the late 1980s. In particular, executive actors began to subscribe to the idea that emerging markets' insufficient institutional maturity ruled out the adoption of market-determined exchange rates and instead favoured self-commitment

by means of pegs (e.g., Andrews and Willett 1997; Fischer 2001; Bubula and Otker-Robe 2003; Odling-Smee 2004: 36).

With respect to coalition-building, the IMF thus plays a key role in, first, setting the scene for the emergence of exchange rate discipline as a tool for coalition management. Secondly, by providing an additional reformist impetus, the IMF also grants further appeal to exchange rate pegs with a view to their coalition-building characteristics. Thirdly, as a result of its adamant support for the implementation of reforms underpinned by a regime of exchange rate discipline, the IMF arguably fuels the exchange rate petrification dynamic. In short:

Proposition 5:

> International actors, especially the IMF, generate circumstances in which emerging market governments feel compelled to enact structural reforms and thus resort to exchange rate pegs. This external validation for the regime contributes to its petrification.

IFIs and other creditors (be they third country governments or international forums, such as the Paris Club) have exerted substantial pressure on emerging market governments to restructure their domestic economies ever since the 1980s debt crisis (e.g., Haggard and Kaufman 1992; Phillips 1998; Biglaiser and DeRouen 2004; Woods 2006). In such tense environment, governments are compelled to exploit all available means for satisfying these demands and to engineer domestic consensus in favour of these reform endeavours. In response to these pressures, governments may employ exchange rate discipline so as to maximise their coalition-building potential. Yet, in pursuing this strategy, governments effectively instrumentalise the IMF rather than being at its mercy. In particular, the pronouncements by IMF representatives – keen to support and further boost reformist efforts – provide a useful 'stamp of approval' for the chosen exchange rate course and the underlying reform agenda. This external validation conveniently legitimises executive initiatives in the eyes of domestic constituents and generates confidence among international (market) actors (e.g., Phillips 1998: 181). Regarding the maintenance of rigid exchange regimes as a precondition for the continuation of the reformist course, but also fearing to precipitate a currency crisis, the IMF finds itself caught in a form of internal 'groupthink' (Janis 1982), which rules out a revision of the fund's *public* exchange rate policy verdict irrespective of whether internal studies may question the long-term sustainability of the regime. In turn, the sustained support's catalytic effect on international financial markets enables and provides additional incentives for governments to postpone exchange regime flexibilisation – and thus paves the road to exchange rate petrification: Sizeable capital inflows undermines the much-

cited external discipline and allows national executives to sustain the regime politically and economically whilst tolerating growing vulnerabilities. In short, rather than providing services of objective exchange rate surveillance and honest policy assessment, the IMF's commitment to facilitating and sustaining reform efforts harbours the risk of undermining the institution's ability to prevent the phenomenon of exchange rate petrification – and may instead feed it.

3.5. Concluding Remarks

This chapter proposed a framework for accounting for exchange rate policy outcomes in Latin American emerging markets. In contrast to institutionalist accounts, I argued that governments deliberately employ exchange rate pegs as coalition-building devices in the context of building and stabilising reformist coalitions. Moreover, the chapter showed that it is this coalition-building dynamic that also harbours the risk of a petrification in the exchange rate stance: Governments – or decisive executive actors – delay exit because they are reluctant to surrender this powerful disciplining instrument and risk reform reversal. In this respect, I also highlighted the role of the IMF, which fuelled the petrification of the exchange rate by exerting pro-reform pressure and by providing external validation to governments' exchange rate strategies. In the following chapters, these propositions will be tested and elaborated upon in the case studies of Argentina and Brazil.

C H A P T E R   I V

ARGENTINA IN THE 1980S

4.1. Introductory Remarks

This chapter explores the politics of exchange rate policymaking during the so-called 'lost decade' of the 1980s in Argentina as the first of four case studies. During this period, Argentina faced significant challenges emanating from the domestic and the international political economy: Mastering the transition to democracy after the traumatic experiences of authoritarianism and military defeat would have represented an enormous feat for a government at the best of times. In Argentina's case, however, democratisation coincided with domestic emergency resulting from economic mismanagement exacerbated by the onslaught of the debt crisis, deteriorating world prices for its agricultural exports, growing exposure to external shocks in both commercial and financial markets as well as the country's heightened dependency on the good will of international financial institutions (Torre 1993; Boughton 2001: 23).

Given these challenges, relatively little academic attention was granted to this period's exchange rate policy decisions. Instead, this policy field was mostly covered only as a preface to studies of Argentina's currency board adopted in 1991 (e.g., Wise 2000; Díaz-Bonilla and Schamis 2001). As this chapter shows, Argentina's exchange rate course was marked by recurrent and destabilising devaluations and regime changes accompanied by the acceleration of inflation. It has been described by Di Tella (1987) and Díaz-Bonilla and Schamis (2001: 67) as exemplifying a cyclical pattern of 'repression' and 'loosening' typical for Argentine economic history: Exchange rate decisions have been subject to an evolving trade-off between anti-inflationary motivations and balance of payments imperatives.

Yet, identifying this core trade-off offers little insight into the actual determinants of ultimately political decisions in favour of one or the other side of the equation and their timing. Electoral motives *per se* cannot explain recurrent regime changes and devaluations, although they do shed some light on the timing of the *Plan Primavera* in 1989 (e.g., Phillips 1998). Similarly, this chapter demonstrates that existing institutionalist and interest group

approaches only provide partial explanations for executive decisions. Institutionalists focus on the executive but nevertheless fail to acknowledge the particular impact of technocrats and the role of intra-executive divisions, which shaped the attitude to the exchange rate trade-off and decisions' timing. Interest group theorists, in turn, struggle to prove the persistency and decisiveness of societal actors' *constructive* influence in the exchange decisionmaking process given the executive's insulated status and the subordinate importance attached to the exchange rate by non-executive actors. Finally, an assessment of external actors, such as IFIs, shows that, despite Argentina's dependency on external funds, the organisations' clout never translated into policy influence at such a micro-level as the exchange rate regime.

The remainder of this chapter is organised as follows. Section 4.2. provides a historical overview of exchange rate policy and its institutional backdrop from the return of democracy in 1983 to the anticipated transfer of power from Alfonsín to Menem in 1989. Section 4.3. applies the argument developed in the preceding chapters to the exchange rate policy decisions of the 1980s by focusing on the role of the executive, the influence of societal interests and the impact of external agents. Section 4.4. concludes.

4.2. Historical Overview of Exchange Rate Policy in the 1980s

There are no other people in this world more interested in exchange rate experiments than the Argentines.

Banker's Magazine 1899[1]

Throughout Argentine history, exchange rate policy has been a highly contentious topic (e.g., Wise 2000; Díaz-Bonilla and Schamis 2001). Since the 1950s Argentina has adopted a variety of exchange regimes ranging from floats, multiple and unified exchange rates, passive and predetermined crawling pegs, fixed-but-adjustable pegs to fixed rates in the context of the 1990s quasi-currency board. These erratic regime changes – often in crisis contexts – have come to symbolise the country's struggle to settle deep-seated distributional conflicts along both class and sectoral dimensions that crystallise around this macroeconomic variable and equally highlight Argentina's *"persistent failure to build enduring political and economic institutions"* (Levitsky and Murillo 2005: 1). Altogether, this makes Argentina an interesting case for studying the political determinants of exchange rate policy (Frieden 1988: 13; Sturzenegger 2003).

[1] Quoted in Sturzenegger 2003: 31.

4.2.1 The Institutional Context of Exchange Rate Policymaking in Argentina

Due to authoritarian legacies, exchange rate policy in re-democratised Argentina was formulated in an executive-controlled institutional context with little or no accountability vis-à-vis other players. Although the constitution (Art. 74 §11) allocated the responsibility for exchange rate decisions with Congress, in practice such decisions were delegated to the executive branch for 'administrative reasons' (Art. 76). Moreover, reflecting the lack of a strong and sophisticated bureaucratic class (e.g., Teichman 1997: 35; Ferraro 2005; Spiller and Tommasi 2007: 183), Argentina at no point instituted a coordinating council along the lines of the Brazilian *Conselho Monetario Nacional*. Instead, exchange rate strategies were defined in an executive-driven discretionary 'dialogue' between the Ministry of the Economy (*Ministerio de Economía* – MECON)[2] and the subordinated *Banco Central de la República Argentina* (BCRA). Technical expertise was scarce, and both institutions – symptomatic for the Argentine state – suffered from institutional fragility (Palermo and Novaro 1996: 42; Halperín in Lanata 2003: 551; Levitsky and Murillo 2005). Internal enclaves of highly-trained individuals were marginalised, lacked policy influence and struggled to retain staff tempted by the private sector (Interview Machinea). Moreover, given the yet central role of the state and its control over strategic resources, especially the MECON had *"become the principal battlefield for opposing political interests"* (Peralta Ramos 1992: 98) and was *"heavily penetrated by societal groups"* (Teichman 1997: 35).

The Argentine Central Bank

Established in 1935 as the successor of the *Caja de Conversión*, under which Argentina had joined the Gold Standard in 1899 (Della Paolera and Taylor 2001), the BCRA had been created as a comparatively weak institution. Nevertheless, over the decades the entity had expanded its range of policy instruments (Azpiazu, et al. 1986: 85-86; Lorenzutti 1996: 382; Braessas and Braessas 1997: 58).[3] When enjoying executive assent and shared ideological and policy objectives with the executive (and particularly the MECON), the BCRA was known to possess considerable (exchange rate) policy influence. Accordingly, it had been acknowledged as the *"actor, ideological engine and executor of the programme of overvaluation"* in the late 1970s

[2] The MECON has undergone several structural and name changes. Under Videla, all functions were concentrated in the MECON. After Viola had divided policy areas into five ministries, Galtieri merged these into the MECON and the Ministry for Public Works and Services (*Obras y Servicios Públicos*). This division was maintained throughout the 1980s. Only in 1991, Menem created the superministry *Ministerio de Economía y Obras y Servicios Públicos*, which De la Rúa then divided into MECON and an Infrastructure Ministry. Duhalde, in turn, worked with a MECON and a Ministry of Production. Finally, Kirchner and the current President Fernàndez de Kirchner pursue(d) their economic policy agenda with a *Ministerio de Economía y Producción* and a *Ministerio de Planificación, Federal, Infraestructura y Servicios*.

[3] E.g., the Law of Financial Entities in 1977 centralised monetary authority in the BCRA.

(Roberto Lavagna in Lorenzutti 1996: 10). Nevertheless, until 1992, the entity remained formally and informally dominated by executive influences and lacked both financial and operational autonomy and any shielding by law or indeed custom, leading Cukierman and Webb (1995: 407) to classify it as *"the most [politically] vulnerable central bank"* in a sample of 67 economies (**Table 9**). The composition of its directorate turned the entity into a battleground of different societal and indeed party-political interests with its eleven members – seven nominated by the executive, two by the legislative and two by the private sector – being repeatedly exposed to sectoral demands. This vulnerability was exacerbated by a twofold mandate, which demanded that the BCRA satisfied the, in the short term often contradictory, aims of ensuring price stability *and* facilitating economic growth (Jácome 2001; Arnone, et al. 2007). Most importantly, its charter stipulated that the monetary entity was subject to executive orders, indications and instructions and thus allowed the executive to interfere with decisions taken by the *'directorio'*. Over the course of the 1980s, this institutional weakness combined with a lack of external pressure on the executive to respect BCRA decisions and to honour prior commitments to end BCRA financing of public accounts had significant inflationary repercussions (Beckerman 1995; Braessas and Braessas 1997: 84-85 + 88-90). In addition, the bank's pronounced political vulnerability to the executive destabilised organisational processes and inhibited institutional learning due to very high rates of staff and presidential turnover (**Table 10**).

Prior to the 1992 reform, the BCRA was thus constitutionally subordinated to the executive. Although the BCRA could significantly undermine policy coherence in the short run by engaging in discretionary actions that contradicted MECON policy or by withholding information, the executive always prevailed in the long run, as is illustrated by MECON Minister Sourrouille's intervention to replace BCRA President Concepción in August 1986. Hence, overall and exacerbated by the ease with which post-authoritarian governments circumvented even existing formal constraints (Negretto 2004), the exchange rate policy process during this period was primarily subject to the executive's, and especially the presidency's, evolving political objectives with little autonomous input by the BCRA (Calcagno 1986: 186; Levitsky and Murillo 2005).

Table 9: Central Bank Vulnerability to Political Influence: Argentina & Brazil, 1972-89

	Vulnerability within 6 months	No. of political transitions	No. of Central Bank Turnovers	
			Total	*Nonpolitical*
Argentina	1.111	9	16	6
Brazil	1.000	5	11	6

Source: Cukierman and Webb 195: 418.
Note: Vulnerability is defined as the fraction of political transitions that are followed promptly by the replacement of the central bank governor. Values greater than 1 imply that more than one replacement took place during this period.

Table 10: BCRA Presidents, 1983-1989

Enrique García Vázquez	10th December 1983 – 18th February 1985
Alfredo Concepción	19th February 1985 – 25th August 1986
José Luis Machinea	26th August 1986 – 31st March 1989
Enrique García Vázquez	1st April 1989 – 8th July 1989

4.2.2 Exchange Rate Policy: Legacies from the Post-War Era

Exchange rate policy has traditionally been highly contentious in Argentina for its distributional implications. The country's key export goods priced to international markets (e.g., wheat, maize, meat, milk and oils) represent a major share of the domestic basic consumption basket. Therefore, when the local currency depreciates, the purchasing power of local salaries declines: *"The real value of the dollar is therefore an inverse measure of the real salary"* (Sturzenegger 2003: 150-151). More than perhaps elsewhere, it has thus been common knowledge that the exchange rate strongly affects workers' real wages (Díaz-Bonilla and Schamis 2001: 73-74),[4] and the issue represents a focal point in the conflict between (and also within) the two socioeconomic alliances, a 'defensive alliance' of organised labour and domestic industrialists and an outward-oriented alliance of agricultural exporters and international capital (Levitsky and Murillo 2005: 25).

Against this background, exchange rate practices have evolved subject to changing development models, which closely reflected the relative power of the aforementioned alliances (Schamis 2003: 144). The pendulum swung from a liberal export-led growth model that relied on the exchange rate stability offered by the Gold Standard at the turn of the 20th century (1899-1929) to the deliberate attempt to insulate Argentina's economy from the international system so as to promote import substitution-industrialisation (ISI) in the aftermath of the 1930s depression and the consequent loss of export markets (Della Paolera and Taylor 2001). One of the central policy instruments of this ISI model, which lasted until the mid-1970s, was a periodically adjusted exchange rate peg, which redistributed the export proceeds of the agrarian sector towards manufacturing (Tedesco 1999: 13-14; Díaz-Bonilla and Schamis 2001). By the early 1970s this inward-looking model had entered stagnation. Frequent devaluations to address balance of payments bottlenecks and expansionary policies fuelled inflation whilst political instability after President Perón's death in 1974 grew (Corden 1993: 200).[5] His successors' misguided decision to implement a 100% devaluation in June 1975 marked a breaking point in inflationary dynamics with annual rates shooting up to 300%

[4] In 1920, Socialist Juan B. Justo criticised the *Peso*'s devaluation when the *Caja de Conversión* was abandoned (*Diario de Sesiones de la Cámara de Diputados* 27th September 1920).

[5] For an overview of the changing political authorities in Argentina and Brazil between the 1970s and 2008, see Appendix II.

(Smith 1989: 229; Tedesco 1999: 19-20). Due to the ensuing popular unrest and rapidly deteriorating economic conditions, the so-called *Rodrigazo*[6] also paved the road for the collapse of democracy: Argentina's middle classes became increasingly accepting of military government in exchange for greater politico-economic stability and thus reacted to the March 1976 coup with great acquiescence (Snow and Manzetti 1993: 31; Schvarzer 1998: 74; Damill 2002; Sturzenegger 2003: 149).

Exchange Rate Policy under the Military Dictatorship (1976-1983): The 'Proceso' and the 'Tablita' (1978-1981)

While the military focused on the '*guerra sucia*' against its political opponents, its Minister of the Economy José A. Martínez de Hoz abandoned the long-established ISI model for an orthodox 'process of national reorganisation' (*Proceso de Reorganización Nacional*), which aimed to address the threefold problems of inflation, external debt and recession by combining a large-scale programme of privatisation with deregulatory measures and liberalisation (Kaufman 1989: 400-401; Lewis 1993: 528; Müller and Rapetti 2000; Canelo 2004: 226). After a large nominal devaluation, which favoured rural interests with whom the minister was closely associated (Schvarzer 2004: 20), the new model – focusing on agricultural and primary commodity exports and financial sector growth – was accompanied by pre-set (multiple) exchange rates and a passive monetary policy (Damill and Frenkel 2003: 6; Canelo 2004: 244-248). The prevalent market-driven rhetoric, however, diverged from government practices, which failed to control spending. The resulting fiscal imbalances meant that the eradication of inflation, promised by the 1976 coup, remained unfulfilled as the recessionary economy experienced inflation of 130% in 1978 (Díaz-Bonilla and Schamis 2001: 78).

This precipitated the adoption of the '1978 stabilisation programme' in December 1978 (Azpiazu, et al. 1986: 87; Canelo 2004: 232; Schvarzer 2004: 21). Paralleling similar experiments in Chile (1973) and Uruguay (1974), this programme sought to counter inflationary expectations by pre-announcing three variables – public utility prices, minimum wages and the devaluation rate of the exchange rate (the *tablita* – a form of crawling peg) – while liberalisation efforts were intensified (Corden 1993: 203-204; Díaz-Bonilla and Schamis 2001: 79; Canelo 2004: 249-255). Yet, the process of exchange rate appreciation, underway since the mid-1970s, accelerated markedly (Schvarzer 2004: 21). Thanks to the strong currency and high domestic interest rate, Argentina experienced significant capital inflows (known as *plata dulce*) as well as waves of imports that led to balance of trade disequilibria

[6] MECON Minister Rodrigo sought to correct balance of payments and fiscal disequilibria by combining a devaluation with utility price increases.

(Bonelli 2004: 37; Fausto and Devoto 2004: 416). Hence, although the artificially low real exchange rate contained annual inflation at 100% with *"the tariff and exchange rate levels providing a ceiling"* (Martínez de Hoz in Di Tella and Rodríguez Braun 1990: 169-170), these efforts accelerated the process of de-industrialisation as the previously highly protected industrial sector struggled to adjust to international competition (Azpiazu, et al. 1986: 88; Hirschman 1987: 15; Schvarzer 2004: 20). Meanwhile, the financial sector entered a period of erratic growth fuelled by speculative investment following the deregulation and financial liberalisation in 1977 and interrupted by the banking crisis in March 1980 (Azpiazu, et al. 1986: 85-86; Smith 1990: 7; Bonelli 2004: 34-35; Damill, et al. 2005). As the current account turned into deficit and capital inflows slowed down thanks to the 'Volcker shock' in the United States, agricultural producers joined industrialists in their critique of the overvalued currency. Eventually, after General Viola took over in March 1981, the *tablita* was abandoned and the exchange rate fixed. Although the new administration sought to convince the public that it would maintain this peg and that *"[e]sta vez, quienes apuesten al dólar, realmente van a perder"*,[7] the commitment proved unsustainable and a devaluation of 30% in the midst of a foreign exchange crisis followed (Martínez de Hoz in Di Tella and Rodríguez Braun 1990: 175-179; Bonelli 2004: 36; Canelo 2004: 255). After a series of devaluations, a multiple exchange rate system together with an exchange insurance system was introduced in September 1981 (World Bank 1985: 67; Ruge-Murcia 1997: 13; Canelo 2004: 300).

Previously, Martínez de Hoz had vehemently resisted devaluation by accumulating short-term external debt to meet the growing demand for US dollars.[8] This build-up of external debt, rapid capital flight and the absorption of a considerable share of the private debt burden in 1982 markedly increased Argentina's dependence on international funds (**Figure 6**)(Ruge-Murcia 1997: 13; Basualdo 2001b: 13; Castellani 2004: 180+183; Damill, et al. 2005: 9 + 47). Meanwhile, divisions amongst the armed forces forced General Viola's resignation (Interview Alemann, Canelo 2004: 302; Schvarzer 2004: 23). Yet, plans to re-orient the economic policy agenda under his successor Galtieri and the monetarist MECON Minister Roberto Alemann failed when Argentina's invasion of the Falkland Islands in April 1982 provoked the suspension of external financing and forced the authorities to resort to monetary emission to meet financing needs. The subsequent ignominious military *débâcle* combined with severe economic crisis, accumulating evidence of state terrorism and rapidly

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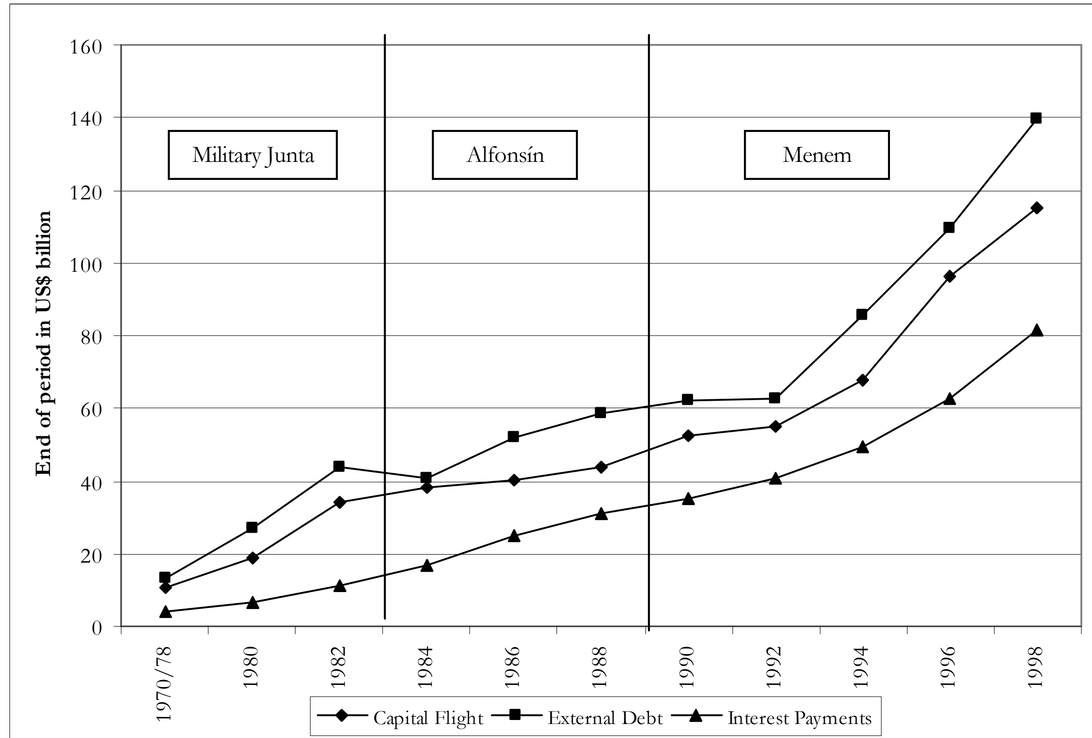
7 *"This time, those who bet on the dollar will really lose out"*. Ever since, this phrase by Lorenzo Sigaut, Viola's MECON Minister, has marked Argentine consciousness symbolising the many broken promises on exchange rate pegs.

8 Trying to prevent a devaluation, the government lost US$6 billion in reserves and accumulated more than US$7 billion in debt between December 1979 and March 1981 (Schvarzer 2004: 22).

accelerating inflation eventually eroded the military's legitimacy and led to the *junta*'s decision to initiate the return to democracy (Smith 1990: 3; Pion-Berlin 1991: 544).

Figure 6: Evolution of External Debt and Capital Flight in Argentina, 1970-1998
(End of period in US$ billion)



Source: Basualdo 2001:13 based on data from INDEC.

4.2.3 Alfonsín in Power: Exchange Rate Policy during the Democratic Transition

More than a year later, on 30th October 1983, democratic elections were held. Surprisingly, the centrist *Unión Cívica Radical* (UCR) and its candidate Raúl Alfonsín obtained an impressive mandate, defeating the Peronist Party (PJ) for the first time in party history in free and fair elections (Smith 1989; Fausto and Devoto 2004: 461). Alfonsín, a popular human rights lawyer, had generated great expectations for a cut with authoritarianism and a pro-active government that would address widening income inequalities and revitalise the stagnating economy (Smith 1989: 272; De Privitellio and Romero 2000: 397-398). Yet, his optimistic economic policy agenda stood in stark contrast to the abysmal economic conditions (Smith 1989; 1990; 1992; Torre 1993: 73): By 1983, external debt had reached US$46 billion with arrears of US$3.2 billion vis-à-vis international creditors, and the country lived through the fourth successive year of recession while annual inflation was running at 600%, with a fiscal deficit of approximately 15% of GDP (Smith 1990: 3; Machinea 1993:

124; Schvarzer 1998: 33; Tanzi 2007: 45).[9] Moreover, from the mid-1970s onwards Argentines' attempts to avoid the 'inflation tax' had converted the country into a *de facto* dollarised economy, which exacerbated the fiscal crisis and eroded the public policies' effectiveness (Palermo and Novaro 1996: 42-43; Damill 2002: 12).

Eager to recreate the economic policies of the last UCR government in the 1960s, Alfonsín and his economic team of party cadres headed by Minister of the Economy Bernardo Grinspun systematically underestimated the changes Argentina's productive structure had undergone since then as well as the imminent danger of hyperinflation (Phillips 1998: 57; Bonelli 2004: 52+58). Similarly, their strategy of resisting external creditor pressures failed to address tightening external constraints (Alfonsín in Giussani 1987: 180-181; Monteón 1987: 21; Schvarzer 2004: 24). Ultimately, Grinspun's ambitious expansionary policy package and attempts to target the real exchange rate collapsed in September 1984 leading to a major devaluation that propelled inflation rates further upwards (Interview Machinea, Machinea 1993; Acuña 1995b: 70).

As his popularity plummeted, Alfonsín announced that 1985 would be a *"year of adjustment and fight for the reduction of the budget deficit and inflation"* (*Clarín* 16th December 1984). With a view to the legislative elections in November 1985, monthly inflation rates of 25% in January 1985 exacerbated Alfonsín's concerns and led him to replace Grinspun's crew on 18th February 1985. Instead, he nominated a group of well-respected technocrats led by Juan Sourrouille at the MECON and Alfredo Concepción at the BCRA (Heymann 1987: 285; Manzetti and Dell'Aquila 1987: 4; Kiguel 1991: 970). Alfonsín's commitment to revising the economic policy agenda was further highlighted by a speech on the *Plaza de Mayo* on 26th April 1985 where he announced that Argentina confronted an '*economía de guerra*' (war economy), which required *"an adjustment that would be hard and that would demand a concerted effort from everyone"* in order to *"win the battle against inflation"*.[10]

4.2.4 The Austral Plan (1985)

On 14th June 1985, Alfonsín and Sourrouille announced a surprise plan, the '*Plan de Reforma Económica'* (DNU 1,096) or *Plan Austral* (Negretto 2004: 551).[11] For this shock

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[9] Some problems had been hidden by inconsistent government statistics, e.g., BCRA balance sheets reported reserves in excess of US$1.5 billion although arms deals had left reserves almost depleted by December 1983 (Rapoport 2003: 905).

[10] See http://lanic.utexas.edu/project/arl/pm/sample2/argentin/alfonsin/851253d.html [cited 7th May 2006].

[11] This decree (DNU = *decreto de necesidad y urgencia*) was the first decree of legislative content enacted by Alfonsín. At the time, DNUs represented a 'paraconstitutional practice' as they were neither authorised by the existing constitution nor explicitly based on congressional delegation. Only in 1990, the Supreme Court recognised DNUs as constitutionally valid legislative instruments and, in 1994, they were incorporated into the Constitution (Negretto 2004: 551; Snow and Manzetti 1993: 43).

approach to succeed, Sourrouille's economic team had made a series of discrete adjustments to correct relative price distortions in parallel to secretly formulating the plan's core elements (Manzetti and Dell'Aquila 1987; Smith 1990; Heymann 1991: 103).[12] Unlike previous orthodox stabilisation attempts, the plan's core objective was to attack inertial forces that Sourrouille's team understood to be rooted in Argentina's *"deeply ingrained culture of inflation,"* which dominated economic practices through forms of implicit and explicit indexation of all types of monetary contracts, rents, wages and bonds (Smith 1990: 4). In the heterodox tradition, stopping inflation thus presupposed the eradication of inflationary memory and all related practices by de-indexing prices and by implementing monetary reform (Frenkel 1986).

At its core, the *Austral* Plan combined the following core elements (see Heymann 1987: 284; Neiburg 2004: 183-184; Schvarzer 2004):

1) **Currency reform:** The *Austral* replaced the *Peso argentino* (**Table 11**) at a rate of 1,000 *Pesos argentinos* to 1 *Austral*.
2) **'Orthodox' fiscal measures**: The plan contained an orthodox element insofar as the government committed to reducing the budget deficit and to putting an end to its monetisation through BCRA credits. This presupposed the generation of additional revenues via lower inflation, higher duties on foreign trade and previously raised public sector prices, while real public sector wages and investment were expected to decrease or remain stable. Additionally, the expected decrease in nominal interest rates would allow for a reduction in the so-called 'quasi-fiscal' deficit of the BCRA (i.e. its payments on bank reserves).
3) **Price and wage freeze:** Having granted a 22% nominal wage increase prior to the plan's announcement, all forms of price indexation were to be abandoned and all prices were legally fixed *"to cool off distributional struggles that plagued conventional stabilisation programmes"* (Smith 1990: 10).
    a. The price freeze included the exchange rate, which was first devalued by 18% and then pegged indefinitely at a rate of 0.8 *Australes* per US$ (Smith 1990; Acuña 1995b: 145).
4) **Conversion rules:** All contracts denominated in *Pesos argentinos* were to be converted into *Australes* according to a sophisticated *'tabla de deságio'* for debt conversion devised by Daniel Heymann.[13]

Table 11: Argentine Currencies and Conversion Rates, 1970-1991

Peso Ley	1970-1983			
Peso Argentino	1983-1985	→	1 *Peso Argentino*	= 10,000 *Pesos Ley*
Austral	1985-1991	→	1 *Austral*	= 1,000 *Pesos Argentinos*

[12] Preparatory measures included the acceleration of the monthly devaluation rate, a 12% increase in import and export tariffs, a rise in public utility and fuel prices (leading to a 30.5% increase in consumer prices and a 42.3% increase in wholesale prices in the month of June 1985), an increase in the taxes on tobacco and alcoholic beverages, and a compulsory savings program for firms and taxpayers based on their 1984 tax return (Manzetti and Dell'Aquila 1987; Smith 1990: 9).

[13] The *'deságio'* table inspired the conversion table of the *Plano Cruzado* in 1986 (Interview de Pablo).

As the list of measures shows, *"the exchange rate policy was just one part of a policy package, and not the most prominent part"* (Corden 1993: 205). Indeed, its treatment paralleled that of other prices insofar as the dollar value of the new currency was temporarily frozen. Given the high degree of dollarisation and the fact that the *Peso argentino* had lost all credibility,[14] the Argentine authorities dedicated comparatively greater attention to the symbolic aspects of the currency reform than their Brazilian counterparts would a year later (see Sourrouille's speech in Solanet 2006: 59). Indeed, one of the purposes of this new currency with fewer noughts and its stabilised nominal rate vis-à-vis the US dollar was the attempt to *"wipe out the collective inflationary memory"* (Acuña 1995b: 140; also Soriano 2002). The desire to contrast the new currency with its predecessor was also manifest in state advertising, which suggested that *"[t]he austral is a strong, healthy currency that does not bear the weight [Spanish: peso] of inflation"* (in Neiburg 2004: 183).

The plan's initial disinflationary success generated great enthusiasm among Argentines: 80% approved of the plan and hence overwhelmed initial criticism from Peronist and union ranks. Monthly inflation fell from 30.5% in June to 6.2% in July, and further to 3.1% in August 1985 (Heymann 1987). In parallel, recovering aggregate demand led to substantial gains in output with (seasonally adjusted) GDP rising by 4% in the last quarter of 1985. Initially, the budget deficit was successfully reduced thanks to real increases in tax revenue at lower rates of inflation, some reductions in government expenditure, new taxes on fuels and foreign trade, and tighter controls on tax evasion (Ruge-Murcia 1997: 18; Díaz-Bonilla and Schamis 2001: 83). Politically, these achievements were rewarded with the rapid recovery of Alfonsín's popularity ratings and led to another, even greater, electoral victory for the UCR in the congressional elections in November 1985.[15]

However, by late 1985, the *Plan Austral* began to lose ground. Inflation had been reduced but not eradicated and, consequently, slowly undermined the price freeze and the sustainability of the exchange rate peg (Damill, et al. 2005: 45)(**Figure 7**). In April 1986, the authorities replaced the freeze with discretionately 'administered prices' and devalued the exchange rate by 3.6% followed by a shift to a crawling peg shadowing inflation rates (Stiles 1987: 78; Smith 1990; Lorenzutti 1996: 434-435). Although price developments after the lifting of the price controls did not justify the opposition's gloomy predictions, prices did rise incessantly (**Figure 8**). Accordingly, the *Austral* underwent six mini-devaluations reaching a value of US$0.885 with a black market quote of US$0.833 by late August (Tedesco 1999: 110).

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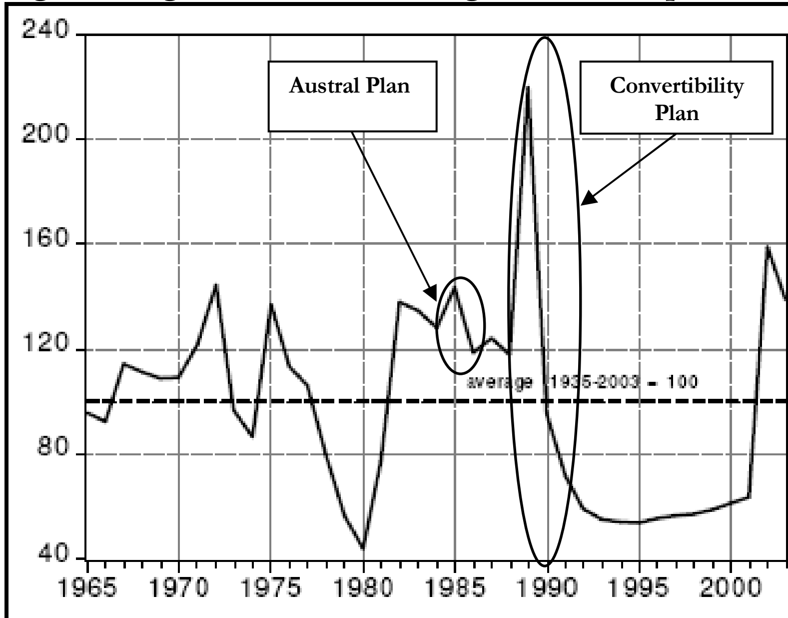
[14] BCRA President García Vázquez told IMF Managing Director de Larosière in December 1983 that *"massive capital flight and dollarisation of transactions [...] had left Argentina essentially a country without a currency"* (in Boughton 2001: 388).

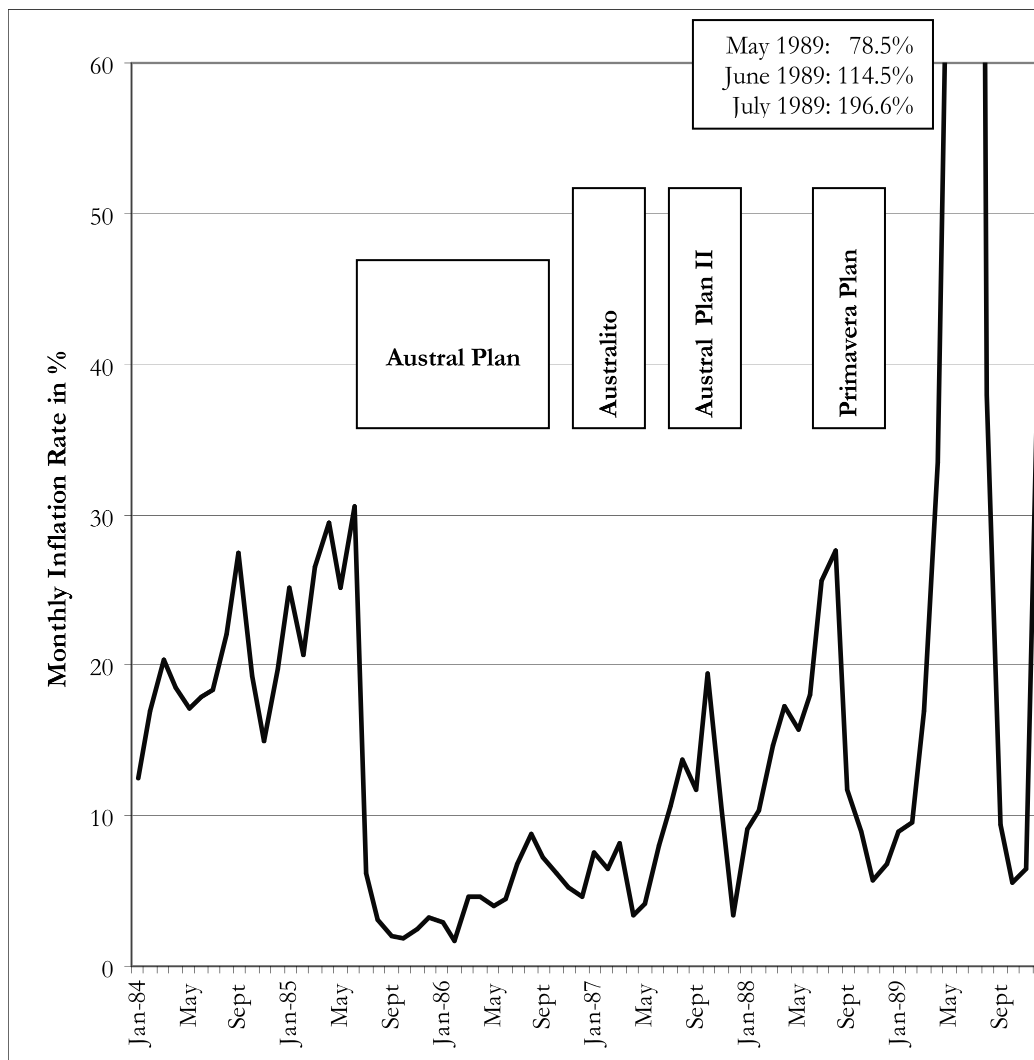
[15] Survey by Somerc de Aftalión, Mora y Araujo y Noguera (Acuña 1995: 179).

Figure 7: Argentina – Real Exchange Rate Developments, 1965-2003



Source: Damill, et al. 2005: 45 based on data from the MECON.

Figure 8: Argentina, 1984-1989 – Monthly Inflation Rates



Source: Own elaboration based on INDEC, *Boletín Estadístico* (various editions).

In addition to pressure on external accounts due to deteriorating terms of trade (World Bank 1988),[16] the *Plan Austral*'s primary Achilles heel was the government's inability to balance the budget by resolving structural imbalances in the public sector (e.g., Machinea and Fanelli 1988; Heymann 1991; Kiguel 1991; Machinea 1993).[17] This lack of sustained fiscal discipline provoked the growth of the budget deficit to 4.3% of GDP during the first quarter of 1986. This deficit was largely driven by provincial governments, which refused to undergo adjustment and repeatedly bypassed BCRA regulations by issuing their own money, and by state-owned enterprises, which sought to reach adjustment targets by postponing payment to contractors and employees rather than by restructuring and enhancing cost efficiency (Acuña 1995b: 142). Secondly, as Machinea (1993: 125) points out, although the *Plan Austral* was *"able to bring the rate of inflation down very quickly […] this alone was not enough to stabilise the economy on a permanent basis."* Permanent stability would have required a more determined stance vis-à-vis vested interests in the context of dismantling subsidy schemes, privatising inefficient and largely uncooperative state enterprises and moving towards greater openness to international trade (Haggard and Kaufman 1992: 308). Ironically, precisely the ease of the initial reduction in price level had a strong negative effect on the perceived urgency and necessity of sustained adjustment and raised the political costs of further structural reforms (Schvarzer 2004: 26).

Table 12: Stabilisation Plans under President Alfonsín, 1983-1989

Austral Plan	June 1985
Australito (or February Plan)	February 1987
Austral II Plan	October 1987
Primavera (or Spring) Plan	August 1988

4.2.5 Stairway to Hyperinflationary Hell, 1987-1989: The Australito (1987), the Plan Austral II (1987) and the Plan Primavera (1988)

The aborted military uprising during Easter 1987 heralded a period of increasingly desperate and ultimately unsuccessful *ad hoc* attempts at re-establishing governmental authority in the economic as much as in the political sphere over the remainder of Alfonsín's term.[18] Yet, the government's three, increasingly reactive and short-termist, stabilisation plans in the aftermath of the *Plan Austral* inspired little confidence among Argentines or the

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[16] Most interviewees pointed to this negative external shock, with Argentina's terms of trade index deteriorating from 100 in 1980 to 79.9 in 1986 (World Bank 1988). Aside from directly affecting external accounts, these events increased pressure for export tax reductions and thus contributed to a growing fiscal deficit (Tedesco 1999: 114-115).

[17] Fiscal revenue was very low with *"only 13% of the registered tax payers paying taxes in 1984"* and private sector tax revenue accounting for only 0.6% GDP and total national revenues amounting to 25.7% GDP (Barkey 1994: 58).

[18] Alfonsín's military policy of punitive budgetary cuts and public trials against human rights abuses had increased resentment among the armed forces. Fearful of a backlash, Alfonsín resigned to signing off the controversial 'due obedience' laws and sacrificed considerable political capital as a result (Pion-Berlin 1991).

international community (Heymann 1991: 123).

Already in February 1987, the *Australito* had sought to counter growing budget imbalances and widespread re-indexation by re-instituting a price freeze. After a 6.6% devaluation, the dollar value of the *Austral* was fixed for two months. Yet, by July 1987 inflation had returned to double-digits (Torre 1993; Acuña 1995b; Ruge-Murcia 1997: 20). Simultaneously, the gap between official and black-market exchange rates grew to reach 43.36% in August 1987 signalling expectations of further devaluations (Tedesco 1999: 112). The internally divided government grew increasingly vulnerable to external pressures in a climate of growing public frustration with an economic performance that defied Alfonsín's earlier promise that *"with democracy one eats, one is cured, one is educated"* (in Tedesco 1999: xiii). The administration's apparent lack of long-term vision was severely punished at the polls in September when the UCR lost all but two of its seven provincial governorships as well as the party's majority in the Chamber of Deputies to the PJ. This turned Alfonsín into a 'lame duck' with compromised political legitimacy and severely curtailed capacity for political action (Torre 1993: 83).

Implemented shortly after this defeat, the *Plan Austral II* was arguably condemned to failure. Coupled with a surprise devaluation of 16.5% on 10th October 1987, this initiative re-introduced a two-tier exchange rate system with one segment for foreign trade operations and another for local financial operations, which persisted until its abandonment in 1990. The measures also foresaw another set of price freezes and renewed efforts towards public sector adjustment (Fernández 1990: 4; Ruge-Murcia 1997). Yet, due to insufficient political resolve and strong Peronist opposition, the budgetary discipline proved elusive and inflation accelerated.

At monthly inflation rates of 27.6% in August 1988, the *Plan Primavera* therefore represented a classic last-ditch stabilisation effort prior to the presidential elections in May 1989 (Snow and Manzetti 1993: 46; Beckerman 1995: 667; Phillips 1998: 60). For the first time, a modest move towards economic liberalism was discernible. Disinflationary efforts were thus underpinned with the deregulation of public services, the partial privatisation of state companies, the reduction of subsidies to industry as well as steps towards trade liberalisation (Torre 1993: 85; Viguera 2000: 66).[19] The 'Spring Plan' itself centred, once again,

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[19] Argentina's protectionist trade regime had been reinforced by *decreto* 4,070 in 1984. Yet, after bilateral cooperation with Brazil intensified on the basis of the *Programa de Integración y Cooperación Económica/Integração e Cooperação Econômica* (PICE) in 1986, some gradual liberalisation took place from March 1987 onwards. Bilateral commitments were strengthened with the *Tratado de Integración y Cooperación para el Desarrollo/Integração e Cooperação para o Desenvolvimento* (TICD) in 1988. More decisive steps to reduce non-tariff barriers and reform the tariff regime were only implemented under President Menem after October 1989 (Viguera 2000; Ernst 2005: 1-3).

on strict guidelines on price and wage increases agreed with the private sector as well as new exchange rate measures, sustained by elevated interest rates: After a 10.5% devaluation, the commercial (or 'official') rate for agricultural exports was pegged at 12 *australes* per US$, depreciating at a monthly preannounced rate of 4%. Meanwhile, the 'free' financial rate applicable to imports and to 50% of the value of exports of manufactured goods was set at 14.4 *australes* per US$ and was to follow a 'dirty float' (Heymann 1991: 105; Torre 1993: 85; Beckerman 1995: 670; Lorenzutti 1996: 442; Bonelli 2004: 66). Given the explicit spread between the rates, this regime introduced a tax on agricultural exports to benefit state coffers (Cavallo 1989: 86-87; Tedesco and Barton 2004: 100). Inflation fell to 5.7% by November 1988 and the interest rate differential attracted significant short-term capital inflows (Ruge-Murcia 1997: 21-22).

Yet, by late 1988, all societal support had been withdrawn from Alfonsín due to persistent frustrations about the overvalued and discriminatory exchange rate, the recessionary monetary policy and uncontained wage pressures (Latin American Weekly Report 1988; Beckerman 1995: 673). As initial disinflationary successes waned and uncertainty about the sustainability of the exchange rate mounted due to intensified capital flight,[20] a run on the *austral* in late January 1989 forced the BCRA to defend the exchange rate at great expense and ultimately in vain (Bonelli 2004: 70). On 6th February, this '*golpe de mercado'* forced the authorities to let the *austral* float (Smith 1990: 2; Lorenzutti 1996: 444). This decision provoked the brisk appreciation of the US dollar from 16 to 1490 *australes* amidst increasingly chaotic exchange market changes (Solanet 2006: 13). It also opened the door to hyperinflation turning Argentina into *"a country without currency"* where *"even those who […] wished to exchange their dollars could not do so because there was no known exchange value for the evaporated australes"* (O'Donnell 1991: 3). This precipitated a series of events, which culminated in the anticipated transfer of power to the PJ's Carlos Menem on 10th July 1989. Indeed, neither the economic team's resignation in March, nor Menem's election to the presidency in May nor a thirty-day state of siege in June could decelerate Argentina's politico-economic collapse (Latin American Regional Report 1989; Phillips 1998: 11). This deep-seated crisis, combined with a decade of drastic economic decline,[21] legitimated radical structural reforms in the 1990s.

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[20] With reduced access to external finance after the cancelling of the World Bank disbursement in January 1989, the administration sought to maintain the peg until May 1989 by accumulating domestic short-term debt, which jumped from 7% GDP in 1986 to 15% in 1989 (Tedesco 1999: 139; Diaz-Bonilla and Schamis 2001: 84).

[21] Real GDP declined at an average rate of 2.6% p.a. between 1982 and 1990. This implied that after Argentina's GDP per capita had been 84% of the world's developed countries in 1950, it had dropped to 43% by 1987 (Blustein 2005: 19).

4.3. Explaining Exchange Rate Policy Choices in the 1980s

This section puts forward an explanation for the erratic exchange rate policy choices outlined in the preceding historical section, looking particularly at the Austral and Spring Plans. Analysts like Di Tella (1987) and Diaz-Bonilla and Schamis (2001: 67) describe Argentina's history of exchange rate policy in reference to a pattern of two-stage-cycles with 'repressed stages' (during which several key prices are controlled for disinflationary purposes) associated with fixed exchange rates being followed by 'loosening stages' during which a more flexible exchange rate arrangement is adopted. Although a useful descriptive device, it does not explain the drivers of these cyclical developments nor the fact that the length of these cycles significantly shortened from the mid-1970s onwards. Investigating the 1980s, a 'loosening stage' characterised by *"increasingly large devaluations and accelerating inflation, which reached hyperinflationary proportions in 1989-90"* (Schamis 2003: 125), this section intends to lay bare the 'politics' surrounding the exchange rate element of the economic programmes of the 1980s. In line with the theoretical framework outlined in previous chapters, the role and interaction of the following three factors is of particular importance:

- **the executive** – in particular the interplay between the presidency and the *equipo económico* in the design and, later on, implementation of the exchange rate strategy as well as the theoretical framework through which these economists perceived their policy options and constraints;
- the **role of societal interests** in influencing exchange rate decisions via their direct lobbying of the economic team, via their impact on intra-executive relations and via their influence on market conditions;
- the **role of external agents** and especially the influence of the IMF in its exchange rate policy surveillance function.

4.3.1 The Role of the Executive

As transpired from the historical section, this analysis shares with institutionalists its core focus on the role of executive actors in explaining exchange rate decisions and their respective timings. Institutionalists, such as Bernhard et al. (2003: 17-18) regard the exchange rate policy trade-off as politically and institutionally conditioned. In other words, policy decisions are shaped by a variety of political incentives and constraints with executive strength or insulation and electoral motives being granted a particularly important role (e.g., Frieden and Stein 2001: 6-7; Schamis and Way 2003).

The argument presented here suggests that the nature of political considerations affecting executive decisionmakers in this field is more complex. Indeed, exchange rate

policymaking did not represent a rational and coherent response to the requirements of the electoral calendar or to the possibilities of executive strength. Rather, I propose that an in-depth analysis of the dynamic relationship between the technocrats, who designed and implemented the exchange rate strategies, and their political superiors sheds light on the issue at stake. More specifically, I argue that the highly erratic nature of exchange rate policymaking during this period reflected the economic team's changing position within the executive as well as the emergence of intra-executive divisions: The remarkable 'window of autonomy' the economic team had been granted in the run-up to the *Plan Austral* proved very short-lived and ultimately insufficient for sustaining the adopted exchange rate strategy. In turn, the reassertion of the *'políticos'* led to a reprioritisation of executive goals, which not only subordinated the aim of price stability to traditional political and, increasingly also, electoral goals but also withdrew the political basis for a coherent long-term currency strategy.

Table 13: The Economic Team of the *Plan Austral* (1985)

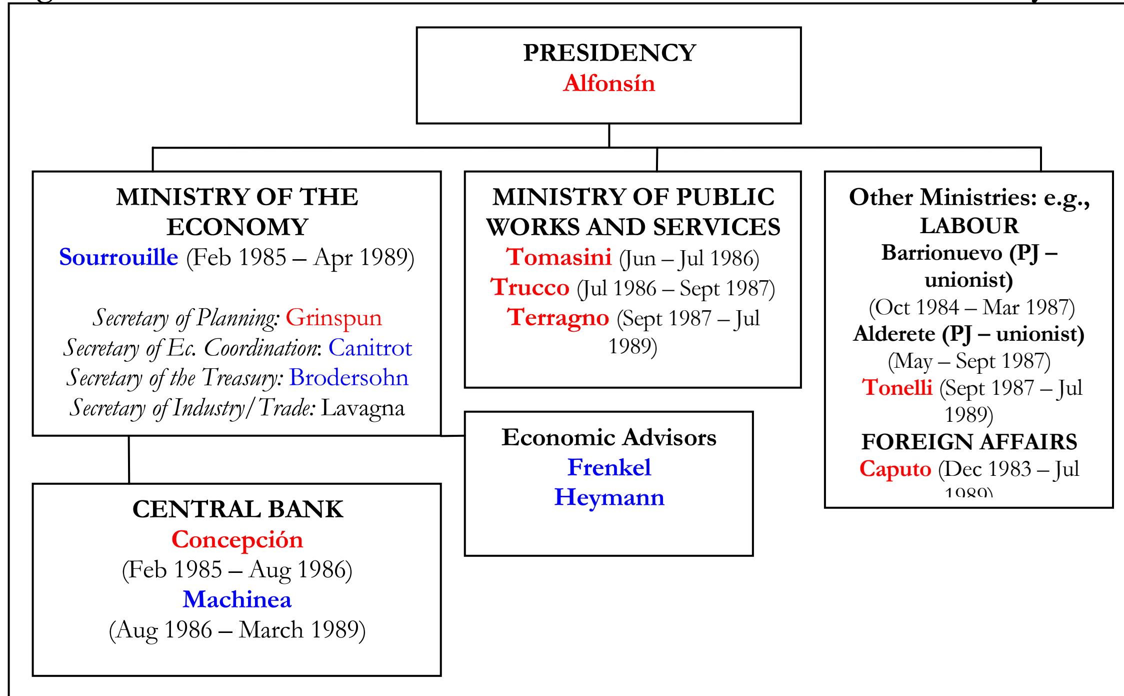
Juan Vital Sourrouille (UBA, Harvard)	Minister of the Economy
Adolfo Canitrot (Stanford)	Deputy Minister of the Economy – Secretary of Economic Coordination
Mario Brodersohn (Harvard)	Secretary of the Treasury
José Luís Machinea (Minnesota)	Sub-Secretary of Economic Policy [BCRA President from August 1986 onwards]
Roberto Frenkel (UBA, PUC-RJ)	Head of Economic Advisors
Daniel Heymann (UCLA)	Economic Advisor

Source: Interviews with Machinea and Heymann; also Smith 1990; Phillips 1998: 60; Heredia 2006.

The Economic Team of the Plan Austral: Composition and Institutional Position

After brief episodes in the 1970s, technocrats re-emerged in the higher echelons of Argentine economic policymaking in February 1985 when Alfonsín replaced the UCR party cadres with Juan Sourrouille, a *"quintessential technocrat: insular, persistent, confident in the logic of his own theoretical formulations"* (Pion-Berlin 1991: 558), who as chief economic planner had long positioned himself as Grinspun's successor (Bonelli 2004: 48-49; Neiburg 2004). The team Sourrouille brought along, under the technical leadership of Roberto Frenkel, was composed of a small group of talented young economists who, thanks to their educational and professional backgrounds (e.g., ECLAC), were active participants in an international network of renowned economists (**Table 13**)(Heredia 2006: 162). In both contemporary as well as retrospective commentary much has been made of the closed nature of this group and its extraordinary influence on the *Plan Austral* (e.g., O'Donnell 1991). The team benefited from, paraphrasing Haggard (1994: 470), being granted a convenient position within the institutional matrix, which proved crucial for its coherence and institutional insulation.

Figure 9: Position of the *Plan Austral* Team within the Economic Bureaucracy



Source: Author's interviews with Machinea and Heymann; also see Phillips 1998: 60; Bonelli 2004.
Note: Depiction as of June 1985. Members of the core economic team (*'técnicos'*) of the Austral Plan are noted in blue font, while UCR members (*'políticos'*) of the economic policy ministries are shown in red font.

First, unlike their predecessors, they were largely *"strangers to the UCR"* and to Argentina's party-political landscape and hence less exposed to the formal and informal pressures from party cadres (Barkey 1994: 43; also Tedesco 1999: 95; Neiburg 2004). At the same time, they were no outsiders to the executive environment given that most of them, and especially Sourrouille, had previously worked at the Secretariat of Planning. Secondly, unlike Brazil's *Cruzado* team, the economists were not dispersed across various ministries with conflicting bureaucratic allegiances but instead worked for or operated as direct ministerial advisors to the MECON, where responsibility for all key economic instruments was centralised (**Figure 9**). In addition to streamlined professional allegiances, group strength was also derived from members' shared personal loyalty towards Sourrouille (Canitrot, et al. 1985: 618; Neiburg 2006). Thirdly, with Sourrouille operating in a double role as an integral member of the economic team, who was actively involved in the policy formulation process, and as the president's key economic policy interlocutor, the team's communication with the presidency was not exposed to any interference (Interview Heymann). Altogether, this made for a degree of insulation that enabled the team to formulate an innovative heterodox stabilisation programme in isolation from other cabinet members or otherwise influential societal actors in an environment resembling a *"semi-clandestine academic seminar or laboratory"* (Neiburg 2006: 623, Interview Heymann). In short,

> [e]laborated in the secrecy of the government offices by technical and highly-qualified personal with very few political contacts to the governing party, the Austral Plan was not previously discussed with anyone and even less with political leaders or with organised interests (Tavares de Almeida and Buj 1992: 107).

The Crucial Role of the Presidency: A Powerful but Fickle Form of Political Insulation

This 'autonomy' proved to be very short-lived and fragile. This was primarily due to the fact that the team's insulated status relied on sustained presidential support. In line with Bates' and Krueger's (1993: 7) conclusion that technocrats only become powerful *"because politicians choose to make them so,"* and that although technocrats appear powerful the success of their policies really *"reflects the structuring of the political process by their political patrons, rather than the power of the technocrats themselves"* (Bates 1999: 7), the *técnicos* owed their very status to Alfonsín. Exploiting his authority to designate ministers and high-ranking executives, Alfonsín *chose* to temporarily guarantee the insulation of the newly appointed technocracy in the hope that this would solve the persistent problems of accelerating inflation and external debt, which had begun to undercut his own popularity (O'Donnell 1991). He could do so thanks to a strong electoral mandate, which had strengthened his position as *de facto* and *de iure* party leader within his party (Heredia 2006: 176-177).

However, even at this early point the team's discretionary space was circumscribed (Interviews Heymann and Machinea, Giussani 1987: 192). For instance, recessionary adjustment programmes, which reawakened popular memories of the *'proceso'*, were unacceptable to Alfonsín who feared the destabilising impact of adjustment and renewed distributional struggle (Smith 1989; Lorenzutti 1996: 426; Palermo and Novaro 1996: 62-63). Novel theories of 'heterodox stabilization' thus posed a useful alternative. They *"had been circulating in international agencies, think tanks, and the economics departments of various North American universities for some time"* (Neiburg 2006: 619).[22] The heterodox emphasis on 'inflationary inertia' and the recommendation to break this inflationary spiral by means of price and wage freezes combined with currency reforms proved particularly appealing. It resonated with Alfonsín's political needs of the moment insofar as it avoided the direct confrontation of societal interests due to the 'neutralisation' of distributional effects and promised the commensurability of stabilisation and growth (Palermo 1990: 349; Smith 1990: 10).

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[22] Heterodox policy recipes had their intellectual origins in Brazil where they had been developed, among others, by Pérsio Arida and André Lara Resende. Exchanges on the theoretical underpinnings of heterodox stabilisation between the two groups greatly informed the *Plan Austral*'s design (e.g., Sardenberg 1987; Neiburg 2006; Interviews with Arida, Machinea and Lara Resende).

Alfonsín quickly subscribed to this logic and, respecting the team's technical expertise in this area[23] but also known for lacking any sustained interest in and understanding of economic matters (e.g., Tanzi 2007: 46), did not seek to interfere with the details of the plan's preparations. Alfonsín's willingness to grant the team significant agenda-setting power with respect to the programme's blueprint also exploited the team's (perceived) neutrality in Argentina's highly polarised political relations insofar as he assumed that a plan, developed by renowned technocrats, would be perceived as *"politically neutral and exclusively driven by technical principles"* (Calcagno 1986: 186) and would thus be granted greater legitimacy.

The untested heterodox shock logic also provided welcome legitimation for the exclusionary decisionmaking during this period. Alfonsín repeatedly justified this unilateralist style and the plan's legal character as an executive decree[24] in reference to technical requirements, by which he had to abide even though they conflicted with his ideals of institutional co-participation. Alfonsín recalls that he did *"not even reveal the plan to ministers from outside the economic area, something which [he] did not like to do"* (in Giussani 1987: 192). Indeed, even his own party was excluded from preliminary discussions (Palermo 1990: 341; Acuña 1995b: 146-147).[25] Yet, the secrecy requirements only too conveniently chimed with the president's long-standing suspicions about Argentina's vested interests and corporatist institutions (Torre 1993: 74-75; Rapoport 2003: 888) and with technocrats' preference against political interference (Acuña 1995b: 145; Corrales 2004: 3).[26]

The team's initial insulation was thus considerable (Palermo and Novaro 1996: 122). Yet, its Achilles heel was the fact that the team – and hence its policies – were at the mercy of the president's changing political calculations, which were increasingly affected by the lack of a legislative majority in the Senate (Huneeus 1998: 183). Moreover, although often overlooked, Alfonsín compromised the technical capacity of Sourrouille's team or, as De Pablo puts it, *"introduced noise to the decisionmaking process"* (Interview) right from the start by appointing economists of conflicting convictions, such as Grinspun and the PJ economist Lavagna, and introducing various mechanisms of control (Huneeus 1998: 191).[27] Hence, even prior to June 1985 Sourrouille's technical capacity was not as complete as it is often presented

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23 Several team members, e.g., Heymann, had written doctoral theses on disinflation from non-monetarist perspectives (Interviews Heymann and Machinea; Neiburg 2004).

24 The decree was validated *post factum* by legislative approval (Palermo and Novaro 1996: 262). Some argue that enacting the monetary reform by decree, instead of congressional law, violated the constitution (Snow and Manzetti 1993: 43).

25 Alfonsín's dominance in the UCR is illustrated by the *"quasi-rubber stamp relationship"* he had established with the congressional UCR, which approved 80% of executive bills prior to the *Plan Austral* (Corrales 2004: 8).

26 Sourrouille, in particular, has been described as *"eager to execute policies without the benefit of consultation, negotiation or compromise with either members of his own political party, other ministers or representatives of leading interest groups"* (Pion-Berlin 1991: 558).

27 Huneeus (1998:187) points to another source of presidential interference: Grinspun's appointment to the Secretary of Planning meant that Alfonsín had a man on the inside of the team, which granted him a secondary channel of information.

given that *"he did not enjoy the subordination of all other economic officials"* (Corrales 2004: 4). Most importantly, Alfonsín denied the team control of the BCRA presidency, a key, if not veto, position during a stabilisation programme. As a concession to the UCR, but also with a view to containing Sourrouille's growing influence, Alfonsín had entrusted the presidency to the developmentalist Alfredo Concepción, an experienced UCR cadre (Palermo 1990: 353; Barkey 1994: 51). Given Concepción's known opposition to Sourrouille's reform course, the team initially excluded him from the plan's preparations – with highly problematic consequences. First, without a high-level BCRA representative the economic team lacked insider information on e.g., the possibilities of pursuing a more restrictive monetary policy, the nature of the 'quasi-fiscal deficit' as well as the evolution of the foreign exchange market and the likely sustainability of the planned exchange rate peg. Secondly, as a result of being side-lined, Concepción later had little incentives for ensuring the plan's success (Barkey 1994: 51+63, Interview Machinea).[28] His opposition to a more restrictive rediscount policy and his public critique significantly undercut the plan's efficacy and credibility (Kaufman 1990: 89). This source of weakness marked the workings of the economic team until Alfonsín finally agreed to José Luis Machinea's appointment, one of Sourrouille's closest allies in August 1986 (NY Times 23rd August 1986; Kaufman 1990: 89).

Overall, this politico-institutional context affected exchange rate policymaking in several respects. First, contradicting accounts by Schamis and Way (2003), who insinuate that exchange rate-based stabilisation programmes are principally driven by electoral motivations, such incentives were of little importance in the team-internal discussions preceding the plan's announcement – although they probably influenced the president's position. As Heymann points out, discussions were marked by a high level of uncertainty regarding the response of economic indicators given that this kind of programme had not yet been tried and tested anywhere else.[29] The idea of being able to engineer a macroeconomic programme around an election week sometime five months later was thus *"appealing but not realistic at the time"* (Interview Heymann).[30] Instead, the atmosphere was dominated by urgent disinflationary concerns and very academically-minded discussions. Secondly, the heterodox logic and its focus on the initial shock allocated only a marginal role to the exchange rate policy pursued in the medium and long run, and little thought was given to concerns, such as the peg's sustainability or modes of exit without reawakening inflation. Its role, and that of the currency

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[28] Concepción, at first, even refused to sign the enabling decree (Barkey 1994: 63).

[29] The Austral Plan was the first of several heterodox experiments including Israel (July 1985) and Brazil (February 1986). Uncertainty about its evolution and success was thus much greater than for the *Cruzado* team (Ruge-Murcia 1997).

[30] The plan's timing was determined by a leak that rendered its anticipation inevitable (Alfonsín in Giussani 1987: 192).

reform, was principally one of underpinning the psychological disruption of inflationary expectations and of granting credibility and confidence to the plan (Interview Heymann and Machinea, Acuña 1995: 140). Moreover, convinced that inertial forces constituted the root causes of inflation, the team failed to posit the necessity of structural reforms to address the fiscal crisis from the outset (Palermo and Novaro 1996: 71). Thirdly, team members suggest that with the benefit of hindsight they overestimated Alfonsín's commitment to stabilisation, which led them to adopt an exchange rate regime that was too demanding in terms of the necessary economic restructuring it presupposed (Interview Machinea; Acuña 1995: 154-155). Moreover, convinced by the technical logic of 'neutrality' inherent to the plan, they failed to foresee the intensity of distributional struggle that would ensue around frozen relative prices (including the pegged exchange rate) and which would position the economic authorities *"in the eye of a wild storm"* (Acuña 1995: 155). In short, exchange regime choice prior to June 1985 was shaped by a very technical – and politically naïve – reading of the situation. Technocrats did not only misjudge the executive's capacity in controlling spending (e.g., in the provinces) and containing distributional conflicts and based their exchange rate strategy on misguided assumptions about the executive's willingness to sustain such demanding regime but, more crucially, they failed to foresee that their unilateralist approach rendered the generation of a wider societal consensus buttressing their reform initiative considerably more problematic. As Canitrot (in Palermo and Novaro 1996: 80) summarised, they mistakenly assumed that the reforms

> would be implemented following on from the *Plan Austral* as an exercise of refinement, by means of a succession of technical corrective operations that would eliminate distortions, without too much conflict, and only with the political support of the presidential authority.

The Repoliticisation of the Austral Plan

The fragility of Alfonsín's support became apparent from 1986 onwards. With the plan's announcement and 'easy' early disinflationary success, two key pillars of the team's autonomy had broken away insofar as secrecy and the notion of 'economic emergency' no longer protected them from demands by party-political and societal actors (Huneeus 1998: 185). More importantly, the UCR's legislative victory of November 1985 had provoked the reassertion of the *políticos* in Congress (but also in the cabinet and in Concepción's case at the BCRA), who began to publicly oppose the economic policy course precisely at a time where (legislative) support to obtain further fiscal adjustment so to sustain stabilisation was vital (Palermo 1990: 352; Phillips 1998: 59; Corrales 2004: 8). The unprecedented electoral victories

seduced Alfonsín to fantasise about the restructuring of Argentina's party-political landscape towards an anti-Peronist *'Tercer Movimiento Histórico'*. This ambition rendered him unable

> to resolve the conflict between trying to strengthen the political position of the Radical Party (which required capturing part of the Peronist vote) and implementing the difficult economic decisions aimed at controlling fiscal accounts (which would have most certainly alienated some of the same groups) (Díaz-Bonilla and Schamis 2001: 85).

Unimpressed by the economic team's attempts to *"convince the government that stabilisation could not be achieved without persistence and continuity"* (Machinea in Torrents and Lewis 1993: 137) and ignoring the emerging consensus among team members that structural reforms were inevitable for achieving long-term stability, Alfonsín chose to prioritise the requirements of 'democratic consolidation' over the consolidation of price stability (Machinea 1993: 80; Torre 1993: 73; Teichman 1997: 43).

This shift in presidential priorities undermined the sustainability of the Austral Plan's exchange rate strategy via various channels. First, it implied greater presidential interference in economic policymaking. Moreover, it gave rise to a series of deals with selected societal actors, which the economic team had no choice but to tolerate given that they *"were obliged to function within the context of democratic rules, remaining loyal to the president"* (Smith 1990: 32). Wage increases for the armed forces in late 1985, which hollowed out the *Plan Austral* and compromised its acclaimed distributive neutrality, constituted but one notorious example (Phillips 1998: 63; Tedesco and Barton 2004: 99). Secondly, intra-cabinet divisions were exacerbated when, in appeasement of selected constituencies, Alfonsín appointed several ministers and state secretaries in 1987, whose ideological convictions jarred with those of their cabinet colleagues. The extent to which these personnel changes impeded meaningful cross-cabinet coordination and consistent policy implementation by, for instance, initiating and propelling forward sectoral deals is illustrated by the misguided stabilisation attempts throughout 1987 (Bonelli 2004: 58; Beltrán 2006).[31]

The effect of this repoliticisation was a loss in fiscal discipline that ultimately rendered the loosening of price controls and the peg's abandonment inevitable in April 1986 (Smith 1990: 14). Technocrats at MECON had sought to force the BCRA to defend the peg for as

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[31] E.g., the appointment of the unionist Carlos Alderete to the Labour Ministry, of the SRA's Ernesto Figueras to the Secretary of Agriculture and of the UIA's Murat Eurnekian to the Secretary of Industry. Especially Sourrouille and Alderete *"worked at cross-purposes"* (Stiles 1987: 78) and Alderete's wage increases and rhetoric (describing Sourrouille as *"the structural enemy of the Ministry of Labour"* (in McGuire 1992: 48)) proved highly disruptive.

long as possible – irrespective of the growing economic costs in terms of overvaluation and elevated interest rates. They felt that having lost control over the incomes policy pillar and struggling to impose discipline on state-owned enterprises losing this last, albeit weak, anchor for reforms and fiscal adjustment would be disastrous (Acuña 1995: 223). In Canitrot's words,

> [w]e knew that the dollar was undervalued. But every morning we would get up and tell ourselves 'just one day more' (in Bonelli 2004: 51).

In an attempt to defend his own influence and counter his marginalisation as UCR politicians blamed the economic team for the party's defeat in the September 1987 elections, Sourrouille himself took on an increasingly political role. With executive strength at an all-time low, Sourrouille sought to heighten his relevance in Alfonsín's eyes by elaborating policy alternatives, which combined tentative orthodox stabilisation measures with a political support base that would ensure the administration's political survival until the 1989 elections – and possibly even the victory for the UCR candidate Angeloz (Smith 1990: 2+18).

This culminated in the *Plan Primavera* gamble. Sourrouille now explicitly used the exchange rate not only to impose anti-inflationary discipline but also to create selected beneficiaries (Palermo and Novaro 1996: 109). Although promises of renewed budgetary discipline and gradual liberalisation in exchange for a 180-day price freeze were also part of the *Plan Primavera*, the multiple exchange rate regime played a key role in generating fiscal revenue and assembling a support coalition based on Sourrouille's 'gentlemen's agreement' with actors from industry and commerce (O'Donnell 1991: 12; Beltrán 2006: 229-230). This deal forced (agricultural) exporters to sell their hard currency earnings at a fixed 'official' rate, which was kept markedly below the floating rate, at which the BCRA would then sell dollars. While the overvalued exchange rate together with extortionate interest rates fuelled speculative capital inflows, the arrangement allowed the government to appropriate agriculture's foreign exchange earnings for fiscal purposes as well as underpinning disinflationary efforts by keeping domestic food prices low (Bates 1981: 35-36 + 101; Smith 1990: 26). Yet, this last-ditch gamble faltered as the resignation of Sourrouille and his team in the aftermath of the 'market coup' and Angeloz' defeat in May 1989 highlight. Having underestimated speculative forces, the co-existence of selective consultation with a unilateralist attitude vis-à-vis other segments of organised society and the massive redistribution of wealth by the February 1989 devaluation alienated wider society and fuelled distrust of the state (Canitrot in Munck 1992: 206).

According to the technocrats, the populism of Argentina's political class and

Alfonsín's cowardice in confronting powerful vested interests greatly provoked the repeated failure of exchange rate-based stabilisation (e.g., Heymann 1987; Machinea and Fanelli 1988; Heymann 1991; Machinea 1993). Yet, the politicisation of Sourrouille's team itself undoubtedly also contributed to excessive risk-taking, to the absence of a sustainable long-term exchange rate strategy and to exchange rate policy's political instrumentalisation towards the end of Alfonsín's presidency.

4.3.2 The Role of Societal Interests

Having highlighted the decisive role of the executive's perspective on exchange rate policy and its growing vulnerability to outside pressures, this section investigates the role of societal interests in shaping the timing and content of exchange rate regime decisions and seeks to unpack the rather vague and unsatisfying notion of 'distributional struggle' commonly employed with respect to Argentina (e.g., Smith 1990; Teichman 2002b). The account is divided into three chronological periods in order to better capture the evolving impact of societal interests:

- from the return to democracy to the adoption of the *Plan Austral* (1983-1985),
- the intermediate phase characterised by the executive's failed efforts to stabilise the economy (1986-1987) and finally,
- the meltdown of the Argentine political economy in the aftermath of the failed *Plan Primavera* (1988-1989).

1983-1985: Going it alone – The Exclusion of Societal Interests

From the outset, the relationship between Alfonsín's incoming administration and organised interests was problematic. For one, the administration's attitude vis-à-vis societal – and especially corporatist – interests was one of deep mistrust given the collusion between business interests and the authoritarian *junta* and labour's ties to the rival PJ (Smith 1990: 7-8; Torre 1993: 79).[32] This hesitation contrasted markedly with the extraordinarily high hopes on the part of Argentine society that expected nothing less than the resolution of the on-going politico-economic crisis. From the outset, the actions of Alfonsín's administration showed that these hopes for enhanced participation in policymaking by groups, such as businessmen's

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[32] Alfonsín repeatedly expressed suspicions regarding labour's relationship to the *junta* and his party, the UCR, lacked close ties to local capital or firm roots in the 'world of organised sectors' (Torre 1993: 79). Overall, Alfonsín regarded political parties as the only legitimate intermediaries in the political process.

'Grupo de los Nueve',[33] were misplaced (Ostiguy 1990; Tedesco 1999: 130; Tedesco and Barton 2004: 98). Instead of stronger engagement, the executive sought to redefine its relations to socio-economic actors and chose to systematically bypass corporatist organisations (Acuña 1995b: 25 + 31). Only once the administration's expansionary policy was faltering in late 1984 some attempts at involving corporatist actors through social pacts (*concertación*) were made (Smith 1990: 8; Acuña 1995b: 109-117). Yet, this initiative proved inconsequential and failed to contain the rapid deterioration of the economy, external creditor demands and protests against the administration's exclusionary style and policy agenda (e.g., the cross-factor alliance *'Grupo de los 11'*). Partly in reaction to this souring of government-society relations, Alfonsín appointed Sourrouille in February 1985 (*Clarín* 9th February 1985; Palermo 1990: 342).

Yet, the run-up to the *Plan Austral* illustrates how misplaced hopes were for greater consultation in government-business relations under Sourrouille: The executive's unilateral adoption of the plan and its exchange rate peg in June 1985 forced societal interests to react to a series of *faits accomplis* (Interviews Heymann, Machinea, Snow and Manzetti 1993: 44). Nevertheless, in a context of popular enthusiasm thanks to rapid disinflation and an ensuing consumption boom, reactions to this 'top-down' stabilisation plan among organised civil society were predominantly positive with the fragmented business community expressing tentative support, and merely labour rejecting the government initiative from the outset (Phillips 1998: 59).

Delayed by internal opposition, the lead representative of the fragmented industrial sector,[34] the *Unión Industrial Argentina* (Argentine Industrial Union – UIA), eventually came out in support of the plan (*La Nación* 26th June 1985; Palermo 1990: 344). Whilst its dominant faction, the *Movimiento Industrial Argentino* (Argentine Industrial Movement – MIA) that *"traditionally represented the larger firms and the more liberal sector of Argentina's industry"*, had welcomed the measures, the plan had received a critical reception by the *Movimiento Industrial Nacional* (National Industrial Movement – MIN), which *"represented the more protectionist interests and those from the interior of the country"* (Interview Massuh, Acuña 1995b: 43; Gaggero and Wainer 2004: 2). The exchange rate peg did not play a prominent role in these discussions – despite the fact that an *"adequate exchange rate policy"* had been identified by the World Bank (1985: 194) as *"the single most important element"* in maintaining industrial competitiveness. Instead, given the drastic decline in industrial production and a fall in its share of GDP from

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[33] This group evolved into the 'Captains of Industry', who took on a pivotal role in Alfonsín's strategy of integrating the bourgeoisie into the redemocratisation process (Acuña 1995: 44+88; Tedesco 1999: 130).

[34] In addition to the UIA, the CGE and the CGI (*Confederación General de la Industria)* traditionally represented industry. Between 1974 and 1976, the UIA and the CGE had been incorporated into the *Confederación Industrial Argentina* (Malamud 1995: 5; Viguera 2000: 37-44).

28% to 22% between 1975 and 1982 (World Bank 1985: 161), industrialists focused on the maintenance of subsidy programmes, the control of labour costs and the revival of domestic consumption. The exchange rate also stood little chance to emerge at the top of the association's political agenda due to the high degree of fragmentation industry had undergone during the 1970s (e.g., Basualdo 2001a; Castellani 2004; Pucciarelli 2004).[35] This structural differentiation translated into deepened factional divisions within the UIA that repeatedly challenged its strategic capacity and forced its leadership to concentrate on issues that united members, i.e. labour legislation and tax reforms, rather than the exchange rate (Interviews Massuh and Arano, Acuña 1998: 67; Schneider 2004: 9 + 178-9). Actions by the association's most influential members, who habitually bypassed corporatist structures to exploit individual contacts and create groupings of a more flexible and exclusionary nature, e.g., the '*Capitanes de la Industria*' (Captains of Industry) or *'Grupo María'*, proved particularly debilitating because they enabled the government to 'divide and conquer' industry by engaging with selected factions instead of operating within established corporatist structures (e.g., Antonio Etchart (MIA) in Acuña 1995: 204; Smith 1990: 9). Sourrouille's decision to grant the 'captains' a special audience on the very day of the Austral Plan's announcement while excluding the UIA is exemplary in this respect (Acuña 1995: 168).

Table 14: The 'Captains of Industry': Companies, Principal Owners and Sector

Acindar *M Alcides-Gurmendi* *[steel]*	Celulosa Jujuy *G. Kuhl* *[paper]*	Massuh *A. Massuh* *[paper]*	Astarsa *Braun Cantilo* *[shipbuilding]*
Alpargatas-Grupo Roberts *R. Cluterbuck* *[textiles and footwear]*	Cartellone *G. Cartellone* *[construction]*	Grupo Pérez Companc *V. Orsi* *[transport and energy]*	Bridas *Bulgheroni* *[oil and gas]*
Astra *R. Gruneisen* *[petrol]*	Saab Scania *G. Kuhl* *[trucks]*	Bagley *J. Nunez* *[food and confectionary]*	Arcor *F. Pagani* *[food and confectionary]*
IMPSA *E. Pescarmona* *[hydromechanical equipment]*	Grupo Bunge y Born *M. Roig* *[food/ agr. commodities]*	Grupo Techint *A. Rocca and C. Tramutola* *[engineering, steel, oil and gas]*	Fate-Aluar *M. Madanes* *[aluminium]*
Laboratorios Bagó *S. Bagó* *[pharmaceuticals]*	Ledesma *M. Blaquier* *[agro-industrial products/ food]*	Garovaglio e Zorraquín *F. Zorraquín* *[agro-industrial products]*	La Serenísima *P. Mastellone* *[milk products]*
BGH *J. Hojman* *[electronics]*	Loma Negra *A. Lacroze de Fortabat* *[cement and construction]*	Grupo Macri *F. Macri* *[construction/ automob./ chem.]*	Finamérica *C. Carbello* *[commercial finance]*

Source: Own elaboration based on Ostiguy 1990 and Tedesco 1999.
Note: Bunge y Born, Techint and Macri are key representatives of the *'grupos económicos'* with great influence and market power since the 1970s (Ostiguy 1990; Tedesco 1999; Basualdo 2000; Basualdo 2001b; Ortiz and Schorr 2006b).

[35] Three groupings can be distinguished: a) the *'contratistas'*, i.e. firms that relied on government contracts, advocated a strong role for the state and were represented by the MIN, b) 'intermediate' firms that had benefited from ISI but had begun to export, and c) the liberal sector of industry, composed of large, often multinational, companies that favoured radical state reform and commercial opening and belonged to the MIA (Acuña 1995: 42).

The financial sector was cautiously positive about the turn towards technocracy and the disinflationary initiative based on a nominal exchange rate peg. Having emerged economically strengthened from the financial liberalisation of the 1970s (Maxfield 1990: 170), banks and their representative associations – ADEBA and ABRA[36] – were acutely aware of their limited political clout as a result of their relationship to the *junta* and the widespread perception of their enrichment at the expense of wider society (Heredia 2003: 86). Hence, instead of asserting demands via the public sphere, sectoral representatives concentrated organisational resources on key issues, i.e. financial legislation and credit policy, which were addressed in direct negotiations with MECON and especially the BCRA. In these institutionalised commissions, banks' relationships to external creditors and their informational advantage on capital market developments could optimally be harnessed for negotiating beneficial agreements (Interview Peruzzotti, Hall 2005: 35).[37]

As key exporters (contributing approximately 74.4% to total exports in the 1980s) and as the greatest generator of foreign exchange, agricultural interests were the only ones to explicitly react to the plan to peg the exchange rate (World Bank 1985: 126; Barkey 1994: 52; Ghezán, et al. 2001: 24). Yet, this aspect did by no means constitute a policy priority for the sector as a whole given that, similar to industry, agriculture's fragmented pattern of political organisation favoured a focus on more widely shared concerns and thus watered down the relatively strong exchange rate policy preferences of some members.[38] Hence, the outward-looking and traditionally arch-liberal *Sociedad Rural Argentina's* (Argentine Rural Society – SRA) welcomed the plan and the abolition of the multiple exchange rate system and hoped that disinflation and exchange rate stability would help mitigating the raging 'rural crisis' due to falling commodity prices (Interview Delfino, Erro 1993: 24; Acuña 1995b: 161 + 169; Malamud 1995: 5-6). Moreover, Sourrouille's reformist image had raised expectations of the elimination of discriminatory export taxes (Ghezán, et al. 2001: 25). In contrast, the *Federación Agraaria Argentina* (Argentine Agrarian Federation – FAA) and the *Confederaciones Rurales Argentinas* (Argentine Rural Confederations – CRA) disregarded the exchange rate issue and, similar to the UIA, focused on the plan's impact on domestic consumption and credit provision (Acuña 1995b: 168-169). Eager to present a united agricultural front vis-à-vis the

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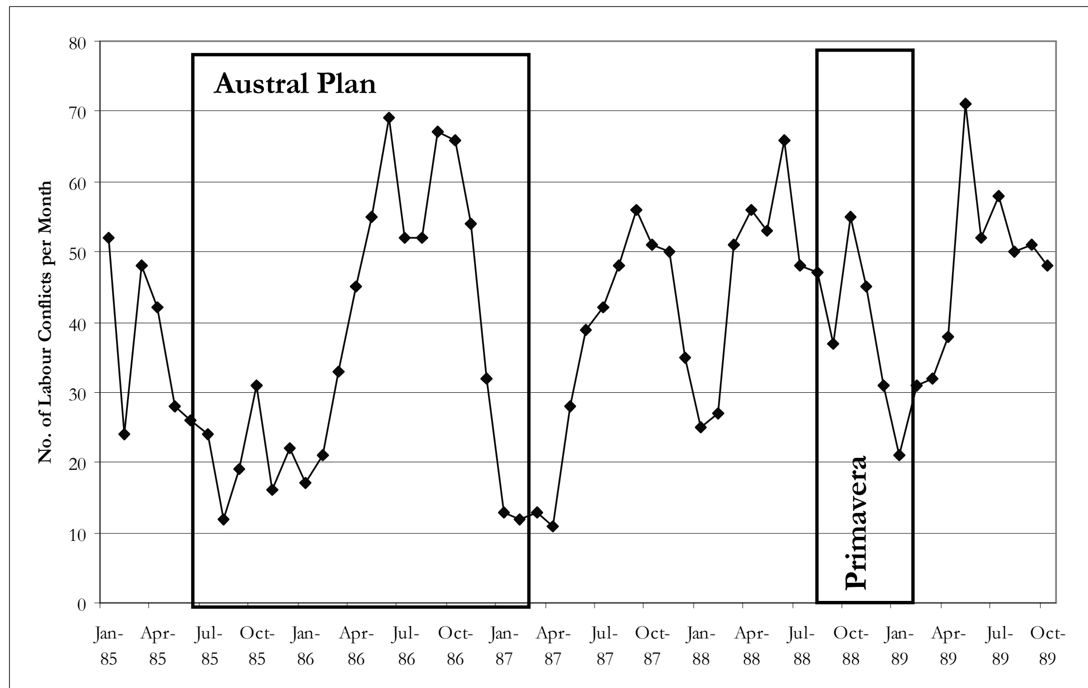
[36] In 1972, ADEBA (*Asociación de Bancos Argentinos* – Association of Argentine Banks) had split from ABRA (*Asociación de Bancos de la República Argentina* – Association of the Banks of the Argentine Republic) in order to better represent the interests of private domestic banks vis-à-vis international capital (Heredia 2003: 85).

[37] Relying on the 'Concepción connection', rediscounts – credit allocated by the BCRA – proved a valuable source of profit, which prior to Machinea's arrival cushioned the sector against policy volatility (Barkey 1994: 51).

[38] Aside from the SRA, which represented the '*latifundistas'* and large-scale agricultural exporters, rural interests were divided into the CRA, representing eleven provincial chambers; the FAA, representing smaller and medium-sized farms; and the *Confederación Intercooperativa Agropecuaria Limitada* (Malamud 1995: 5-6).

government,[39] these intra-sectoral divisions meant that the sector's primary political impetus was on common concerns, such as rural credits, with the SRA's exchange rate policy concerns initially falling by the wayside (Interview Delfino).

Figure 10: Labour Conflicts in Argentina, 1985-1989



Source: Own elaboration based on data from *El Bimestre Político y Económico*, various issues.

The most confrontational response to the *Plan Austral* was that of organised labour. Embittered by Alfonsín's attempts at unions' *'desperonización'*,[40] the *Confederación General del Trabajo* (General Confederation of Labour – CGT) was gradually overcoming long-standing personal rivalries and sectoral disagreements by uniting in opposition to the administration's agenda (Acuña 1995b: 162; Tedesco 1999: 71-72; Rapoport 2003: 884-886).[41] Exploiting unions' traditional opposition to stabilisation programmes, the CGT's emerging leader Saúl Ubaldini presented the Austral Plan as another executive attack on workers' interests and demanded compensation backed by strike threats (Smith 1989: 277; McGuire 1992: 58; Tedesco 1999: 115-116). Given the multiplicity of challenges to workers' interests emanating from government policy as well as structural changes in Argentina's employment profile, the exchange rate peg and its implications for real wages escaped Ubaldini's criticism – partly due to unions' lack of technical expertise (Interviews Castro and Puigbó). Moreover, due to

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[39] The SRA hesitated taking an isolated stance given its past as one of the most vociferous supporters of the *'proceso'*.

[40] In 1983, Alfonsín and Labour Minister Mucci had introduced the '*Ley de reordenamiento sindical*' to 'democratise' unions, that is to break their links to the PJ, which eventually failed in March 1984 (Levitsky and Murillo 2005: 187-188).

[41] In the early 1980s, organised labour, representing 56% of the workforce in 1985, was divided between the dissident CGT-Brasil (led by Saúl Ubaldini) and the CGT-Azopardo (led by Jorge Triaca) (Ranis 1995: 56; Murillo 2001: 91).

overwhelming public enthusiasm for the plan, aware of its own image as overly radicalised and corrupt (Murillo 2001: 91) and weakened by the *Plan Austral's* ban on collective bargaining (Malamud 1995: 9; Ranis 1995: 48),[42] the CGT leadership initially held off strike plans although its demands had remained largely unheard (**Figure 10**).

In short, societal interests played no decisive role in the *Plan Austral's* exchange rate decisionmaking nor did the exchange rate element receive any sustained attention in initial reactions to this audacious plan. Societal interests were not only excluded at this stage but, due to internal fragmentation, historically-rooted sectoral antagonisms and organisational renewal in the new democratic environment, they lacked the technical expertise and organisational resources to develop a coherent exchange rate policy position.

1986-1987: Dividing without Conquering – Selective Consultation and Growing Opposition

As the plan's weaknesses in terms of overvaluation, residual inflation and persistent budget deficits surfaced in late 1986 with the onset of recession, the government became increasingly dependent on societal cooperation so as to re-define the economic agenda and flexibilise price controls and the exchange rate whilst containing the zero-sum 'struggle for shares' (Tedesco 1999: 109). Yet, the executive's initial exclusionary approach and its half-hearted efforts at *'concertación'* in the *Conferencia Económica y Social* (July 1985) had undermined its ability to generate a more durable reform consensus (Snow and Manzetti 1993: 44). Forced into building ever-changing and increasingly opportunistic support coalitions, this approach ultimately alienated all societal actors, opened the government to attacks by economic interests and the armed forces (e.g., the Easter rebellion in 1987) and undermined the economic agenda's own credibility and coherence.

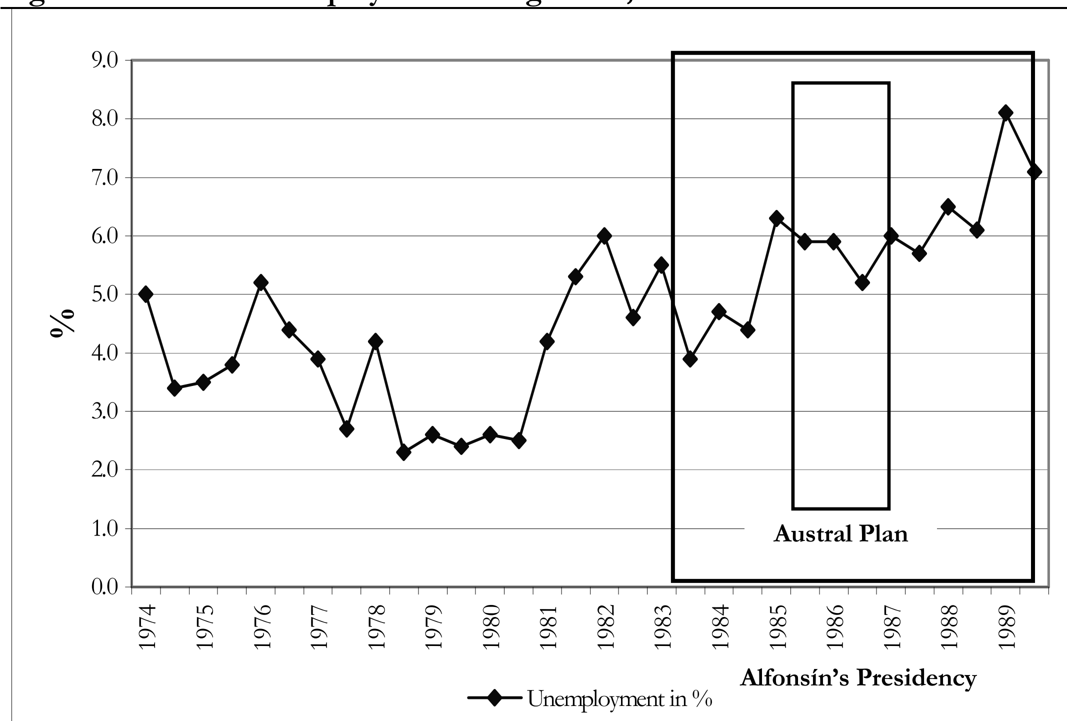
One clear indication was the proliferation of labour unrest after September 1986 (Smith 1990: 13; Ranis 1995: 63; Bonelli 2004: 53). Protesting against falling real wages and rising unemployment (**Figure 11**), these strikes created great uncertainty but the issued demands initially fell on deaf ears (Kaufman 1990: 89; McGuire 1992: 46; Phillips 1998: 59+62). Having strengthened Ubaldini's position within the CGT,[43] this combative approach also exacerbated frictions with rival leaders Lorenzo Miguel and Jorge Triaca, who became increasingly amenable to approaches by the executive (Palermo and Novaro 1996: 97). These encounters led to a controversial deal in early 1987, which committed the executive to

[42] The ban had deprived organised labour of all political instruments except strikes, which – given that strike days were unpaid – had to be wielded wisely.

[43] Ubaldini was confirmed as the CGT's sole secretary-general in September 1986 (McGuire 1992).

appointing Carlos Alderete (PJ; Light and Power Union) to the Labour Ministry and agreeing to sectoral wage increases in exchange for a truce by participating unions (McGuire 1992: 46-47). Alfonsín thus sacrificed wage restraint and cabinet coherence as well as risking relations to the increasingly concerned business community for the price of temporarily weakening labour and reducing strike activity (Acuña 1995b: 171+255; Tedesco 1999: 119).

Figure 11: Official Unemployment in Argentina, 1974-1989



Source: Own elaboration based on INDEC – www.indec.gov.ar [accessed 25th October 2006].

Industrialists were similarly divided. With the MIA and the 'captains' supporting governmental efforts, the MIN raised its internal profile by maintaining a highly critical posture, which highlighted – especially once the executive broached the issue of trade liberalisation – the dangers of such initiative under an overvalued exchange rate (Acuña 1995b: 173). When the MIN won the leadership race for the first time in April 1987, this strategy had successfully shifted the internal balance of power in favour of government critics (**Table 15**). Yet, rather than enabling the UIA to pursue a more unified opposition line and to take decisive stances on issues such as the *'atraso cambiario'* (overvaluation), the new leadership was forced to concentrate on mending internal fissures after these polarising elections and begun an intense process of re-organisation. The resulting arrangement, centring on the rotation of the presidency, established a *"more conciliatory management of [internal] cleavages"* (Schneider 2004: 192) but could not prevent recurrent episodes of infighting nor put a check on Alfonsín *"using the 'captains of industry' in order to neutralise the criticism of other industrialists"*

(Acuña 1995: 260; Interviews Massuh, Arano and Liubitch). With these organisational challenges occupying the industrial leadership, demands for exchange rate adjustment further faded when the government earmarked various export promotion benefits so as to compensate industrial exporters after February 1987.

In the eyes of agricultural interests, this industry-focused export promotion programme re-confirmed perceptions of being the *"real losers of the Austral Plan"* (Tedesco 1999: 117). Indeed, although their calls for a devaluation had eventually been heard in April 1986, the four agricultural associations had organised a series of *"Jornadas de Protesta Agropecuaria"* in protest against the continuation of discriminatory export taxes in a context of resurging real exchange rate appreciation from mid-1986 onwards. As the opening of the economy established itself on the political agenda, the exchange rate, together with the *retenciones* or *derechos de exportación*, began to play an increasingly prominent role in agriculture's negotiations with the government (Acuña 1995b: 213). In an attempt to appease this influential sector and to gain rural votes in the 1987 elections, Alfonsín eventually agreed to several concessions (Ghezán, et al. 2001: 24): Paralleling his tactic vis-à-vis labour, a SRA representative, Ernesto Figueras, was appointed Secretary of Agriculture and the reduction (and later the elimination) of agricultural export taxes was approved (Acuña 1995b: 212+253; Schvarzer 1998; Rapoport 2003: 889).[44] Once more, compensatory concessions by the executive removed the urgency and thus political priority of the sector's exchange rate policy demands, which *per se* remained unaddressed.

As alluded to in section 4.3.1, the economic team, pressured by its political superiors who eyed the upcoming elections, was repeatedly forced to yield to interest group demands in this period. Yet, instead of dampening distributional conflict, these concessions fuelled perceptions of clientelism and, as economic conditions worsened, increasingly provoked the anger of societal actors. In addition to acting via their representative associations,[45] businessmen pressured the administration and its increasingly fragile exchange rate strategy through market-based actions, e.g., by reducing investment to a bare minimum and through intensified capital flight (Phillips 1998: 62; Ortiz and Schorr 2006b: 320). These actions further undermined public confidence and contributed to the government's defeat at the hands of a reinvigorated PJ in the September elections. In short, although direct exchange rate

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[44] The rural sector's requests for the abolition of export taxes were difficult to accommodate given that revenues from *retenciones* represented an important share of fiscal income (approximately 25% in 1985) at a time when the authorities were desperately trying to balance the budget (World Bank 1985: 151; Schwarzer 1998). Also, export taxes are applied for extra-fiscal reasons, e.g., to keep domestic (food) prices low for key constituencies and to counter inflationary tendencies.

[45] The SRA, the *Bolsa de Comercio*, the *Cámara de Comercio* (Chamber of Commerce – CAC), the *Unión de Construcción* (Constructors' Union), the *Cámara de Construcción* (Chamber of Construction), ABRA, ADEBA and the UIA formed the *'Grupo de los Ocho'* in opposition to the government in August 1987.

policy influence remained minimal and could often be diverted by executive-designed compensation packages, a hype in societal pressures and concessions ranging from wage increases to selective tax reforms and the appointment of sectoral representatives to the heart of policymaking increasingly shaped the chaotic and ever-changing context within which exchange rate policy had to be formulated.

1988-1989: Granting Selective Access to Policymaking – The Plan Primavera

By 1988, state-civil society relations had deteriorated across the board (Acuña 1995b: 306+309): The *Plan Austral II* had been resisted by exporters opposing the new two-tier exchange rate system, by entrepreneurs for the renewed price freeze, and by labour due to its failure to adjust salaries in line with inflation. Moreover, after losing the 1987 elections and hence its capacity for political initiative, the government had no option but to seek new societal support coalitions. After attempts to collaborate with the PJ's Antonio Cafiero were cut short by the PJ primaries and relations to the *'capitanos'* cooled as a result of their intensifying ties to Carlos Menem (Ortiz and Schorr 2006a: 462), the administration was forced to re-enter negotiations with selected societal actors to buttress a renewed stabilisation effort prior to the 1989 election. Given prevailing fears of a Peronist presidency, the UIA and the CAC leadership proved particularly amenable to these approaches and their leaders began to negotiate the terms of their participation in, what became known as, the *Plan Primavera* (Phillips 1998: 60). The result was a desperate alliance between the administration and the liberal factions of industry and commerce against their historical opponent and Argentina's most profitable sector, agriculture (Peralta Ramos 1992: 107; Acuña 1995b: 311; Tedesco and Barton 2004: 100). In contrast to the executive-only preparations of the *Plan Austral,* selected societal groups thus participated directly, and notably at the expense of rival groups, in defining public policy (Peralta Ramos 1992: 105; Muchnik 2001: 49). Crucially, the vehicle for the redistribution of resources at the core of this opportunistic alliance – also known as the *"pact between democracy and production"* (Alfonsín in *Clarín* 13th August 1988) – was the exchange rate and in particular a modified two-tier exchange regime, which strongly discriminated against agricultural exporters (Muchnik 2001: 50).

As was to be expected, the excluded actors – agriculture, the financial sector and organised labour – reacted with fury. Rural interests rejected the new exchange regime, which implied an effective tax of approximately 20% on agricultural exports, and were only marginally appeased by promises that export taxes would not be reintroduced (NY Times 3rd August 1988, Peralta Ramos 1992: 105; Bonelli 2004: 66). Yet, this concession was

insufficient given that after September 1988 exchange rate developments proved increasingly worrisome with rapid real exchange rate overvaluation as the 'official' rate lagged inflation. Demands for the urgent unification of the exchange rates thus united the rural sector against Alfonsín's struggling administration (Acuña 1995b: 324; Tedesco 1999: 138). Lacking meaningful corporate access to policymaking circles, which catered to their allies in industry and commerce, agricultural exporters mobilised their assets to resort to market-based opposition: Statistics show that, although export sales had grown significantly, sales of hard currency earnings to the BCRA were 46.5% lower in late 1988 than the previous year. Exporters were thus withholding foreign exchange speculating on a devaluation and obtained domestic currency by illegally selling export revenues in Montevideo or through black-market sales (*Clarín* 13th November 1988 and 27th February 1989; Lázara in Tedesco 1999: 166).[46]

The pressure thus generated on the administration via the rapid erosion of international reserves was also sustained by the actions of the excluded financial sector (Bonelli 2004: 55). Similarly hampered by their associations' limited resonance with the government, banks held two market-based trumps: On the one hand, via their analysis and communication with international market actors, they could determine the government's perceived credibility and thus affect the risk premium on public debt. On the other hand, as owners and intermediators of (often highly liquid) capital, they wielded *"tremendous veto power over government policies"* (Smith 1990: 6) by channelling funds abroad.

Opposition on the part of organised labour, in turn, was surprisingly subdued during this period considering the dire consequences of the failed stabilisation plans for labour with official unemployment exceeding 6.5% in early 1988 at falling real wages (Snow and Manzetti 1993: 45). Yet, in addition to the reduction in unionised labour and the deepening of the economic crisis, which turned strikes into a more costly instrument, the movement's influence had waned since Alderete's forced resignation in late 1987 and, more importantly, due to the CGT leadership's distraction and close involvement in the on-going PJ leadership struggles (Murillo 2001; Levitsky and Murillo 2005).

The inherent contradictions marring the alliance backing the Spring Plan ultimately took their toll as divisions between the respective leaders and growing internal divisions endangered the associational unity of both the CAC and the UIA (Acuña 1995a: 26). In the case of the UIA, its liberal-minded leadership around De la Fuente and Montagna[47] had been

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[46] Smith (1990: 17) also points out that speculation against the *Austral* in late January 1987 had contributed to the derailing of the *'Australito'* as the BCRA had to raise interest rates in defence of the exchange rate and thus staved off growth.

[47] De la Fuente (MIN) and Montagna (MIA) operated companies in sectors (metals and agro-industry), which had greatly benefited from the Spring Plan. This may explain their attitude in defiance of their factional origins (Acuña 1995: 330).

successfully co-opted by the executive. Yet, initiatives, such as the appointment of Murat Eurnekian as the Secretary of Industry, had failed to win the support of the wider membership. The leadership duo, in turn, with Montagna replacing De la Fuente in 1989 (**Table 15**), was ruthlessly exploiting this opportunity to replace the 'captains' as the government's key interlocutors and throughout this period acted with utter disregard for the UIA grassroots (e.g., the renewal of the price freeze in October 1988; see Acuña 1995: 307+325). Meanwhile, internal opposition intensified[48] as the prospect of commercial opening and extortionate credit costs worsened operating conditions especially for small and medium-sized industrial companies. These circumstances facilitated, with Héctor Massuh, the emergence of a new MIN leader whose radical critique of the leadership's *"blind loyalty to a plan destined for failure"* (Interview Massuh) found growing support not only among his own faction but also among MIA members, whose profitability was increasingly exposed to the effects of overvaluation (Acuña 1995: 344). Eventually, these concerns were taken up by Montagna and especially Eurnekian, who could *"exert pressure from within, especially to modify the exchange rate policy [towards a unified rate] and interest rates"* (Acuña 1995: 345).

Table 15: Presidents of the UIA, 1979-1991

Period in Office	UIA President	Affiliation
July 1979 – March 1981	Eduardo V. Oxenford (nominated by the military)	MIA
March 1981 – April 1983	Dr. Jacques Hirsch	MIA
April 1983 – 1987	Roberto Favelevic (two terms)	MIA
April 1987 – 1989	Dr. Eduardo de la Fuente (metallurgy)	MIN
April 1989 – 1991	Gilberto L.H. Montagna (agro-industry)	MIA (joint list)

Source: Own elaboration based on www.uia.org.ar [accessed 12th April 2005]) and interviews with UIA representatives.

By January 1989, support for the government had thus become increasingly fragile, and agricultural and financial actors sought to torpedo government policy by means of both political and market-based protest. Although concessions, auch as a tighter schedule for public sector reform and the gradual reunification of the exchange rate from March 1989 onwards, had temporarily appeased the UIA and the CAC (Acuña 1995: 345), their support withered in the face of increasingly desperate interest rate hikes (Ortiz and Schorr 2006a: 464). Meanwhile, speculative pressure against the dual exchange rate regime intensified. By this point, capital-rich actors from industry and commerce, while paying lip service to their pact with the administration, actively joined into the speculatory frenzy (Smith 1990: 27). Canitrot recalls that the private sector was *"turning to the dollar en masse [with] […] one firm buying 700 palos [i.e. US$700,000] in one day"* (*Página 12* 10th September 1989). Illustrating the structural power

48 In September 1988, these divisions led to an open letter by UIA dissidents, which opposed the tariff reductions to which the UIA leadership had agreed (Acuña 1995: 332).

of a core group of economic interests spearheaded by the 'captains', which had been able to maintain or indeed enhance the share of capital concentrated under their control since the 1970s (Azpiazu, et al. 1986; O'Donnell 1991), the economic authorities were forced to liberate the exchange rate leading to a substantial devaluation in early February and marking the collapse of the Spring Plan (Smith 1990: 27; Tedesco and Barton 2004: 100). The remainder of Alfonsín's term in office provided a clear illustration of the ability of these dominant socio-economic actors to *"sabotage the attempts by the government to at least get to the elections with stabilised interest and exchange rates"* (O'Donnell 1991) whilst a growing number of business actors joined organised labour in backing Carlos Menem as the 'least bad' option.

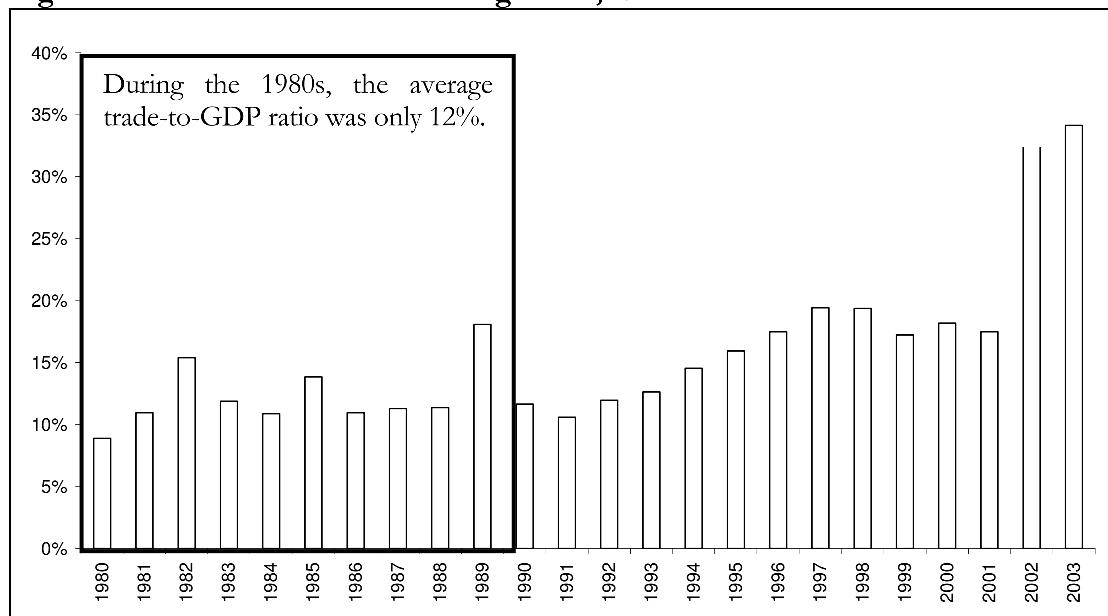
In summary, over the course of the 1980s relations between organised society and the executive with respect to the exchange rate issue evolved markedly. Having been presented with the *faits accomplis* of the *Plan Austral* and inhibited in their exchange rate policy influence by organisational fragmentation, internal fissures and the issue's subordinate role relative to other more pressing areas in 1985, societal actors as an aggregate succeeded in developing *de facto* veto power by late 1988. As the two preceding sections highlighted, socioeconomic actors were empowered by the government's growing political and structural vulnerabilities, which *"encouraged among societal actors a form of increasingly aggressive parasitism"* (Halperín in Lanata 2003: 551) and especially the 'Captains of Industry' became privileged interlocutors of the government. In this context, socio-economic actors were not only able to derail stabilisation attempts, illustrating their *destructive* exchange rate policy influence, but in the context of the *Plan Primavera* selected actors from industry and commerce also obtained direct, albeit short-lived, access to policy design (Palermo and Novaro 1996: 81-82 + 90). Although the process was at no time fully captured by societal interests, constraints on the economic team tightened and rendered the formulation of a coherent and long-term exchange rate strategy virtually impossible by 1989.

Five key aspects can therefore be highlighted with respect to societal interests' evolving role in exchange rate politics. First, the role of executive behaviour as an enabling condition for societal influence is emphasised. Alfonsín succeeded in insulating exchange rate policy decisions in the run-up to the *Plan Austral* thanks to a strong electoral mandate. Yet, as economic conditions deteriorated, intra-cabinet divisions deepened and elections approached, the authorities' heightened political *and* economic dependence on support from powerful societal interests created an opening for selected groups. A permissive executive was therefore a necessary pre-condition for societal groups' policy impact.

Secondly, the pattern of societal activity vis-à-vis the exchange rate differed markedly

from the literature's expectations due to the pattern of political organisation, which distorted and, at times, inhibited actors' potential for decisive policy influence. As a legacy of authoritarianism, traditional corporatist actors had been systematically weakened. In conjunction with the absence of an encompassing business organisation (Acuña 1998; Weyland 2002; Schneider 2004)[49] and given Argentina's highly polarised society with bitter divisions running along both factoral as well as sectoral lines this fundamentally challenged the political effectiveness of capital as a whole and undermined all efforts to coordinate positions vis-à-vis the government (Torrents and Lewis 1993: 2; Barkey 1994: 53; Schamis and Way 2001). In short, a purely structural analysis *à la* Frieden (1991) cannot capture the lobbying dynamics witnessed during the 1980s, which were significantly shaped by the relative organisational capacity and structure of societal interests (also Bates 1981: 88).

Figure 12: Trade-to-GDP Ratio in Argentina, 1980-2002



Source: CEA-UCEMA 2004. Available at http://www.cema.edu.ar/~marfer/14_de_septiembre_de_2004_final.ppt [accessed 13th December 2007].

Thirdly, the enhanced importance of the exchange rate issue during the *Plan Primavera* confirms the interaction between (prospects of) commercial liberalisation and the politicisation of the exchange rate. Conversely, the semi-closed nature of Argentina's economy subdued societal activism in this area during much of the previous period (**Figure 12**). An additional determinant of the low intensity of explicit exchange rate lobbying was the

[49] Peak business organisations made only very sporadic appearances. Perón's *Confederación General Económica* (General Economic Confederation – CGE), founded in 1952, lost influence over time, and attempts by the UIA, the *Sociedad Rural Argentina* (Argentine Rural Society – SRA) and the *Cámara de Comercio Argentina* (Argentine Chamber of Commerce – CAC) to create a sustainable rival organisation failed twice (Acuña 1998).

fact that due to the high concentration of export activities only a small group of large (often multinational) agricultural and some agro-industrial companies had a pronounced interest in this issue (Azpiazu, et al. 1986; Palermo and Novaro 1996: 151; Schorr 2004). Yet, precisely this group had been able to consolidate its structural and political influence over the course of the 1980s[50] so as to be capable of negotiating highly discriminatory cross-issue deals as compensation (e.g., reduced export taxes, tax holidays, export promotion schemes) instead of problematising the non-excludable issue of exchange regime choice (Interview Delfino; Acuña 1995: 36; Schorr 2004: 69). For wider Argentine society, in turn, the exchange rate was no doubt important given the widespread use of the US dollar as an insurance against inflation and Argentines' dollar holdings abroad. Yet, rather than lobbying or expressing strong exchange rate policy interests, as would be the case in the late 1990s, society took exchange rate developments largely as indicators of government credibility rather than as a policy priority in its own right (De Pablo 1990).

Fourthly, this case study and especially the events of February 1989 highlight the importance of *market-based* actions available to business in order to obtain exchange rate concessions and thus direct attention to an area of oversight in the interest group literature, which focuses primarily on *political* acts of lobbying. Indeed, given the high ownership concentration in domestic markets and an 'institutionalised' tradition of capital flight, large business groups possessed significant threat potential thanks to their unrivalled capacity to set prices (and accelerate inflation), to withhold foreign exchange earnings and postpone export contracts (and thus increase pressure on external accounts) or to speculate against the government's currency arrangements (Azpiazu, et al. 1986: 116 + 132; Peralta Ramos 1992: 101; Teichman 2002b: 494; Castellani 2004: 182). Given Argentina's severe 'problem of domestic transfer' (Smith 1990: 4), it granted holders and generators of foreign exchange considerable leverage over exchange rate decisions (Viguera 2000: 34-35). Crucially, these actors did *"not need to organise or mobilise politically to press [their] case"* and traditional collective action problems are surmounted by actions, which are coordinated by market signals, given that these interests' *"power resides in the highly credible threat of exit or in continued unwillingness to lend or invest"* (Haggard and Maxfield 1996: 41). Hence, anticipating non-cooperative behaviour, the executive at times hesitated or even refrained from pursuing policies against the interest of influential groups (e.g., the erratic devaluations in 1987-1988). Moreover, even if demands had been ignored, private sector actors could 'torpedo' a regime by withholding foreign exchange and forcing a regime change, as in the case of the *'golpe de mercado'* in 1989.

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[50] E.g., via the nationalisation of private debt, industrial promotion and export subsidies (Schorr 2004: 71).

Finally, the literature tends to overlook the impact of politico-economic crisis and heightened uncertainty on societal interests' lobbying behaviour and policy influence. During the transition to democracy but also once hyperinflation took its course in 1989, societal actors and their representative organisations were overwhelmed by a multitude of organisational, political and economic challenges to their and their members' interests. In this atmosphere of uncertainty, economic actors' short-termism was exacerbated and political resources tended to be directed towards policy areas with greater mobilisation appeal, which also promised selective benefits to members, such as special tax and subsidy arrangements, and delegated questions of exchange regime choice to the back of political priorities (also De Pablo and Broda 2000).

4.3.3 The Role of External Agents

As previous sections showed, given Argentina's debt burden, relations to both bilateral, multilateral and private creditors as well as structural conditions in international capital markets constituted significant constraints on the range of feasible exchange rate policies from which the Alfonsín administration could choose. These ties also greatly affected the balance of power between the government and private economic actors. In particular, the deregulation of financial markets in the late 1970s and the advanced processes of de-industrialisation and dollarisation had left the country highly vulnerable to capital flight. These circumstances, which compared negatively with the conditions in which Brazil adopted its heterodox stabilisation plan in 1986, heightened Argentina's dependence on constructive relations to external creditors (Tedesco 1999: 82) and account for Argentina's efforts to maintain a relatively more constructive dialogue with creditors and IFIs throughout this period (Kaufman 1989: 400-401; Boughton 2001: 462). Relations to the IMF played a particularly important role in this respect insofar as the Fund was the source of crucial technical advice in these trying times and because Argentina could not sustain the costs of prolonged confrontations with the IMF and its other external creditors. Yet, acknowledging this degree of leverage of the IMF does not imply that the Fund played a decisive role in determining exchange rate policy decisions during this period. Besides Argentines' determination to maintain relative policy autonomy in this area, the IMF's ineffectiveness in decisively shaping Argentina's policy choices in this field was also rooted in the lack of consensus on the scope of its surveillance function and the appropriate exchange rate strategy for developing countries within the institution, as alluded to in Chapter III. Indeed, during the 1980s exchange rate prescriptions were rarely included among IMF loan conditionalities.

Table 16: Argentina's Agreements with the IMF in the 1980s

Type of Agreement	Dates	Amount
Stand-By Agreement	January 1983 – March 1984 (negotiations opened by Bignone government in October 1982)	SDR 1.5 billion – SDR 0.6 billion disbursed.
Stand-By Agreement	December 1984 – June 1986	SDR 1.42 billion – SDR 1.18 billion disbursed
Stand-By Agreement	July 1987 – October 1988	SDR 1.11 billion – SDR 0.78 billion disbursed
Stand-By Agreement	November 1989 – May 1991	SDR 1.1 billion – SDR 0.5 billion disbursed

Sources: Own elaboration based on World Bank 1985 and IMF – IEO 2004.
Note: Total purchases made by Argentina during the period amounted to about SDR 4.4 billion, including SDR 1.5 billion drawn under the Compensatory Financing Facility (IMF – IEO 2004: 79).

The IMF and the Plan Austral

During the first months in office, Alfonsín and MECON Minister Grinspun pursued a confrontational stance with the IMF and external creditors, likened to 'brinkmanship' by some analysts (Stiles 1987; Bonelli 2004: 52-53).[51] In addition to questioning the debt's legitimacy, the authorities' verbal offensive demanded a 'democratic dividend' from the international community and classified creditor demands as threats to the survival of Argentina's fragile democracy (Alfonsín in Giussani 1987: 180-181; Monteón 1987: 21; Schvarzer 2004: 24; Michalowski 2007). In parallel, the government sought to establish a debtor cartel among Latin American debtors in the context of the 'Consensus of Cartagena' (Alfonsín in Giussani 1987: 193; Tedesco 1999: 90-91).[52] Although the latter tactic remained largely inconsequential, the authorities did succeed in completing agreements with the IMF and the Paris Club in late 1984. Yet, by early 1985, a cooling down of relations to the IMF due to disputes over the fiscal deficit coincided with the deterioration of economic conditions in Argentina, which deprived the authorities of their initial room for manoeuvre and eventually led the government to move away from its defiant negotiation stance (Stiles 1987: 72). As a result, consultations with the Fund intensified once again and concluded with several extensions of the December 1984 programme in June 1985 – just weeks prior to the announcement of the *Plan Austral.*

There is considerable controversy as to how far and at what level of detail the Argentine authorities consulted the IMF on the plan itself. Lorenzutti (1996: 427), Tedesco (1999: 96-97) and Kaufman (1989) hold that the government was eager to generate consensus on the intended stabilisation measures, while Stiles (1987) posits that the consultations

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51 For an account of executive motivations in this early phase, see Stiles 1987: 65. The tough attitude may have simply resulted from policymakers' unfamiliarity with IMF customs as is illustrated by Alfonsín's submission of a genuinely 'home-made' letter of intent in June 1984 (ibid.: 68).

52 Bolivia, Brazil, Colombia, Chile, Ecuador, Mexico, Peru, the Dominican Republic, Uruguay and Venezuela were signatories.

coincided with the plan's preparations but that the government did not inform the Fund on the measures. While it is beyond doubt that the plan, both in its design and outcome, was strongly conditioned by the reality of the debt crisis and the near-continuous and at times rather disruptive negotiations with external actors, my interviews suggest that international agencies were consulted about the proposals but – given the aforedescribed lack of a well-established institutional line – did not have any decisive input into the policy formulation process. This is also supported by Alfonsín, who stated that it was *"an Argentine plan, devised and orchestrated by Argentines, that succeeded in bending the classic criteria of the IMF"* (in Giussani 1987: 192), and chimes with complaints by IMF Executive Directors:

> Staff returns from Buenos Aires with a deal […]. Almost immediately thereafter, we learn, *again through the press*, that the Argentine authorities have themselves, spontaneously, *without any pressure from this or any other institution*, enacted a series of measures which make the programme agreed with our staff look like a pale imitation of what a stabilisation plan ought to resemble (in International Currency Review 1985: 44 - my emphasis).

In short, understanding that an IMF agreement would serve as a valuable 'stamp of approval' (Alfonsín in Giussani 1987: 193), the authorities were keen to build a constructive relationship with the Fund and benefit from technical advice and assistance while nevertheless formulating a stabilisation plan, which committed them to fiscal and monetary austerity conditions as well as to maintaining a commercial surplus, in full autonomy (also Woods 2006: 69). This strategy was successful insofar as in August 1985, in spite of their explicit scepticism regarding the fixed exchange rate element of the plan (Bonelli 2004: 62-63),

> all [IMF] Executive Directors warmly welcome[d] the new economic program, which they qualified as bold, courageous, and imaginative (First Deputy Managing Director Erb quoted in Boughton 2001: 400-401).

Fund staff however did not hide their preference for *"an 'orthodox' approach that emphasized fiscal and monetary restraint alone"* (Chwieroth 2007b: 13), which contrasted with the logic of the 'heterodox' plan (Lorenzutti 1996: 427). Their decision to support the plan must be seen as due, at least in part, to Argentines' appeal to US officials to press the IMF to embrace the programme (Kaufman 1989: 400-401). These efforts ultimately generated loans of over US$1.2 billion and US$470 million from the IMF and the U.S. Treasury, respectively

(Smith 1990: 12). This international approval[53] undoubtedly helped to stabilise inflationary expectations, underpinned the exchange rate regime's credibility in the eyes of the public and thus contributed to the successful initial disinflation after June 1985. Nevertheless, rather than supporting the plan's individual elements, such as the exchange rate peg, this approval was premised on sustained disinflationary success – and thus quickly unravelled as budgetary discipline slipped and inflation re-emerged (de Beaufort Wijnholds 2003).

The IMF in the Aftermath of the Plan Austral

The failure of the *Plan Austral* as a result of insufficient fiscal discipline and erratic policymaking, which demanded recurrent modifications of arrangements with the IMF and the granting of several waivers for the non-observance of quantitative performance criteria, rapidly dissipated good will among IMF staff and particularly its new Managing Director Michel Camdessus (de Beaufort Wijnholds 2003: 104; IMF - IEO 2004: 79). By late 1987 Argentina was in clear violation of previously accepted conditionalities whilst its dependence on external finance grew steadily. This increased the institution's leverage over the government and rendered its intransigent stance vis-à-vis demands for additional financial support for the *Plan Primavera* politically sustainable and justifiable towards major shareholders (Stiles 1987: 80). Ignoring growing pressures from the US Treasury, the Fund thus refused to lend to Argentina prior to a credible commitment to fiscal adjustment (Lorenzutti 1996: 443; Boughton 2001: 521; Chwieroth 2007b: 13-14). This stance contrasted markedly with that of its sister organization, the World Bank, which ultimately approved four loan packages totalling US$1.25 billion (Tedesco 1999: 136-137; IMF - IEO 2004: 78). The availability of alternative finance undermined the IMF's ability to effectively impress its policy advice and to pursue exchange rate surveillance with respect to the controversial exchange rate element of the *Plan Primavera*. Once more, the economic authorities thus could pursue a risky and politically highly divisive exchange rate policy course, which eventually collapsed precipitating the politico-economic meltdown in 1989, in relative autonomy from the IMF.

In sum, external creditors as providers of external finance and holders of Argentine debt substantially determined the outside constraints on the economic policy agenda of the Alfonsín administration, who eventually acknowledged the need for non-confrontational relations to the IFIs given the repercussions for policy credibility and uncertainty. Yet, in spite of these constraints, the Argentine authorities repeatedly succeeded in re-establishing their

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[53] The 'Argentine miracle' was also praised by renowned foreign economists (e.g., Franco Modigliani) and US officials (e.g., Dep. Treasury Sec. Mulford (Acuña 1995: 140).

discretionary policy space by reneging on commitments and obtaining waivers. With respect to the particularities of exchange rate policy, the influence of external agents proved particularly limited due, first, to the attitude on the part of the Argentine authorities who repeatedly engaged in exchange rate decisions that surprised external agents and ignored their advice and, secondly, to the indecisive stance and lack of internal consensus within the IMF itself, which meant that the exchange rate stance was not granted central importance in the formulation of policy conditionalities (see section 1.3.3.).

4.4. Concluding Remarks

El Plan Austral se basaba en una promesa.

Graziano (2001: 32)

Argentine society remembers the *Plan Austral* and its successor plans as symbols of a 'lost decade' marred by broken promises: promises about the consolidation of democratic institutions, promises about a sustained (judicial) engagement with the horrors of authoritarianism, but most of all promises about the re-ignition of growth and a return to a more egalitarian society. This chapter traced the way in which the legacies of the 1970s constrained economic policymaking and reinforced the 'logic' of Argentine politics that ruled out the emergence of a sustained will to reform the country's political economy. Similar to most other policy fields, exchange rate policy was thus dominated by an erratic and, from 1987 onwards, outright chaotic approach by Alfonsín's administration. This policy course reflected the curious politico-institutional position of his technocratic team and in particular the executive's risky and ultimately self-defeating approach of oscillating between excluding, confronting and selectively consulting societal interests in search for *ad hoc* support coalitions. Societal interests, in turn, merely amplified these short-termist tendencies of executive policymaking. In turn, contradicting accounts that emphasise the almost unlimited leverage of the IMF over developing country governments in the wake of the debt crisis, the Fund failed to play a decisive role in shaping Argentina's exchange rate policy course and was on several occasions reduced to an embittered bystander. Looking forward, this chapter highlighted how the disappointment with the *Plan Austral,* combined with the unprecedented depth of the 1989 crisis and the emergence of a new set of reform-minded technocratic experts, which began to conceptualise the exchange rate as a tool for managing Argentina's complicated political economy, paved the way for the adoption of a rigid currency board and a radical programme of neoliberal reforms in the 1990s.

C H A P T E R V

ARGENTINA IN THE 1990S

5.1. Introductory Remarks

Argentina entered the 1990s as a stagnating economy in hyperinflationary turmoil, burdened by foreign debt, persisting fiscal deficits and marked by political instability. A decade later, Argentina was praised for its miraculous economic transformation having re-inserted itself at the heart of international economic relations. Arguably, one of the key factors contributing to this transformation into Latin America's 'poster child' was the decision to adopt a disciplining quasi-currency board regime, the '*Plan de Convertibilidad*' (Convertibility Plan), which contrasted with the continental trend to adopt more flexible exchange regimes and contradicted expectations generated by OCA approaches. This super-fixed peg is considered to have provided the essential backbone to the successful implementation and consolidation of market-oriented reforms and was described as the *"essential resource of governability over more than ten years"* (Novaro 2002a: 37). Yet, what dominates much current analysis as well as Argentines' perception of recent history is the country's exit from precisely this quasi-currency board arrangement and the disorderly devaluation-cum-default (Pastor 2002). Consequently, most recent research aims to understand the policy choices of the 1990s with a view to identifying the roots of this profound socio-economic crisis.

This chapter uses the Argentine case to prove that existing accounts of exchange rate policy determinants from both institutionalist and interest group approaches only provide partial explanations. Indeed, while institutionalist theories contribute the insight of governments adopting exchange rate pegs as a means of (re-)establishing their credibility, they fail to show why policymakers held on to this arrangement up to a point where the commitment to the peg had *"turned from being a source of strength to becoming a liability"* (IMF 2004b: 3). Similarly, although interest group arguments have some mileage in accounting for the delay in exiting from the Convertibility Regime, they run into difficulties when pushed to corroborate evidence for the influence of societal interests in determining policymakers' decision to adopt the quasi-currency board regime in the first place. For instance, Blomberg et

al.'s (2005) expectation that a country like Argentina, whose manufacturing sector contributed more than 30% to GDP, would opt for a relatively flexible regime was proven wrong. In addition, neither of these explanations can account for the role of external actors and especially the importance of the IMF in validating the exchange rate policy course chosen by the authorities and therefore providing an external 'stamp of approval' that strengthened the executive's resolve to hold on to the regime.

Therefore, what is currently lacking is a coherent conceptual framework for exchange rate policymaking that exploits the complementarities of existing approaches and that accommodates the different political dynamics *throughout* the life cycle of an arrangement. Aiming to provide such analysis, this chapter is organised as follows. Section 5.2. traces exchange rate policy decisions and relevant institutional changes of the 1990s. Against this historical background, section 5.3. applies the argument developed in Chapter III capturing the interplay between executive, interest group and external factors that drove the adoption of the rigid quasi-currency board as well as its petrification. Section 5.4. concludes.

5.2. Historical Overview of Exchange Rate Policy in the 1990s

In this section, I provide the historical background to Argentina's exchange rate policy decisions and an overview of the institutional evolution by focusing on four key episodes of the *Plan de Convertibilidad*.

5.2.1 The Run-Up to the Convertibility Regime (1989-1991)

In the aftermath of the anticipated transfer of power in July 1989, the first 18 months of Menem's presidency were marked by persistent economic instability and social violence as hyperinflation continued at annual rates approaching 5,000%. Uncertainty about the new Peronist government persisted due to prior populist promises (*salariazo*). Countering these expectations and repudiating traditional Peronist principles of statism and economic nationalism, Menem surprised observers when he nominated Miguel Roig and then Néstor Rapanelli, two renowned 'Captains of Industry' and former vice-presidents of Argentina's largest multinational company *Bunge & Born*, to the MECON as well as including outspoken economic liberals, such as Alvaro Alsogaray (*Ucedé*), in his cabinet (Erro 1993; Camou 1998; Stokes 2001). Completing the u-turn, he announced that an ample economic reform programme would be implemented, resembling *"major surgery without anesthesia"* (Menem in Smith 1991: 53). Yet, by December 1989 the first of what became a rapid succession of *ad hoc*

stabilisation attempts had failed (**Table 17**). Similar to previous episodes, the underpinning exchange rate peg had eventually become unsustainable due to a growing gap between official and parallel market exchange rates (*brecha cambiaria*), which forced Rapanelli to implement a controversial 57% devaluation in December 1989. Irrespective of his path-breaking legislative activity (see p. 124), this devaluation and the subsequent inflationary surge undermined Menem's confidence in the minister and provoked his resignation on 15th December 1989 (Carrera 1994: 346; Weyland 2002: 114).

Table 17: Emergency Packages Prior to the Convertibility Plan, 1989-1991

Date	Name of Programme	Minister of the Economy	Key Policy Measures	Exchange Rate Policy
July 1989	*Plan Bunge y Born I*	Roig / Rapanelli	Maxi-devaluation by 170% to 650 *Australes* per US dollar; public utility price increases; suspension of tax breaks/subsidies; price accords;	Peg
December 1989	*Plan Bunge y Born II*	Rapanelli	Devaluation by 57%; public utility price increase; increase in import duties; abandonment of export tax reduction; unilateral domestic debt moratorium	Peg
December 1989	*Plan Erman I*	González	Liberalisation of foreign exchange market	Dirty float
January 1990	*Plan Bonex / Plan Ermán II*	González	Conversion of time-deposits into 10-year dollar-denominated bonds	Dirty float
March 1990	*Plan Ermán III*	González	Fiscal shock – increase in export taxes; VAT increased and extended in coverage; suspension of public works payments; reorganisation of public agencies; cuts in education and judicial system	Dirty float
July 1990	*Plan Ermán IV*	González	Deregulation of imports; elimination of protectionist measures	Dirty float
August 1990	*Plan Ermán V*	González	Acceleration of privatisation and/or liquidation of state enterprises	Dirty float
December 1990	*Plan Ermán VI*	González	Further liberalisation of foreign trade; 'tax-forgiveness' plan (*blanqueo de capitals*)	Dirty float
January 1991	*Plan Cavallo I*	Cavallo	Further liberalisation of foreign trade; abandonment of export taxes by 1st April 1991; announcement of tax reforms (VAT)	Dirty float within bands

Sources: Own elaboration based on Smith 1991; Carrera 1994; Solanet 2006.

Continuing the practices of the 1980s, exchange rate policy prior to 1991 consisted of a series of short-lived attempts at fixing the exchange rate ending in crisis devaluations and frequently changing foreign exchange regulations, which altogether exacerbated the prevailing climate of uncertainty (Phillips 1998: 73; Echegaray and Elordi 2001: 193). With the arrival of Menem's close aide Antonio Ermán González at MECON as well as a change at the helm of the BCRA in December 1989, the first marked re-evaluation of this strategy can be discerned. By moving to a floating exchange rate (albeit with discretionary BCRA intervention), González moved away from the predominant *"use of the exchange rate as an instrument of stabilisation towards a greater emphasis on fiscal and monetary discipline"* (Phillips 1998: 73). This shift

was flanked with efforts to liberalise and unify the foreign exchange market (IMF 1990; Carrera 1994: 349). While in the medium run successful in re-establishing some monetary autonomy, this initiative provoked another hyperinflationary outbreak given the weight of price indexation to the US dollar and distrust in Menem's austerity pledges (Echegaray and Elordi 2001: 196).[1] In response, a series of emergency packages were implemented, starting with the confiscatory and highly controversial '*Plan Bonex*'[2] on 1st January 1990 and followed by five increasingly desperate initiatives over the remainder of the year. These plans – in particular *Plan Ermán III* in March 1990 – constituted a radical effort at fiscal consolidation and successfully contained inflation (Palermo and Novaro 1996: 157-165). A floating and yet strongly overvalued *austral*, reaching 4,500 *australes* per US dollar in December 1990 – instead of an estimated equilibrium rate of 12,000 – resulting from highly restrictive government measures that tied up vast quantities of US dollars, underpinned these disinflationary efforts and yet introduced a certain precariousness (NY Times 30th January 1991, Solanet 2006: 192).

International recognition for the ambitious reform agenda initiated in 1990, seeking to attain fiscal adjustment, deregulation, trade liberalisation[3] and privatisation, led to the normalisation of Argentina's relations to external creditors.[4] Yet, the reforms' promised benefits were slow to materialise as monthly inflation continued unabatedly at levels above 10% while growth stagnated (**Figure 14**). Together with the backlash from sectors targeted by budget cuts, liberalisation and overvaluation, this contributed to plummeting approval ratings at rising levels of political uncertainty in late 1990 (Echegaray and Elordi 2001: 194; Weyland 2002: 113).[5] When foreign exchange market corrections, provoking a drop to 9,500 *australes* per US dollar, threatened to plunge the country into hyperinflation in late January 1991, Menem nominated the Harvard-trained economist Domingo Cavallo, then Foreign Minister, to be his fourth Minister of the Economy.

Foundations for Structural Reforms: The State Reform and the Economic Emergency Laws

Although stabilisation had remained elusive, the first 18 months of Menem's presidency proved path-breaking. The *Ley de Reforma del Estado* (*Ley* 23,696 – State Reform

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1 Argentina was highly dollarised with the value of circulating US dollars exceeding that of *australes* (Smith 1991: 73).

2 *Plan Bonex* (Decree 36/90) converted all fixed-term deposits exceeding 1 million *australes* into 10-year dollar-denominated federal bonds, which replaced most short-term domestic debt with dollar-denominated medium-term debt so to enable the government to honour its obligations in the domestic financial system (ibid.: 57).

3 In 1990, import licensing requirements were removed (except for automobiles) and uniform tariffs (21%) were introduced and progressively reduced (Heymann 2000: 18; Ernst 2005: 1-3).

4 This led to Argentina's participation in the Brady Plan and to the restructuring of US$23 billion of capital debt and US$8.6 billion of interest into long-term 'discount' or 'par' bonds' backed by IFI and creditor guarantees (Stallings 1992: 62).

5 Polls suggested that 50% of respondents were going to oppose the PJ in the September 1991 elections due to the persisting recession (13.8%) and economic instability (6%) (*The Buenos Aires Herald* 20th January 1991).

Law) and the *Ley de Emergencia Económica* (*Ley* 23,697 – Economic Emergency Law), enacted by Rapanelli in August and September 1989, respectively, constituted the core of a new legal framework for economic policymaking, which targeted the root causes of Argentina's chronic fiscal instability. Thanks to the delegation of significant legislative faculties to the executive, these two pieces of legislation enabled Rapanelli's successors to implement a series of radical reforms (Palermo and Novaro 1996: 258-259). The State Reform Law authorised the executive to commence the privatisation of notoriously inefficient and highly endebted state-owned companies ranging from telecommunications to TV stations and steel companies. In turn, the Economic Emergency bill prepared the ground for the reduction of Argentina's fiscal burden by enabling the executive to abolish subsidies and tax exemptions, introduce changes to public sector employment, liberalise capital markets and international trade by phasing out export taxes, import tariffs and quotas, as well as initiating the revision of the BCRA charter (Smith 1991: 54-55; Gerchunoff and Torre 1998: 118-119; Wise 2000: 97). In sum, this bold legislation paved the road for successful stabilisation under Cavallo.

Table 18: Argentine Currencies and Conversion Rates, 1989-2008

Austral	1985-1991	→	1 *austral*	= 1,000 *pesos argentinos*
Peso (Convertible)	1992-present	→	*1 peso (convertible)*	= 10,000 *australes*

5.2.2 The Adoption of the Convertibility Plan (1991-1993)

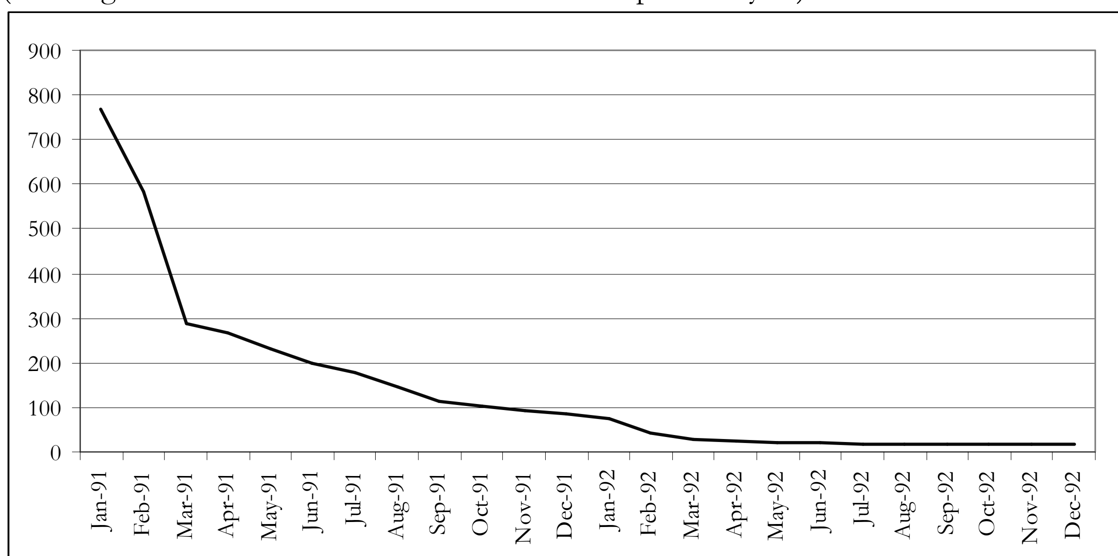
Reacting to foreign exchange market turbulences and mounting criticism of González' exchange rate strategy, Cavallo's first initiative was to stabilise the *austral* in a system of exchange rate bands between 8,000 and 10,000 *australes* per US dollar whilst committing himself to the deepening of the on-going reforms in trade (with export taxes being abandoned by 1st April 1991) and tax legislation.

The Convertibility Plan (1991)

In parallel and utter secrecy, a small team of Cavallo's men prepared more radical steps. Having accumulated some US$4.8 billion in international reserves by mid-March, the authorities announced the *'Plan de Convertibilidad'* (Interviews Alemann and Cavallo, World Bank 1993: 181; Cavallo 1997; 2001: 157-158). At its core was the *Ley de Convertibilidad (Ley 23.928),* which entered into force on 1st April 1991 after congressional ratification (Wise 2000: 96; Díaz-Bonilla and Schamis 2001: 86). Although often described as 'fixing' the dollar exchange rate of the *austral*, Cavallo insists that it merely *"prohibited the depreciation of the currency against the US dollar"* and thus, in principle, resembled a one-way peg (Interview Cavallo;

Cavallo 2001: 167-168).[6] Moreover, the law abolished indexation and required that the monetary base not exceed the dollar value of international reserves. Effectively, this turned the BCRA into a quasi-currency board as issued money had to be backed by foreign reserves and thus imposed a strict constraint on notorious deficit financing via the BCRA and, by extension, on fiscal policy (Carrera 1994: 350; Pou 2000).[7] In short, except for reserve inflows generated by trade surpluses or net capital inflows the monetary base could not be expanded.

Figure 13: Disinflation under Convertibility – Evolution of the Argentine CPI, 1990-91
(% change in CPI relative to the same month of the previous year)



Source: Own elaboration based on CPI data from INDEC – www.indec.gov.ar [accessed 15th January 2008].

These measures constituted *"a dramatic gamble"* given Argentina's tainted history of maintaining exchange rate commitments (Smith 1991: 63). Having transferred the power to devalue the currency to Congress, the executive would have to seek adjustment and adhere to a rules-based policy agenda if the extortionate socio-economic costs associated with the reversal of this commitment were to be avoided (Díaz-Bonilla and Schamis 2001: 87; Corden 2002: 183).[8] This granted Menem's promises of structural reforms unprecedented credibility.

The impact of this new *"bulwark against inflation"* combined with further trade liberalisation[9] manifested itself in the dramatic reduction in inflation from 29% in February 1991 to 0.4% in November 1991 as expectations were reversed and domestic producers had

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[6] On 1st January 1992, *Decreto 2.128* (of 10th October 1991) replaced the *Austral* with the *Peso*.

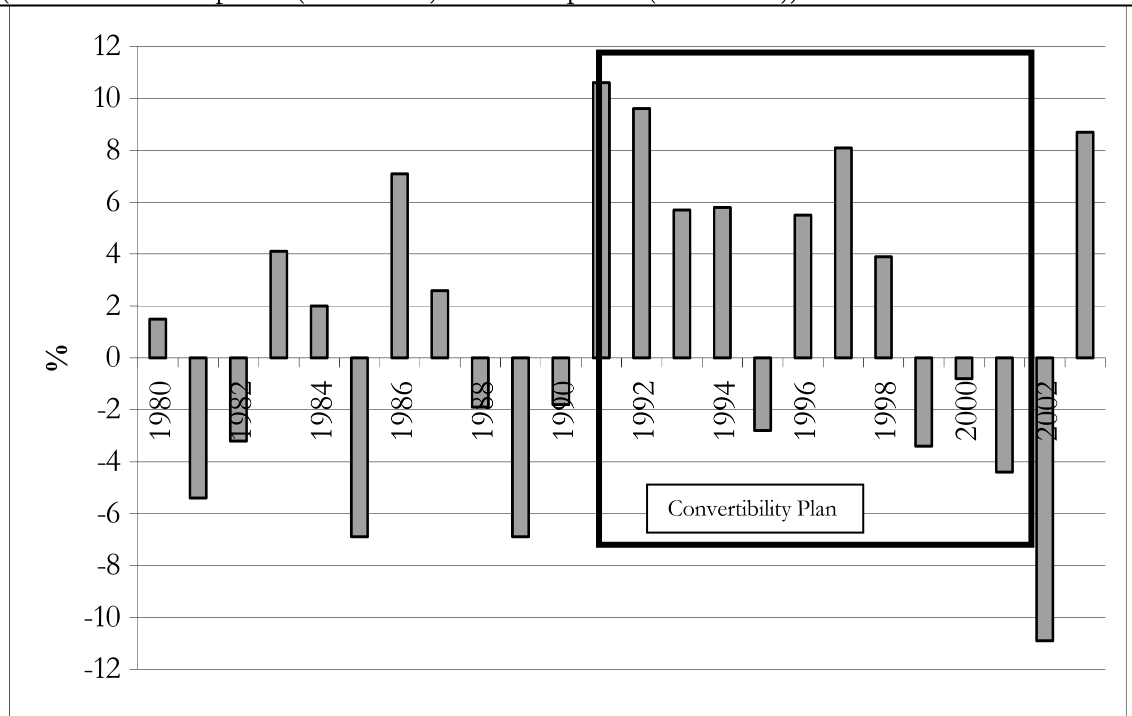
[7] Contrary to a textbook currency board (with 100% backing in foreign reserves), the BCRA could back the monetary base up to one-third with dollar-denominated federal government bonds priced at market price. Its holdings of these securities could not grow more than 10% p.a. (Pou 2000).

[8] The law reinforced Art. 75 §11 of the Constitution and amended Arts. 617, 619 and 623 of the *Código Civil*, which weakened the role of the *austral/peso* as sole legal tender leading to the accumulation of dollar-denominated contracts.

[9] In April 1991, tariffs were reduced to 0% for primary materials and inputs, 11% for intermediate goods and 22% for consumption and 35% for electronic goods (Heymann 2000: 18; Ernst 2005: 1-3).

to confront international competition by cutting prices and enhancing productivity (Starr 1997: 91; Heymann 2000: 18; Ernst 2005: 1-3).

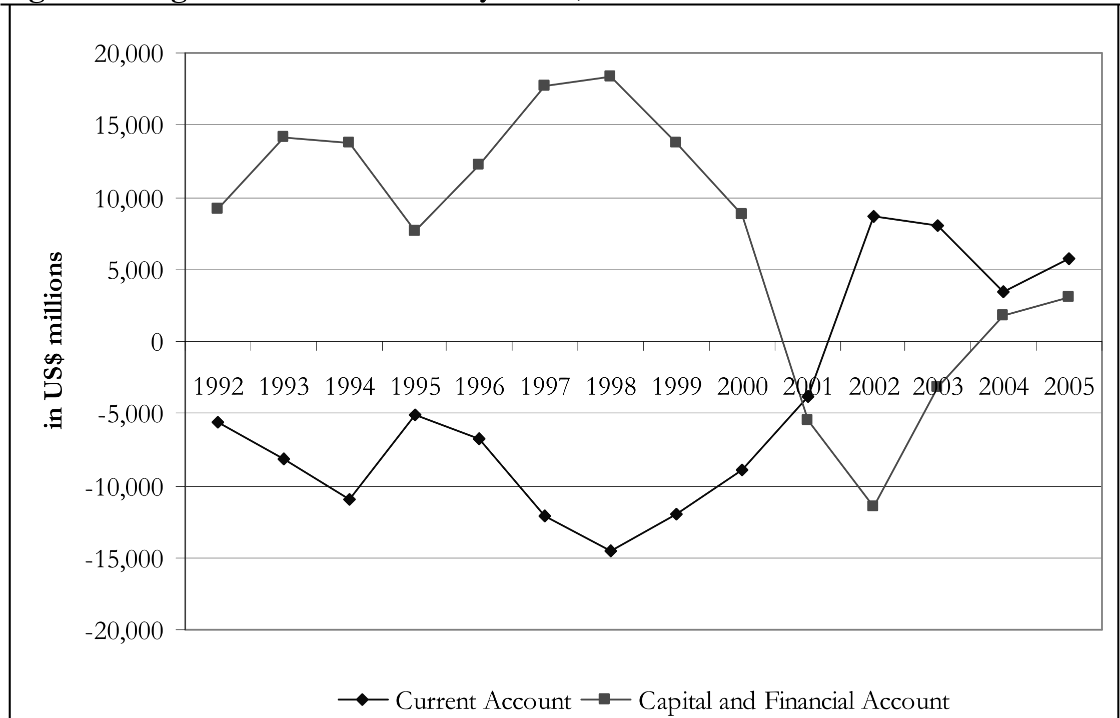
Figure 14: Changes in Annual Growth in Argentina, 1980-2003
(at constant 1986 prices (1980-1992) and 1993 prices (1993-2003))



Source: Own elaboration based on data from MECON – www.mecon.gov.ar [accessed 12th September 2005].

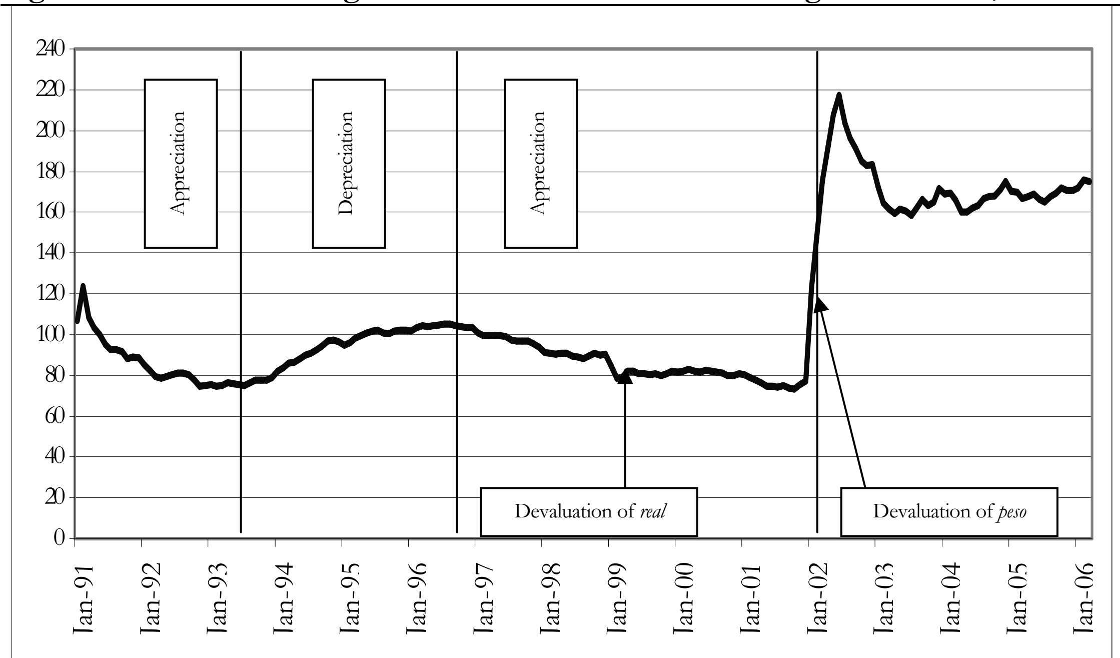
The press, the Argentine population as well as foreign actors followed this 'Argentine miracle' with such enthusiasm that warnings of traumatic failure given the regime's inherent risks, such as the authorities' inability to accommodate future adverse shocks via monetary or indeed exchange rate policy adjustments, were side-lined (Weyland 2002: 115; Spiller and Tommasi 2007: 187). The benefits of new-found stability were only too evident and heralded, together with the rapid remonetisation of the economy and large interest rate reductions, the most robust growth period in Argentine post-war history with average rates exceeding 5% between 1991 and 1995 (**Figure 14**)(Gerchunoff and Torre 1998: 127-129; Starr 1999: 92). Meanwhile, Cavallo's fiscal restructuring efforts generated primary surpluses in 1992 and 1993 (thanks to privatisation receipts, public sector cuts, tax reforms and a boom in consumption), and jobs were created at an almost unprecedented rate (Carrizosa, et al. 1996; Cerrutti 2001: 4; Eaton 2002). Signalling financial recovery, bank credit expanded to reach 19% of GDP in 1994 (Starr 1999: 132; Baldi and Mulder 2004: 17). Meanwhile, external constraints loosened thanks to rising primary export prices and rampant capital inflows due to low OECD interest rates (Dornbusch, et al. 1995: 262).

Figure 15: Argentina - Balance of Payments, 1992-2005



Source: Own elaboration based on MECON data – http://www.mecon.gov.ar/cuentas/internacionales/series_ anuales.htm [accessed 27th June 2006].

Figure 16: Evolution of Argentina's Multilateral Real Exchange Rate Index, 1991-2006



Source: Own elaboration based on BCRA's Multilateral Real Exchange Rate Index [accessed 26th April 2006].

Exploiting this optimistic atmosphere, Cavallo pressed on with the reform agenda: trade was further liberalised both unilaterally and in the context of Mercosur; domestic markets ranging from petroleum and banking to agriculture were deregulated; public sector reforms – including privatisation – were pushed forward and tax reforms eliminated several

distortionary taxes whilst enhancing the central government's ability to control tax evasion and increase revenues (Tedesco and Barton 2004: 111-112; Guidotti 2006). As the economy continued to expand, the *peso*'s continuous real appreciation due to residual inflation and, consequently, growing current account deficits were considered merely a transitional phenomenon and unproblematic given plentiful capital inflows (**Figure 15** and **Figure 16**) (Dornbusch, et al. 1995).[10] However, precisely these shortcomings of currency boards and exchange rate-based stabilisation programmes more generally, i.e. countries' growing reliance on external capital to sustain growth, were to manifest themselves from late 1994 onwards (e.g., Cukierman, et al. 1992; Schwartz 1993: 183-184; Bennett 1994).

Institutional Reform: Central Bank Reform (1992)

As part of his reformist zeal and to reinforce the quasi-currency board, Cavallo accelerated the revision of the BCRA's *Carta Orgánica* in September 1992 (Lorenzutti 1996; Heymann 2000: 13; Jácome 2001). The new charter, as Pou (2000) put it, *"made the central bank independent of the executive and legislative branches and [in Carta Orgánica Art. 3] set as its principal goal that of maintaining the value of the domestic currency"*.[11] Independence was ensured by stipulating that the ten *'directorio'* members, who served six year terms once appointed by the executive and approved by Senate (Art. 7), could not be removed except for legal reasons or if a congressional commission had established *'bad conduct'* or *'failure to comply with the contents of the charter'* and recommended their dismissal (Art. 9) (Powell 2002: 10). In principle, this reform thus granted autonomy to the BCRA leadership from executive actors and cemented the administration's credibility both vis-à-vis economic actors at home and abroad (Maxfield 1997). Yet, with respect to exchange rate policymaking, this new-found independence was largely inconsecuential given that the Convertibility Law had delegated exchange regime decisions to the legislative reducing the BCRA's discretion in this area to practical aspects of foreign exchange interventions[12] and decisions on the 'quality' of the monetary base (Bonvecchi 2002: 118).[13] Similarly rigid but even more risky with respect to financial stability were the constraints on the bank's ability to serve as lender-of-last-resort in its role as banking supervision agency in this new context (Heymann 2000: 15; Pou 2000).

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[10] Dornbusch et al. (1995: 262) recommended that *"Brazil should devalue […], while Argentina should hold out and foster deflation."*

[11] In spite of the BCRA's bank supervision role, the legislation subordinated financial system stability to price stability.

[12] Yet, as Pou's policy to sell *and* purchase dollars at 1:1 (rather than to treat the 1:1 as a floor) showed, the BCRA could influence the nature of exchange rate decisions within these guidelines and significantly contributed to the regime's petrification (Interviews Cavallo; Pou).

[13] This second area of BCRA discretion provoked substantial tensions with MECON in 2000-2001 (Powell 2002).

5.2.3 Strengthening Commitment: The Wake of the Tequila Crisis (1994-96)

Although depicted as a 'sign of strength' and welcomed as an additional check on inflationary tendencies (Cavallo in Latin American Weekly Report 1994), the growing trade deficit exacerbated Argentina's reliance on external finance precisely at a time when financial flows to emerging markets declined in response to rising OECD interest rates in 1994. Initially, Menem sought to avoid comprehensive adjustment to these circumstances, i.e. greater fiscal austerity, given his on-going attempt to win the constitutional right to a consecutive presidential term.[14] Instead, he demanded that the limited room of manoeuvre to generate credit and increase public expenditure within the Convertibility Regime be exploited (Latin American Regional Report 1994; Starr 1999: 225). Yet, another rise in US interest rates on 17th November 1994 and a leaked IMF report indicating Argentina's failure to meet several spending targets forced policymakers to emphasise their strong commitment to fiscal prudence by terminating all discretionary federal spending (Allen 2003).

The Tequila Crisis: Testing Argentina's Commitment to the Convertibility Plan

However, this policy re-orientation failed to shelter Argentina from the shock wave that swept emerging markets a few weeks later: The repercussions of Mexico's devaluation on 20th December 1994, the so-called 'Tequila Crisis', exposed Argentina's extraordinary vulnerability to external shocks. Capital flight amounting to US$7.5 billion between January and April 1995 reduced foreign exchange reserves by 24% and forced a dramatic tightening of the monetary base (Fanelli and Machinea 1995: 174). The subsequent liquidity crisis provoked a credit crunch and the near-collapse of the financial system (with aggregate deposits falling by 20% to a low of $36.8 billion in May 1995) and, consequently, marked the beginning of drastic restructuring measures in the banking sector (Zarazaga 1995a: 17; Wise 2000: 101). Heavily constrained in its lender of last resort function and pressing the legislation to its very limits, the BCRA eventually succeeded in providing sufficient liquidity to avoid systemic collapse (Carrizosa, et al. 1996).[15]

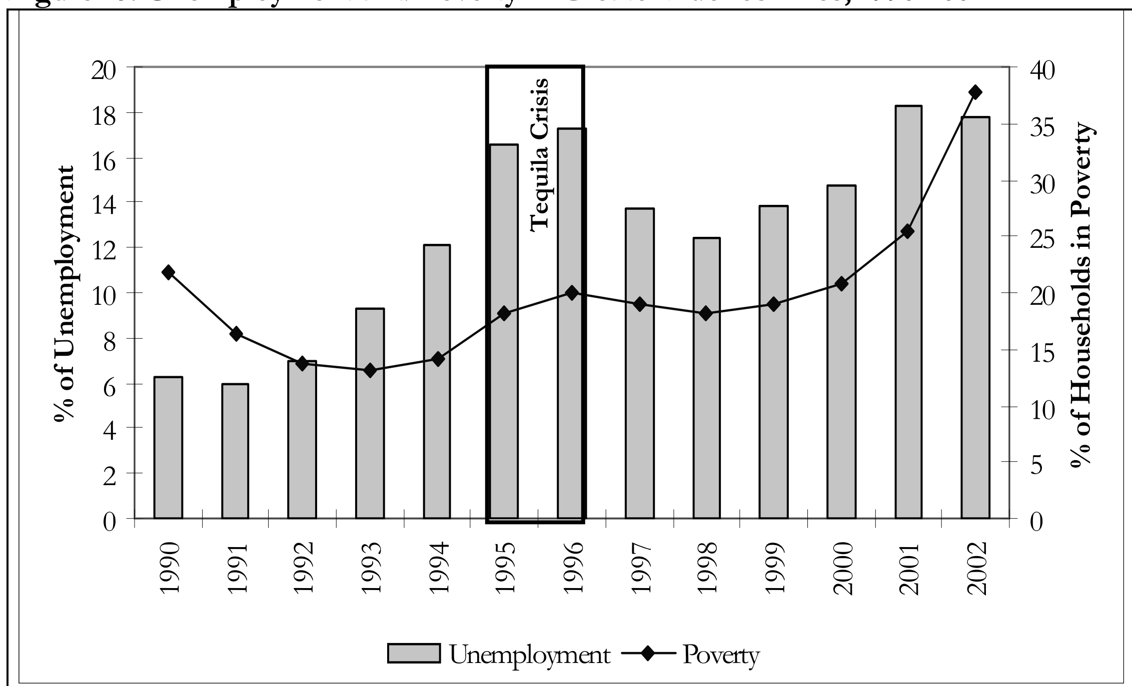
With its hands tied by the quasi-currency board, the government had to rely on market forces for the necessary adjustments. Interest rate hikes to stem capital outflows translated into a contraction of economic activity by 4.4% in 1995, a 5%-increase in unemployment reaching 18% in October 1995, lower tax revenues and consequently a

[14] The new constitution was approved on 22nd August 1994. Its contents, pre-determined by the *'Pacto de Olivos'* between Alfonsín and Menem, included the shortening of the presidential term to four years and possible presidential re-election.

[15] Recognising these limitations, the government initiated negotiations with banks to create a safety net under which illiquid wholesale bank assets could be bought in exchange for lower reserve requirements. In March 1995, a 'trust fund' was set up to facilitate acquisitions, mergers or the restructuring of insolvent banks (Carrizosa et al. 1996).

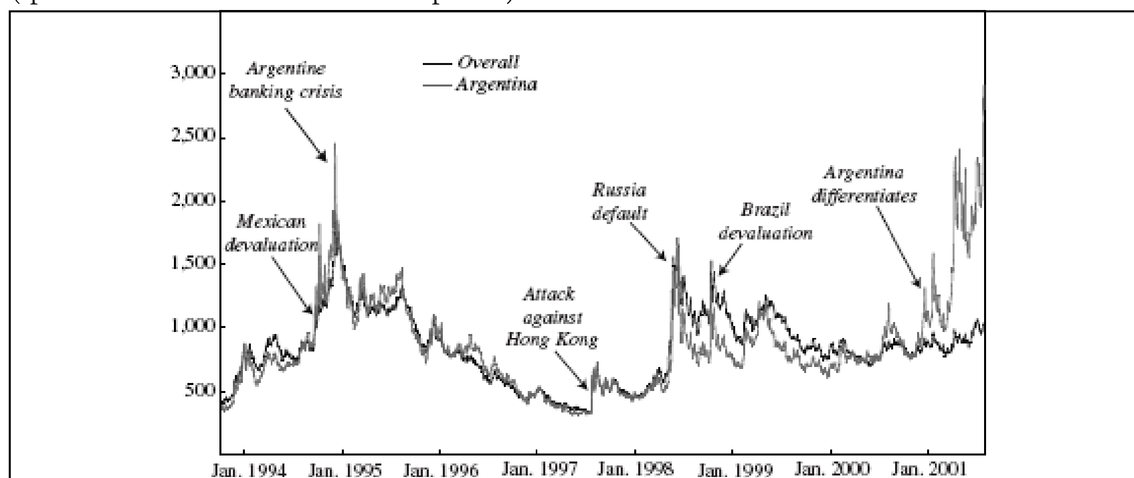
growing budget deficit, which as sources of financing had dried up forced the government into the 'budgetary straightjacket' created by the currency board (Pastor and Wise 1999; Guidotti and Powell 2002: 10). At great social costs, these efforts led to a turnaround in Argentina's balance of payments and rapid economic recovery in 1996. The government's seemingly unconditional commitment to market-oriented reforms, its willingness to deepen the initiated reforms and its ability to nevertheless maintain electoral support (e.g., Menem's re-election in July 1995), convinced the IMF and financial market actors who began to celebrate the solidity of Argentina's monetary system (IMF 1995a; 1995b; Blustein 2005: 29).

Figure 17: Unemployment and Poverty in Greater Buenos Aires, 1990-2002



Source: Own elaboration based on data from INDEC – http://www.indec.gov.ar [accessed 27th June 2006].

Figure 18: Overall and Argentina's EMBI Spread, 1994-2001
(spread over US treasuries in basis points)



Source: Powell (2002: 4) based on data from JP Morgan Chase.

5.2.4 Missed Opportunities for Non-Crisis Exit (1996-1999)

A peso was equivalent to a dollar – but only in Argentina.
Outside the country, a peso was nothing more than printed paper.

Rodolfo Terragno 1994

In contrast to the near unanimous agreement that maintaining the Convertibility Regime was the optimal response in 1995, the subsequent period of economic recovery and financial market stability arguably constituted a good, if not an ideal, opportunity for exiting towards greater flexibility and thus allowing the economy to grow at reduced external vulnerability. After all, the government's readiness to incur the political costs of market-driven adjustment without reverting to discretionary policies had reinforced its credibility to such an extent that markets barely reacted to Menem's decision to replace Cavallo in July 1996 (NY Times 27th July 1996, Heymann 2000; Krueger 2002; Mussi 2002).[16] The period between 1996 and the devaluation of the Thai *bath* in July 1997 therefore represented an unexploited *'window of opportunity for orderly exit'* (Perry and Servén 2002: 61-62): annual growth rates reached 8.4% in 1997; capital inflows recovered to reach unprecedented levels in 1997 as a mirror image to falling sovereign spreads (**Figure 18**) and global risk indicators even fell in early 1997 (Pastor and Wise 1999: 480). However, instead of taking advantage of these circumstances by introducing greater exchange rate flexibility or furthering reform of the state apparatus so to improve fiscal accounts and tackle politically complex reforms (e.g., the *coparticipación* system of fiscal transfers to provinces and labour market reforms), the Menem administration reinforced the Convertibility Regime's hold on the economy while Argentina's external vulnerability grew thanks to a massive build-up of foreign debt after 1996 (De la Torre, et al. 2002; Powell 2002: 1-2; Guidotti 2006).

International Financial Crises: Asia (1997) and Russia (1998)

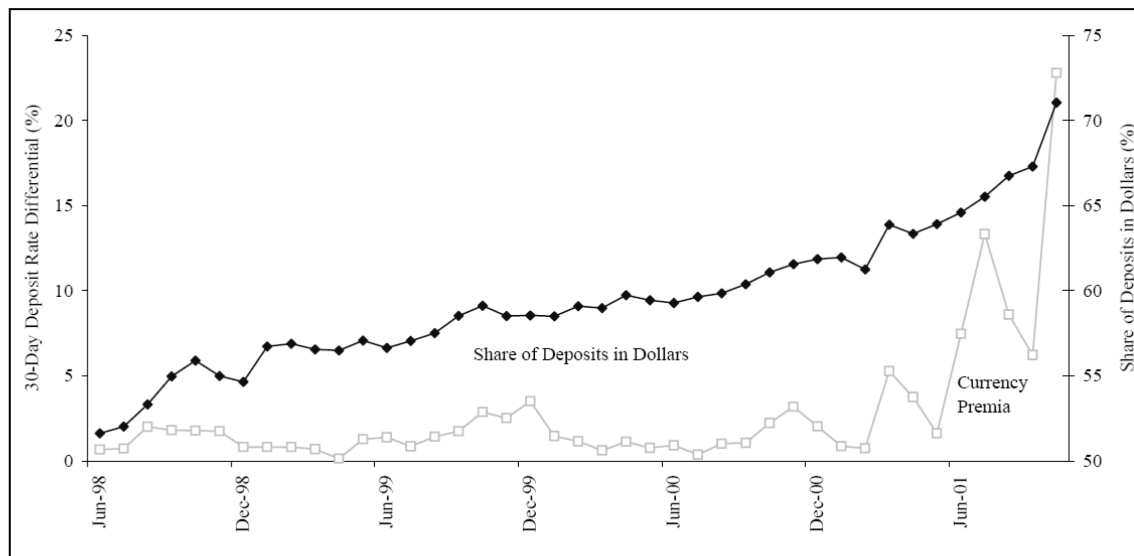
The administration's resolve was again tested when capital flows experienced a substantial reversal in the aftermath of the 'Asian crisis' in 1997-1998 and again after the Russian default in August 1998 (Bruno and Chudnovsky 2003: 67).[17] This time, emerging markets' access to international capital markets recovered only sluggishly as investors' risk aversion had increased (Powell 2002: 3). Yet, once more, the Convertibility Regime appeared to emerge strengthened from these prolonged episodes of capital flight and emergency

[16] Cavallo resigned after disagreements with Menem. As founder of *Acción por la República,* he was elected to Congress in 1997.

[17] 'Asian crisis' refers to a period of financial crisis from July 1997 onwards affecting Thailand, Indonesia, South Korea and Hong Kong, which sparked a reappraisal of international financial norms and exchange rate policy prescriptions.

austerity measures. Indeed, Argentina was the first emerging-market country to return to international capital markets. Moreover, the emerging academic debate on exchange rate pegs in times of high capital mobility and the consensus around the so-called 'bipolar view' (Fischer 2001) seemingly legitimated this rigid monetary rule, praised its sheltering of Argentina's real economy, which grew by 8.2% in 1997 and 3.9% in 1998 (MECON 1997; 1998), and thus pre-empted a re-evaluation of the 'iron-clad peg' (Blustein 2005: 37).[18] As Wise (2000: 104) argues, by late 1998, it was clear that *"[i]f not a perfect arrangement, convertibility had certainly become the preferred one."* Hence, against these three painful yet successful recoveries under the quasi-currency board and in spite of the costs of persistent real appreciation in terms of losses in tradable sector competitiveness and employment as well as growing inequality, Argentina's political class[19] and the wider population continued to subscribe to the regime as polls and the growing financial dollarisation show (Novaro 2002a: 36).[20]

Figure 19: Deposit Dollarisation in Argentina, 1998-2001[21]



Source: De la Torre et al. 2002: 34. Original deposit data from MECON and 30-day deposit interest rates from Bloomberg.
Note: Currency premia are defined as the difference of domestic interest rates for 30-day deposits in pesos and US dollars.

The Devaluation of the Brazilian Real (1999)

Doubts regarding the regime's sustainability only mounted when Brazil devalued the *real* on 13th January 1999 leading to a 14% nominal appreciation of Argentina's multilateral real exchange rate. In addition to financial contagion, this devaluation by Argentina's most

[18] In large part, the resilience of Argentina's financial system to these two external shock waves was rooted in sophisticated banking sector reforms and enhanced supervision initiated in 1995.

[19] In October 1997, the PJ was defeated in congressional elections by an *'Alianza'* of UCR and Frepaso.

[20] On 15th September 1998 a *La Nación* poll reported that 70% of Argentines supported the maintenance of the peg.

[21] The share of total loans to the public sector (excluding public bonds) and to the private non-financial sector denominated in US dollars increased from 56.8% in 1994 to 66.9% in 2000. See www.bcra.gov.ar [cited 23rd June 2004].

important trading partner (accounting for 23% of its imports and 30.5% of its exports) had a profoundly negative real effect: In conjunction with an appreciating US dollar and deteriorating terms of trade, the devaluation drastically reduced exports[22] and essential foreign exchange earnings to back the money supply. Within the constraints of the exchange regime, some modest policy changes were made, e.g., tax reductions for exporters. Yet, given its systemic lack of competitiveness Argentina was unable to export its way out of the recession. Unable to accelerate adjustment through nominal exchange rate changes and with productivity gains being ruled out by congressional opposition to (further) tax and labour market reforms, this loss of competitiveness had to be rectified through deflation at high social cost in an already recessionary economy (e.g., Bruno and Chudnovsky 2003: 69).

Excursus: Argentina and the Dollarisation Option (1998-2000)

Already in 1998, acknowledging the high degree of *de facto* dollarisation and inspired by European monetary integration, leading government economists, such as Pablo Guidotti (MECON) and Andrew Powell (BCRA), had suggested that the currency board mechanism ought to be deepened by adopting official dollarisation (Guidotti and Powell 2002). Their proposal, the blueprint for later negotiations with US authorities, recognised the political importance of seigniorage (US$500-600 million) and suggested a seigniorage-sharing arrangement anchored in a treaty of 'monetary association' (Díaz-Bonilla and Schamis 2001: 112; Guidotti and Powell 2002). In September 1998, Cavallo's successor Fernández raised this possibility with US Treasury Sub-Secretary Summers but the US government showed little interest (Cohen 2004a).[23] Only when the Brazilian devaluation ignited a public debate on exchange regime alternatives, Menem and BCRA President Pou publicised the dollarisation option so to reassure investors (*Clarín* 15th January 1999; *La Nación* 22nd January 1999; Interviews Pou and Cavallo). Yet, as US support remained elusive, as the IMF remained indecisive (IMF 1999a) and failed to *"take a strong position on the dollarisation issue"* due to *"an understandable lack of consensus on the benefits of full dollarisation"* (IMF - IEO 2004: 21) and due to strong domestic opposition, the dollarisation proposal stalled until the incoming President Fernando De la Rúa and his MECON Minister José L. Machinea eventually abandoned negotiations (e.g., Calcagno and Calcagno 2001; De la Torre, et al. 2002: 12).

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[22] Exports to Brazil fell by 28% whilst Brazilian exports replaced Argentine goods in third markets and imports from Brazil increased (Wise 2000: 105; Powell 2002: 3).

[23] US Senator Connie Mack III proposed a rebate of up to 85% of seigniorage gains to countries that unilaterally dollarised in November 1999 (S.1879 – an identical bill was introduced to the House (H.R.3493)). Both bills remained inconsecuential.

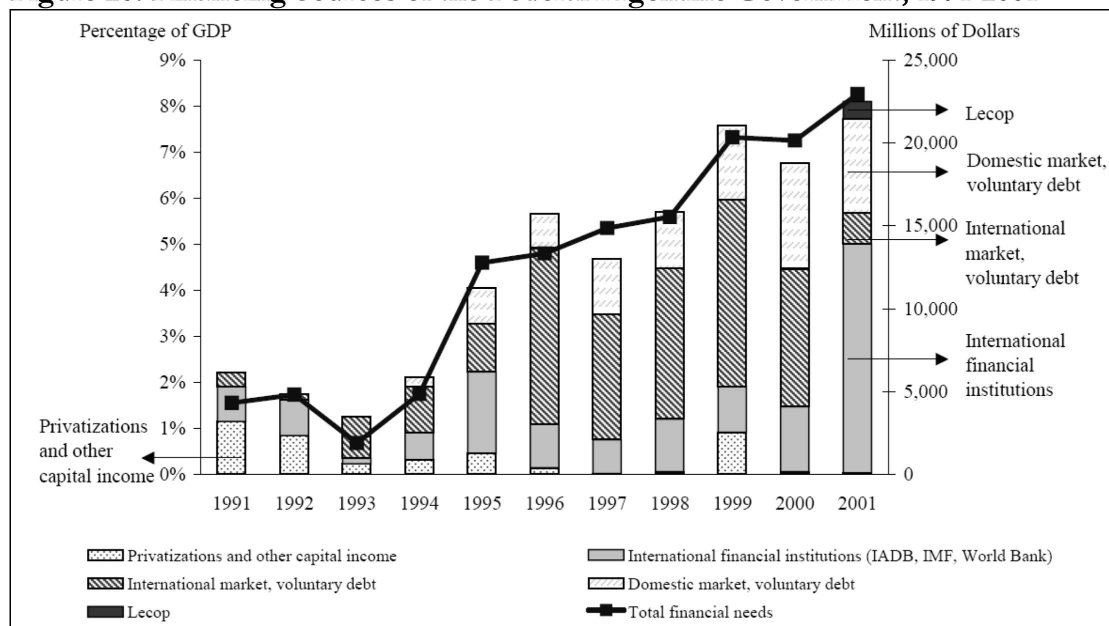
5.2.5 Exit, Devaluation and Exchange Regime Shift (2001-2002)

Convertibility basically put the inflation monster into a bottle, corked it and left the bottle sealed.

Senator Oscar Lamberto 2002

The *Alianza por el Trabajo, la Justícia y la Educación* (Alliance for Work, Justice and Education), composed of the UCR and the *Frepaso,*[24] which replaced Menem in January 2000, thus confronted multiple challenges: The country was caught in a year-long recession, marred by rising unemployment and poverty, and suffering from a systemic lack of competitiveness due to an overvalued currency. Meanwhile, the debt burden had ballooned to 46.5% of GDP and the fiscal situation was significantly more precarious than expected (Interview Machinea, Novaro 2002a: 72; Guidotti 2006: 80). Moreover, the coalition's political resources for decisively addressing these circumstances were circumscribed by the Peronist majority in the Senate (Bonvecchi 2002: 120). Initially, MECON Minister Machinea focused on rebalancing fiscal accounts so to contain debt accumulation by means of tax hikes and radical budget cuts (**Figure 20**). Yet, this intiative was ineffectual with respect to reducing country risk and interest rates and undermined the *Alianza*'s fragile popular backing as well as exacerbating programmatic differences within De la Rúa's cabinet (MECON 2000: 4; Novaro 2002a: 37+67).

Figure 20: Financing Sources of the Federal Argentine Government, 1991-2001



Source: De la Torre et al. 2002: 32 based on BCRA data.

24 Formed in August 1997, the *Alianza*'s committee (Alfonsín, De la Rúa and Terragno from the UCR and Álvarez and Fernández-Mejide from *Frepaso)* decided to compete on a shared ticket in the 1999 presidential elections in 1998.

The administration's inability to contain the economic crisis during 2000 deepened internal divisions to such extent that the coalition *de facto* collapsed when Vice-President Álvarez, *Frepaso's* leader, resigned in October 2000 setting off a vicious circle of spiralling politico-economic uncertainty (Novaro 2002b: 99). Indeed, the events triggered a hike in country risk, generating an interest rate of 14%, which priced Argentina out of international financial markets (Bonvecchi 2002: 139) and forced Machinea to implement further, politically divisive, fiscal adjustment and to initiate negotiations with the IMF for a *'blindaje'* (support package) of US$30 million (Mussa 2002). But sustained recovery remained elusive. A change at the helm of the MECON to Ricardo López Murphy in March 2001 was short-lived as his radical spending cuts proved unacceptable to the UCR's key constituencies. Desperate for breathing space, De la Rúa eventually invited Domingo Cavallo to return to the *Palacio de Hacienda* – a decision, which 72% of Argentines approved, hoping that the 'father of Convertibility' would rescue Argentina's economic model.[25]

Cavallo's Return to the MECON

Having been granted extraordinary legislative powers, Cavallo quickly eclipsed De la Rúa as key protagonist. Distinguishing himself from his predecessors by betting on economic reactivation to address fiscal imbalances instead of retrenchment, he authored the 'Competitiveness Plans', a regime of sectoral subsidies financed by a new financial transaction tax (*Ley de Competitividad 25.413* – 24th March 2001) and proposed eventually shifting to a €-US$-basket so to *"move away from the rigid dollar peg without sacrificing the discipline of the currency board"* (Interview Cavallo, Powell 2002: 9-10). In the short term, paralleling another round of debt restructuring (*megacanje*), he compensated exporters with a new *'Régimen de Exportaciones'* (*Decreto* 803), which introduced a convergence factor in mid-June 2001 (Schvarzer 2006: 86). Exporters thus received for their foreign currency *"the price of the old convertibility plus a convergence factor of 8 centavos per dollar"* while *"[i]mporters have to pay a dollar plus the convergence factor, that is 8 centavos […]"* (Cavallo in *La Nación* 15th June 2001). Meanwhile, the exchange rate for financial transactions was kept fixed.

Yet, these measures, equivalent to a mere 7% devaluation, were nothing but a drop in the ocean. Worse, they pushed country risk up to 1,000 basis points and aggravated tensions with IMF staff, who argued that this move had undermined the credibility of the government's resolve to maintain the regime (Galiani, et al. 2003: 28; Claudio Loser in

[25] 78% believed that the Convertibility Regime should be maintained, while 14% were unsure. Even after 30 months of recession, only 8% rejected the peg (Gallup poll in *La Nación* 30th March 2001).

Tenembaum 2004: 191-192; Blustein 2005: 120). On 30th July 2001, faced with having to service mounting external debt and unable to stem capital flight, which between April and July 2001 had amounted to a haemorrhage of close to US$10,000 million, a 'zero deficit' plan was launched (NY Times 12th August 2001, Lewis 2002). In response, the IMF disbursed another US$8bn loan, which provided some breathing space but also demanded progress towards reforming revenue-sharing arrangements with the provinces. However, the political 'bill' for the spending cuts materialised in October 2001, when frustrated voters rejected the *Alianza*, leaving the PJ in control of both houses of Congress and most provinces.[26] All attempts at resolving the deepening crisis thus became conditional upon Peronists' assent (Bonvecchi 2002: 159). Cavallo's decision to implement a 90-day deposit freeze (*corralito*) on 30th November 2001 so to halt the deposit drain while preparing another debt swap constituted the final tipping point.[27] Convinced that

> 99% of all cash withdrawals were less than 1,000 dollars per month and that banks would cooperate in allowing people to mobilise their savings and current accounts as well as time deposits through debit cards and cheques,

the authorities were *'utterly surprised'* by the popular discontent this measure provoked (Interview Cavallo). The IMF's decision against disbursing the next loan instalment proved the 'final straw' and unleashed violent protests that led to the resignation of both Cavallo and De la Rúa in the midst of a state of siege in mid-December 2001. After an intense struggle for the presidency coinciding with the Senate's decision to default on US$144 billion of debt, the presidential sash ended up in the hands of Eduardo Duhalde on New Year's eve.

Table 19: Argentina's Gross Debt Stock (as of 31st December 2001)

	In US$ millions	% of Total Debt
Bonds	61,803	42.8%
Bilateral Debt	4,477	3.1%
Commercial Banks	2,015	1.4%
Other Creditors	1,537	1.1%
International Financial Institutions	32,362	22.4%
Guaranteed Bonds (Provinces)	42,258	29.3%
TOTAL DEBT (as of 31.12.2001)	**144,453**	**100%**

Source: MECON 2003.
Note: 38.4% of the debt made eligible for the debt restructuring in 2003 (i.e. bonds, bilateral debt, bank and other debt) was held by Argentines. It is likely that Argentine residents also hold a significant proportion of debt issued in other countries.

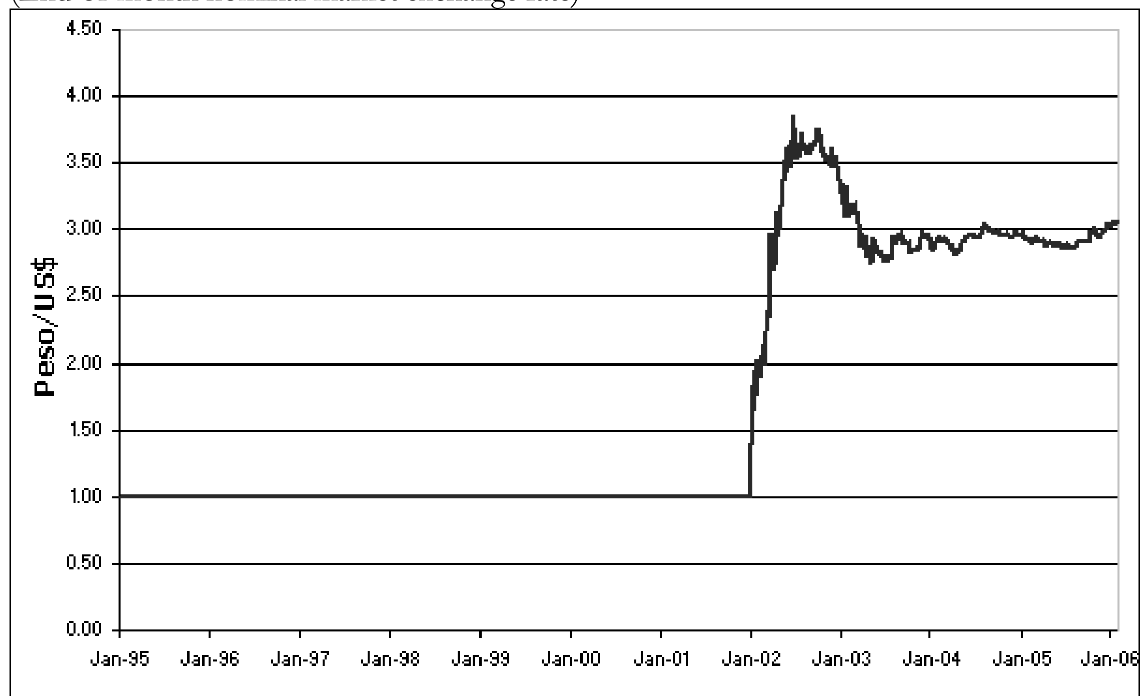
[26] In some districts, blank votes (21%) exceeded the votes won by the winning party (*EIU Country Report* December 2001).

[27] Banks lost US$14.5bn (17% of deposits) between January and November 2001 provoking a sharp decline in central bank reserves. The *corralito* sought to address this by limiting cash withdrawals from savings/checking accounts to ARG$1,000 per month. Electronic purchases and cheques were not affected, while international transfers exceeding ARG$1,000 were outlawed. The *corralito* lasted until November 2002.

Devaluation and Pesification

In the midst of this chaos and breaking earlier promises, Duhalde and his MECON minister Jorge R. Lenicov sought congressional approval for the abandonment of the Convertibility Regime on 6th January 2002 (*Ley de Emergencia Pública y de Reforma del Régimen Cambiario (25,561)).* This law relocated the competence for exchange rate policymaking (Art. 2) and transferred powers to restructure affected public and private contracts (Arts. 6-11) to the executive (Congreso de la Nación Argentina 2002a). The same day, a dual exchange regime was introduced with a pegged commercial rate set at 1.40 *Pesos*/US dollar – implying a 40% devaluation – and a floating rate for other transactions, while exchange controls and the *corralito* were maintained (Frenkel and Rapetti 2007: 9). As pressure against the peg accumulated, the authorities re-unified the foreign exchange market in early February 2002 and floated the *peso*. In order to protect the highly dollarised financial system, these steps were accompanied by the widening of the deposit freeze (*corralón),* and an asymmetric pesification of dollar-denominated contracts: While dollar deposits were pesified at a rate of 1.4 to 1 (plus inflation index), domestic dollar debt was converted at 1 to 1 (Lora and Panizza 2002: 48).[28]

Figure 21: The Devaluation of the Argentine Peso in January 2002
(End-of-month nominal market exchange rate)

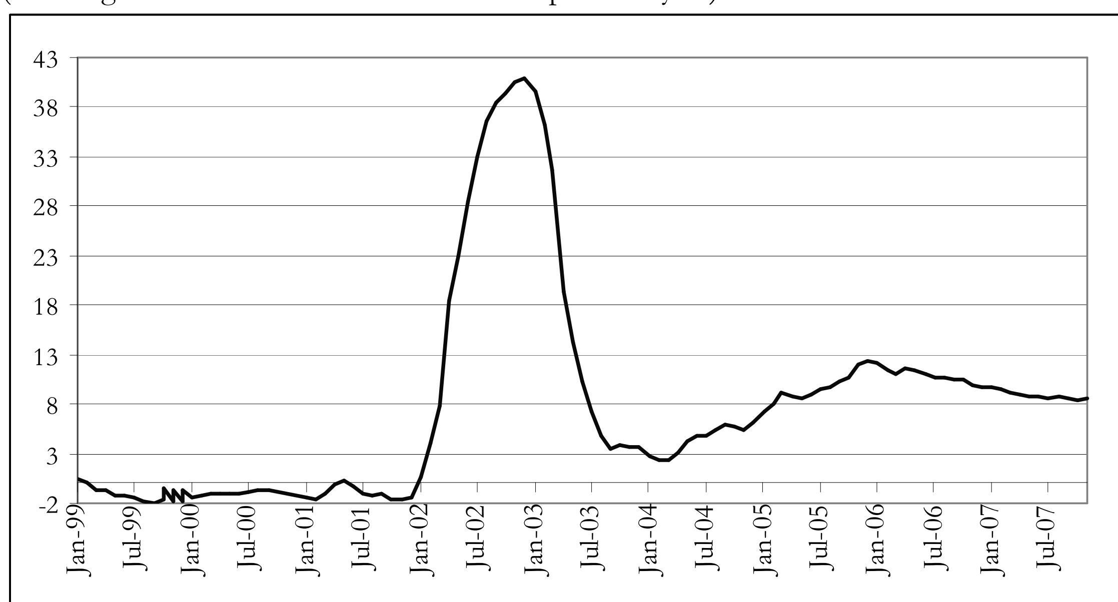


Source: LatinFocus based on BCRA data. – http://www.latin-focus.com/latinfocus/countries/argentina/argexchg.htm [accessed 25th February 2006]

[28] Banks were later compensated with BODEN2007 bonds. Additional asymmetries were introduced by indexing 'smaller' credits to wage inflation, while 'bigger' credits and deposits were indexed to price inflation with the ceiling being arbitrarily defined in negotiations with special interests (Lora and Panizza 2002).

In the short run, these highly controversial measures exacerbated the crisis by undermining confidence: As **Figure 21** and **Figure 22** show, once floating, the *peso* depreciated dramatically while inflation rates exploded. The economy slipped deeper into recession, and a period of protracted social unrest and political crisis ensued (Epstein and Pion-Berlin 2006). Only a year later, in mid-2003, did a comprehensive strategy emerge. Centring on the preservation of *"a stable and competitive real exchange rate"* (Frenkel and Rapetti 2007: 21), this new *'proyecto nacional'* of export-driven growth and re-industrialisation has since been consolidated and will be addressed in detail in Chapter VIII.

Figure 22: Post-Devaluation Inflation: Evolution of the Argentine CPI, 1999-2007
(% change relative to the same month of the previous year)



Source: Own elaboration based on CPI data from INDEC – www.indec.gov.ar [accessed 15th January 2008].

5.3. Explaining Exchange Rate Policy Choices in the 1990s

The adoption of the Convertibility Regime fundamentally shaped economic policy over the course of the 1990s. This section seeks to provide an explanation for the executive's decision to sacrifice exchange rate flexibility in 1991 and to hold on to this constraining regime over the course of the 1990s as well as accounting for the modalities of the disorderly exit in 2002. Inspired by the explanatory model presented in Chapter III, this analysis emphasises the interplay between three key factors:

- the **motivations of the executive** as the key agents determining exchange rate policy decisions;

- the **influence of societal interests** on executive decisionmaking over the course of the 1990s; and
- the **role of external interests** – especially the IMF – in shaping these policy decisions and their timing.

In particular, I seek to dispute the notion that the adoption of the quasi-currency board had been pre-determined by the circumstances, i.e. that *"the administration [...]* had little choice but to *pursue one of the most credibility-enhancing strategies available to a country in the throes of hyperinflation"* (Wise 2000: 94 - my emphasis). However, the chosen regime only represented *one* of several options to deal with such emergency (Calcagno and Calcagno 2001: 126). Indeed, as Ocampo (2003: 22) highlights, no other Latin American country suffering hyperinflation during this period followed Argentina's path. If feasible alternatives existed for those countries, what drove Argentina's decision in favour of the Convertibility Regime? This section seeks to elucidate these political dynamics, which Wise's fatalism has largely obscured (also Lewis 1999: 38; Pastor and Wise 1999: 485).

5.3.1 The Role of the Executive

In the first instance, this analysis addresses the questions of where the locus of decisionmaking was, what kinds of constraints decision-makers perceived in the process, and how these perceptions shaped decisionmaking. After delineating the extent to which the adoption of the Convertibility Regime was rooted in technocratic attempts to build credibility by means of self-binding, as highlighted by the institutionalist literature, I propose a more political reading, which focuses on the peg's employment for the purpose of building and disciplining coalitions in support of structural reforms, and argue that it was this latter appeal that provoked the petrification of the regime, as economic authorities were reluctant to let go of this powerful political tool.

Table 20: The Economic Team of the Convertibility Plan
(as of March-April 1991)

Domingo Cavallo	Minister of the Economy
Juan J. Llach	Chief Advisor to MECON / Secretary of Economic Planning (1991-1996)
Horacio Liendo	Legal and Technical Advisor to MECON
Carlos Sánchez	Deputy Minister of the Economy and Secretary of Commerce and Investment
Ricardo Gutiérrez	Secretary of Hacienda
Marcelo Ragúnaga	Secretary of Commerce and Industry
Felipe Murolo	Vice-President of the BCRA
Roque Fernández	President of the BCRA
Daniel Marx	External debt negotiator (based in Washington DC)

Source: Interviews with Cavallo; Cavallo 1998: 174; Hunneus 1998: 190.

Cavallo's Economic Team: Convictions, Backgrounds and the Relationship to the Presidency

The decision to adopt the Convertibility Regime was taken by an insulated team of technocrats at the core of the executive, whose autonomy in exchange rate matters stemmed from four factors. First, in response to several failed attempts at generating confidence, ranging from delegating authority to renowned businessmen to appointing a loyal aide, Menem resigned to entrusting economic matters to a group of *técnicos* led by his former Minister of Foreign Affairs Cavallo (Carrera 1994; Palermo and Novaro 1996: 293-294; Dominguez 1997; Weyland 2002: 113+157). The team's autonomy was considerable given that Menem *"set no visible mechanisms of control or checks on Cavallo's power"* (Huneeus 1998: 182), leading the NY Times to report that *"Cavallo has been vested with powers that lead many to refer to him as the country's prime minister"* (28th April 1991). Tellingly, prior to the adoption of the Convertibility Plan, only very loose consultation took place:

> The President never had the patience for me to enter into the details of what I was going to do but he sought to understand what the expected result was and the reason for adopting such decision. And then he would deal with communicating this decision, something which he did with great efficacy (Interview Cavallo, also see Cavallo 2001: 165-166).

Secondly, unlike Alfonsín, Menem had the political and institutional capabilities to shelter the team from political pressures[29] thanks to an unprecedented concentration of authority within executive ranks, described by O'Donnell (1994) as a case of 'delegative democracy'.[30] Indeed, although the Argentine state was infamous for its permeability, Menem's status as autonomous leader of the highly disciplined PJ and his intimate ties to the labour movement, combined with his party's dominance in Congress and in provincial governments, granted him control over key institutional veto points and allowed him to discipline organised labour and coopt other actors (Levitsky and Murillo 2005: 198). Contrary to institutionalists' expectations, technocrats' sheltered position thus flowed precisely from the absence, rather than presence, of strong state institutions that imposed checks and balances on presidential power and also from the high degree of organisational fragmentation among societal interests (Oxhorn and Ducatenzeiler 1999).[31] As section 5.3.2 shows, this

[29] This included pressures from other cabinet ministers who belonged to the 'historical' wing of the PJ and regarded Cavallo's agenda as a threat to their support base (Palermo and Novaro 1996: 299-300).

[30] 'Delegative democracy' describes executives that, relying on majoritarian principles embodied in free elections, enjoy discretionary authority and govern largely unconstrained by mechanisms of horizontal accountability to courts or the legislative (O'Donnell 1994).

[31] The one remaining veto point, the Supreme Court, was reined in by expanding the court and violating the appointment

constellation did not imply that societal interests were excluded from policymaking but rather that the executive opportunistically chose whom to consult (Palermo and Novaro 1996; Gibson 1997; Etchemendy 2001; 2005).

Thirdly, the team was considerably more cohesive than the *Team Austral*, whom the economists had *"built their theoretical and political identity in opposition to"* (Neiburg 2004: 193). In addition to loyalty towards Cavallo, team members had shared roots in the consultancy *Instituto de Estudios Economicos sobre la Realidad Argentina y Latinoamericana* (IEERAL) of the *Fundación Mediterranea* (FM). By the time Menem took office, IEERAL had espoused ideas of market-oriented reforms for over a decade (e.g., Cavallo 1984) and had played a major role in shifting Menem's economic agenda towards neoliberalism in 1988-1990 (Camou 1998; Dominguez 1998: 114; Echegaray and Elordi 2001). Other than academic credentials, as consultants, the economists had developed an acute understanding of private sector preferences.

Finally, contrary to Sourrouille, Cavallo succeeded in establishing a coherent economic policy vision across economic authorities by positioning the monetarist Roque Fernández at the BCRA and appointing 80 loyal FM economists to his new reinvigorated 'super-ministry' (Huneeus 1998: 190; Molano 2001: 215; Williams 2002: 406; Spiller and Tommasi 2007: 183).[32] Given that the cabinet, composed of reform-minded ministers (Diaz 2001: 74), had already embraced the so-called 'Washington Consensus' with the dismantling of excessive state and commercial regulations as well as fiscal restructuring already well underway, the new team could thus immediately focus on designing strategies for deepening the reform paradigm. In short, the team combined *"strong leadership, common conceptions, strong internal coherence and represented a critical mass"* (Palermo and Novaro 1996: 298) and thus underpinned Cavallo's emergence as the unrivalled protagonist in debates determining the future exchange regime.[33]

Credibility Building: The Lure of Convertibility

Many scholars employ the institutionalist language of seeking to 'build credibility' by 'signalling commitment' to account for Cavallo's radical exchange regime choice (e.g., Cohen 1998; Starr 1999; Wise 2000; Díaz-Bonilla and Schamis 2001). Pointing to the country's need

process, creating what became to be known as the *"mayoría automàtica menemista"*.

[32] After merging with the Ministry of Public Works, MECON had extended its remit over Finance, Trade and Investment, Economic Programming, Agriculture, Public Works, Energy, Transportation and Communications (Molano 2001).

[33] These characteristics explain why Cavallo's team remained in office for an unusually long period and only left when Cavallo resigned in 1996. The team's loyalty is also highlighted by the fact that all key technocrats accompanied his return to MECON in 2001 (*El Cronista* 21st March 2001).

to rehabilitate itself after the 1989-1990 crisis[34] and rehearsing Elster's account (1979) of Ulysses' decision to bind himself to his boat's mast in order to heed the sirens' songs without being tempted to jump off-board, institutionalists depict the Convertibility Regime as an attempt to root out ungovernability by means of self-restraint. This perspective convinces on several grounds. First, key protagonists themselves resort to this logic and had long emphasised the importance of credible and transparent rules (e.g., Cavallo 1984; 1986; also see Cavallo 2001: 163). Moreover, as advocated by Cavallo's legal expert Horacio Liendo, with the *Caja de Conversión* (1899-1929), Argentina's economic history provided a well-known precedent for the use of rigid institutional solutions to instil credibility.[35] After having been rejected by Menem in 1990, Cavallo's appointment in 1991 was tantamount to presidential assent to this radical plan (Cavallo 1997: 174; 2001: 162; Weyland 2002: 114).[36]

Having diagnosed an acute credibility deficit, the quasi-currency board constituted a powerful 'commitment device' (Isard 1995; Leblang 1999; Broz 2002). Given that the system merely formalised Argentina's *'remedio casero'* (household remedy) against inflation, i.e. using the US dollar, the team hoped to quickly restore public confidence and reverse inflationary expectations (Interview Cavallo). Granting even further credence to the permanence of the regime, Cavallo enshrined the arrangement in congressional legislation, rather than enacting it by decree, and thus granted Congress the role of a 'veto player' in exchange regime choice (Tsebelis 2002: 204).[37]

Secondly, considering why the authorities opted for this institutional proxy rather than outright dollarisation highlights that their willingness to sacrifice policy autonomy in the search for credibility was not unlimited. Abandoning the symbolically important national currency was deemed economically and especially politically *'unwise'* (Interview Cavallo), and sacrificing seigniorage income would have further strained fiscal accounts. Moreover, aware of the risk of external shocks, the technocrats greatly valued the *"limited amount of 'wiggle room'"* for the discretionary use of monetary policy left by the Convertibility Regime (Cohen 1998:

[34] Often overlooked by Anglophone accounts, Cavallo's own reputation was tainted as a result of his implementation of the controversial 'debt reduction' project whilst BCRA President in 1982. Local observers interpret the Convertibility Plan as a gamble to overcome Argentina's credibility problem as much as his own (Interviews Alemann, Keifman and Peruzzotti).

[35] A particularly biased reading of economic history accompanied the Convertibility Law (e.g., *Congreso de la Nación Argentina* 1991: 5369), which focused on stability gains rather than on equity considerations and overlooked the regime's disastrous end (Lanata 2003: 605-606). Cavallo himself claims to have been aware of the inherent dangers of the regime, but *"thought that even if it would end in depression because there is no exit strategy or because exit is not timely implemented, it would be after several decades and by that time we would all be dead"* (Interview).

[36] Since the late 1990s, there has been an on-going debate between Cavallo and Menem regarding the plan's intellectual origin. My research could not corroborate Menem's intellectual contribution. Cavallo has always acknowledged Liendo's contribution but continues to be adamant that the idea itself was his. Others suggest that the idea was originally promoted by Juan Llach and Carlos Rodríguez (Díaz-Bonilla and Schamis 2001: 86; Blustein 2005: 14).

[37] Other measures to underpin the regime consisted of the introduction of dollar checking accounts in 1993 and the introduction of dollar transactions (except for wages and taxes) in the domestic financial system (see Molano 2001: 218).

54). At the same time, Cavallo keenly exploited the symbolic power of pegging the *peso* at 1 to 1 to the US dollar. Convinced that productivity gains would compensate for the likely overvaluation he thus prioritised dollar equivalence over the *ex ante* adjustment of the exchange rate peg down to an 'ideal rate' (Palermo and Novaro 1996: 326; Cavallo 2001: 165).

Thirdly, this drastic institutional solution was particularly appealing with a view to re-entering international financial markets. For one thing, against Argentina's track record the rigid regime would *"signal an institutional caesura"* to investors (Interview Cavallo), and the authorities' *"commitment not to play games with other people's money"* (Rodrik 2002: 2) would reduce sovereign risk. The regime thus constituted a powerful 'information shortcut', which would make Argentina stand out as a highly profitable 'low risk' investment destination in an increasingly competitive global environment (Griffith-Jones and Stallings 1995; Mahon 1996: 133; Starr 1999; Mosley 2003b: 34-40). Moreover, given that the regime's structural reliance on capital inflows effectively exposed the authorities' policies to the discipline of international financial markets, the resulting leverage proved a strong incentive for investors to opt for Argentina (Maxfield 1997: 36; Phillips 1998: 88-89). Overall, as institutionalists argue, the arrangement thus helped acquiring the necessary credibility at home and abroad for facilitating Argentina's re-entry into global financial markets, to differentiate herself from other destinations and to rebuild bridges to the international business community.

The Exchange Rate as a Political Instrument

Although contributing key insights, this institutionalist reading is not unproblematic. Not only does it beg the question of why this device was not used before, but its focus on credibility-building by means of Ulysses-style self-binding depoliticises the decision-maker's situation. By detaching the decision-maker from his wider context, this approach fails to problematise decision-makers' self-interests, dynamics between different actors in the decisionmaking process (e.g., technocrats and politicians) as well as distributional consequences (see Horkheimer and Adorno 1972; Shapiro 1989). In the following, I argue that Cavallo did not only employ the dollar peg as a 'commitment device' but in order to build, consolidate and discipline a coalition supportive of the wider pro-market reform agenda he had long advanced (also Starr 1997: 99). The decision thus did not solely reflect the immediate need to signal radical policy change but was rooted in medium-term considerations and the desire to exploit the 'window of opportunity' opened by post-stabilisation euphoria for the consolidation of reforms (also Molano 2001; Acuña, et al. 2006: 10-12).

Cavallo recognised how useful the regime could be in creating the political conditions for reforms, for binding Argentina's multiple veto players and – crucial for convincing Menem – for making reform efforts compatible with electoral success. Especially in a divided society like Argentina's the regime's rigid policy rule had great political appeal. By 'bracketing' exchange rate policy decisions and emphasising the resulting *absolute* disinflation and growth gains, the regime also depoliticised a whole range of policies that simply had to be brought into line if the dollar peg was to be sustained and thus presented policymakers with a powerful way of 'framing' the need for structural reforms. The peg itself reinforced the urgency of structural reforms by putting a premium on liberalising capital markets in order to guarantee capital inflows to back the monetary base and on further trade liberalisation, which via increased imports forced firms to reduce prices and increase productivity. In this sense, *"[c]onvertibility was […] much more than a monetary institution"* (Acuña, et al. 2006: 11); it constituted an invaluable political instrument for generating support for profound structural change. It helped to rein in those actors that possessed veto power, disciplined others who risked falling victim to complacency after initial disinflationary success and actively built a coalition around this 'master' contract. The regime was thus *"a double strategy [aiming at] the reconstruction of the monetary order and the reconstruction of political authority"* (Palermo 2002: 300).

The Convertibility Regime: Locking in Reforms at the Risk of Petrification

In seeking to account for the petrification of the Convertibility Regime in the late 1990s, an analysis centring on this inherently political character of the monetary regime is crucial insofar as it captures the gradual shift from the executive's – and especially the economic team's – maintenance of the regime for reformist purposes throughout the crises of the late 1990s to its being caught by this shackle in later years. Acutely aware of the need to broaden and consolidate its support coalition after two years of 'surgery without anaesthesia', in 1991 the authorities understood that

> [i]f you suddenly deliver price stability and currency stability, then you receive much popular support, you win elections, and you are able to assemble a coalition in Congress that will approve the necessary measures to open up the economy, to deregulate, to privatise, and to undertake economic reform programs (Cavallo 1999).

The monetary regime thus provided the essential backdrop for assembling a powerful reform coalition that *"looked nothing like the union-based, nationalist-populist supporters who had been instrumental in electing Menem"* (Wise 2000: 98). Instead, this *"strange collection of bedfellows"* (Starr

1997: 99) ranged from members of lower income strata, the dominant section of the CGT, the middle classes and liberal technocrats to domestic-international industrial consortia and the banking sector: In short, a heterogeneous support alliance with a high potential for intra-coalition conflict, united only by their overriding interest in monetary stability (also Starr 1999; Wise 2000: 99; De la Torre, et al. 2002: 12; Acuña, et al. 2006: 12). This coalition, together with the PJ-*Ucedé* majority in Congress, successfully carried the reform agenda during the first half of the 1990s. Yet, it would exhibit significant weaknesses once inflation subsided and divergent second-order policy interests emerged (Starr 1999: 223).

The technocrats had learnt from the *Plan Austral* how crucial it was to deepen structural reforms so to consolidate the disinflationary success before political complacency set in among policymakers and the citizenry. This scenario manifested itself in 1994 when, after the 1992-1993 boom, Menem's reform commitment visibly diminished (Llach 1997: 237; Weyland 2002: 160). Eyeing constitutional reform and the upcoming presidential elections, he sought to ensure support from key constituencies (especially labour and provincial governments) and attenuate emerging intra-coalitional conflicts by means of manifold side-payments and compensation deals and by slowing down and diluting controversial reforms (Etchemendy 2001; Molano 2001: 221). Increasingly exposed to Menem's interference, Cavallo learnt to appreciate the extent to which the Convertibility Regime, reinforced by international financial market discipline, constrained presidential actions and prevented a reversal of reforms (Interview Cavallo; Weyland 2002: 148-149). The sustained commitment to the rigid exchange regime also framed the congressional agenda and contained critical debates (Gerchunoff and Torre 1998: 130). The threat of regime breakdown and strategically invoked scenarios of a return to hyperinflation allowed technocrats to propel their reform endeavours forward (also Corden 2002: 181; Espert 2002: 2-3; Weyland 2002: 160). Indeed, on the eve of the 1995 presidential elections – and hence contradicting political business cycle scholars' expectations – widespread fear of the regime's collapse in the aftermath of the Tequila crisis granted Cavallo a political 'carte blanche' for further reforms. Presenting contagion *"not as a sign of permanent weakness"* but as *"vulnerability that came from the lack of reforms"*, Cavallo himself reckons that stressing the regime's likely collapse in case of inaction allowed him to gain presidential and wider political support for addressing *"politically more sensitive issues such as the privatisation of provincial banks and the financing of provincial deficits",* as well as the partial flexibilisation of labour laws and the implementation of budget cuts amounting to US$1 billion (Interview Cavallo, Scott 1995; Cavallo and Cottani 1997: 18; Wise 2000: 102; Baer 2002: 76). This interpretation is shared by Camdessus and Krueger, who recall that Cavallo

proposed *"to turn the crisis into an opportunity for reforms"* (Camdessus 1996a) and that *"reformers saw [the Convertibility Regime] as a useful source of leverage to bring about open market-oriented structural reforms"* (Krueger 2002). Accounts by critics from various walks of life corroborate this reading. Pointing to their marginalisation within Congress and wider society, they recall how Argentine society *"made sure not to criticise the creature – irrespective of the associated socio-economic costs for maintaining the arrangement"* and displayed great acquiescence to previously controversial reform projects (Interviews Terragno, also Rial, Massuh, Peruzzotti and Keifman).[38] Support for the monetary regime thus raised the wider public's willingness to bear short-term adjustment costs in exchange for what was hoped to be a return to the boom years (Díaz-Bonilla and Schamis 2001: 87).

Table 21: Structural Reform Index for Argentina, 1985-1999

	1985	1989	1990	1991	1992	1993	1994	1998	1999
Argentina	0.338	0.366	0.468	0.551	0.574	0.602	0.598	0.604	0.616
Average Latin America	0.341	0.399	0.436	0.455	0.484	0.503	0.522	0.573	0.583

Source: Lora 2001. *Note:* The index goes from 0 (no reform) to 1.

Yet, the regime's resilience, the degree to which Menem's support hinged on discretionary deals that had proliferated in the run-up to his re-election, and the extent to which *"the fixed exchange rate […] had become the linchpin of investor confidence"* (Starr 1999: 206) eventually turned into a double-edged sword. Ironically, these factors contributed to the petrification of the exchange rate regime whilst undermining its long-term sustainability. For one, Menem's complacency reached a new climax as his re-election and the lucky recovery after the Tequila crisis convinced him that the regime was invincible (Clarín 18th March 1996, Graziano 2001: 131; Weyland 2002: 161). Moreover, in the short run, the regime proved conveniently compatible with the maintenance of politically invaluable *"illiberal enclaves"* (Bambaci, et al. 2002), for instance with respect to labour markets, and fiscal deficits given that IFIs' and financial markets' enthusiasm fuelled the absorption of government bonds (Wise 2000: 99; Blustein 2005: 51-53; Acuña, et al. 2006). The discipline, Cavallo had hoped, financial markets and the quasi-currency board would jointly impose on Argentina's political class thus evaporated, and mounting tensions with Menem eventually culminated in Cavallo's resignation in August 1996 (Interview Cavallo).

Access to external finance, even in difficult market conditions, allowed Menem's administration to veil its inability to attain fiscal balance in the late 1990s and to simulate the

[38] As the abysmal performance of the 'Convertibility critic' Massaccesi (UCR) in the 1995 elections showed, the executive did not have to fear that the opposition would gain ground by criticising the regime. To the contrary, it became common knowledge that parties critical of the regime were unelectable (also Wise 2000: 113; Weyland 2002: 180).

solution of Argentina's deep-seated distributional conflicts by eliminating its key symptom – inflation – at the expense of a growing burden of external debt (Baer 2002: 71).[39] The resulting dependence on maintaining investor confidence, which itself centred on the dollar-parity hypothesis, thus ruled out the regime's flexibilisation. Similarly, Argentina's weathering the Asian and Russian crises and the emerging 'bipolar consensus' among international economists and continued praise from IFI representatives provided welcome external validation. The resulting 'one-way vision', imperative to sustain the authorities' *'confidence game'* with financial markets (Pastor and Wise 1999: 484; Santiso 2003), became highly problematic as it ruled out a sober assessment of the regime's relative benefits, *"provided a self-sustaining system of shared beliefs"* about the indefinite maintenance of the regime (Acuña, et al. 2006: 12) and, more importantly, rendered an orderly exit increasingly unlikely (Weyland 2002: 204; Aizenman 2005: 976).[40] For instance, banking regulations could not signal the possibility of a devaluation through prudential norms without risking investor panic and heavy reserve losses (De la Torre, et al. 2002: 6; Acuña, et al. 2006: 11).[41] Under the resulting implicit exchange guarantee, the share of unhedged dollar debts held by firms and individuals mounted and raised the risk of systemic financial crisis in case of a parity change. Given this scenario and the explicit support of his new economic duo Fernández-Pou, Menem had no incentives for exiting from the regime. Instead, he passed the poisoned chalice of doubtful debt sustainability, fiscal imbalances and deteriorating current accounts on to his successor.

The *Alianza*'s 'imprisonment' in the Convertibility Regime thus had multiple roots. In addition to public opinion that favoured the maintenance of the regime, the coalition had early on tied its own hands by turning their commitment to Convertibility into a cornerstone of their electoral campaign (Interview Machinea, NY Times 29th September 1999, Novaro 2002a: 35+60; Terragno 2005: 127-132).[42] Moreover, due to the *Alianza*'s fragile institutional position vis-à-vis a Peronist majority in the Senate, room for legislated change was limited (Novaro 2002a: 36-37; Palermo 2002: 310). Instead, Machinea's team focused exclusively on addressing the deteriorating economic conditions *"from within the black box of Convertibility"*

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[39] Characteristic of this *de facto* lack of international market discipline was Menem's invitation to the IMF's Annual Meeting in October 1998 and the fact that Argentina was bestowed the 1998 award for 'Issuer of the Year' (Blustein 2005: 51).

[40] The monetarist axis Fernández-Pou, which succeeded Cavallo, contributed to these developments and thus to the petrification of the regime by means of their foreign exchange and regulatory interventions (also fn 12 on p. 129).

[41] Similarly, the combination of the institutional 'lock-in' with high capital mobility effectively ruled out an orderly exit in accordance with constitutional provisions (i.e. after congressional approval).

[42] The *'Carta a los Argentinos'* of August 1998 stated that *"[a]s part of the efforts to consolidate stability, the Alianza is determined to maintain 'convertibility'. At the same time, the Alianza is aware of what is necessary in order to preserve it in the current context of international financial crisis: fiscal equilibrium, exporting impulse, strengthening the financial system and economic growth"* (*Alianza por el Trabajo* 1998). This commitment was reinforced by De la Rúa's electoral slogan *'Conmigo, un peso, un dólar'* (With me, one *peso*, one dollar) and provoked major tensions with 'Convertibility critics' such as Terragno (2005).

(Interview Machinea, also Pucciarelli 2002: 84; Bonelli 2004: 130). This generated a 'catch-22' situation: In order to render the popular regime sustainable in a context of international financial turbulences, the *Alianza* had to tackle those reforms, which Menem had persistently postponed for fear of alienating voters and key institutional veto players: further flexibilisation of labour markets, a restructuring of provincial finances and external debt as well as sustained public sector adjustment to attain fiscal solvency. Ironically, seeking to sustain the regime that had generated unprecedented reformist support under Menem the *Alianza* now eroded its own backing until it had not only sacrificed its political legitimacy as an alternative to the *'Menemista'* project but had also lost its capacity for political initiative: Ulysses had drowned with his hands tied.

In sum, this section highlighted the politically instrumental character of the quasi-currency board. While credibility considerations capture some of the executive motivations of its adoption, it is the political dynamic associated with technocrats' desire to garner democratic support for structural reforms and to discipline opportunistic policymakers that accounts especially for the regime's later petrification. Technocrats' hope that Convertibility could impose an unprecedented degree of discipline on opportunistic policymakers whilst propelling forward market-oriented reforms proved not only politically naïve but ultimately disastrous as it introduced disabling rigidity in one area, which provided a veil for particularistic practices in others. In short, contrary to Cavallo's hopes, the currency board functioned more as a *"suppressor of symptoms [rather] than as an engine for fundamental change"* (de Beaufort Wijnholds 2003: 106) – and these symptoms reappeared with a vengeance in 2001.

5.3.2 The Role of Societal Interests

The previous section highlighted the degree of executive dominance in the process of exchange rate policy formulation as well as pointing out how its use of the dollar peg for coalition-building purposes shaped policy and underpinned the regime's maintenance during the late 1990s. This section presents the other side of the coalition dynamic. Going beyond traditional sector-based interest group accounts, which struggle to account for the absence of political pressure for exchange regime change once its limitations became apparent, I refer to the organisational structure of Argentine society, its 'inflationary scar' and government-engineered compensation deals and show how actors' sectoral exchange rate policy interests were increasingly dominated by their unhedged financial exposure to nominal exchange rate changes. The resulting 'Convertibility consensus' could only be punctured once a critical mass of organised societal actors had acknowledged that changes 'within' the regime would be

insufficient to overcome the prolonged recession, once profound politico-economic crisis opened up space for such interests to intensify their influence on the executive and, last but not least, once a solution to the dollar debt problem had been integrated into the exit proposal. Only in this extraordinary 'window of opportunity' in early 2002 were societal interests able to overcome internal divisions and executive insulation to implant a new exchange rate-political paradigm, which persists until this day.

1989-1994: Oscillating Relations – From Incorporation to Exclusion

Prior to the Convertibility Plan, executive-society relations had undergone several twists and turns as the Menem administration tried to (re-)construct its capacity for decisive governance. By 1991, the executive successfully prepared the radical exchange rate-based stabilisation in isolation from societal actors and yet obtained widespread backing for its initiative. Recalling Alfonsín's fateful confrontation with organised labour, Menem set out to loosen the constraints rooted in his party's traditional alliance with the unions. Instead, he established close ties with big business by granting individual entrepreneurs *"easy and immediate personal access"* (Interview CEA member) as well as transferring direct economic policy responsibilities to corporate representatives when he appointed first Roig and then Rapanelli to the MECON (Carrera 1994; De la Balze 1995: 70; Phillips 1998: 93-96; Teichman 2002a: 495). Meanwhile, traditional corporatist organisations, *"among the weakest and most fragmented in the region"* (Schneider 2004: 196), were marginalised and struggled to rival individual members' open and regular access to cabinet members throughout Menem's presidency (Weyland 2002: 181; Phillips 2004: 191; Schneider 2004: 192). When reforms stalled due to *Team B&B*'s vulnerability to sectoral demands, Menem further reduced the executive's permeability by appointing his loyal aide González and adopting strict fiscal orthodoxy whilst accelerating market-oriented reforms (Palermo and Novaro 1996: 272). Businessmen now *"witnessed how the government implemented the plan they had always dreamt of"* but *"did not understand why they were excluded from the decisionmaking table" (Clarín* 27th July 1990).

Given Menem's turn to business, Peronism's historical opponent, organised labour confronted multiple challenges. Caught between their loyalty to Peronism and the threat posed by Menem's business-friendly agenda, labour leaders struggled to re-define their relationship to the governing party (Epstein 1992; Phillips 1998: 96-100; Murillo 2001). In the process, the split of the CGT was exploited by the executive, which coopted the reformist CGT-San Martín faction by means of granting it the legal monopoly of representation, nominating representatives to the Labour Ministry and offering special access to

policymaking, whilst reducing the funding for the government-critical CGT-Azopardo (Acuña 1995a: 30; Murillo 2001: 167; Tedesco and Barton 2004: 121). In parallel, unions' historical influence in the PJ had markedly declined (Levitsky 2001; 2003).[43] Hence, highly fragmented, deprived of its prior party-internal influence and yet restrained in its militancy for lack of political alternatives, organised labour had become surprisingly acquiescent to Menem's reforms by the time Convertibility was announced.

The Convertibility Plan caught organised society by surprise (Interviews Castro, Massuh, Delfino and Rial, Gerchunoff and Torre 1998: 131). Due to a resilient congressional PJ-*Ucedé* majority, expedited legislative procedures and the plan's legitimacy, engendered by strong popular support and crisis-generated urgency, legislative conflict was subdued and the law speedily approved.[44] No sustained debate about the inherent risks took place and even when concerns about the unresolved fiscal situation and the impact of likely overvaluation on industry were addressed by opposition politicians, they failed to pierce enthusiastic public support (Baglini, Rodriguez and Guerrero (all UCR) in Congreso de la Nación Argentina 1991: 5310-5322).

This enthusiasm also conditioned organised society's response and left critical voices, such as those of the CGT-Azopardo leadership, isolated insofar as the plan was welcomed by both reformist labour factions and Azopardo's own grass-roots (Úbaldini in The Buenos Aires Herald 22nd March 1991, Murillo 2001: 139; Weyland 2002: 141). After the CGT reunited in March 1992 on the terms of the reformist faction, the movement's renewed bargaining power was utilised primarily for obtaining concessions *within* the neoliberal agenda, such as consultation on labour market reforms and unions' participation in the privatisation of utilities, trains and pension funds (Murillo 2001: 2; Etchemendy 2005; Etchemendy and Berins Collier 2007: 26). Although this accommodationist course provoked the defection of two smaller unions and the formation of the oppositionist CTA (Congress of Argentine Workers) later that year, organised labour's overall very cooperative stance granted Menem the popular and electoral backing for sustaining the reform agenda.

Argentina's business class, in spite of its deep divisions, was united in welcoming the new regime given that it coincided with their long-standing demands for rules-based

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[43] From controlling a third of PJ seats (*'tercio'*), the share of unionists in the congressional PJ declined from 27.7% in 1985 to 15.0% in 1991 and to 4.2% in 1997 (Levitsky 2001).

[44] Dep. Lamberto (PJ) emphasised that *"society had already accepted the plan before we, the legislators, even knew the text of the proposed law. The confidence vote that the Argentine people have given to this plan is much greater than the expectations of those of us who make laws on a daily basis"* (in *Congreso de la Nación Argentina* 1991: 5291). Senate passed the legislation with a vote of 27 against 7 UCR votes. Meanwhile, Congress approved the legislation with 115 votes to 64. Unexpectedly, 11 *Ucedé* deputies had joined the UCR as well as PJ dissidents, the Popular Democrats, the Popular Socialists, the United Socialist and some Christian Democrats in opposition to the Convertibility Law (*The Buenos Aires Herald* 24th and 28th March 1991).

policymaking, a strong commitment against inflation and, in the case of the rural sector, the elimination of export taxes (Interview Delfino, Montagna and Pietrantueno (CEA) in The Buenos Aires Herald 22nd March 1991, Acuña 1995a: 29; Birle 1995: 349). Initial scepticism about its sustainability and possible overvaluation evaporated after a few months thanks to the *"utter relief of leaving hyperinflation behind"* (Interview Massuh). The ensuing recovery enabled businesses to extend their planning horizons, develop more sophisticated markets (e.g., futures in agriculture) and exploit the *'dólar barato'* for the modernisation of production facilities. Even exporters, after vociferous complaints about the rapid appreciation of the freely floating *austral* in late 1990 (Palermo and Novaro 1996: 281), welcomed the exchange rate stability enshrined in the new regime and

> discovered that the profitability of their activities – rather than being linked to exchange rate depreciation – was more closely associated with the elimination of export taxes, the infamous *retenciones*, with the greater facility to invest and conquer higher productivity levels, with the elimination of regulations that in the past had reduced profitability, as well as the improvements in infrastructure that came from modernisation associated with privatisation and as a result of a huge amount of FDI in the infrastructure sector (Interview Cavallo).

Government-business relations were thus unusually positive (Acuña 1995a: 40; Birle 1995: 342-343; Phillips 2004: 192).

By 1993, witnessing this allround support and the macroeconomic regime's success, even politicians who had opposed the legislation admitted that *"Cavallo chose the most effective remedy"* and that *"[n]othing else could [have] produce[d] faster and more reliable changes"* (Terragno in Lanata 2003: 605-606). Noting public acquiescence vis-à-vis rising unemployment and signs of widening income inequalities, PJ dissident Álvarez concluded that Argentines had resigned to the fact *"that even stability with injustice was preferable to instability"* (in *The Guardian* 6th October 1993; also Tedesco and Barton 2004: 124). The long-awaited stability and rapid recovery thus allowed the executive to overcome collective action problems that had sabotaged previous stabilisation efforts and to unite an alliance of urban labour, big business as well as the middle classes and consumers around the importance of consolidating price stability by means of overhauling Argentina's economy (Gibson 1997; Murillo 2001; Corrales 2002). This consensus, reinforced by the front-loading of reform concessions and payoffs to key coalition segments, generated an unprecedented acceptance of reforms and tolerance for adjustment costs (Wise 2000: 111; Etchemendy 2005). As the competitiveness losses due to overvaluation were compensated by productivity gains, the *"potential problems associated with the exchange rate peg*

and its effect on competitiveness initially got lost within the wider positive picture" (Santangelo 2000: 6).

1995-1998: The Downsides of Stability and the Taboo of Exchange Regime Change

After 1994, real appreciation and the resulting trade deficits became increasingly apparent (Canitrot 1994: 89; Pastor and Wise 1999: 480). Besides highlighting the regime's macroeconomic vulnerabilities, these developments reflected its profound distributional character (De la Torre, et al. 2002: 12). Especially the steep rise of the relative price of non-tradables to tradables provoked significant structural change, such as the rapid growth of and investment in non-tradable goods and services (especially financial services, construction and privatised utilities) at the expense of industry with manufacturing's share of GDP dropping from 31% in 1989 to 16% in 2000 (Wise 2000: 107; Tresca 2001: 312; OECD 2004: 19). But also within industry, the impact of trade liberalisation, regional integration, subsidy cuts and overvaluation was uneven. While those sectors where import structures were well-established, such as metallurgy, textiles and paper, *"found themselves immediately under a lot of price pressure"*, other industrial activities, such as pharmaceuticals, food and automobile parts, initially remained relatively sheltered from international competition and, thanks to e.g., government regulations, *"were actually in a position to raise prices considering the evolution of domestic demand at the time"* (Interview Arano, also Acuña 1995a; Lewis 2001; Kosacoff 2005).

Considering these structural shifts, it is surprising that no sustained debate emerged around the rigid exchange rate peg. Having highlighted executive motivations for holding on to the exchange regime, I now draw attention to how aspects of organised society contributed to its petrification by muting pressure in favour of flexibilisation at a time when orderly exit would have been feasible. Four aspects were key: the role of government-engineered deals that compensated affected actors; the organisational make-up of Argentine society; actors' contradictory commercial and balance sheet interests; and fear of hyperinflation, which provoked a form of exchange rate fetichism.

The executive consciously used the currency board to build a pro-reform coalition that centred on members' loyalty to the monetary regime and their willingness to bear the transitional costs of far-reaching structural reforms so to sustain it indefinitely. By 1994, executive actors implicitly admitted to overvaluation's detrimental impact on its support coalition and on Argentina's export performance more generally. While continuing to publicly present complaints as illegitimate grievances uttered by isolated industrialists who *"were trying to achieve through corporatism what they hadn't achieved as businessmen"* (Fernández in Teichman 2002a: 495) and appealing to entrepreneurs to seek productivity gains, the authorities engineered

several disguised devaluations through tariff increases, tax reductions and subsidies for exporters, and measures to lower labour costs (Interview Serrichio; *Clarín* 6th February 1994; Wise 2000: 102). Although insufficient to fully compensate for the accumulated overvaluation (Edwards 1995a), these measures – together with expedited anti-dumping procedures, new special promotion regimes (e.g., automobiles) and specific protections in future markets (e.g., for privatised utilities) – at first reduced the urgency of exchange regime change (Starr 1997: 119; Etchemendy 2005: 62).

In turn, organisational obstacles to exchange rate politicisation served as a powerful intermediating variable that is overlooked by conventional interest group accounts. Unlike influential individual entrepreneurs, business organisations struggled to obtain direct access to senior cabinet members, and their concerns tended to be brushed aside (Interview Massuh and Delfino; also Teichman 2002: 495). Yet, in addition to 'not being heard', the exchange rate issue was simply not addressed with priority by corporate associations. The reasons were twofold: First, organisations struggled to represent their respective members whose exchange rate political interests had become increasingly heterogeneous due to their uneven exposure to adjustment and overvaluation. Secondly, the aggregation of member interests was seldom if ever linear. In addition to the distortive effect of leaders' personal political affiliations, reforms tended to benefit precisely those actors who already possessed significant institutional influence within associations and who could thus block the issue from emerging on the agenda.

Table 22: Presidents of the UIA, 1989-2008

Period in Office	UIA President	Affiliation
April 1989 – 1991	Gilberto L. H. Montagna	MIA
April 1991 – 1993	Israel Mahler	MIN
April 1993 – 1997	Jorge Blanco Villegas	MIA
April 1997 – September 1998	Claudio Sebastiani	MIN
September 1998 – April 1999	Alberto Álvarez Gaiani	MIA
April 1999 – 2001	Osvaldo Rial	MIA
April 2001 – January 2002	Dr. José Ignacio De Mendiguren	MIN
January 2002 – April 2003	Héctor Massuh (interim)	MIN
April 2003 – 2005	Alberto Álvarez Gaiani (contested election)	MIA
April 2005 – 2007	Héctor Mendez	*Celeste y Blanca* *
May 2007 -	Juan Carlos Lascurain	*Industriales*

Source: Own elaboration based on interviews with UIA representatives Massuh, Arano and Liubitch and newspaper coverage.

This is best illustrated by dynamics within the UIA. Here, struggling sectors were initially not only outnumbered by influential members, such as *Techint*, who had strongly benefited from the status quo, but in Jorge Blanco Villegas (1993-1997, **Table 22**) they also

confronted a leader who suppressed criticism for his personal alignment with Menem.[45] The division between industrial winners and losers was not exclusively the product of market forces but had been strongly determined by the government's strategic apportioning of rents and property rights during the reform process (Bambaci, et al. 2002). Especially the privatisation programme (and the suboptimal enforcement of anti-trust regulation) had bound influential *grupos económicos* to Menem – and to the Convertibility Regime: First, firms had relied on external dollar-denominated financing. Secondly, they had used this opportunity to concentrate their assets in activities aimed at the expanding domestic market that were both highly profitable under the currency board and would remain relatively sheltered from competitive pressures thanks to incomplete reforms (Basualdo 2000; Llanos 2001; Gaggero and Wainer 2004; Phillips 2004: 188-189). Protected from the brunt of adjustment and heavily indebted in dollars, these firms' interests became largely detached from smaller and medium-sized industrial enterprises (Wise 2000: 109; Bambaci, et al. 2002; Schorr 2004; Bolten forthcoming in 2009). Worse, this growing complexity in interests to be represented, also due to the consolidation of foreign firms' participation in Argentine industry in the second half of the 1990s,[46] coincided with a drastic reduction in institutional capacity given that sectoral decline had reduced the UIA's financial resources (Acuña 1995a: 42). Consequently, a *"culture of every man for himself"* took root among members and, once more, put dominant industrial groups at an advantage whilst further undermining the UIA's policy relevance (Interview Massuh). Altogether, these internal cleavages, the political orientation of the UIA leadership and the distribution of influence within its hierarchical structure thus muted critical voices for much of the decade.[47]

Thirdly, growing numbers of Argentine firms and individuals joined 'big business' in accumulating dollar-denominated debt. In addition to rendering the identification of actors' exchange rate policy interests more complex, for tradable sector interests the resulting balance sheet exposure to downward adjustments of the nominal exchange rate pulled in the opposite direction to positive real-economic effects. Hence, even highly exposed producers were

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[45] After a short interlude under the critical Claudio Sebastiani (1997-1998), the UIA returned to a more accommodationist course under Alberto Álvarez Gaiani (1998-1999) from the food sector, which had expanded dramatically.

[46] After 1996, larger corporate groups underwent restructuring by selling their interests in recently privatised firms to multinational companies, transferring capital abroad (Basualdo 2001) and withdrawing entirely from tradable sectors (Gaggero and Wainer 2004). For example, *Sociedad Macri* withdrew from the automobile sector in order to consolidate its assets in the agro-food business in both Argentina and Brazil focusing on the Mercosur market, while *Pérez Companc* sold its holdings in several privatized companies and purchased firms in the food sector. This retreat from manufacturing coincided with the consolidation of foreign firms' participation in Argentine industry with the share of Argentina's 500 largest firms controlled by foreign capital rising from 31% in 1993 to over 50% by 2001 (Schorr 2004: 164-168).

[47] This is illustrated by an episode in 1996, when an internal MIN document, which proposed *retoques'* ('a retouching') of the exchange regime, leaked to the press. Blanco Villegas strongly distanced himself from its authors and emphasised that the UIA did *"not want to modify the Convertibility Regime but, to the contrary, deepen it"* (*La Nación* 18th January 1996).

willing to accommodate the growing loss in competitiveness and shied away from exit initiatives because of the estimated balance sheet effect and bankruptcy fears (Díaz-Bonilla and Schamis 2001; Weyland 2002: 160+203; Woodruff 2005: 10). Instead, tradables producers in this new dollar debtor constituency were keen to find mechanisms for compensating for the nominal rigidity of the exchange rate whilst maintaining the regime.

Fourthly, the Convertibility Regime had taken on powerful symbolic value, or 'god-like qualities' as Baglini noted (Congreso de la Nación Argentina 2002b: 5321), turning criticism into ill-respected acts tantamount to blasphemy (Corden 2002: 181; Espert 2002: 2-3; Beltrán 2006: 213-214). Due to Convertibility pledges by all major parties and an official discourse that depicted the alternatives as 'Convertibility or chaos' (Pucciarelli 2002: 88), discussions about a possible exit had become a taboo, with actors from all sectors – notably academia – admitting to either having been caught by a mirage or having exerted *'auto-censura'* (Interviews Peruzzotti, Delfino, Keifman and Damill). Machinea states that *"it was almost impossible to argue against Convertibility"* (Interview) and Massuh remembers that one *"could not say that one opposed the regime […] because it had become a 'sacred cow'"*. Instead, critics *"talked about 'a distortion of relative prices' as an academic euphemism for a gigantic overvaluation"* (Interview Massuh). Taken together with growing balance-sheet exposures, it is not surprising that even when critics emerged, e.g., Blanco Villegas' successor Claudio Sebastiani, they suggested compensatory measures and hesitated advocating the regime's abandonment. When interviewed, Machinea, then UIA's Director of Research, explained that exposed sectors

> tried to create and imagine new instruments or mechanisms to improve the situation without moving out of Convertibility. […] These instruments ranged from reductions in taxes on labour and on exports, reductions in electricity and natural gas prices – basically reducing the costs of enterprise, the 'Argentine cost', and of inputs and also to apply different kinds of protectionist measures to the imports that were coming in from abroad.

In short, even though actors were acutely aware of the regime's detrimental impact, they *"[a]t no point […] worked on alternatives to Convertibility"* but *"worked on alternatives within Convertibility"* (Interview Machinea). This stance was shared by the rural sector, the other key tradables segment. Here, exporters' comparative advantage, realised once rural markets had been deregulated and *retenciones* abandoned (Birle 1995: 349), and rising profit margins and market shares thanks to buoyant international prices in 1996-1997 had muted the regime's detrimental impacts for much of the 1990s. After the collapse of world prices in 1999, overvaluation was more acutely felt and rural producers joined the push for a reduction of the

'costo argentino' – without however questioning the Convertibility Regime *per se* (Interview Delfino).[48]

Organised labour proved an equally passive bystander. Although labour militancy increased after 1994 in protest against rising unemployment and a 17.2% drop in real wages between 1991 and 1994, thanks to an increasingly well-organised CTA, the movement's critique tended to be ideologically-tainted and often rather vague and unsophisticated in nature (Etchemendy and Palermo 1998: 570; Gerchunoff and Torre 1998: 129; Interview Maffei, Levitsky 2001). In addition to a lack of technical in-house expertise, unions struggled to define a shared stance due to the growing heterogeneity of working conditions and downward wage pressures across sectors and the overall ambiguous effect of stabilisation-cum-reforms on workers' interests given that the restoration of purchasing power and union finances (via the *Obras Sociales*) as well as widening consumer credit coincided with substantial job losses, restrictions to wage-negotiations and unions' reduced density and market power (Murillo 2001: 138-139). Although labour at no point targeted the exchange rate regime, the manifold concessions unions obtained during Menem's second term in exchange for continued support did affect exchange rate policy insofar as, for instance, the dilution of labour market reforms permanently blocked labour market flexibility and productivity improvements, which in turn rendered the exchange regime increasingly recessionary.

In sum, this section showed why it was possible for the executive to use the Convertibility regime to propel forward the reform agenda without provoking outright opposition to the exchange rate policy course. Only once the recession had significantly reduced the profit margins of 'winning' sectors and a policy proposal emerged that combined devaluation with the pesification of dollar assets and liabilities could this resilient consensus eventually be punctured.

1999-2002: From Growing Mobilisation and Disappointed Hopes for Change to Policy Capture

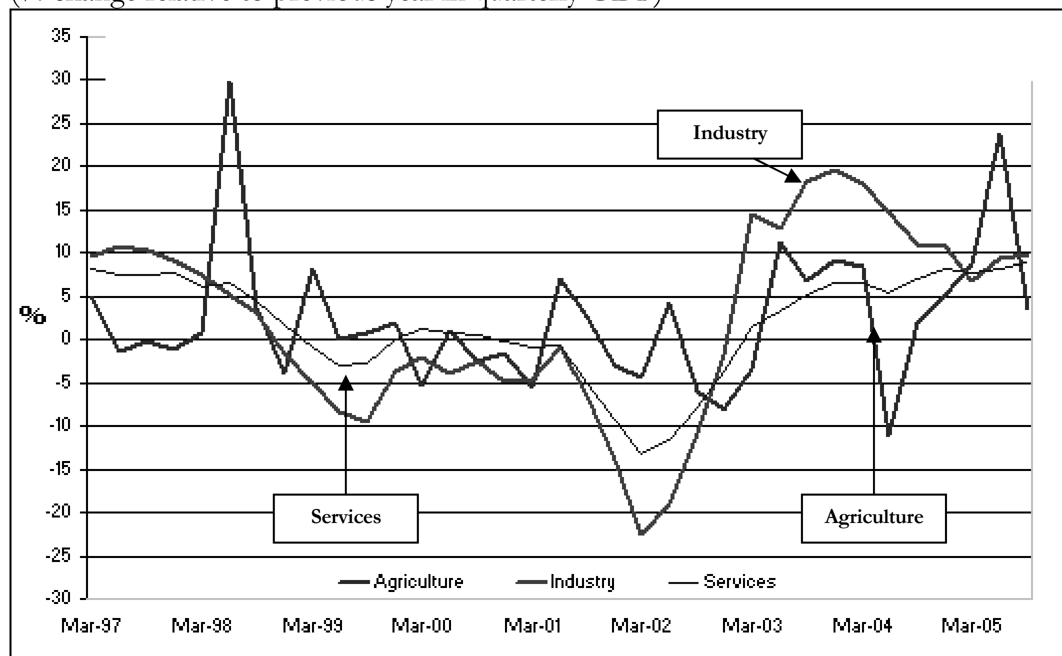
Looking at this final period and comparing it with other episodes of major exchange regime decisions in Argentina and elsewhere, it is striking both how long the 'Convertibility consensus' persisted and how a relatively small group could succeed in implanting a new policy paradigm. This sub-section traces how the UIA overcame internal divisions and its exchange rate policy adversaries.

After betting on the *Alianza* already in late 1998 and successfully positioning José Luis

[48] Delfino recalls how SRA President Enrique Crotto's (1994-2002) very close relationship to Menem suppressed internal criticism that begun to emerge in late 1997 (Interview).

Machinea, the former head of the UIA's *Instituto de Economía Industrial*, at the MECON hopes were high that he *"would take the bull by its horns and exit from the Convertibility Regime"* (Interview Massuh and Rial). Frustrated by the *Alianza*'s economic stewardship and pressured by the deepening recession (**Figure 23**), UIA President Rial sought to increase the UIA's lobbying effectiveness by establishing the *'Grupo Productivo'*, which united the *unión* with the CAC, the CRA and ABAPPRA in 1999. Countering the SRA and the financial sector, the formation of this grouping heralded a period of intense intra-capitalist struggle (Basualdo 2000; Muchnik 2001: 252; Pucciarelli 2002: 87; Woodruff 2005: 27). Rial's successor, the flamboyant José Ignacio De Mendiguren (2001-2002), expanded this alliance into the *Núcleo Nacional*, which also incorporated the CGT and local private banks and aimed to define a new 'national project' (De Mendiguren in *Página 12* 9th December 2001). Formed in November 2001, what united these historical adversaries was their growing concern about efforts by privatised utilities, transnational companies and foreign banks to push for dollarisation – especially once political turmoil intensified after the imposition of the *corralito* (La Nación 4th November 2001, Página 12 1st December 2001, Interviews Massuh and Peruzzotti, Castellani and Schorr 2004: 69-71). It was against this background that the UIA launched its attack on the 'Convertibility consensus'.[49]

Figure 23: Argentina - Year-over-year Growth by Sector, 1997-2005
(% change relative to previous year in quarterly GDP)



Source: LatinFocus – Available at http://www.latin-focus.com/latinfocus/countries/argentina/arggdpsector.htm [accessed 25.02.2006] based on data from MECON's *Secretaría de Programación Económica.*

[49] The UIA's public initiative was arguably triggered by a meeting with Cavallo, which had left UIA leaders convinced that the minister himself would adopt dollarisation (Interview Massuh; Bonelli 2004: 207).

After years of debilitating internal divisions, proposing exit from the Convertibility Regime had become feasible for four coinciding reasons. First, there was a *"general realisation among UIA members but also the national business community that the 'recession' really was a depression of the economy"* and that sustainable reactivation would presuppose an overhaul of the regime itself (Interview Massuh). The recession's effect on internal demand provoked the plummeting of profits even in those sectors that had previously benefited from the Convertibility model. Hence, even factions that had categorically opposed exchange regime change became increasingly willing to negotiate the conditions under which a devaluation would be acceptable. Secondly, Brazil's experience had demonstrated devaluations' powerful effect on export competitiveness as well as reinforcing arguments that the floating of the currency would not necessarily imply renewed hyperinflation (Interview Liubitch). Thirdly, MIN representatives had come to understand that a solution to Argentina's high degree of asset and liability dollarisation had to be part and parcel of a politically sustainable exchange regime shift. Indeed, not only did fear of devaluation create a strong constituency for exchange rate stability among the wider public, but precisely the most powerful UIA members were among the 1,221 debtors that held half of all dollar debt in Argentina (Basualdo, et al. 2002: 2). Finally, De Mendiguren's efforts to build cross-sectoral and cross-factoral consensus for change for the first time granted radical proposals to exit from the Convertibility Regime the necessary political backing and legitimacy. Since late 2000 and in parallel to this *'concertación'*, a small group of MIN representatives around De Mendiguren – Héctor Massuh, Federico Poli, Miguel Peirano, Mercedes Marcó del Pont and Héctor Valle – had thus secretly studied different modes for combining the floating of the currency with de-dollarisation (Interviews Massuh and Arano, Teichman 2002a: 502; Bonelli 2004: 198).[50]

In the wake of De la Rúa's resignation De Mendiguren seized the opportunity to decisively shape the agenda by publishing the *"first doable plan for exiting from the Convertibility Regime"* on 21 December 2001 (Interview Massuh; La Nación 22nd December 2001). Entitled 'Telling the truth means taking on reality', the document argued that *"[c]onvertibility no longer exists"* and identified *"the fixed exchange rate as the principal obstacle to development"* (Unión Industrial Argentina 2001: 1). It then proposed the *"[t]otal de-dollarisation or pesification of the economy",* that is of *"contracts between private agents, financial contracts (deposits and loans), and contracts with privatised companies"* as well as the *"floating of the exchange rate"* (ibid.: 2-3). Welcomed by the CAC, the CRA and ABAPPRA as well as the labour movement (Lozano in *La Nación* 27th December 2001) but forcefully opposed by the CEA and the financial sector (Teichman 2002a: 502;

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[50] Similar proposals had been made by IDB chief economist Ricardo Hausmann (*Financial Times* 30th October 2001).

Phillips 2004: 193), the plan's implementation however was only assured once the UIA had gained direct influence on the disoriented new cabinet and on President Duhalde via De Mendiguren, who had been appointed to the new Ministry of Production (Interviews Massuh and Arano, Weyland 2002: 206; Schneider 2004: 193).[51] By then, however, the circumstances had gained in complexity due to Duhalde's misguided promise that *"[t]hose who deposited dollars will receive dollars; those who deposited pesos will receive pesos"*, which directly threatened the stability of Argentina's financial system (Bonelli 2004: 226). Eager to cement relations with the new executive by helping Duhalde to overcome this impasse, the UIA thus amended its plan and included the asymmetric pesification of dollar debts and deposits. It was this plan, responsible for the massive redistribution of wealth benefiting especially dollar-indebted companies with exporting capacity from among the usual dominant economic groups, that was adopted against the opposition of foreign investors and the financial community.[52]

Table 23: Top 10 – Businesses Benefiting from Devaluation-Cum-Pesification
(in millions of US$ and pesos)

Rank	Corporate Group or Firm	Type of company*	Exports		Internal Debt		Total Benefit	
			Increase in pesos	Increase in US$	Liquidation in pesos	Liquidation in US$	In pesos	In US$
1.	Repsol	FC	2.127,5	1.063,7	324,6	162,3	2.452,1	1.226,0
2.	Techint	FC – roots in Arg	1.652,1	826,0	228,6	114,3	1.880,6	940,3
3.	Pérez Companc	LCH	1.024,3	512,1	373,8	186,9	1.398,0	699,0
4.	Cargill	MNE	1.285,0	642,5	0,0	0,0	1.285,0	642,5
5.	Aceitera General Deheza	LCH	755,5	377,8	0,0	0,0	755,5	377,8
6.	Louis Dreyfus	FC	750,0	375,0	0,0	0,0	750,0	375,0
7.	Glencore	MNE	543,3	271,7	0,0	0,0	543,3	271,7
8.	Bunge Ceval	MNE	530,0	265,0	0,0	0,0	530,0	265,0
9.	Vicentín	LCH	521,0	260,5	0,0	0,0	521,0	260,5
10.	Nidera	MNE	432,7	216,4	50,3	25,1	483,0	241,5

* FC = Foreign Conglomerates; LCH = Local Corporate Holdings; MNE = Transnational Enterprises.
Source: Basualdo et al. 2002 based on data from the *Instituto de Estudios y Formación* of the CTA.

This dramatic shift in exchange rate regime was thus the direct result of industrial interests' involvement. Yet, it was not only the government's disorientation and the ability of the UIA leadership to temporarily overcome internal divisions that allowed an economically battered sector to shape exchange rate policy but also the paralysis that had afflicted other

51 In December 2001, plans to introduce a third currency, the *argentino*, to run parallel to the US$ and ARG$, circulated but failed to command sufficient societal backing.

52 One lesson drawn from this episode on the part of UIA leaders was a stronger commitment to investing in internal research capacities and programmes so to be a pro-active policy player (Interviews Massuh; Unión Industrial Argentina 2006: 26-28).

sectoral organisations and especially the financial sector. Most corporatist organisations – especially those with conflictual relations to the PJ party base like the SRA – had opted to *"keep a low profile"* whilst Peronists chose the next president and thus failed to establish an intimate relationship to the Duhalde government (Interviews Delfino and Peruzzotti).[53]

Particularly surprising, given its depiction as hegemonic throughout the 1990s and the political capital it commanded with the international financial community, was the financial sector's failure to defend its interests. In addition to its abysmal public image for its (perceived) role in the *corralito* and its historically difficult relationship to Duhalde, this political weakness was first and foremost the product of profound divisions between foreign and domestic-owned banks (Interviews Peruzzotti, Bleger and Wilson). Argentina's banking sector had undergone dramatic internationalisation, accelerated by the restructuring and concentration process after the Tequila crisis (**Table 24**). Reflecting these developments, foreign and local private banks had merged their representative associations to form the ABA in 1999 under the leadership of Eduardo Escasany (*Banco Galicia*). Yet, by late 2001 the position of local and foreign banks had diverged significantly with one of the principal points of contention being foreign banks' vocal support for dollarisation.[54] Escasany's defection from ABA to join ABAPPRA and the *Núcleo Nacional* had left the ABA effectively leaderless during the decisive weeks in December 2001 (*Página 12* 1st December 2001).[55] Having been excluded from earlier negotiations between the new executive and selected groups spearheaded by the UIA, banks *"could only defend what was left to defend after decisions that had taken [them] by surprise"* (Interview Peruzzotti). Having failed to block the devaluation and the ensuing asymmetric pesification, all they obtained was compensation for pesification losses.

Table 24: Internationalisation of the Argentine Banking Sector, 1994-2000
(End of year values)

	1994	1998	2000
Total No. of Banks	166	104	89
No. of Private Local Banks	133	49	35
No. of Public Local Banks	32	16	15
No. of Foreign Banks	31	39	39
Share of Total Assets (in %)	15	55	73

Source: BCRA data from De la Torre et al. 2002: 27.

[53] In the SRA, discussions mounted with some members acknowledging the strongly beneficial impact of a devaluation whilst others feared the impact of inflation and a return to populist policymaking (Interview Delfino)

[54] Even in the aftermath of the devaluation, foreign banks held onto the dollarisation option and offered Duhalde the lifting of the *corralito* (made possible by capital brought in from the banks' foreign headquarters) in exchange for a shift to dollarisation (*Página 12* 20th January 2002).

[55] In April 2003, local private banks split from ABA and reformed ADEBA under Jorge Brito (*La Nación* 8th April 2003).

Summing up, this section highlighted the importance of the institutional make-up of organised society in determining exchange rate policy influence. However, this episode and the extent to which a relatively small group of industrialists was able to capture the usually rather insulated locus of exchange rate policymaking must be regarded as the extraordinary result of the confluence of a set of rather specific circumstances. Not only did it presuppose a deep recession, but it also took a high degree of institutional fragility in the midst of a deep constitutional crisis, the fragmentation of opposing interests and, last but not least, the IMF's discontinuation of external validation to finally surmount the 'Convertibility consensus' (Bolten forthcoming in 2009). This final dimension is addressed in the subsequent section.

5.3.3 The Role of External Factors

Since the crisis, much criticism has been levelled against the international financial community and particularly the IMF for failing to avoid or for, as some argue, propelling the unprecedented socio-economic emergency (e.g., Stiglitz 2002; Weisbrot and Baker 2002; Allen 2003). Yet, beyond these general accusations, these accounts fail to shed light on the Fund's role in the petrification of the quasi-currency board and do not address the *problématique* of exchange rate surveillance in a world of growing capital mobility.

From Reservations to Enthusiastic Support

A common misperception depicts the market reforms of the 1990s and the Convertibility Regime as IMF-imposed policies.[56] Yet, IMF staff played no role in the decisionmaking process that led to the adoption of the quasi-currency board in 1991 (e.g., Cavallo 2001: 167-168; Bonelli 2004: 106-108; IMF - IEO 2004; Tenembaum 2004; Blustein 2005; Tanzi 2007: 68). To the contrary, given Argentina's track record, IMF staff were initially reluctant to support this risky plan (Claudio Loser, Director of the Western Hemisphere Department (1994-2002), in Bonelli 2004: 106). Yet, constrained by the *Articles of Agreement,* the choice of exchange regime was seen to be Argentina's prerogative, with the IMF's role being limited to encouraging the adoption of economic policies necessary to sustain the chosen regime. As outlined in Chapter IV, the Fund still struggled to get to grips with the implications of growing capital mobility for its exchange rate surveillance duties (Boughton 2001: 41). Pushed by the US, the IMF reluctantly and only after initial disinflationary success had materialised accepted the authorities' decision in conjunction with medium-term

[56] Cavallo (2004: 141-142) argues that the U.S., despite its influence on Menem, did not affect exchange rate choices.

structural reforms (Interview Cavallo, Cavallo and Cottani 1997: 27; Allen 2003: 142; Cavallo 2004: 143).

Fund reservations were silenced not only because staff were acutely aware of the possible negative market consequences of IMF criticism but also due to private creditors', domestic experts' and foreign governments' wholehearted approval of the plan. Hesitation abated further when Cavallo's commitment to the reform agenda advocated by the IMF and other international organisations led to growth rates exceeding 8% in 1991-1992 conjuring up images of a miraculous turnaround.[57] Eager to claim some credit for these developments given the IFIs' longstanding involvement in the country, the IMF's Managing Director Michel Camdessus began to cite Argentina as a stellar example of successful emerging market reforms in 1993 (Woods 2006: 68).[58] This explicit support was invaluable with respect to strengthening the credibility of the arrangement, not only because it went hand-in-hand with the provision of external financing and served as a *"catalyst for funding from the WB, the IADB, and the Eximbank of Japan"* (Cavallo and Cottani 1997: 19), but also because it provided a 'stamp of approval' and generated confidence in this audacious regime.

The IMF's Evolving Stance on Exchange Rate Policy

While the IMF leadership joined into the chorus of enthusiasts, scepticism persisted among the staff (IMF Staff Report from March 2005 in Blustein 2005: 28-29). Resident representatives, such as the World Bank's Myrna L. Alexander, early on voiced their concerns about the private sector's ability to respond to the challenge of trade liberalisation, subsidy cuts and overvaluation, creating a situation that *"is do or die for the private sector"* (Alexander in Goad 1991; also IMF - IEO 2004: 17). Initially, the staff's lack of enthusiasm also reflected the fact that Argentina had ignored its advice to use flexible and competitive real exchange rates as *"the first essential element of an 'outward-oriented' economic policy"* (Williamson 1990). However, shortly after, *"Washington began to edge toward the two-corner doctrine"* (Williamson 2004: 3+7). Precisely Argentina's experience of disinflation-cum-growth under a hard peg contributed to this new paradigm – also known as 'bipolar view' – that gradually took hold of

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[57] Business Week's issue of 21st October 1991 stated: *"It is spring in Buenos Aires. […] The changes of the last three years represent no more and no less than an economic revolution. […] While communism is coming down with great noise in Europe, the old Latin American orthodoxy centring on state control of strategic industries evaporates in silence. Now the Latinos, just like the Eastern Europeans, turn their heads towards the markets and compete in attracting investments capable of revitalising their semi-destroyed economies. For the first world bankers, this change means mega-profits as this allows them to introduce the methods of financing, mergers and acquisitions of the North to the Americas – and to accumulate huge commissions for this help."* Similarly, *The Economist* (13th November 1993) complimented Argentina on its *"commitment, competence and consensus"* around the reform agenda.

[58] World Bank officials, in a 1993 report based on missions to Argentina between November 1991 and October 1992, stated that *"results have been impressive"* (World Bank 1993: xi) and that the *"Menem administration has made the most impressive progress in improving Argentina's growth prospects of any recent administration"*(ibid.: xxvii).

IFIs over the course of the 1990s. Already in 1991 a review published by the IMF's Research Department (Aghevli, et al. 1991) had proposed rigid exchange rate arrangements as forms of self-commitment given the authors' conviction that *"what mattered most for economic performance was for countries to establish discipline and credibility"* (Boughton 2001: 86-87). Over the course of the decade, this view, supported by a growing theoretical literature, was lent further credence by the events in Mexico and East Asia. This led economists (e.g., Obstfeld and Rogoff 1995; Calvo and Reinhart 2000) and especially the IMF's Deputy Managing Director Stanley Fischer to conclude that for countries open to international capital flows *"intermediate policy regimes between hard pegs and floating were not sustainable"* (Fischer 2001; also see 2007) and encouraged others to emulate Argentina's policies.

A Surveillance Failure? The IMF's Failure to Encourage Orderly Exit after 1995

There is little doubt that *"[t]he Mexican crisis of 1994-1995 represented a turning point in the IMF staff's view of the [Argentine] peg"* (IMF - IEO 2004: 30). Impressed by the decisiveness with which the authorities confronted the crisis, implementing a politically painful fiscal adjustment of almost 2% of GDP and pushing forward several reform projects, IFI staff and investors regarded the crisis as a successful test of the authorities' commitment to the model and to the neoliberal agenda. In March 1995, for the first time, staff thus explicitly recommended the peg's maintenance given that it *"had been critical to the successful performance of the economy in recent years"* (Staff Report in IMF - IEO 2004: 19). This view was reinforced by Camdessus, who turned into a prominent advocate of the Menem administration, commending the authorities on their *"strong actions"* and their *"firm commitment to maintaining fiscal and financial equilibrium and price stability"* (IMF 1995a; Camdessus 1996a; 1996b) and emphasising the extent to which the reform drive had *"increased the efficiency and competitiveness of the economy"*, which would *"ensure the viability of Argentina's currency board arrangement"* (IMF 1995b).[59]

In addition to fuelling investment in Argentina and thus allowing for Menem's aforedescribed complacency to be – at least in the short run – politically sustainable, the IMF also encouraged the authorities to persevere along this path at a time when exit towards a more flexible regime would have been economically less costly (IMF – IEO 2004: 20). The failure to impress this scenario on the Argentine government and *"to encourage serious consideration of the exit option through policy advice and an offer of financial support"* (ibid.: 20) and the

[59] Policymakers like Warren Christopher (U.S. Secretary of State) made similar endorsements declaring that *"US businessmen are voting for Argentina with their money. They are investing here because President Menem's reforms made Argentina one of the success stories of the decade if not of the century"* (see http://www.fas.org/news/argentina/4777409-4783149.htm [cited 14th June 2006]).

"reluctance to analyse and discuss fundamental issues of the Convertibility Regime" (ibid.: 22) resulted from the coincidence of internal politics with the consolidation of the 'bipolar view' among influential IMF staff and deep-seated fears of being blamed for a self-fulfilling crisis in case such discussions became public knowledge. These inherent weaknesses in the Fund's surveillance practices were compounded by the deteriorating economic conditions in Argentina from late 1998 onwards, which increased the short-term costs of regime change.

Contributing to Surveillance Failure: Bureaucratic Politics and Institutional Culture

Accounts by IMF staff suggest that the role of bureaucratic politics and institutional culture in impeding effective exchange rate policy surveillance during this period was paramount (e.g., Loser in Tenembaum 2004; Tanzi 2007). First, the IMF's leadership around Camdessus was set on making sure that Argentina continued to constitute an example for successful market-oriented reforms, the so-called 'poster-child syndrome' (Blustein 2005: 199). Convinced that a regime change would provoke policy reversal in other areas, the pro-convertibility mindset became deeply entrenched among Fund leaders.

Secondly, the leadership's stance meant that profound inter-departmental differences[60] and disagreements within the economics profession on the desirability of maintaining the regime were not accurately reflected in the Fund's official advice. Equally, it generated an institutional culture that discouraged open discussion leading to instances of severe 'groupthink' (Janis 1982), in which staff struggled to challenge the mainstream view. Critical voices were not only systematically excluded from key meetings (Tanzi 2007: 111; also Loser in Tenembaum 2004: 194) but senior management also explicitly suppressed adverse comments with a view to preserving access to Argentine policymakers (Woods 2006: 4).[61]

Thirdly, these bureaucratic dynamics and a lack of *"objective tools to evaluate the appropriateness and sustainability of a country's exchange rate arrangement"* (IMF – IEO 2002: 22) led to the disappearance of the exchange rate regime dynamic from the IMF's Argentina agenda: By 1996, IMF staff were designing all their econometric models on the assumption that the Convertibility Regime would remain in place. This effectively de-prioritised studies into regime sustainability and focused all attention on reforms that supposedly minimised the regime's vulnerabilities, as is illustrated by the conditionalities of the 1996 precautionary credit

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[60] Loser and Tanzi highlight divisions between the *"pure economists"* working in the Departments of Research and Political Analysis and Fiscal Affairs and the Western Hemisphere Department, which was *"closest to the battlefield and worried about the social, political and economic consequences of a devaluation"* and thus began advocating exit (in Tenembaum 2004: 194; Tanzi 2007). These divisions were also visible to Cavallo and Machinea (Interviews).

[61] Camdessus' decision to invite Menem to the 1998 Annual Meeting and his speech, which described Argentina as in *"excellent compliance with the performance criteria"* illustrating *"the importance of fiscal discipline [and] of structural change"* ridiculed staff concerns.

line. Hence, in contradiction to its institutional brief, IMF staff no longer devoted *"sufficient analytical resources"* to the exchange rate question and although *"the issue was raised from time to time at [Executive] Board meetings"* there was *"virtually no substantive discussion of the peg within the staff and the Argentine authorities"* (IMF - IEO 2004: 20).

Seeking to explain this surveillance failure, IMF executives, such as Anne O. Krueger (2002), First Deputy Managing Director during the 2001-2002 crisis, suggest that in addition to the above, staff also struggled to comprehend their institutional responsibilities given that

> it is for a member – not for us [at the IMF] – to choose its own exchange rate regime and to put in place the supporting policies necessary to maintain it. Our Articles of Agreement require us to support the basic policy strategy adopted by our members, as long as it has a reasonable chance of success.

Yet, as Mussa (2002) argued, it is a matter of discussion whether after several external shocks and a year of deep recession exacerbated by Brazil's devaluation, the Convertibility Regime still had 'a reasonable chance of success'. Nonetheless, the IMF failed to revise its exchange rate policy verdict as a 1999 Staff Report illustrated, which highlighted the need

> to reaffirm, indeed reinforce, the strong commitment to the policy framework that has served Argentina well, including the automatic adjustment mechanism implied by the currency board, prudent fiscal and debt policies cast in a medium term framework, and significant structural reform to bolster banking soundness and flexibility in the economy (in IMF – IEO 2004: 21).

It was only later that year and in extreme secrecy that an internal 'IMF Argentina Task Force' was formed with the purpose of estimating the exit costs (Loser in Tenembaum 2004: 142). Yet, fear of re-igniting inflation and the likely collapse of the banking system led staff to continue to publicly endorse the exchange regime (Blustein 2005: 96). By December 2001, more than forty exit reports had been produced – none of which had been shared with Argentine policymakers. Again, rehearsing Krueger's point, *"the Fund wanted to be ready to offer well-reasoned analysis should Buenos Aires request it,"* but the *"weighty choice [itself] would have to be Argentina's"* (Blustein 2005: 112).

Disentrechment of Convertibility 'Groupthink'

The 'groupthink' vis-à-vis the Convertibility Regime only became disentrenched once a substantial economic deterioration coincided with Cavallo's unilateral initiatives in mid-2001, which aggravated his relations to the IMF under its new Managing Director, Horst

Köhler. Already in their first meeting in April 2001, Köhler addressed the exchange rate but was taken aback by Cavallo's hostile reaction. Fearful of a breakdown in relations, the IMF leadership once more abandoned a focus on exchange regime change and refocused on fiscal efforts instead (Loser in Tenembaum 2004: 215). The decision to issue an ultimatum in the context of the fourth review of the SBA in September 2001 – should reserves fall below US$16 billion, the exchange rate stance would be subject to discussion – thus marked a radical, if not publicly visible, change in the IMF's strategy (Interview Cavallo, Loser in Tenembaum 2004: 215-216; Blustein 2005: 155-156). Yet, this attempt to force the Argentine authorities to survey exchange regime alternatives was too little too late. In practice, Argentina would have had to confront a massive outflow of capital before this clause kicked in. By then, even an open discussion of all alternatives would have been unlikely to attenuate a major crisis. Hence, although in the public's perception the IMF's withdrawal of financial support in December 2001 represented a radical surprise *volte face*, this interpretation does not fully do justice to the negotiations that had taken place behind closed doors since August 2001.

Of course, this is of little consolation for those who were surprised by the dramatic events triggered by the IMF's decision not to complete the fifth SBA review and who had acted on the basis of the IMF's *public* appraisal for Argentine policies. Aside from all justified criticism levelled against the IMF, the Fund's ineffectiveness in constraining Argentine policies during the mid-1990s, its vacillating posture during 2001 and failure to signal its evolving stance on the quasi-currency board were all rooted in the structural constraints within which it operates: In buoyant economies with plentiful alternative sources of finance, its disciplinary potential is heavily circumscribed as the years between 1995 and 1998 illustrate. In turn, once economies are under stress, the IMF's usual threats are constrained by fear of precipitating, or being accused of provoking, a wider financial crisis. This *problématique* is difficult to solve simply by reformulating the surveillance guidelines as has been done by the *'Decision on Bilateral Surveillance over Members' Policies'* (IMF 2007).

In sum, the fact that Argentina operated virtually continuously under IMF scrutiny suggests that there was a profound surveillance failure given the increasingly inappropriate combination of fiscal profligacy with a rigid exchange regime. Yet, the aforedescribed obstacles the IMF faced in asserting effective exchange rate policy influence provide further credence to the argument that ultimate policy responsibility lay with Argentine policymakers. Yet, I also highlighted the IMF's non-negligeable role in providing external validation to an increasingly fragile economic model and thus in paving the road to exchange rate petrification.

5.4. Concluding Remarks

The fixed exchange rate closed off foreign markets to national products, inundated the internal market with imported merchandise, provoked bankruptcies and destroyed employment. Was the remedy badly chosen? No. It was badly administered during a longer period of time than would have been reasonable.

Terragno in Lanata (2003: 605-606)

This chapter sought to account for the adoption and especially the petrification of the Convertibility Regime over the course of the 1990s. By building onto the institutionalist reading of Argentine exchange rate policy and its focus on 'credibility-building' and complementing it with an interpretation of the dollar peg as a particularly useful political instrument for policymakers eager to lock in a structural reform agenda, I have been able to capture the 'petrification' dynamic, which conventional institutional accounts fail to do. Furthermore, I have shown that the institutional make-up of corporatist associations represents a key intervening variable that is overlooked by societal accounts of exchange rate politics, which tend to focus on structural attributes. While muting pressure for exchange regime change during much of the decade, organisational factors also shed light on the dynamic, which culminated in Argentina's exit from the Convertibility Regime in the midst of profound socio-economic crisis. Complementing this three-dimensional analysis, I pointed to the role of the IMF in creating an environment, which allowed for the petrification of the exchange rate regime in violation of the Fund's institutional responsibility of exchange rate surveillance.

C H A P T E R   V I

BRAZIL IN THE 1980S

6.1. Introductory Remarks

Brazilian exchange rate policy during the politico-economic turmoil of the 1980s followed a cyclical pattern of currency reforms and exchange regime changes. This pattern has led analysts, such as Bonomo and Terra (1999: 15), to suggest that exchange rate policy was torn between inflation and balance of payments imperatives, whose political weight varied according to the electoral calendar. As a result, incessant but half-hearted stabilisation attempts, usually prior to elections, were interrupted by short-termist demands for exchange rate adjustment to address balance of payments concerns. This trade-off accurately captures the fundamental tensions in exchange rate policy during the 1980s. Yet, by merely describing the nature of the trade-off this rather schematic model does not shed much light on the determinants of decisions in favour of one or the other side of the trade-off and their timing. Furthermore, although the delayed exit from the *Plano Cruzado's* exchange rate peg was undoubtedly related to electoral motives, such motivations fail to convincingly account for *all* exchange rate decisions during this period. For instance, how can President Collor's decision to float the *Cruzado Novo* in 1990 be rationalised by this framework, and what explains the timing of several larger devaluations between 1987 and 1990?

Existing accounts from either institutionalist or interest group perspectives also fail to generate compelling explanations. Although institutionalists rightly focus on the central role of the executive, these accounts tend to oversimplify the decisionmaking process *within* the executive. Similarly, interest group arguments have only limited explanatory mileage insofar as the *Plano Cruzado* and *Plano Collor* are known for having *"been developed in isolation from any organised group"* (Kingstone 1999: 40). Yet, by combining interest group and institutional explanations we can shed light on the *temporal* and erratic logic of exchange rate policy during this period. Similarly, a more realistic assessment of the role of external actors and the extent of their leverage over the Brazilian executive contributes to our understanding. The remainder of this chapter is thus organised as follows. Section 6.2. offers a historical overview over the

institutional background and the evolution of exchange rate policy. Section 6.3. applies this thesis' argument to the key instances of exchange rate politics in the 1980s by highlighting the relative importance of three factors: the role and motives of the executive, the impact of societal interests on exchange rate policy decisions and, last but not least, the constraints imposed by external agents. Section 6.4. concludes.

6.2. Historical Overview of Exchange Rate Policy in the 1980s

Throughout its economic history, which has been marked by chronic high inflation and recurrent balance of payments crises, Brazil's exchange rate has always played a crucial if not independent role. The common thread that runs through the post-war history of exchange regime choice is the enduring presence of the state – via a broad variety of exchange controls – in the foreign exchange market (Maxfield 1990: 182; Coes 1995). An understanding of the constitutional relationships of key government authorities and of the instruments available to them is therefore essential for grasping the political dynamics in this field. Prior to offering a chronological overview, the next sub-section sketches the institutional backdrop, which in its core characteristics persists until the current day.

6.2.1 The Institutional Context of Exchange Rate Policymaking in Brazil

The institutional structures within which exchange rate policymaking took place displayed great continuity during the transition from authoritarianism to democracy (Sola 1988; 1991; Loureiro 1997). Constitutionally, the presidency possessed ultimate, albeit indirect, decisionmaking influence in exchange rate policy matters via the *Conselho Monetário Nacional* (CMN – *Lei* 4.595/64) and could replace council members at will. Yet, presidential control remained indirect, and the presidency usually followed decisionmaking from the margins and only intervened when major regime changes, such as maxi-devaluations, were implemented. This willingness to delegate minor decisions had arisen due to the highly technical nature of this policy field and its sensitivity with respect to on-going foreign debt and balance of payments concerns. Even presidential initiatives in the CMN relied heavily on information and advice presented by technocrats and especially by the ministers from *Fazenda* and Planning. Rather than developing independent policy positions, presidents merely selected from – and at most suggested amendments to – pre-packaged policy options. Although it is therefore problematic to trace the presidency's exact exchange rate influence, it is beyond doubt that presidential consent to a chosen exchange rate policy regime constituted

a necessary pre-condition while operational questions and the day-to-day management of the exchange regime were delegated to the CMN and its enforcement agency, the *Banco Central do Brasil* (BCB)(Art. 9 of *Lei* 4.595/64).

The National Monetary Council

Since its inception in 1964, the National Monetary Council represents the highest authority in Brazil's financial system (Lafer 1975: 84). Its central role has been described as follows:

> If the Brazilian economy was a human organism, the CMN would be one half of the brain. It had under its authority nothing less than the BCB, in addition to the *Banco do Brasil*, the *Caixa* [*Econômica*] and the BNDES, and decisionmaking power over a good part of the public credit operations in the country (Fiuza 2006: 97).

To this day, the CMN is responsible for formulating foreign exchange policy norms, determining monetary policy as well as regulating and supervising the financial system (Lafer 1975: 87-88).[1] Established by the authoritarian regime as a council of representatives of government agencies, federal financial institutions and ministries, CMN membership was widened in 1974 to incorporate selected members from *private* financial and industrial circles (*Lei* 6,045/74).[2] Since then, the CMN has operated along the same corporatist lines as a myriad of other *'conselhos'* established by the military in order to foster a closer nexus between the state bureaucracy and key factions of Brazilian business (Lafer 1975: 97-100; Sola, et al. 2001: 47; Nervo Codato 2003b: 126). Substituting competitive pluralist politics, these councils have articulated and aggregated a wide range of carefully selected interests into public policies (Cardoso 1975).[3]

The council's politicisation is also reflected in frequent changes in its composition due to presidential nominations that mirrored the executive's evolving political motives. From 1974 onwards, the presidency could directly influence the council's political outlook by nominating six private sector members. Signalling the presidency's heightened role during the democratic transition, this number was raised first to ten in April 1985 (*Decreto* 91,185) and then to eleven in May 1987, of which one seat was reserved for a working class representative (*Decreto* 94,303). Otherwise, democratisation did not fundamentally alter the council's

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[1] For an overview of the CMN's role since 1964, see Lafer 1975: 89-100.

[2] For a list of CMN members, see http://www.bcb.gov.br/Pre/CMN/composição_CMN.pdf [17th December 2006].

[3] Cardoso (1975: 182) described this setting as 'bureaucratic rings', which linked private agents and the public administration.

composition. To the contrary, as **Table 25** shows, President Sarney confirmed the council's public-private and executive-led character and maintained several members who had been nominated by the military. During the *Plano Cruzado* and indeed until the 1994 reforms the CMN was composed of:

- several cabinet ministers, such as the Minister of Finance (CMN chair) and the Ministers of Planning, Agriculture, the Interior (until 1990), Urban Development (until 1989), Infrastructure (until 1992), Social Security, Labour (since 1987) and Industry and Commerce;
- the representatives of federal financial entities, such as the presidents of the BCB, the BNDES, the *Banco do Brasil* (BB) and the *Caixa Econômica Federal*, and the President of the *Comissão de Valores Mobiliários* (CVM); as well as
- several leading businessmen and, from 1987 onwards, a trade union activist, nominated by the presidency in recognition of their *"irreproachable reputation and known expertise in economic-financial matters"* (*Lei* 6,045/74)(Lafer 1975; Maxfield 1994: 562; Loureiro 1997: 110-111; Sola, et al. 2001: 47).

Table 25: The 25 Members of the CMN during the *Plano Cruzado*

Dilson Domingos Funaro	Finance Ministry
João Sayad	Planning Ministry
Fernão Carlos Botelho Bracher	BCB
José Hugo Castelo Branco	Industry and Commerce Ministry
Íris Rezende Machado	Agriculture Ministry
Ronaldo Costa Couto	Interior Ministry
Deni Lineu Schwartz	Urban Development Ministry
Victorio Fernando Bhering Cabral	*Comissão de Valores Mobiliários* (CVM)
André Franco Montoro Filho	BNDES
Camillo Calazans de Magalhães	*Banco do Brasil*
Marcos de Barros Freire	*Caixa Econômica*
José Maria de Aragão Melo	*Banco Nacional da Habitação* (BNH)
Roberto Fendt Júnior	*Carteira de Comércio Exterior do Banco do Brasil* (Cacex)
Delile Guerra de Macedo	*Banco da Amazônia S.A.* (BASA)
José Pereira e Silva	*Banco do Nordeste do Brasil S.A.* (BNB)
Jorge Hilário Gouveia Vieira	*Instituto de Resseguros do Brasil* (IRB)
*Octávio Gouvêa de Bulhões (since 1974)	Nominated Member (Former Finance Minister)
*Ângelo Calmon de Sá (since 1979)	Nominated Member (banker – *Banco Econômico*)
*Luiz Eulálio de Bueno Vidigal Filho (since 1979)	Nominated Member (industrialist – *Grupo Cobrasma*; SINDIPEÇAS president, Fiesp president, 1980-1985)
*Antônio J. D. de Oliveira Santos (since 1982)	Nominated Member (businessman – CNC president)
*Pedro Conde (since 1984)	Nominated Member (banker – *Banco de Crédito Nacional* (BCN))
*Amador Aguiar (since 1984)	Nominated Member (banker – founder of *Banco Bradesco SA*)
*João Carlos Paes Mendonça (since 1984)	Nominated Member (entrepreneur – *Grupo Bompreço* (retail); president of ABRAS (*Associação Brasileira dos Supermercados*))
Sérgio Franklin Quintella	Nominated Member (entrepreneur and academic economist at UERJ and PUC; president of ABNT (*Associação Brasileira de Normas Técnicas)*)
Abílio dos Santos Diniz	Nominated Member (entrepreneur – *Companhia Brasileira de Distribuiçao* (retail))

Source: Own elaboration based on documentation provided by the BCB. * Members nominated by military.
Note: The table shows CMN members as of 28th February 1986. The Labour Ministry only enjoyed representation after 31st October 1986 (*Decreto* 93,490), and working class representatives only gained a seat on 6th May 1987 (*Decreto* 94,303).

Due to its paramount role and public-private character, the CMN was dominated by clientelist practices, and pressures emanating from society exacerbated the ideological disputes among members during the transition. In the run-up to the *Plano Cruzado,* this loss in operative ability enabled the executive to go unpunished for turning the CMN into a mere façade for decisions that had *de facto* been taken by the so-called *'grupo palaciano'*, i.e. by executive agents including the presidency, the ministries of *Fazenda* and Planning and the BCB (Nervo Codato 2003a: 515-516). Indeed, during Sarney's presidency critical exchange rate decisions were made by a minority group of executive CMN members pushing the council itself to the periphery of decisionmaking processes by the late 1980s (Baer 2001: 136).

The Brazilian Central Bank

Operational exchange rate decisions, within the guidelines defined by the CMN, are executed by the BCB (Art. 10 *Lei* 4.595/64). Besides the economic policy ministries and the presidency, the BCB therefore constitutes the third key player in exchange rate policymaking. Created only in 1965 (Chapter III of Lei 4.595/64, Minella 1988; Skidmore 1988: 30-31), the BCB was highly dependent on executive assent and lacked any significant 'informal authority' (Maxfield 1994: 558) or policy autonomy in the 1980s insofar as

- until 1988, it operated as the direct financial agent of the National Treasury;
- it was financially subordinated to the commercial *Banco do Brasil* (BB), its predecessor, until July 1986 when the BB's *'conta movimento'* at the BCB was extinct and thus the separation between fiscal and monetary budgets established (Flynn 1986: 1154; Sola, et al. 2002: 136); and
- the presidency could impose personnel changes at the BCB at will (Maxfield 1990: 175; Franco 2006: 279). Indeed, the BCB president's formal status was that of an 'aide' to the Minister of Finance.[4]

In this light, Maxfield's diagnosis that as late as 1994 the BCB was *"still struggling to build an institutional identity"* and *"had to compete for a voice in economic policy-making against numerous other public and semi-public institutions"* (1994: 562) is an accurate depiction of the BCB's subordinate role in the 1980s. In spite of possessing some of the most able and renowned technocrats, the BCB directorate rarely succeeded in promoting its preferred policy stance. Due to its dependent position in the institutional hierarchy, it had to rely on the intermediation of the Finance Ministry and lacked direct communication channels with the presidency (Interviews

[4] This inferiority to *Fazenda* is illustrated by frequent changes in the BCB directorate, which closely mirrored those at the Ministry of Finance. For instance, Dornelles' departure in August 1985 precipitated Lemgruber's exit and thus allowed for Funaro to invite like-minded economists, such as Bracher, Lara Resende, Mendonça de Barros to become BCB directors.

Arida and Lara Resende, Sardenberg 1987: 75). The 1988 Constitution increased its autonomy only at the margins, for instance by eliminating the automaticity of Treasury access to BCB finances. Yet, such minute gains in autonomy were accompanied by the introduction of enhanced legislative oversight: From 1988 onwards, the BCB directorate, once nominated, had to be approved in a secret vote by the Senate (Santos and Patrício 2002: 99-100).

In contrast to the dominant role the BCB would play in the 1990s, the central bank remained an often marginalised exchange rate policy player in the 1980s and was largely constrained to providing advice and to acting within the limits defined by the CMN and approved by the presidency. Correspondingly, the ministries of Finance and, to a lesser extent, Planning maintained a much tighter grip on exchange rate policy decisions than in later years. Thanks to their closer political and institutional ties to the presidency they could marginalise the BCB's position (almost) at will.

In summary, as is typical for post-authoritarian contexts, formal institutions only affected actual policy dynamics at the margins insofar as strong executive players repeatedly violated the spirit, albeit not necessarily the letter, of constitutional provisions (also Levitsky and Murillo 2005). The CMN's marginalisation and the BCB's low level of institutional insulation meant that technocratic considerations repeatedly fell victim to political objectives, especially of the *Palácio do Planalto*.

6.2.2 Exchange Rate Policy under the Industrialisation Imperative, 1945-1985

Against this remarkably constant institutional background, this section provides a brief overview of exchange rate policymaking up to the 1980s. Since President Kubitschek's *'Planos de Metas'* in the 1950s, overvalued exchange rates combined with elevated tariff structures and an intricate web of non-tariff barriers have been central to Brazil's model of 'Import-Substitution Industrialization' (ISI) insofar as these measures enabled the state to actively influence allocative decisions (Hay 2001: 623; Corseuil and Kume 2003: 9; Gala 2004: 3; Saba Arbache 2004: 14). In this context, the exchange rate was systematically manipulated by means of extensive foreign exchange controls, and a multiple exchange rate system was in place during most of the 1950s (Maxfield 1990: 166 + 182-183; Baer 2001: 52 + 54-56; Helleiner 2003: 62).

Table 26: Annual Inflation Rates in Brazil and Argentina, 1948-1995

	1948-57	1958-67	1968-77	1978-87	1988-95
Brazil	14.6	44.9	26.0	138.2	893.4
Argentina	20.2	32.9	75.2	211.2	229.1

Source: Guilhoto and Hewings 2001: 34.

Table 27: Brazilian Currencies and Conversion Rates, 1942-1993

Cruzeiro	1942-1967			
Cruzeiro Novo	1967-1970	→	1 *Cruzeiro Novo*	= 1,000 *Cruzeiros*
Cruzeiro	1970-1986	→	1 *Cruzeiro*	= 1 *Cruzeiro Novo*
Cruzado	1986-1989	→	1 *Cruzado*	= 1,000 *Cruzeiros*
Cruzado Novo	1989-1990	→	1 *Cruzado Novo*	= 1,000 *Cruzados*
Cruzeiro	1990-1993	→	1 *Cruzeiro*	= 1 *Cruzado Novo*

1964-1973: The Shift to a Regime of Mini-Devaluations (1968) and the 'Brazilian Miracle'

The economic authorities installed by the 1964 military coup introduced a stronger export-oriented component to Brazil's ISI model. Recognising the detrimental impact of rising inflation rates (**Table 26**) on creditworthiness, foreign investment and political stability, the neutralisation of inflation took on greater importance yet remained subordinate to the commitment to industrial development. These twofold considerations motivated the restructuring of Brazil's financial institutions in 1964, entailing the establishment of the BCB and the CMN and the introduction of general indexation (*Lei* 4,357)(Skidmore 1988: 29).

After struggling to maintain the inherited exchange rate peg due to balance of payments bottlenecks (Amann 2003), Finance Minister Delfím Netto opted for a system of periodic nominal mini-devaluations informed by the doctrine of purchasing power parity in 1968 (Frieden 1991a: 80; Eichengreen and Fishlow 1998: 38-39; Baer 2001: 75; Bonomo and Terra 2001; Corden 2002: 174). The aims of indexing the exchange rate to inflation were twofold. First, preventing inflation-induced overvaluation and stabilising the real exchange rate would steady the export sector's real earnings and therefore foster export diversification (Skidmore 1988: 91; Bonomo and Terra 1999: 7; Garofalo Filho 2005: 28). Secondly, this highly discretionary policy of executive-controlled mini-devaluations (generally not exceeding 2%) would be less disruptive to capital inflows (Maxfield 1990: 183; Coes 1995: 125; Zini Jr. 1995: 107; Garofalo Filho 2005: 99). With the exception of short diversions in the early 1980s and under the *Plano Cruzado*, this 'crawling peg' regime remained in place until 1990. As the dominant exchange rate strategy in post-war Brazil, it fundamentally affected foreign exchange practices among actors in both the bureaucracy and foreign exchange markets as well as among organised business and labour. Moreover, its close association with the *'milagre brasileiro'* (Brazilian miracle) of high growth rates and export expansion-cum-diversification in the late 1960s meant that this system of executive-controlled mini-devaluations retained high acceptability among government economists, politicians and the wider public alike (Carvalho 1985; Corden 1993: 206).[5]

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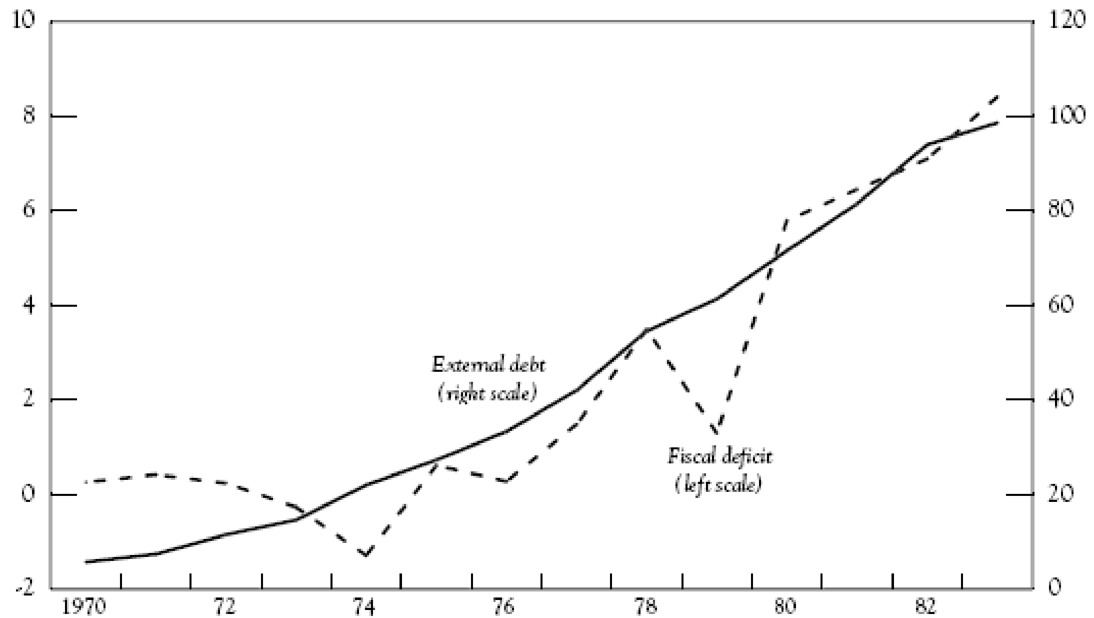
[5] Industrialisation efforts since the late 1940s brought about dramatic structural change: Agriculture's contribution to GDP

Figure 24: Fiscal Deficit and External Debt in Brazil, 1970-1983
(in billions of US$)



Source: Boughton 2001: 337 based on IMF and World Bank data.

1973-1985: Perpetual Adjustment Crisis – Foreign Debt and Inflation

Although the 1973 oil shock had put an end to this virtuous cycle by accelerating inflation and, given Brazil's dependence on oil imports, strongly affecting external accounts (Bonomo and Terra 1999: 8), the military authorities persevered with their export-led growth agenda and intensified public investment while holding onto the increasingly overvalued mini-devaluations scheme and financing growing current account deficits in international capital markets (Kaufman 1989: 397). This debt-cum-growth strategy became unsustainable with the second oil shock in 1979 and the subsequent rise in world interest rates. Debt servicing costs shot up to equal 66% of Brazil's export earnings; recession in key export markets provoked an economic slowdown that threatened to undermine the military's legitimacy; and persisting fiscal disequilibria[6] forced the authorities to resort to further increases in domestic public debt and to engage in inflationary money creation (Carvalho 1985: 91; Skidmore 1999: 192). As accumulating overvaluation threatened the influx of essential export earnings, the authorities implemented a maxi-devaluation at the end of 1979, which pushed annual inflation in 1980 to levels exceeding 110% (Diaz Alejandro 1983: 527; Skidmore 1988: 230; Coes 1995: 126; Zini

declined from 28% in 1947 to about 10% in the late 1990s while the share of Brazilian industry rose from less than 20% to about 36% over the same period (Baer 2001: 3). With respect to export diversification in the 1960s, the share of primary products in total exports was reduced from 91.1% in 1968 to 64.4% in 1974, while the share of industrial exports increased from 8.9% to 35.6% (Carvalho 1985: 91).

[6] Increases in public expenditure resulted primarily from rising interest payments and payments to exporters, which sought to compensate for the 30% increase in the *Cruzeiro*'s value relative to the US dollar since 1974.

Jr. 1995: 118; Garofalo Filho 2005: 134).

The 1982 debt crisis hit Brazil in the midst of a three-year-long recession. Reduced export earnings and extortionate debt servicing costs provoked the dwindling of reserves and pushed the government into accepting an IMF loan (Bonomo and Terra 1999: 12; Baer 2001: 232). Another maxi-devaluation in February 1983 and the acceleration of mini-devaluations failed to attenuate overvaluation. Eventually the on-going recession, exceptional foreign debt levels and accelerating inflation took their toll and spurred on-going civilian action for a democratic *'Nova República'* (Smith 1987: 43; Fanelli, et al. 1994; Sallum Jr. 2004: 50).

6.2.3 Abertura Política – Exchange Rate Policy during the Democratic Transition, 1985-1986

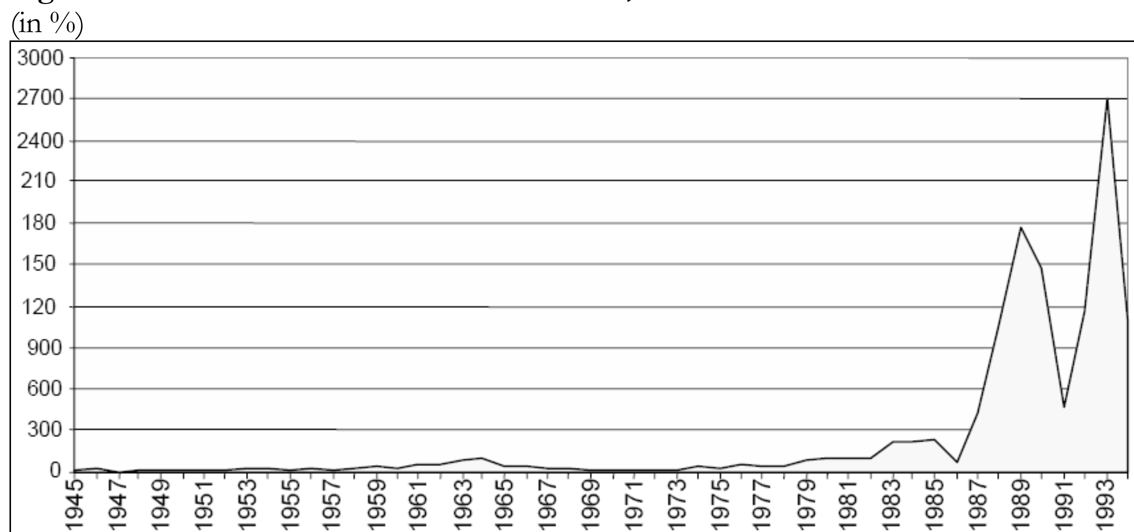
The inauguration of Brazil's first civilian administration after 21 years of military government in March 1985 represented the climax of a long process of opening underway since the mid-1970s. The gradualism and the explicit participation of sectors linked to the military side-by-side with democratic forces distinguish this transition from other regional experiences of democratisation (Smith 1987; Wirth, et al. 1987: 2; Diniz 2000: 78). Among other things, conservative congressional forces successfully resisted demands for direct elections. Instead, Tancredo Neves and his vice president José Sarney (both Party of the Brazilian Democracy Movement (PMDB)) were elected by an electoral college (Sallum Jr. 2004: 52). However, President-elect Neves' sudden illness and unexpected death put into question the new leadership's legitimacy and political authority: Sarney – the new default President – had been a member of the pro-military *Partido Democrático Social* (PDS). This need to compensate for his legitimacy deficit came to strongly affect economic decisionmaking throughout his presidency insofar as he was particularly vulnerable to popular and party-political pressures from within the *Aliança Democrática* (Sardenberg 1987: 106-107; Bonomo and Terra 1999: 13; Cardoso 2006b: 104-106).

Even for a prepared president, the economic agenda confronting Sarney would have been daunting: He inherited an unparalleled foreign debt burden, a state in perpetual fiscal crisis, triple-digit inflation, falling investment and extreme income inequality.[7] Yet, resurging growth rates of 8.3% in 1985 and a surprisingly favourable balance of payments in the aftermath of recession-driven adjustment also granted him some, albeit temporary, breathing space. In the short run, widespread indexation stabilised monthly inflation at high but not yet hyperinflationary rates. Besides these challenging economic circumstances, Sarney inherited

[7] With 0.55 in 1983 and 0.57 in 1989, Brazil's Gini coefficient was among the highest in the world (Bittencourt 2006: 10).

Neves' cabinet, which was deeply divided between the orthodox Francisco Dornelles at the Finance Ministry and the Keynesian economist João Sayad (PMDB) at *Planejamento*. Dornelles' orthodox agenda provoked immediate tensions with Sayad, who advocated redistributionist policies. Sayad had developed a keen interest in heterodox stabilisation proposals and had appointed one of the key heterodox proponents, Pérsio Arida, as his ministerial advisor. After four months of bitter cabinet infighting, Sarney withdrew his support for Dornelles for fear of a popular backlash (Flynn 1986: 1168; Sardenberg 1987: 102; Guilhoto and Hewings 2001: 36) and replaced him with the BNDES president Dílson Funaro, a *paulista* industrialist with developmentalist beliefs more congruent with Sayad's convictions (Sardenberg 1987: 105; Sola and Kugelmas 2006: 94).

Figure 25: Annualised Inflation Rates in Brazil, 1945-1993
(in %)



Source: Ipeadata – IGP-DP as presented in Saba Arbache 2004: 16.

6.2.4 The Plano Cruzado (1986)

This is the plan that in popular memory is equally associated with having made meat widely affordable as with the deception experienced after the plan's collapse.

R.M. do Prado (2005: 234)

One of Funaro's first initiatives was the reversal of Dornelles' prior decision to index the exchange rate to past inflation and to restore Netto's original mini-devaluation formula. Although Dornelles' intervention had reduced uncertainty, the backward-looking devaluation rule had also tightened the inertial relationship between inflation and the exchange rate, which Funaro was eager to break (Bonomo and Terra 1999: 14). In the subsequent months, the executive implemented a series of seemingly *ad hoc* policy measures, which – unknown to non-executive circles – sought to reduce inflation to its inertial component so as to prepare the

ground for a heterodox shock.[8]

In December 1985, responding to public demands for immediate anti-inflationary action in the face of accelerating inflation (**Figure 25**), Sarney and Funaro had given the green light to intensified preparations of a heterodox shock (Skidmore 1988: 278). Hyperinflation had become an increasingly realistic prospect – and a particularly dangerous one for a president who was under attack from his own party for his indecisiveness in economic matters and whose popularity was in free fall (Flynn 1986: 1171; Solnik 1987; Skidmore 1988: 279; Sola 1991: 175). In this precarious situation and having witnessed the electoral benefits of similar plans in Israel and Argentina, Sarney had come to accept the risks of a heterodox shock (Sardenberg 1987: 155; Pio 2001b: 34; Weyland 2002). On 28th February 1986, he announced the *Plano Cruzado* (officially the *Programa de Estabilização Econômico*). Its final contents had been defined in absolute secrecy. Enshrined in the *Decreto-Lei* 2,284, the plan's key elements can be summarised as follows (see Baer 2001: 148-149; Guilhoto and Hewings 2001: 37-38):

1) **Currency reform:** The *Cruzado* (Cr$) replaced the *Cruzeiro* at a rate of 1,000 *Cruzeiros* to one *Cruzado.*
2) **Prize and wage freeze:** All prices were legally fixed at the level of 27th February 1986. All forms of indexation were to be abandoned.
3) **Elimination of indexation:** All forms of price and contract indexation were to be eliminated with contracts only being adjusted after a one-year-period (as opposed to on a monthly basis as it had been the rule previously).
    a. Abandonment of mini-devaluations and adoption of an exchange rate peg: The elimination of indexation and the freezing of prices included the *Cruzado* exchange rate, which was to be pegged indefinitely.
4) **Conversion rules:** All contracts denominated in *Cruzeiros* were to be converted into *Cruzados* in accordance with pre-defined rules of conversion (*tablita*), which discounted the new contract value in order to neutralize the expected higher inflation rates incorporated in the *Cruzeiro* contracts.
5) **Wage adjustment:** Wages were first increased by 8% (15% for minimum wage earners (*abono*)) and then converted into *Cruzados* based on their averaged real value over the previous six months. A 'wage-escalation' trigger (*gatilho salarial*) was introduced, which automatised equivalent wage increases as soon as the CPI had risen by more than 20%.

The plan only granted marginal importance to the role of the exchange rate and relied primarily on a combination of de-indexation and price freezes. In a sense, the exchange rate

[8] Changes in the tax system combined with expenditure cuts in late 1985 aimed to reduce the public deficit, while limitations were imposed on the BB's access to BCB resources and a single price index for wages, monetary correction and exchange rate devaluation was introduced (Flynn 1986: 1154-1155).

was treated like any other indexed price, which had to be de-indexed and then frozen indefinitely for the heterodox shock to succeed. It is thus not surprising that the implementing decree did not make any reference to the exchange rate strategy that would be adopted in the medium run. Even the government's intention to peg the *Cruzado* to the US$ at the current rate of 13,840 *Cruzados* per US dollar only transpired from accompanying public statements by government officials (Baer 2001: 148).

Similar to Argentina's *Plan Austral*, the plan was an instant success with the Brazilian public as it delivered on Funaro's promise of *"Swiss inflation with Japanese growth"* (Funaro in Smith 1987: 54) by rapidly reducing inflation to levels of 3.38% between March and May 1986 at stable growth rates, thus generating considerable improvements in real wages. This spurred an unprecedented consumer boom, which Brazilians still remember as the time 'when meat became widely affordable'. However, excess demand and the resulting shortages in (consumer) goods soon triggered illegal pricing practices and thus the re-emergence of inflation. Acting on Sarney's call to enforce price freezes as *'fiscais do Sarney'* (Sarney's price inspectors), Brazilians denounced non-complying traders giving the 'war on inflation' an unprecedented populist dimension (Hirschman 1987: 29). These problems inherent to the plan's design and, more importantly, the lack of political will to address the imminent risk of overheating became apparent in May 1986 at the meeting of Carajás, when Sarney vetoed Funaro's proposal to liberalise prices. Some minor remedial measures (*'Cruzadinho' – DL 2,288*) to reduce consumption were agreed in late July 1986 but, to the economic team's great frustration, more sweeping modifications were rejected prior to November when a new Congress would be elected, which would simultaneously serve as Constitutional Assembly (Smith 1987: 47).

Hesitation to amend the plan that had generated unprecedented popularity for Sarney also motivated the delay of exchange rate adjustment (Pio 2000: 13; Weyland 2002: 85).[9] This postponed flexibilisation contributed to the *Cruzado* Plan's failure insofar as heightened domestic demand and effective, if not fully measured, inflation from mid-1986 onwards led to the *Cruzado's* overvaluation, which at rising levels of economic activity, stimulated import demand while sharply cutting the competitive edge of Brazilian producers (**Figure 26**)(Baer 2001: 162). As black market premia signalled intensifying speculation, the authorities were eventually forced to devalue the *Cruzado* by 1.6% in October 1986 (Sola 1991: 188 + 190; Pio 2000: 16; Garofalo Filho 2005: 137). Yet, as the PMDB's resounding victory in the November

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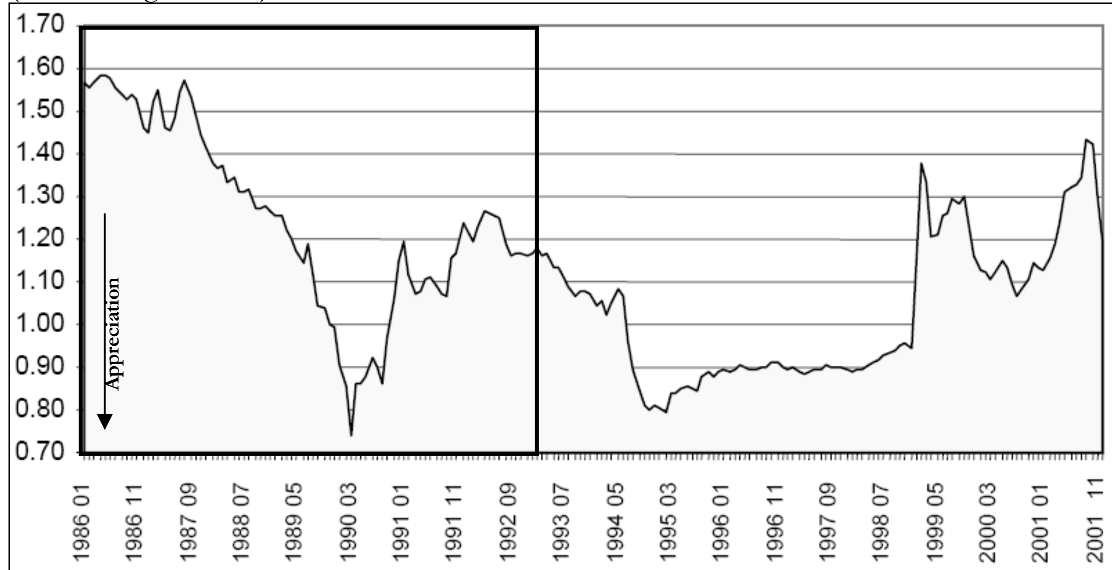
[9] According to DataFolha, Sarney's popularity increased from 33% in October 1985 to 82% in March 1986. After the collapse of the *Cruzado Plan*, his popularity dropped to 34% and further to 8% by May 1987 (Roxborough 1992: 648).

elections illustrates, Sarney's electoral appeal remained largely unaffected by this external crisis and the plan's increasingly apparent economic difficulties.[10]

Figure 26: Real Exchange Rate Developments in Brazil, 1986-2001
(base = August 1994)



Source: Saba Arbache 2004: 18.

Riding on the wave of electoral success but confronted with demands from his advisors to address the risk of overheating, Sarney reticently implemented a cosmetic corrective package, the *'Cruzado II'*, only a week later. This set of measures hit the middle classes by increasing indirect taxes, adjusting 'frozen' public utility prices upward and re-indexing financial contracts to the *Letras do Banco Central* (LBC).[11] Most importantly, the exchange rate peg was abandoned in favour of a return to mini-devaluations (Pio 2000: 16-17). Yet, even the daily adjusted crawling peg failed to turn around the trade balance or to attenuate the erosion of international reserves. Instead, in the absence of fiscal adjustment, the program itself proved highly inflationary, eventually triggered the wage *'gatilho'* and thus pushed monthly inflation to levels exceeding 20% in 1987 (Smith 1987: 55; Amann 2003). In February 1987, Sarney finally agreed to the liberalisation of most other prices. After several episodes of collective protest and as reserves dwindled, interest payments on US$67 billion in foreign commercial debt were suspended in an attempt to regain popularity by appealing to nationalist sentiments.[12] But Sarney's gamble failed on all accounts: Poll ratings dropped

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[10] The PMDB took 261 of 487 seats in the Chamber of Deputies, captured 22 of the 23 state governorships and also controlled the Senate with a large majority. The PFL could establish itself as Brazil's second party.

[11] The effects of the *Cruzado II* on real incomes can be summarised as follows: While e.g., rents increased by 710% between January and June 1987, the price of bus travel in São Paulo rose by 530% and milk prices increased by 436% at an official inflation of 127%, nominal wages only grew by 144% (Baer 2001).

[12] Foreign debt in 1987 amounted to US$109 billion with interest payments of US$9.6 billion due that year (Smith 1987: 56).

further and more favourable repayment conditions could not be obtained (Bonomo and Terra 1999: 15). The end of the '*Cruzado* adventure' was nigh when general indexation returned and the technocrats around Arida and Lara Resende left the economic team voicing frustration about the continuation of clientelistic practices, political meddling and Sarney's unwillingness to reform the defunct economic model (Interviews Lara Resende, Arida; Pio 2000: 18).

Table 28: Stabilisation Plans under President Sarney, 1986-1989

Cruzado Plan	March 1986
Cruzado II Plan	November 1986
Bresser Plan	June 1987
Verão (Summer) Plan	January 1989

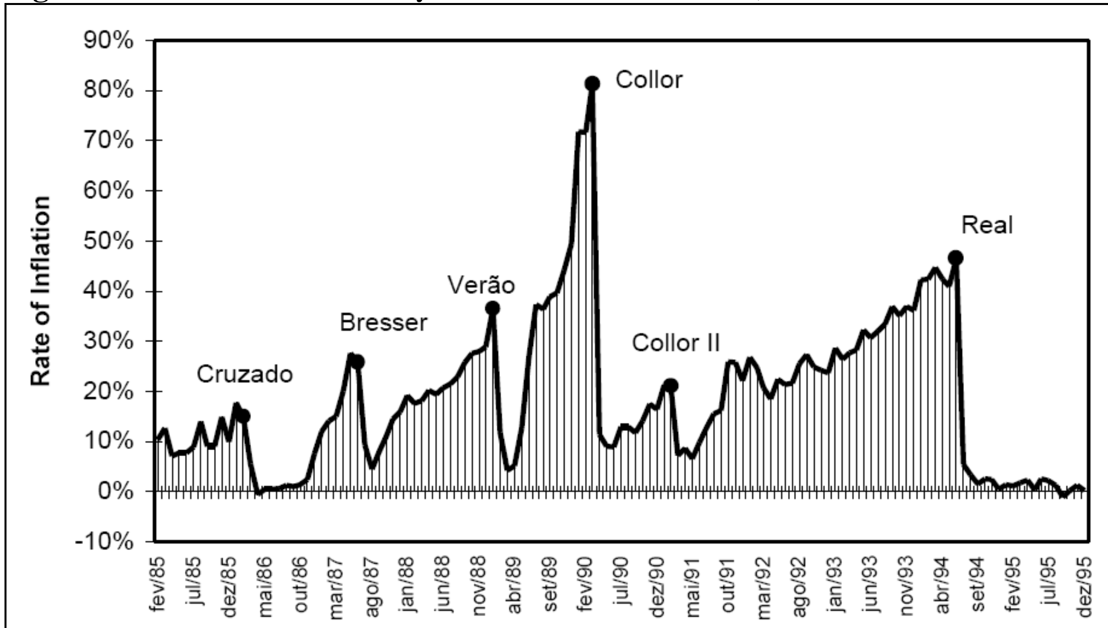
6.2.5 The Failed Plans, 1987-1989: The Bresser Plan, the 'Rice and Beans' Strategy and the Summer Plan

In response to the inflationary upsurge in the aftermath of the *Plano Cruzado*, Luiz Carlos Bresser Pereira was offered Funaro's post. In June 1987, Bresser announced another attempt at stabilisation – the first in a series of failed heterodox plans during the remainder of Sarney's term (**Table 28**). Known as *'Plano Bresser'*, this initiative primarily aimed at preventing hyperinflation rather than achieving substantial disinflation by combining heterodox elements, such as rent control and deindexation, with rigid monetary and fiscal controls. Given that reserves had dropped below US$ 3 billion, Bresser did not have the option of anchoring these efforts with an exchange rate peg and maintained the crawling peg (Bresser Pereira 1990). Yet, once again, the rate of devaluation remained insufficient and eventually precipitated a 'small maxi-devaluation' (*uma pequena maxi*) of 8.5%. Facing the prospect of another failed macroeconomic experiment in a context of rising economic instability and urban violence, Sarney appointed Mailson da Nóbrega as Bresser's replacement in December 1987.

Confronted with the executive's utter loss of credibility and growing opposition from business (Kingstone 1999: 42), da Nóbrega's minimalist policy strategy – also known as *'arroz com feijão'* (rice and beans) – sought to control government spending by e.g., enforcing a public sector hiring stop. Yet, in the absence of structural reform measures, da Nóbrega's attempts at achieving some disinflation via real exchange rate appreciation were in vain. A year after his appointment, daily inflation rates of 1% demanded another intervention, the *Plano Verão,* which heralded the return to price and wage freezes. In exchange rate policy terms, the Summer Plan constituted another exception to the mini-devaluations system insofar as, after its devaluation, the newly introduced *Novo Cruzado* – three noughts 'lighter' than its predecessor – was pegged to the US dollar at a rate of 1:1 in order to restore trust in the

national currency. Yet, the authorities' decision to revert to irregular mini-devaluations in July 1989 pushed monthly inflation to 37.9% adding accusations of incompetence to claims of corruption against Sarney (Roxborough 1992: 639).[13]

Figure 27: Evolution of Monthly Inflation Rates in Brazil, 1985-1995

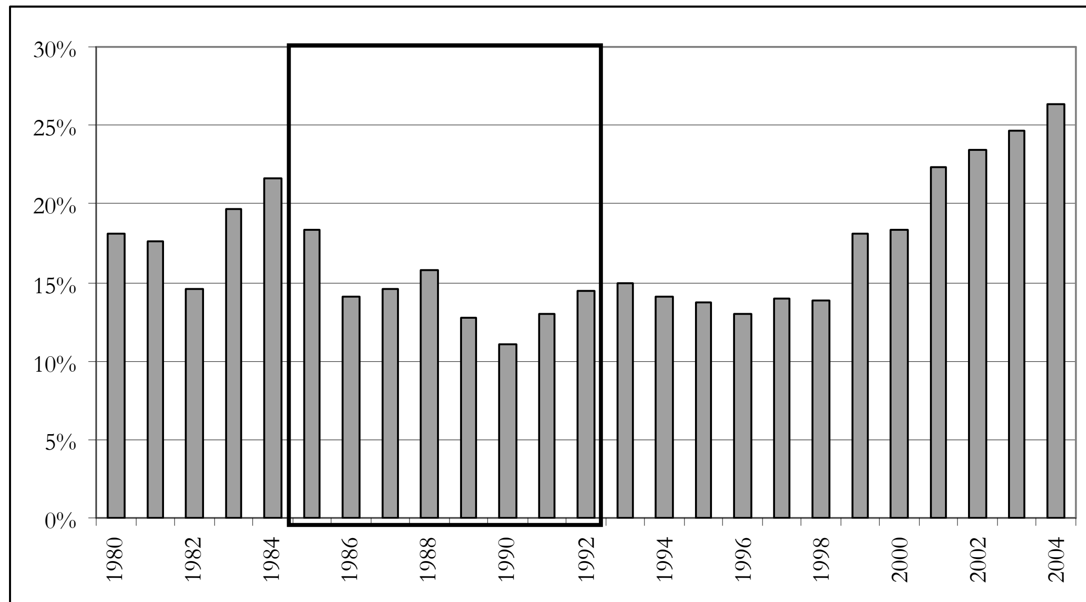


Source: Falção Silva 2001 based on data from various issues of FGV's *Conjuntura Econômica.*

During this period of heightened instability, the first negative effects of the 1988 Constitution on Brazil's public finances manifested themselves (Cardoso 2000: 71; Elliott Armijo 2005: 2020). Sarney's loss in popularity as a result of the failed *Plano Cruzado* in 1987 had undermined his ability to exert leadership in the drafting of the constitution, which consequently proceeded in a piece-meal fashion producing an almost unworkable document that exacerbated existing institutional imbalances (Cardoso 2006b: 108). On the one hand, the presidency's position was strengthened by granting him the right to issue *'medidas provisórias'*, that is executive decrees with the force of law that, in practice, could be re-issued until explicitly rejected by Congress (de Souza 1999: 51-52). On the other hand, the new constitution assumed that this *"plebiscitarian presidency"* would be capable of *"counterbalancing the centrifugal forces at work elsewhere in the political system,"* for instance, in Congress (ibid.: 51). In addition to highly permissive electoral and party laws and the systemic overrepresentation of smaller backward states in the *Congresso Nacional*, the new constitution implied greater resource transfers from the federal to the state/municipal levels at even greater federal obligations and thus undermined the federal government's ability to control spending and thus inflation.

[13] In late 1988, a congressional committee recommended that impeachment proceedings be initiated against Sarney. Thanks to the Chamber's President de Oliveira (PFL) the committee report was 'archived' before Congress had voted on the issue.

Figure 28: Trade-to-GDP Ratio in Brazil, 1980-2004



Source: Own elaboration based on data from Saba Arbache 2006.

6.2.6 Exchange Rate Policy during Collor's Liberalisation Project, 1990-1992

The presidential elections in November 1989 took place in a climate of great economic uncertainty and public cynicism into which a new political actor had emerged: Fernando Collor de Melo, a young self-stylised crusader against corruption and Brazil's economic backwardness (Weyland 1993; 2002: 100). His neoliberal propositions and populist promises won the support of Brazil's frustrated business leaders as well as inspiring hope for change among ordinary Brazilians after two years of ministerial turnovers, governmental indecision and macroeconomic instability (Skidmore 1999: 217). After an ideologically-laden contest, Collor triumphed with 42.7% of the votes over the PT leader da Silva.

Upon Collor's inauguration in March 1990, his economic team identified the liquidity overhang generated by high levels of internal public debt as driving, what had come to resemble, 'suspended' hyperinflation (Sola 1991: 167). In response, the *'Plano Brasil Novo'*, a drastic programme for 'national reconstruction', was implemented. At its core, an 18-month asset freeze confiscated 70-80% of Brazil's total liquidity, stunned the Brazilian public and paralysed individual savers and larger firms (Valença 2002: 133; Fausto and Devoto 2004: 465). Within months, Collor and his Finance Minister Cardoso de Mello reoriented Brazil's public policy agenda towards neoliberal principles (Diniz 2000: 48)(**Table 29**). Other than introducing a new currency and breaking with Brazil's ISI model by deepening commercial liberalisation (**Figure 28**),[14] Collor introduced a flexible exchange regime and some cautious

[14] Collor abolished the non-tariff barriers of the *Anexo C* and all 42 'special regimes' and announced tariff reductions, which

measures towards capital account liberalisation.[15] An official foreign exchange market (*mercado comercial*) was created for transactions related to commerce, services, external debt and external investment in parallel to the floating market for unilateral transfers and tourist transactions (*mercado turismo)* that had been established in 1989. For the first time in decades, the authorities moved away from a government-determined exchange rate system (Filgueiras 2000: 86; Garofalo Filho 2005: 304-305; da Nóbrega and Loyola 2006: 74).

Table 29: Core Elements of the *Plano Brasil Novo*

- Asset freeze over 18 months of all deposits exceeding 50,000 Cruzados (i.e. US$1,300) at an interest rate of inflation plus 6%
- Currency reform: The *Cruzeiro* replaced the *Cruzado Novo* at a rate of 1:1
- Shift to a floating exchange rate system and initial attempts at further capital account liberalisation
- Initial price and wage freeze over 45 days
- Fiscal adjustment: introduction of a tax on financial transactions; elimination of many fiscal incentives; application of income tax to profits from stock market operations, agricultural activities and exports; imposition of wealth tax; indexation of taxes to inflation; anti-tax evasion measures; public goods price hike; efficiency reforms in public sector employment; closure of some federal agencies and administrative reforms (superministry *Economia, Fazenda e Planejamento*); cuts in public sector employment
- Commercial liberalisation and reform of industrial policy (drastic cuts of subsidies)
- Start of privatisation and deregulation process (*Programa Nacional de Desestatização):* privatisation of 18 state-owned companies between 1990 and 1992 mostly in the steel and petrochemical sectors

Yet, in practice, fears of deteriorating trade accounts and mounting political pressure in response to the *Cruzeiro*'s appreciation in a context of rapid trade liberalisation led the government to resort to irregular interventions (Baer 2001: 182; Kume and Bráz de Souza 2003: 72; Garofalo Filho 2005: 105). After some gradual real depreciation had been achieved, another stabilisation plan in February 1991, the *Plano Collor II*, once again adopted price freezes and an exchange rate peg. Once collapsed, increasingly desperate measures followed in September 1991 (Kume and Bráz de Souza 2003: 72). Once again, the lack of fiscal discipline fuelled by the deepening political crisis around Collor's impeachment condemned these efforts to failure. After a congressional inquiry had produced substantial evidence of influence peddling, impeachment proceedings were initiated against Collor in September 1992. Collor's resignation on 30th December 1992 merely pre-empted the Senate's decision to strip him of his political rights for the next eight years. The impeachment of Brazil's first directly elected president left behind a rapidly deteriorating economy with worsening social indicators, accelerating inflation and a political system, which had lost almost all its citizens' trust.

over a four year period lowered tariff lines to maximum rates of 40%. With the *Act of Buenos Aires* in 1990 and the *Asunción Treaty* in 1991, Collor also consolidated Sarney's Mercosul project. Between 1987 and 1992, the weighted average nominal tariff was thus reduced from 55% to 14% leading to a rise in trade intensity with imports and exports increasing by 257% and 151% respectively between 1990 and 1996 (Corseuil and Kume 2003: 15; Saba Arbacha 2004: F80).

[15] These measures significantly liberalised portfolio investment in the domestic financial markets but limited hard currency transactions to public debt indexed to the exchange rate and exchange rate-indexed credits (Garofalo Filho 2005: 107).

6.3. Explaining Exchange Policy Choices in the 1980s

Building onto the historical overview, this section seeks to account for the exchange rate policy choices made over the course of the 1980s. I specifically focus on the exchange rate political decisions surrounding the *Plano Cruzado,* that is on the decision to move from a crawling peg to a 'conventional' peg at its outset, on the political drivers that led to the delay of essential exchange rate adjustment and on the peg's eventual collapse in late 1986. Where appropriate, I will make reference to how this explanation bears upon the decision to float the *Cruzeiro* in the context of the *Plano Brasil Novo* in 1990 and on the return to mini-devaluations soon after. In line with Chapter III, this analysis is structured around three groups of factors:

- the **role of the executive and the technocrats** – in particular the role of the respective Presidents and Finance Ministers and their relationships to the technocrats involved in the drawing up of Brazil's exchange rate policy strategy as well as the ideational realm in which these economists operated;
- the **role of societal interests** in influencing the decisionmaking process by directly interacting with the executive and by affecting the sustainability of a given exchange rate regime through their political and market-based actions; and
- the **role of external factors** and especially the influence of the IMF and its exchange rate policy advice and conditionalities as well as the role of foreign creditors.

6.3.1 The Role of the Executive

As the historical section suggested, I share the interpretation of most accounts (e.g., Bonomo and Terra 1999; Bonomo and Terra 2001; Frieden and Stein 2001), which focus on the role of the executive and the trade-offs and constraints it faced in explaining exchange rate policy choices. However, I am keen to distance myself from explanations, which reduce exchange rate policy cycles during this period exclusively to electoral motivations. According to this perspective, the *Plano Cruzado* constituted nothing but an electioneering device of a rational and coherent executive, whose long-term aims were doomed from the outset due to its populist, unsustainable policies (e.g., Bonomo and Terra 2001, 2005; Frieden and Stein 2001). Such explanations must be regarded as unnecessarily one-dimensional accounts of the crisis politics that drove the adoption of a plan, which marked a generation of Brazilians and left a powerful legacy for subsequent attempts at stabilisation. Instead, I point to the decisive role of a group of actors within the executive and its relationship to the presidency: the so-called *equipe econômica*, i.e. the economists in charge of designing the stabilisation plan and therefore responsible for drawing up the underlying exchange rate strategy. In particular, I

argue that the institutional position and the degree of autonomy of this group of young high-calibre economists, which diminished as the preparations for the plan proceeded, but also the body of economic ideas developed by them and emerging group-internal fissures shed decisive light on exchange rate decisions taken during the first stabilisation plan under democracy. An assessment of the social construction of exchange rate policy within this influential policy network (Granovetter 1992), which operated in a policymaking process characterised by a high civic participation deficit and frequent resort to executive decrees, highlights the subordinate role of electoral motives at the outset of the plan. These, I argue, only entered the equation once technocrats had to relinquish control of the plan to their political superiors.

Table 30: The *Cruzado* Team: University Education and Function

Name	Function
Heterodox Wing of the Team:	
Fernão Bracher	BCB President
Pérsio Arida (MIT, PUC-Rio, USP)	Secretary for Economic and Social Coordination at the Planning Ministry/Director for Banking at the BCB
Edmar Bacha (Yale, PUC-Rio)	IBGE President
André Lara Resende (MIT, PUC-Rio)	Director for Public Debt and Open Market Operations at the BCB
L. C. Mendonça de Barros (Unicamp)	Director of Capital Markets at the BCB
Francisco Lopes (Harvard, PUC-Rio)	Informal Consultant to the Finance Ministry
João Sayad (USP)	Planning Minister
Developmentalist Wing of the Team:	
Dílson Funaro	Finance Minister
Luiz G. de Mello Belluzzo (Unicamp)	Special Advisor to the Finance Ministry
João M. Cardoso de Mello (Unicamp)	Special Advisor to the Finance Ministry
Andrea Calabi (Berkeley, USP)	General Secretary of the Planning Ministry/Secretary of the National Treasury at the Finance Ministry

Source: Interviews with Lara Resende, Arida and Bacha; and Lara Resende in Solnik 1987: 22.

In contrast to the group's depiction in the press and unlike their counterparts in Argentina or the '*equipe do Real*' eight years later, the '*Cruzado* team' did not constitute a homogeneous, closely integrated and self-contained team (Kaufman 1989: 403; Fortes 2004). Rather, they represented an almost coincidental combination of *"individuals with varied and contrasting academic paths, political legitimacy and political loyalties"* (Neiburg 2004: 190), or a *"mosaic of different tendencies of [economic] thought"* dispersed across different ministries (R. M. do Prado 2005: 111). While Sayad and Bracher had advocated Arida's and Lara Resende's appointments for their long-standing professional relationships and shared heterodox convictions, Funaro's nomination of the developmentalist economists Cardoso de Mello and Belluzzo meant that economists from opposing economic traditions were forced to cooperate (**Table 30**). Although they shared a strong sense of commitment to the *Nova Republica* and harboured

similar mistrust of monetarist principles (Flynn 1986: 1152), the economists diverged in their outlooks on the efficiency of market adjustment and thus on the desirability of price freezes and the necessity of fundamental fiscal adjustment (Interviews Arida, Lara Resende).

Institutional Insulation of the Economic Team

Over the course of the team's time in office, this heterogeneous group came to enjoy a curious temporary form of autonomy from their superiors in government and especially from actors beyond the executive. A common depiction of the team's position prior to the announcement of the *Plano Cruzado* in February 1986 describes the economists as having had *"absolute capacity to control the design of the plan"* and that

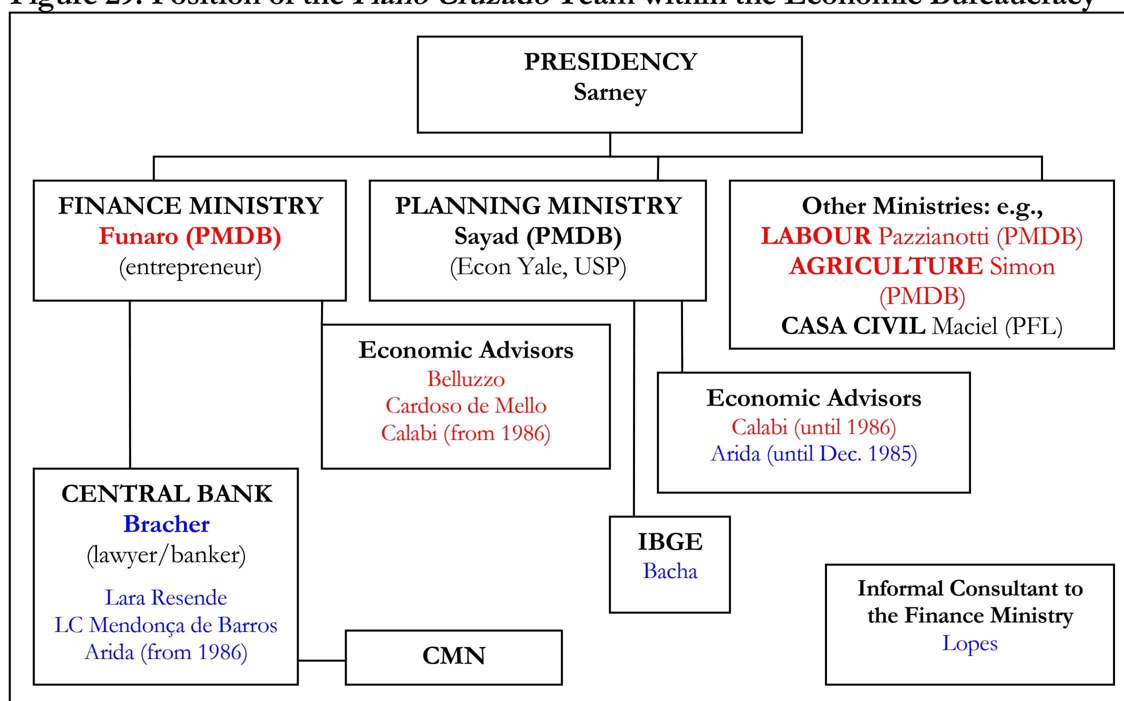
> it was only after the definition of the basic set of measures by the two experts [Lara Resende and Arida], that all the other members of the government [...] had a chance to alter the content of the package (Pio 2000: 10, also Sola 1991: 175 + 183).

This autonomy during the early stages of the plan's design was the combined result of a post-authoritarian institutional setting, which insulated macroeconomic decisionmaking processes from competitive politics (Sola 1988: 20; 1991: 172) and the preliminary granting of autonomy by the team's direct superiors, the ministers of *Fazenda* and Planning. Thanks to this constellation and to its agenda-setting power with respect to producing the first blueprint of the plan the group shaped the final outcome (Pio 2000; 2001a). More cynically, one could argue that this initial room for discussion merely resulted from the group's perceived irrelevance in the eyes of – especially – Finance Minister Funaro, who at first viewed the group's discussions as *"non-priority evening activities"* of some government economists (Sardenberg 1987: 135). This highlights that assent by the superior 'gatekeepers' at *Fazenda* and at the *Palácio do Planalto* represented a precondition for the plan's implementation.

Institutional factors affected the team along three dimensions. First, as **Figure 29** shows, the economic team was formally dispersed over the Ministries of Finance and Planning and the BCB. Secondly, in addition to being subject to diverging organisational logics, the team's economists *"were in subordinate positions in the decisionmaking apparatus"* (Pio 2000: 10). Hence, even the mere formalisation of their cross-ministerial working group on 22nd October 1985 depended on Sayad's and especially Funaro's assent (Arida and Lara Resende in Solnik 1987: 22 + 87; Skidmore 1988: 279-280; Skidmore 1999: 192). Thirdly, there was a power imbalance not only between the ministries and the subordinate BCB but

also between *Fazenda* and *Planejamento*. Since re-democratisation the control of short-term economic policy had been centralised in the Finance Ministry – at the expense of Sayad's Planning Ministry, which was left with the lofty task of *"formulating the plans for the future"* (Sardenberg 1987: 92). In discussions on immediate macroeconomic policy decisions *Planejamento* was deprived of many of its former tools and had to rely on – but could equally disrupt decisions with – its control over federal budgetary decisions and state-owned companies (Sardenberg 1987: 104; Sola 1991: 175).[16] This disequilibrium was exacerbated by Funaro's flamboyant character and his links to the business community, which had earned him particular influence with Sarney (Arida in Solnik 1987: 76).

Figure 29: Position of the *Plano Cruzado* Team within the Economic Bureaucracy



Source: Author's interviews with Pio, Lara Resende, Arida, LC Mendonça de Barros and Bacha; Solnik 1987: 22.
Note: Members of the *Plano Cruzado* team are noted in colour: blue font designates advocates of a heterodox programme, whereas red font indicates actors of a develomentalist conviction.

This constellation exacerbated ideological tensions among team members and, especially after the plan's implementation, exposed technical decisionmaking to inter-agency disputes that undermined policy coherence (Pio 2001b: 35). The developmentalists at *Fazenda*, Cardoso de Mello and Belluzzo, could exploit their affiliation to Funaro and became a counterweight to the more liberal-minded Arida and Lara Resende, who had been dominant in the drafting stage and were regarded as *"the principal brains behind the plan"* (*Istoé* 5th March

[16] Planning lost control over the Interministerial Price Council (CIP), the Special Secretary of Supply and Prices (SEAP) and the National Superintendence of Supply (SUNAB). Key anti-inflationary instruments were thus controlled by *Fazenda*. Sayad's personal relationship to Sarney also suffered from presidential doubts about his ties to traditional PMDB segments.

1986). Yet, in the post-drafting stage, their institutional affiliation with the, relative to Funaro, less influential Sayad and Bracher contributed to the loss of their prior central role (Arida in Solnik 1987: 75; Pio 2000).[17] Interbureaucratic conflict clearly determined decisionmaking. For instance, in the run-up to the *Cruzado II* Sarney excluded the BCB – and therefore input from Bracher, Lara Resende and Arida – and delegated the drafting of corrective measures to Funaro and Sayad. The result was an inconsistent set of measures, which reflected the Finance Ministry's wishes (except for public spending where Planning retained its institutional veto): no increases in interest rates or direct taxes, no cuts in public spending but some increases in indirect taxes (also Nervo Codato 2003a). In short, a set of cosmetic measures, which failed to provide the necessary fiscal and monetary discipline to ensure the sustainability of the price freezes.

The Side-lining of the CMN

With respect to institutional factors, the systematic side-lining of the CMN during the run-up to the plan is also noteworthy. Unlike the *Real* team, the *Cruzado* economists did not advance any proposals to reform the council. This suggests that members did not recognise the CMN as a genuine obstacle to disinflationary success and that they acknowledged the president's unwillingness to confront vested interests. Notably, the plan's architects only had indirect representation on the council (**Table 25** on p. 172). Nevertheless, interviews confirm that thanks to the active sheltering by the respective ministers, the team successfully either bypassed the council or marginalised non-executive council members by fostering closer and exclusive cooperation among cabinet members and government actors (Interviews Arida, Lara Resende, Sardenberg 1987: 42-43; Loureiro 2005: 36).

The Concept of 'Inertial Inflation'

A better conceptualisation of the heterodox shock logic, which offered a 'third way' to the classical dilemma between growth and stabilisation, and its ramifications for the negotiations leading up to the *Plano Cruzado* sheds further light on the roots of this technocratic autonomy and equally explains the subordinate role of the exchange rate in the final design of the plan.

There is little doubt that Arida's, Lara Resende's and (to a lesser extent) Lopes' expertise and their international prestige granted the team additional autonomy. The

[17] Arida's influence on Sayad is illustrated by the minister's *"Diretrizes Gerais de Política Econômica"* in May 1985, which became the first government document that made reference to 'inertial inflation' (Sardenberg 1987: 112).

technocratic aura generated by their unconventional reasoning and the issue's technical complexity raised the threshold for external intervention and facilitated the construction of a sphere of temporary autonomy from ministerial superiors and permanently defined the *Plano Cruzado*'s core contents. Moreover, the economists' focus on the inertial characteristics of price developments offered a politically appealing alternative to the orthodox recessionary measures that had failed to stabilise Brazil and another opportunity for Sarney to distinguish himself *"from the previous administration […] and to be the team associated with growth"* (Lara Resende in Solnik 1987: 158).

The failed experience with monetarist recipes in the early 1980s had led several economists (*economistas da oposição)* to conclude that these programmes had wrongly identified money supply excesses as causes of inflation (see e.g., Bresser Pereira and Nakano 1984: 27). From this observation, two alternative visions for stabilisation policy had emerged. On the one hand, Bresser Pereira and Nakano (1984) and Lopes (1984) focused on inflation as a function of past inflation, transmitted through formal (and informal) indexation of wages, prices and the exchange rate into current prices. General indexation (or *correção monetária*) had been introduced in 1964 and had come to take hold of virtually all domestic markets (Lara Resende and Lopes 1981; Diaz Alejandro 1983; Simonsen 1983; Coes 1995: 89; Neiburg 2004: 281).[18] For the military, indexation had constituted a *"socially and politically convenient instrument"* (Sola 1991: 164), insofar as indexation aligned wages and prices and temporarily accommodated distributive conflicts (Fishlow 1974; Kingstone 1999: 41). However, indexation merely addressed the symptoms of inflation and exacerbated domestic income inequality (e.g., Bittencourt 2006). Worse, it had introduced a strong inertial component to Brazilian inflation (Kingstone 1999: 41; Elliott Armijo 2005), which Bresser Pereira and Nakano argued could be broken by unannounced price and wage freezes (Sola 1991: 177).

This inertia diagnosis, described as a *"true theoretical innovation, a contribution by the Brazilian university landscape"* (Sardenberg 1987: 20), was shared by a second group of economists. Arida and Lara Resende focused on the role of inflationary expectations (rather than memory) in highly indexed economies. Diagnosing a similar inertial dynamic, they however opposed nominal price freezes as forms of involuntary contracting, which would petrify relative price imbalances (Arida in Solnik 1987: 90; Pio 2000: 6; 2001b). In contrast, their 1984 'Larida Proposal', which would become the backbone of the *Plano Real* eight years later, combined the tight control of the public deficit and the elimination of inflationary

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[18] Agriculture was exempted from indexation but compensated via the issue of subsidised rural credits. In the 1960s, general indexation had successfully stabilised prices. Yet, the 1973 oil shock exacerbated its inertial characteristics (Simonsen 1983).

inertia by resorting to generalized indexation (later on published as Arida and Lara Resende 1986).[19]

The fact that the *Plano Cruzado* eventually combined the substitution of the currency with a shock price freeze demonstrates that both proposals *"had undergone a process of synthesis"* (Sardenberg 1987: 226). Lopes had long been convinced of the merits of the 'Larida Plan', while Arida and Lara Resende had eventually agreed to the incorporation of a price freeze provided that it would merely constitute a short term measure lasting a maximum of 90 days (Lara Resende in Solnik 1987: 161). Arida and Lara Resende accepted this compromise once their proposal had run into constitutional difficulties[20] and it became clear that, due to its counter-intuitive nature, it could not mobilise the political support a straightforward price freeze enjoyed (R. M. do Prado 2005: 112). In particular, the 'Larida Plan' demanded a longer timeframe than policymakers, eyeing the November elections, were willing to grant (Solnik 1987: 90-91; Pio 2001b: 36).

Unveiling the intellectual origins of the *Plano Cruzado* also accounts for the subordinate role of the exchange rate. Technical discussions surrounding the regime to be adopted after the currency reform took on a rather marginal character. Crucially, neither Lopes' heterodox shock nor the 'Larida Plan' had addressed this aspect in greater detail, largely because the economists were operating with a closed economy model (R. M. do Prado 2005: 109 + 122). From this perspective, the *Cruzado*, similar to other prices, would simply be de-indexed and then fixed. Moreover, the centrality of the plan's 'shock' element and the necessity to keep the duration of the price and exchange rate freeze open meant that the exchange rate policy to be followed in the medium and long run received little or no consideration (Interview Arida; R.M. do Prado 2005: 109). Yet, in spite of the consensus in favour of abandoning the long tradition of the mini-devaluation system for the sake of the *Plano Cruzado*, exchange regime choice was not uncontroversial (Sardenberg 1987: 158-159).[21] Concerns about Brazil's balance of payments situation were subordinated to the goal of suppressing inflationary memory by pegging the new *Cruzado* to the confidence-inspiring US dollar (Funaro in Sardenberg 1987: 214). The exact rate at which to peg was subject to discussion but the team finally decided against a devaluation given that *"[t]he exchange rate to the*

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[19] This proposal was published in a three-part-article in the *Gazeta Mercantil* (27-28th September 1984) and presented as 'Inertial Inflation and Monetary Reform: Brazil' at IMF/IIE workshops in December 1984. It was only published in Portuguese in May 1986. The plan foresaw the indexing of *all* contracts at the *same frequency* to the *same* ORTN (*Obrigação Reajustável do Tesouro Nacional*), the most traded government bond, which would then be declared the new currency (*otenização*). Real rather than nominal prices would thus temporarily be frozen. The idea was that the voluntary conversion of contracts would break inertial inflation without violating the price mechanism. See R. M. do Prado 2005: 94-109.

[20] The plan's parallel circulation of two currencies was deemed unconstitutional. Arida's 1992 solution to this problem – creating a unit of account that would *not* be a unit of payment – was a prerequisite for the *Real* Plan.

[21] At the time, Carlos A. Sardenberg was Sayad's public relations director.

US dollar was good, i.e. depreciated enough to foster exports" and that *"contrary to Argentina, it was not necessary to create incentives for the repatriation of 'black money' from abroad"* (Sardenberg 1987: 159).[22] Hence, the authorities simply pegged the new currency to the going rate (Coes 1995: 132; Baer 2001: 163). This attitude to the exchange rate neatly illustrates the little consideration given to its role as 'nominal anchor' at this point in time and shows that, on the part of the economists, the commitment to the peg as long-term stabilisation device was weak.

The Politicisation of the Plano Cruzado

Once the blueprint progressed through the executive hierarchy, political demands increasingly shaped the decree-law. The economic team's dependence on presidential assent forced the economists to make a series of concessions *"to meet the political and circumstantial demands of that moment in time"* (Sardenberg 1987: 226). Sarney himself only became acquainted with the plan on 24th February 1986, that is only a week prior to its launch (ibid.: 228)! Yet, neither the short notice period nor the fact that he had not been able to *"follow this economic debate in great detail"* (ibid.: 105) stopped him from demanding last-minute modifications, which diluted the plan's consistency. Most importantly, Sarney seconded Labour Minister Pazzianotti's requests for a wage bonus and a 'wage trigger' as pre-emptive appeasement of organised labour.[23]

One crucial factor in explaining Sarney's interventions was his precarious relationship to the PMDB, the dominant partner in his governing alliance. He was forced to make extraordinary efforts to maintain the party's support as key members remained suspicious of his military past. Although the party leadership around Ulysses Guimarães had been excluded from the preparations, the party's open criticism of the administration exerted substantial pressure on Sarney, who sought to pre-empt further condemnations by means of policy concessions (Skidmore 1988: 288).[24] As Sardenberg recalls, *"[t]he stronger these criticisms, the more social and distributive the programme put together inside the governmental 'kitchen' became"* (1987: 228). According to the economic team, it was this politicisation of the plan's contents that provoked its eventual failure (Interviews Bacha, Lara Resende, and Arida). Especially the incorporation of the wage bonus was regarded as a fatal flaw (Baer and Beckerman 1989; Baer

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22 General indexation offered Brazilians an alternative to shifting into dollar-denominated assets or transferring financial assets abroad. Capital flight and dollarisation levels were thus low (Dornbusch et al. 1995: 263; Kaufman 1990: 64; Armijo Elliott 2006: 133; World Bank 2006: 30).

23 In my interviews, Arida and Lara Resende emphasised that these decisions were not only taken against their advice but that the wage bonus had even been agreed without their prior knowledge (also Pio 1999: 13).

24 The party's association with the stabilisation failures and members' dissatisfaction with the results of the Constitutional Assembly provoked the PMDB's debilitating split. The new PSDB, founded in June 1988, became the fastest growing party in Brazilian history and between 1994 and 2003 controlled the presidency under Cardoso.

2001: 145).[25] Over the course of 1986, incessant political manipulation of economic decisionmaking affected the economists' morale and weakened the administration's credibility (Arida in Solnik 1987: 128; Kingstone 1999: 40-42). Similarly, Sarney's unwillingness to confront vested interests and to address inflationary causes other than inertia meant that fiscal adjustment and monetary discipline proved insufficient to back up the new currency (Roxborough 1992: 647; Kingstone 1999: 40-41; Cardoso 2000: 73).

The Role of Electoral Politics

This exposure of macroeconomic decisionmaking to erratic presidential interference also opened the door to the disruptive impact of electoral politics (Bresser Pereira and Nakano 1987: xiii). Having shown that political phenomena *other than* merely electoral considerations shaped decisionmaking during this period, there is little doubt that the considerable electoral dividend for the PMDB in the November 1986 elections intensified Sarney's irrational attachment to the price freeze and to the frozen *cruzado* (Skidmore 1988: 304). As some of the literature expects (Frieden and Stein 2001; Leblang 2003; Blomberg, et al. 2005), electoral motivations also drove the excessive delay of exchange rate adjustment in 1986. In spite of the currency's sharp depreciation in parallel markets and a rapidly deteriorating trade balance, the fixed rate was only abandoned after the November elections (Cukierman, et al. 1992: 22).[26] In part, this reluctance was rooted in fears of a devaluation-inflation cycle set off by the wage *'gatilho'* and in concerns about accelerated capital flight (Baer 2001: 162 + 164). Moreover, genuine uncertainty about economic agents' response to an eventual liberalisation of prices and to an exchange rate adjustment was great among politicians and technocrats. Yet, the decisive factor in delaying adjustment seems to have been Sarney's reluctance to incur the short-term risks of adjusting the *cruzado* and endangering the *"direct appeal to the people over the heads of party and Congress"* the plan had offered (Flynn 1986: 1171) as well as his naïve belief that the day of reckoning could be postponed indefinitely (Weyland 2002: 85).

6.3.2 The Role of Societal Interests

Complementing the previous section, which highlighted the dynamics within the executive, this section addresses the role of societal interests in exchange rate policy decisions.

[25] This diagnosis is shared by Arida and Lara Resende (Loureiro 2005: 38), who argued that *"the Cruzado Plan was a good plan in terms of its theoretical coherence or technical correctness; its failure was due to the political constraints and to the populism of President Sarney and his party"* (Sardenberg 1987). This explanation enabled the return of the PUC-Rio economists to design the *Plano Real*.

[26] The authorities sought to relieve balance of payments pressures via an ultimately insufficient devaluation in October 1986.

In particular, I argue that the literature (e.g., Frieden 1997; Hefeker 1997; Frieden 2000; Frieden and Stein 2001) misconstrues interest group behaviour and overestimates their influence on exchange rate policy during this period in Brazil. Unlike Wise (2000: 11) states, domestic producers, for instance, have *not* been *"the most vociferous [...] in stating their currency preferences"* but on average have been accommodationist, disinterested and notably quiet on this policy issue. I argue that their misrepresentation stems from four factors.

First, due to Brazil's semi-closed economy at the time, the distributional impact of the exchange rate was limited and did not constitute a political priority for the vast majority of societal agents during most of the 1980s. This, however, changed with the advent of trade liberalisation after 1988, which intensified during Collor's *'abertura commercial'* from 1990 onwards. Secondly, in addition to this structurally limited interest in the exchange rate during most of the decade, several features of their political organisation reduced interest groups' potential for decisive policy influence and exacerbated collective action problems, such as associations' tainted public image, inter-associational as well as internal conflicts and a strategic re-orientation in the new democratic context. Thirdly, as section 6.3.1 showed, executive behaviour and the explicit insulation of exchange rate policy decisions from societal pressures put societal actors in a disadvantaged position with respect to obtaining relevant information, establishing policy positions and effectively influencing the formulation of policy once they had identified the exchange rate as an issue of interest. Finally, the literature tends to assess exchange rate policy in 'normal times'. Yet, the coincidence of democratic transition with rapidly deteriorating economic conditions made for a context of crisis and uncertainty, which rarely, if ever, resembled the literature's assumptions. Not only do societal actors, whether representing labour or business, confront a multitude of organisational obstacles to their member interests' effective articulation and representation in such contexts of simultaneous political and economic change where new modes of state-society interactions emerged, but the interests of societal groups are affected and have to be defended along multiple dimensions. This focuses all attention on a limited number of urgent issues with relatively greater mobilisation appeal rather than on technically complex issues where actors struggle to correctly identify their personal interests, such as the exchange rate. Reflecting this evolution, the analysis of societal actors' role in shaping exchange rate policy will be divided into three chronological periods covering the adoption and failure of the *Plano Cruzado* (1985-1987), the intermediate period of increasingly desperate macroeconomic plans (1987-1989) and finally the Collor years, when trade liberalisation coincided with a brief attempt at floating the *Cruzeiro* (1990-1992).

1985-1987: The Logic of the 'Heterodox Shock' – Secrecy and Exclusion

Brazilian society and especially the business community had great expectations for the Sarney administration. Frustrated with the military's economic policy agenda after the debt crisis, business had actively supported the transition to democracy from 1983 onwards (e.g., Frieden 1991a; Sallum Jr. 2004: 51). After initial disappointment with Dornelles' orthodox policies, business – and industry in particular – viewed the nomination of the former Fiesp director Dilson Funaro as reason for cautious optimism and hoped for more fruitful government cooperation (Vidigal Filho in Bianchi Mendez 2004: 193, also Frieden 1988). After all, *"for the first time in several decades a representative of the industrial bourgeoisie [was] in charge of the economy"* (LARR quoted in Smith 1987: 51).

Yet, these hopes were to be disappointed. Although there had been some overtures regarding a trilateral social pact in late 1985, these efforts quickly faded when confronted with technocrats' scepticism and union hostility (Roxborough 1992: 652; Payne 1994: 90; Cook 2002). Meanwhile, reproducing the technocratic style of previous authoritarian governments (Sola 1988; Loureiro 1997: 95), the decisionmaking processes that culminated in the pegging of the exchange rate at the outset of the *Plano Cruzado* took place behind the walls of, what industrialists often referred to as, the *'laboratório Brasília'* (Payne 1994: 87; Kingstone 1999: 40; Panizza 2000). This stands in stark contrast with expectations by scholars like Frieden (e.g., 1991b; 1994) and ought to surprise institutionalist scholars, who emphasise the role of institutional organs like the CMN and the representation they grant to business.

The secrecy[27] surrounding the *Plano Cruzado,* and similarly the *Plano Brasil Novo*, meant that measures were completely unanticipated putting societal interests in a position where, irrespective of their traditional links to the economic bureaucracy and to individual decisionmakers, they could merely react (Kingstone 1999: 40). From the outset, the plan's support base was vulnerable and incentives for cooperating with this 'top-down' programme limited (Kingstone 1999: 40; Weyland 2002: 82), and while society showed great enthusiasm about the plan's ***ultimate objective,*** stabilisation, consensus on the means or indeed on the distribution of sacrifices necessary for obtaining this ambitious goal was inexistent.

The business community's responses to the plan ranged from enthusiastic support to veiled scepticism, but little open opposition was recorded. Critics were largely marginalised by overwhelming public enthusiasm, which left little space to critics (Fortes 2004: 9).[28] The

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[27] The argument that secrecy in the planning stage was unavoidable so to preclude actors from scrambling for advantage prior to the freeze is less convincing when considering that a similar, more successful program in Israel involved extensive consultations with labour and business groups (Kaufman 1989: 400).

[28] With popular support for the plan exceeding 90%, the two most vociferous and yet isolated critics were Leonel Brizola, the

marginal importance of the decision to adopt an exchange rate peg in the eyes of business is proven by the lack of attention associations paid to this aspect in their public statements. Instead, their analysis centred on the price freeze and its implications for labour costs and contract conversion rules and was driven by a short-termism generated by a persisting crisis sentiment. As Kingstone (1999: 64) explains,

> the enormous difficulties and therefore the organisational costs of lobbying Congress or the executive on broad, encompassing issues [such as the exchange rate] made lobbying on narrow, private issues [such as special permits and credit lines] the only means of shaping the reform process.

These difficulties were exacerbated by the diversity of interests and their fragmentation across different representative associations in the absence of a peak organisation (Frieden 1988: 5; Payne 1992; Schneider 1998; Weyland 1998; Kingstone 1999: 114-115; Phillips 2004: 195). In part, this division stemmed from the low level of structural integration of industrial and financial capital in Brazil at that time, which left little room for congruent policy interests and spurred antagonisms between sectoral organisations (Barker 1990; Maxfield 1990: 178).

Industrial federations, such as Fiesp, which had replaced the CNI as the lead representative of Brazilian industry (Diniz and Boschi 1988; Kingstone 1999: 114; Phillips 2004: 195),[29] welcomed the plan as an alternative to the anti-growth orthodoxy, and approval ratings for the government were extraordinarily high among industrialists (Kingstone 1999: 42; Bianchi Mendez 2004).[30] The accommodationist attitude on the part of the associational leadership, however, did not reflect industry's overall assent to the economic programme. As shown by the government-friendly rhetoric over the course of 1986, which ignored members' growing dissatisfaction, this stance was strongly motivated by leaders' personal objectives: Given that five federation presidents were standing in the November 1986 elections, they preferred 'not to rock the boat' by criticising the popular administration (Bianchi Mendez 2004: 196). In contrast, the *Cruzado* Plan's approach to contract conversion and prices provoked a sceptical reaction from commerce and banking representatives (e.g., the Commercial Association of São Paulo (ACSP) and Febraban)(Neves Costa 2003; Bianchi Mendez 2004: 194). Their critical stance reflected the threat, which stabilisation posed to the

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populist PDT politician, and Jair Meneguelli, the CUT president (Panizza 2000: 185).

[29] Within Brazil's hierarchical corporatist system, the National Industry Confederation (CNI) had formally been the peak industry organisation since Vargas' times. Yet, by 1988, Fiesp had come to represent more than 50% of Brazil's industrial GNP (Schmitter 1971; Kingstone 1999: 114; Shadlen 2004).

[30] This reflected a boom in industrial production in the first three quarters of 1986 (Baer and Beckerman 1989).

financial sector's business model, which had been built around high inflation (Flynn 1986: 1158), and the acknowledgement that after years of overexpansion, price stability would demand restructuring and retrenchment (Skidmore 1988: 280; Sola 1991: 188).

More generally, business organisations' influence was hampered by their undergoing a process of organisational renewal in order to overcome their negative public image and to address internal demands for institutional reform (Kingstone 1999: 116-118). Their public reputations as closely associated with former authoritarian governments and as *"bastions of distinctly unentrepreneurial rent-seekers"* (Weyland 2002: 92) hindered the diversification of their lobbying strategies away from relying on backroom negotiations and special access to decisionmaking circles and towards a more open and opinion-making mode of participation in the democratic debate.[31] Similarly, democratisation had given new impetus to members' demands for reforms of the associations' structures away from 'big business' domination and towards a more equal participation of smaller firms (Weyland 2002: 93; Shadlen 2004). This re-orientation combined with the emergence of polarising new leaders (e.g., Mario Amato at Fiesp in 1986) further reduced the available organisational capacity for a pro-active engagement with the government on complex issues with little selective benefits, such as the exchange rate (Kingstone 1999: 131).

Moreover, over decades the mini-devaluations strategy had largely depoliticised exchange rate policy and had removed the topic from organisational agendas insofar as individual firms would lobby for selective protection or government subsidies instead of seeking to influence the exchange strategy *per se* (Zini Jr. 1995: 125). Confronted with an exchange rate peg, business actors had to re-assess their exchange rate preferences and re-develop an active policy stance in this field. Nevertheless, studies of business' behaviour illustrate that the exchange rate only took on a marginal role at best in associations' political agendas, which instead concentrated their political resources on issues such as price legislation, labour relations and the protection of property rights in the context of constitutional reform (e.g., Payne 1992; Schneider 1998; Weyland 1998; Kingstone 1999).

These difficulties in coherently articulating exchange rate policy interests were exacerbated by the executive's unilateralist attitude. For instance, due to the systematic marginalisation of the CMN in macroeconomic policymaking, business also lost previously institutionalised access to exchange rate policymaking. Having traditionally been best represented in the CMN, this affected the financial sector in particular and reduced the

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[31] Part and parcel of this diversification was the growing number of Congressmen from business circles from 1986 onwards when *"somewhere between one-fifth and one-half of the deputies elected […] had business backgrounds"* (Schneider 1998: 105).

council to an exclusive forum for socialisation and the articulation of sectoral interests as well as for information exchange (Minella 1988).[32]

Organised labour equally struggled to respond coherently to the *Plano Cruzado*. The plan's novel approach to disinflation disrupted the traditional context of wage bargaining and forced the union leadership to re-evaluate its tactics. Unwilling to simply accommodate the plan and eager to exploit their revitalised political position, union representatives like Joaquim dos Santos Andrade (President of the *Conferencia Nacional das Classes Trabalhadoras*) argued that *"[t]he package was about 97% right"* (Payne 1991). Ironically, unions' critique targeted the wage adjustment formula, which Sarney had introduced precisely as a pre-emptive concession to labour (Skidmore 1988: 295). Workers' real wage increases quickly silenced these complaints and frustrated union leaders, who concluded that *"[their] people are confused and still don't see the truth hidden in this Decree Law"* (Luís Gushiken (Bank Workers' Union of São Paulo) in Flynn 1986: 1173). Similarly effective in placating workers was the announcement that the Minister of Labour and a working class representative would be incorporated to the prestigious CMN.

In addition to the credibility loss as a result of unions' miscalculation of the plan's distributional effect, labour's political influence was constrained by internal divisions as well as by the movement's radicalised public image (Weyland 2002: 91). Aside from geographic and sectoral groupings, workers were divided between the confrontational CUT (*Central Unica dos Trabalhadores* – Central Workers' Union) and the moderate CGT (*Confederação Geral dos Trabalhadores* – General Workers' Council)(Roxborough 1992: 654; Cook 2002) and disagreements over strategy and policy priorities repeatedly reduced labour's capacity for effective protest and policy influence. Finally, similar to business, organised labour had little awareness of its members' interests with respect to the exchange rate after decades of operating under a mini-devaluations system. Used to the inflationary but highly indexed environment of a semi-closed economy, unions lacked technical expertise as well as the manpower and financial resources to quickly develop a position on this variable.

The first sustained critique of the government's unilateralist approach emerged in response to the *Cruzado II* measures in November 1986 and strengthened hand-in-hand with the rapid erosion of public support that culminated in episodes of public unrest and looting (Kingstone 1999: 226). The impact of price deregulation on consumer prices united the unions and won them new supporters among disgruntled white-collar workers. This paved the way for the first general strike on 12th December 1986, which heralded, as **Table 31**

[32] While the potential policy influence generated by such public-private encounters should not be underestimated, it could not compare with the sector's *de facto* political weight in previous periods (Minella 1988).

shows, a period of intense industrial action (Antunes and Wilson 1994). Concomitantly, individual businessmen began to vigorously criticise their associations' accommodationist stance (Kingstone 1999: 118)[33] and especially those members who enjoyed individual access to decisionmakers began to withdraw their active participation from business associations (Skidmore 1988: 305; Payne 1992: 4).

Table 31: Strikes in Brazil, 1985-1988

	1985	1986	1987	1988
No. of strikes	843	1,493	2,259	1,914
Days missed	4,635	7,842	18,291	17,883
Striking contingent	6.64 mio	7.15 mio	8.30 mio	7.14 mio
Workdays lost*	48.81 mio	32.19 mio	58.96 mio	63.50 mio

Source: Antunes and Wilson 1994: 28. * Number of striking workers times the average number of days on strike.

Notably, the effects of the accumulating real overvaluation on Brazil's export competitiveness in the months prior to November 1986 did not play a central role in the growing political confrontations between societal actors and the government. Instead, affected exporters – yet a small minority – resigned to using their market power to affect policy change. Given Brazil's reliance on foreign exchange generated by the private sector to continue debt service, exporters possessed a powerful trump in purposefully delaying contracts and thus provoking balance of payments crises (Sola 1991: 188 + 190; Pio 2000: 16; Garofalo Filho 2005: 137). However, although societal interests did not problematise the exchange rate strategy of the *Plano Cruzado*, their pressure in other fields of public policy led Sarney to make decisions against his advisors' recommendations that undercut the sustainability of the exchange regime. Ranging from pre-emptive concessions to labour to the president's reluctance to confront vested interests in far-reaching tax and trade reforms, aggregate societal pressure determined the context within which exchange rate policy was developed but did not explicitly target the policy variable itself.

1987-1989: Growing Opposition in a Context of Politico-Economic Instability

In the aftermath of the failed *Cruzado* Plan, societal opposition to the executive's erratic economic policy agenda strengthened. Representative associations had overcome the initial phase of organisational renewal and hence had developed greater institutional capacity for articulating their interests in a democratic setting. Yet, given the intransigency of the economic bureaucracy, heightened public critique did not translate into greater influence in

[33] E.g., instead of communicating members' discontent, Fiesp president Amato chose to express industrialists' whole-hearted support for the government. See Mario Amato (1986), "Os Amplificadores da Crise," *Indústria e Desenvolvimento* XX: 50.

the policymaking process, and organised society's impact on the policy agenda remained minimal. Moreover, due to the persistent relative insulation of domestic markets from international competition thanks to tariff and non-tariff barriers, the exchange rate continued to be pushed towards the lower end of associations' priorities.

Business opposition to government policy took on a more organised and confrontational character in this period. In a letter to Sarney in January 1987, the presidents of several sectoral associations demanded a *"new and serious programme of economic recovery"*, the end of unpredictable initiatives and greater private sector participation (Bianchi Mendez 2004: 199). Tensions had accumulated since the *Cruzado II* and were exacerbated by the on-going negotiations on constitutional reform. In particular, generous provisions with respect to labour rights, redefinitions of property rights in the context of agrarian reform and greater state interventionism threatened the operational business environment (Cardoso 2006b: 112). Yet, even in this context *"business associations did not consistently challenge the government's economic policies"* (Payne 1992: 6). Instead, they vacillated between support for and opposition to Sarney. Fernando H. Cardoso (then a member of the Constituent Assembly) recalls, business only *"mobilised intensively around some carefully selected nevralgic points to bundle attack"* (Cardoso 2006b: 117). Notably, the exchange rate, which since November 1986 had returned to the mini-devaluation rule, did not represent one of these 24 'nevralgic points' (Lehman and McCoy 1992: 616; Payne 1992: 5; Schneider 1998: 106).

By 1988, disappointed by the new constitution, policy reversals and high ministerial turnover, businessmen had given up their hopes for economic recovery under Sarney and lobbied to bring forward the 1989 elections (Payne 1994: 93). In their eyes, the administration had lost all credibility, and unmanageable uncertainties rendered cost planning and long-term thinking impossible (Kingstone 1999: 103). Tellingly, businessmen's level of dissatisfaction with the leadership of their representative associations was similarly high, as illustrated by the controversial Fiesp elections in 1989 (Payne 1992: 23; Schneider 1998). In the absence of an influential peak organisation and with defenders of the defunct ISI-corporatist model still dominating the higher echelons of most associations, businessmen who increasingly embraced neoliberal concepts sought to exploit individualised access to policymakers and established alternative modes of representation. These efforts had culminated in the foundation of the PNBE (*Pensamento Nacional das Bases Empresariais*) in 1987 and in the establishment of the IEDI (*Instituto de Estudos para o Desenvolvimento Industrial*) in 1989 (Schneider 1998; Kingstone 1999: 110; Sallum Jr. 2004). Yet, whilst providing business with two innovative tools for influencing the public debate, these developments also split the

community and weakened the associations by forcing their leadership to contain bitter internal struggles so as to ensure institutional survival.[34]

Union opposition and strike activity strengthened with every failed stabilisation plan (Antunes and Wilson 1994). Benefiting from the lessons of labour's lobbying successes in the constitutional assembly and from the movement's close links to one of the key opposition parties, the *Partido dos Trabalhadores* (PT), organised labour became increasingly effective in mobilising members of Congress in its favour as is illustrated by the protracted approval of the 'Summer Plan' in January 1989 (Cook 2002: 8; Sallum Jr. 2004: 56). These legislative activities were underpinned by another general strike in March 1989 demanding the restitution of real wage losses accumulated since 1986 (calculated at around 41-49%)(Antunes and Wilson 1994: 28). Yet, given the little impact of these efforts, labour eventually resigned to concentrating efforts on the preparations of the PT's presidential campaign.

1990-1992: From Hope to Utter Disappointment under Collor

The role of societal interests in exchange rate politics during the Collor presidency and especially with respect to the 1990 decision to float the currency and to then resort to regular market interventions to mediate appreciation can also be explained using the three dimensions of executive insulation, organisational capacity on the part of organised interests and the ranking of the exchange rate issue on organised interests' lists of political priorities.

With respect to the degree of insulation from societal interests, Collor's economic team initially enjoyed even greater autonomy from outside pressures, and societal actors' scope for effective policy influence was very limited. First, the team was effectively sheltered from outside pressures by Collor's strong presidential prerogatives, by the great legitimacy conferred to him by the victory in the first direct elections and by his high approval ratings, which permitted him to follow an inherently anti-institutional path that systematically sidestepped Congress. As Weyland (1993: 4) points out,

> Collor's very insulation from conventional channels of political power meant that those in the business sector, accustomed to seek favours from the state […], now found many of their customary links to that state either severed or far less functional than in the past.

These customary links were also weakened by the composition of Collor's economic team. Individual members were overwhelmingly rooted in academic circles or were businessmen.

[34] Fiesp president Amato expelled PNBE members in December 1988 (Kingstone 1999: 133).

Links to traditional corporatist actors were weak given that Collor had rejected all external suggestions for nominations to the key economic ministries and had instead appointed the little-known academic Zélia Cardoso de Mello to *Fazenda* (Payne 1992: 20; Panizza 2000).

Secondly, as part of his strategy to present himself as an 'outsider', Collor had antagonised organised business as much as organised labour with his neo-populist appeal to individual citizens and through outright attacks on Brazil's corporatist apparatus. As a result, conservative politicians and business had only closed ranks behind him once the choice was between him and the Socialist da Silva (Kingstone 1999: 152-153). Meanwhile, Collor rejected Fiesp's endorsement and refused to enter formal alliances with any interest groups (Weyland 1993: 8-9). Although arguably weakening his long-term political success, this attitude granted the presidency the necessary latitude to implement the *Plano Brasil Novo* with its drastic asset freeze and revolutionary shift to a floating exchange rate as well as the wide-reaching programme of trade liberalisation without consulting societal interests (Cardoso 2000: 73; Panizza 2000: 185).[35] Completing this picture, an overwhelmingly positive coverage of the plan in Brazil's media and a National Congress that had shifted towards the right of the political spectrum provided additional, if temporary, insulation for the executive (Boito Jr. and Randall 1998: 78; Kinzo and Dunkerley 2003: 300).

By 1990, the institutional capacity of key organised interests had adapted to the democratic setting and efforts to reform representation by granting greater weight to expertise and sectoral coverage in the associations' boards of directors generated hope for *"more effective leadership in the business community"* (Payne 1992: 23). Yet, the unilateralist imposition of the Collor Plan once more underlined the exclusion of corporatist agents. This is nicely illustrated by Alysson Paulinelli, the National Farmers Federation's president, who compared entrepreneurs' sentiment with the sensation of *"jumping out of the 21st floor and, on passing the 10th floor, still feeling the breeze because the impact has not yet hit"* (NY Times 17th March 1990).

This lack of influence was exacerbated by renewed internal divisions, brought about by the emergence of neoliberal ideas since the early 1980s and deepened by Collor's neoliberal project. In the absence of consensus among entrepreneurial elites, the ideological change in the executive strengthened some members of the community at the expense of others (Filgueiras 2000: 86; Sallum Jr. 2004: 57). For instance, the dissidents of the PNBE and the IEDI temporarily became *"Collor's preferred business interlocutors"* (Kingstone 1999: 136)[36] while

[35] Business constituted a 'captive community' for Collor, whom he did not owe anything once in office (Kingstone 1999: 153).

[36] After the Collor II Plan, the PNBE revised its course and joined other associations in criticising the administration. IEDI's turnaround took place a year later when it attacked the de-industrialising effects of Collor's programme of commercial opening in the absence of sustained stabilisation (Kingstone 1999: 136-140).

the Fiesp leadership, which continued to hold on to more protectionist idea(l)s, was largely excluded. This increase in influence of the new associations outside the established corporatist framework escalated conflicts within Fiesp (Kingstone 1999: 63). Furthermore, the structural change resulting from Collor's liberalisation and deregulation initiatives split firms across and within sectors depending on their exposure to heightened competitive pressures and their ability to exploit new commercial and financial opportunities (Weyland 1993: 11). The struggle for survival on the part of many (especially smaller) firms was worsened by the systemic decline in competitiveness during the previous decade when investment in infrastructure and production facilities had repeatedly been put off and by reduced domestic demand due to recession (Kingstone 1999: 38; Baer 2001).

Divisions within organised labour equally intensified during this period as a result of tensions between the CUT and the CGT and due to the emergence of a new labour organisation in the form of the *Força Sindical* (FS) in 1991. The rise of the FS, which united smaller unions from the interior, exacerbated traditional differences between the CUT and the CGT given that the FS had opted, similar to the CGT, to support elements of Collor's neoliberal policies, which the CUT opposed (Roxborough 1992: 655; Boito Jr. and Steiger 1994: 12; Boito Jr. and Randall 1998: 73; Tumolo 2004: 12). In addition to these disputes, the change in the trajectory of Brazil's key unions during this period was also driven by the on-going recession, which contributed to a drastic diminution in strike activity: After 12.4 million workers participated in strikes in 1990, participation fell to 2.9 million by 1992 (Costa 1995). Simultaneously, between August 1990 and September 1991, a change in strategy was taking place within the CUT, the largest union. Reacting to the end of the Cold War and the collapse of the Soviet Union, the leadership around Jair Meneguelli abandoned the 'defensive' and 'merely reactive' unionism of the 1980s in favour of a 'unionism of proposals', which aimed to enter a critical dialogue with the government (Tumolo 2004: 13).

These tensions within organised labour and business were exploited by the Collor administration as the failure of his audacious stabilisation plan became undeniable. Collor eagerly consulted PNBE and IEDI members while bypassing other business associations. Similarly, he co-opted some elements of the labour movement while ostracising others. For instance, he chose Rogerio Magri – associated with the reformist branch – as his Labour Minister whilst provoking great antipathy from the CUT after withdrawing from another attempt at a social pact (Roxborough 1992: 655). Overall, Collor and his administration repeatedly used their advantageous position and the attention of the Brazilian media to allocate blame for the failed plan with the business community and successfully proliferated

associations' image as old-fashioned rent-seeking organisations (Kingstone 1999: 171-172).

Yet, what marks the most distinct change in this period and set the scene for years to come, is the slow emergence of the exchange rate policy issue among the higher political priorities of organisations representing business interests. Due to the effects of trade liberalisation, which removed (many of) the highly selective forms of protection and export incentives that had served as *"substitutes for a depreciation"* (Pinheiro and de Almeida 1994; Coes 1995: 128; also see Baer 2001: 231) and with room for negotiating selective protection being decimated, the focus turned to the exchange rate itself. Now that the variable had taken on an increasingly decisive role in determining not only disinflationary success but also profit rates, market shares and export potentials of different economic sectors, its importance in the eyes of businessmen grew (Pio 2000; Hay 2001; Fernández 2002). As Oliveira (1993: 19) shows, businesses struggled not only to compensate for the appreciation but also to accommodate exchange rate variability as hedging mechanisms available at that time remained underdeveloped. Although in 1990 62% of the surveyed firms approved of the floating exchange rate regime with only 9% preferring a fixed rate, 48% of the consulted businessmen identified the appreciating exchange rate as an obstacle to the successful opening of the Brazilian economy, superseded only by the factors 'infrastructure' (67%) and 'recession' (49%). Especially firms operating in the more exposed capital goods sector expressed concerns (ibid.: 24).

As the recession deepened, business began to exert comprehensive and systematic pressure on the administration regarding the exchange rate. Rather than directly accessing technocrats, affected firms sought to influence policy using all channels at their disposition. They exploited private relationships to the political echelons of the economic bureaucracy and tried to push the issue onto the agenda of representative organisations. By doing so, business magnified the role and frequency of politically-motivated presidential interventions vis-à-vis the economic team. In conjunction with technocratic concerns about balance of payments imbalances, these pressures made an important contribution to Collor's decision to refrain from pursuing a fully floating exchange rate and instead to resort to irregular interventions to counteract appreciation after mid-1990 (**Figure 26** on p. 181). Once this took place, the exchange rate issue quickly shifted out of the limelight. By 1992, a CNI survey suggests that 60.4% of respondents regarded the exchange rate still as an important but notably more subordinate obstacle to 'adjustment', which was superseded by the role of the 'domestic tax burden' (91.2%), 'uncertainty' (79.6%) and the 'lack of credit' (76.3%) (Kingstone 1999: 184).

In summary, overall, the influence of societal interests on exchange rate decisions was

minimal. In addition to being excluded by the executive, this marginal role resulted from a lack of organisational capacity on the part of organised interests and, most importantly, from the low ranking of the exchange rate issue on organised interests' lists of political priorities during a period of fundamental politico-economic change. The marked but temporary rise to importance of the exchange rate issue in 1990 highlights two key insights for understanding exchange rate politics in subsequent decades: the impact of trade liberalisation on policy dynamics and the persistent attenuating effect of political organisation on the articulation of exchange rate policy interests.

6.3.3 The Role of External Factors

In the aftermath of the 1982 debt crisis, the external context, i.e. both relationships to international actors and structural conditions in international capital markets provided key parameters for exchange rate policy. As many scholars have argued (e.g., Boughton 2001; Sallum Jr. 2004: 56; Woods 2006), the resulting loss of access to international capital markets and the necessity to generate growing quantities of foreign exchange in order to meet interest payments increased the leverage of international actors and thus introduced an additional political dimension and considerable tensions to the dynamics of exchange rate policy during this period (Kaufman 1989). In addition to sovereign creditor organisations, such as the Paris Club, the role of the IMF in influencing exchange rate policy deserves special attention not only because of its formal role as institution entrusted with exchange rate surveillance responsibilities but given its role as gatekeeper to creditor negotiations and source of finance. Yet, compared to Argentina, Brazil enjoyed considerably greater room for manoeuvre in its dealings with its creditors and the IMF. Brazil's relatively diversified industrial economy with a considerable export sector and a comparatively low tendency towards capital flight permitted a more militant posture (Kaufman 1989: 400).

The IMF and Brazilian Exchange Rate Policy during the Plano Cruzado

Brazil's relationship to the international financial community went through various phases in the aftermath of the debt crisis. Given its *"unhappy experiences with the IMF during the late 1950s"* (Diaz Alejandro 1983: 534-535), Brazil had avoided agreements with the IMF until December 1982 (Bonelli and Malan 1987b: 39; Martone 2003: 144). Even during the ensuing two-year EFF programme, relations to the Fund continued to be 'painful' (Dias Carneiro in Baer 2001: 101) and were marked by repeated non-compliance (Boughton 2001: 372; de

Almeida 2004: 11). The ensuing recession permanently marked Brazilians' relationship to the IMF, which ever since has been considered harmful to national economic well-being (Baer 2001: 102; Cardoso 2006b: 114).[37]

Sarney's new democratic administration was thus left with the 'unfinished IMF business' and outstanding negotiations to reschedule US$ 45.3 billion due between 1985 and 1989. Although the IMF appeared eager to complete an agreement with the newly elected government, cabinet unanimously decided *against* an involvement of the Fund after the purge of the pro-IMF Finance Minister Dornelles. This stance was feasible thanks to Brazil's strong foreign reserve position and positive growth developments (Skidmore 1988: 255; Martone 2003). The final year of the EFF agreement was thus not activated (Lehman and McCoy 1992: 613).[38] Although this antagonistic posture had repercussions for the renegotiation of private and public debts as creditors refused to enter negotiations without an IMF agreement, these circumstances did not prove sufficiently threatening for the administration to revert its course (Boughton 2001: 384).

Antagonism to the IMF also shaped the *Plano Cruzado*'s intellectual roots and public presentation: Especially President Sarney went to great lengths to frame the plan as a break with the IMF influence of the past (Kaufman 1989: 400). Similarly, Brazilian economists criticised IMF practices and demanded a more differentiated diagnosis that took into account Brazil's particular history of inflation (Sola and Kugelmas 2006: 89-90). *"Confident in Brazil's capacity to formulate and implement a stabilisation programme without foreign interference"* (Bonelli and Malan 1987a: 57), especially thanks to the international praise Arida and Lara Resende had received since late 1984, the authorities decided to embark on the preparations for the programme without informing the Fund. Compared to the 1990s, the 'stamp of approval' the IMF could offer and its technical advice were not valued as highly in a context where capital inflows were unlikely to resume any time soon and where private capital inflows were yet of marginal importance. Nevertheless, concerns about the future relationship to the Fund motivated BCB President Bracher to, at least, 'indirectly communicate' the implementation of the plan by faxing Brazil's IMF representative a copy of the official press release (Sardenberg 1987: 296).

Scepticism at the IMF regarding this heterodox programme was strong. Yet, acknowledging the public enthusiasm in Brazil as well as initial successes in terms of reducing inflation whilst maintaining growth, the Fund followed the *Plano Cruzado* from afar. The

[37] For detailed coverage of this episode, see Boughton 2001:372-384.

[38] Funaro's confrontational stance vis-à-vis the IMF is also illustrated by his attempts to prevent the external debt negotiations from being linked to an IMF agreement (Lehman and McCoy 1992: 613).

IMF's attitude towards the plan was softened by the reaction of the international financial community, which – rather prematurely – jubilated that *"[t]he Plan has worked wonders for the inflation"* and that these policies *"provide Brazil [with an] opportunity to be the first Latin American country to recover normal access to international capital markets"* (Morgan Guaranty Trust Company in August 1986 in Lehman and McCoy 1992: 614).

The Brazilian authorities reacted to creditors' intransigent stance in the debt renegotiations with a two-level strategy: Although Sarney continued to publicly display his antipathy for the Fund, Funaro took up a more conciliatory position in private negotiations with IMF staff. This was acknowledged by Managing Director de Larosière in October 1986 when he expressed *"his sympathy and admiration for the very courageous actions taken in Brazil"* (Boughton 2001: 456) for the first time and proposed 'enhanced contacts' (as opposed to formal monitoring) to normalise Brazil's creditor relations.

The IMF in the Aftermath of the Plano Cruzado

However, the international community's goodwill ended abruptly in reaction to Sarney's debt moratorium on 20th February 1987 – only a month after the debt rescheduling request had finally been approved. While Brazil lived through one more failed stabilisation attempt and formal negotiations were frozen, international private actors – especially banks – increased pressure on the government to return to the negotiating table by clamping down on trade credits (Kaufman 1989: 403). In June 1988, a new programme was agreed with the IMF, which shortly after precipitated an agreement with the Paris Club (Boughton 2001: 529; Martone 2003). However, once again, commitment to the program was compromised by short-termist political imperatives, including the approaching presidential elections, which ruled out compliance with IMF conditionalities and put an end to cooperation with the Fund (Cardoso 2000: 73; de Almeida 2004). Brazil's intransigence continued under President Collor, which meant that from March 1989 until November 1998, *"Brazil lived without the formal supervision of the Fund"* (Martone 2003: 142).[39]

This account of Brazil's volatile relations to the international economic community highlights the limitations of effective policy influence on the part of the international financial institutions during this period. Given that Brazil was under no contractual obligations to the IMF in the run-up to and over the course of the *Cruzado* Plan and enjoyed temporary breathing space with respect to international reserves, the authorities chose not to consult the

[39] In January 1992, another stand-by agreement remained largely ineffectual and expired in August 1993 (Cardoso 2000: 74).

IMF on its exchange rate policy. More importantly, even where conditions were stipulated and underpinned by an agreement, the IMF refrained from defining requirements with respect to the exchange rate (see Boughton 2001). Similarly, even public criticism by the IMF or the withholding of supportive statements at the outset of the *Plano Cruzado* had little constraining force insofar as the IMF's public image in Brazil was so negative that the executive could instrumentalise IMF disputes so to generate nationalist backing (e.g., Collor's demands for the head of the IMF mission to resign in July 1991). Yet, although not yet of great significance during this period, the long-term impact on exchange rate policymaking of multilateral agencies' activities especially in the social construction and diffusion of neoliberal ideas from 1988 onwards should not be underestimated, as Chapter VII will show (Biersteker 1995; Sallum Jr. 2004).

6.4. Concluding Remarks

> *The Cruzado Plan, which brought such hope […], was dissolved by the fiscal incontinence and, once again, relaunched popular depression and led to the discrediting of the political class.*
>
> Cardoso (2007: 106-107)

As Cardoso's statement illustrates, the 1980s entered Brazilian history as a period of bitterly disappointed hopes. Nevertheless, this dramatic failure of the *Plano Cruzado* also set off a process of intense policy learning among Brazil's political class and especially its lead economists, which culminated in the successful stabilisation of the *Plano Real*. In addition to drawing out the historical legacies of the 1980s for subsequent periods, this chapter highlighted the legacy of the mini-devaluations system for the executive's approach to exchange rate policy as well as the societal dynamics around this issue during this period.

With respect to the drivers of the erratic exchange rate policy course, this chapter – similar to Chapter IV – emphasised the extent to which high executive insulation in and of itself proved insufficient for achieving a sustainable exchange rate strategy during the 1980s. This is a somewhat counterintuitive conclusion given the depth of the democratic transition literature, which emphasises the need for insulation if reforms and stabilisation are to be successfully implemented (e.g., Haggard and Kaufman 1992; 1995), but chimes with Armijo Elliott's perspective (2005; 2006), which emphasises the positive impact of mass democracy in this respect. Indeed, if we accept that the building of conflict-mediation institutions is essential for durable stabilisation, unilateralist shock solutions like those associated with the

plans of the 1980s are clearly suboptimal. Moreover, relative insulation from external factors, be they foreign influences or societal pressures, does not preclude irrational and erratic decisions. To date, this aspect has not been captured by institutionalist accounts, which tend to oversimplify the executive decisionmaking process and fail to problematise the role of a constitutionally empowered president acting in a context of weak institutional norms and internal divisions. Similarly, societal interests' helplessness vis-à-vis exchange rate decisions should be sobering evidence for interest group scholars. In addition to being actively excluded, organised interests often disqualified themselves from being influential contributors to exchange rate policymaking by failing to assign political importance to this policy field and struggling to develop a coherent strategy of articulating sectoral interests.

C H A P T E R   V I I

BRAZIL IN THE 1990S

The exchange rate has been at the very core of the complex political economy surrounding the stabilisation and reform process in Brazil during the last few years.

Gustavo Franco (2000: 1)

7.1. Introductory Remarks

As shown in Chapter VI, Brazil struggled to achieve macroeconomic stability in the 1980s. In turn, many commentators highlight the paradigmatic change induced by the *Real* Plan and its structural reform agenda since 1994, which paved the way for improvements in macroeconomic 'fundamentals' and contributed to Brazil's current long-term growth prospects (Goldman Sachs 2003).[1] Similar to Argentina's experience and illustrated by the above quote by Gustavo Franco, the intellectual 'father' of the *Real* Plan's strategy of a *'câmbio valorizado'* (appreciated exchange rate) serving as *'âncora cambial'* (exchange rate anchor), exchange rate policy was key to these reform efforts. The exchange rate, its level and sustainability have also repeatedly been at the centre of a highly polemical public debate that overlaps with a wider on-going dispute within Brazilian society about Brazil's mode of insertion into the world economy. Indeed, while Franco and other liberals are adamant that *"[w]ithout the exchange rate anchor it would not have been possible to defeat hyperinflation"* (Franco 2006: 331), others have described the exchange rate stance of the 1990s as merely creating 'the illusion of stability' at the expense of heightened external vulnerability and growing domestic inequality (Amann and Baer 2000; Falção Silva 2001; Saad-Filho and Mollo 2002). Contrasting Brazil's tendency towards overvalued exchange rates in (recent) history with the development strategy of East Asian economies, which grew against the background of relatively undervalued exchange rates, these critics caution that this exchange rate stance will hinder Brazil's long-term development (Gala 2004; 2006).

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[1] Brazil is not only one of the BRIC economies identified by Goldman Sachs (2003), its longterm sovereign credit ratings have also been upgraded in mid-2007 to BB+ bringing the country within one step of an 'investment grade' rating.

Against the background of this controversy, this chapter demonstrates that existing accounts of the drivers of exchange rate policy choice during the period between 1993 and 1999 from institutionalist and interest group perspectives provide only very partial explanations. Institutionalist theories rightly direct our attention to the centrality and relative autonomy of executive policymakers, but their explanatory tools fail to capture the dynamic constraints inherent to Brazil's exchange rate policy institutions and do not problematise the extent to which questions of exchange regime choice proved internally divisive and thus at times contingent on personalities and personal relationships in and across institutional roles.

Similarly, interest group arguments are partially vindicated insofar as Brazil witnessed a growing politicisation of exchange rate policy matters over the course of the 1990s. This perspective also correctly highlights that Cardoso's decision to devalue in 1999 represented an attempt to appease increasingly vociferous critics. However, it has little to contribute to accounts of why a highly insulated team of technocrats opted for a stabilisation strategy that increasingly hinged on an exchange rate 'anchor' in the first place and why the executive could ignore this opposition for a significant period of time. These explanatory weaknesses are largely due to these accounts shedding little light on the *de facto* positioning of societal interests over time. Indeed, putting into question some of the underlying expectations of interest group explanations, the Brazilian case shows that societal actors struggled to identify and pursue their exchange rate policy interests. Therefore, their lobbying behaviour generated an outcome that diverged considerably from a simple map of sectoral cleavages inferred from socio-economic structures as interest group accounts would have it.

Furthermore, what both accounts fail to acknowledge is the potential political use of the exchange rate above and beyond distributional considerations in the narrow sense, that is for instance its instrumentalisation in internal power struggles and also in wider ideological debates as it was the case when developmentalist critics targeted the strong *real* as a proxy for the administration's reform agenda and especially its 'growth-cum-debt' model. Similarly disregarded is the role of external actors, of the IMF and of the international community of economists in interfering with the interactions between the government and the wider public insofar as they validated and praised the authorities' policy course and thus delegitimised the gradually emerging domestic opposition.

Seeking to integrate these insights, this chapter sets out to analyse the internal mechanisms of exchange rate decisionmaking, which so far have often been treated as a so-called 'black box'. The remainder of this chapter is organised as follows. Section 7.2. provides a historical overview of the key exchange rate decisions and relevant institutional changes in

this policy area over the course of the 1990s. In doing so, it prepares the ground for section 7.3., which applies this thesis' argument to the four key episodes of exchange regime change during this period by focusing on the interplay between and the relative importance of the executive, the role of societal interests and the role of external agents. Section 7.4. concludes.

7.2. Historical Overview of Exchange Rate Policy in the 1990s

This section provides a historical overview of exchange rate policymaking and its institutional evolution. In doing so, it concentrates on four key episodes of the *Real* Plan.

7.2.1 No Fear of Floating? Opting for a floating *Real* at the outset of the *Plano Real* in July 1994

The aftershocks of the political crisis surrounding President Collor's impeachment in late 1992 had resulted in rapidly deteriorating economic conditions partly due to interim-President Itamar Franco's inability to address Brazil's notorious fiscal imbalances. Unemployment had risen to 4.5% during the 1992 recession, and average monthly inflation exceeded 30% in 1993 (Baer 2001: 187). Against a background of high ministerial turnover at *Fazenda*, President Franco's economic policy agenda only gained definition with the appointment of his fourth Finance Minister Fernando Henrique Cardoso in May 1993. From the outset, Cardoso was determined to address Brazil's three problems – 'inflation, inflation, inflation'. Thanks to a political mandate for stabilisation and considerable decisionmaking autonomy, which he had negotiated with Franco as a prerequisite for accepting the post, he had attracted a group of high calibre economists (Interview Cardoso). Shortly after, on 14th June 1993, this new '*equipe econômica*' (**Table 32**) made a first attempt at fiscal adjustment by means of the 'Immediate Action Plan' (*Plano de Ação Imediata*).[2]

With respect to the exchange rate, Cardoso's team initially maintained the 'dirty float' and, for largely administrative reasons, merely opted for a currency reform, which replaced the *cruzeiro* with the *cruzeiro real* at a rate of 1,000:1 on 1st August 1993 (Garofalo Filho 2005: 143; Mosley 2005)(**Table 33**). The administered float also operated during the initial stages of the *Plano de Estabilização* announced on 7th December 1993 (R. M. do Prado 2005: 78). Representing a radical shift away from the 1980s tradition of shock measures, these

[2] This is illustrated by the immediate forwarding of the PAI to IFIs and key market actors (R.M. do Prado 2005: 141; Fiuza 2006: 102). The PAI included measures to reduce public spending (US$6 billion cut) and recover federal tax revenue. It consolidated state/municipal debt with the federal government, imposed stricter controls on state banks, restructured federal banks and streamlined the privatisation program.

announcements carefully explained the plan's *modus operandi* (Bacha 2003). Drawing on lessons from previous failures – particularly the *Plano Cruzado* – and based on the diagnosis that Brazilian inflation resulted from a unique and complex combination of monetised fiscal deficits and inflationary inertia rooted in widespread indexation arrangements, the logic of this 'heterodox' stabilisation plan, which later on came to be known as *'Plano Real',* was strongly influenced by the works of two team members – Pérsio Arida and André Lara Resende. Their *'Plano Larida'* (1986), the idea of an indexed currency (*moeda indexada*) and their personal experience of the collapsed *Cruzado* Plan decisively framed the team's discussions[3] and led to the implementation of a three-staged stabilisation programme. In a nutshell, initial fiscal adjustment would be followed by the elimination of inflationary inertia through the creation of a stable parallel unit of account so to gradually stabilise agents' inflationary expectations. In the third phase, once market actors had voluntarily adopted this 'virtual' currency, a new currency, free from inflationary inertia, would be introduced (Pio 2001a; Bacha 2003).

Table 32: The Economic Team of the *Plano Real*

Edmar Bacha*	Consultant of the Ministry of Finance / BNDES President
Pedro Malan	BCB President / Minister of Finance
André Lara Resende*	Chief Negotiator of External Debt (exit in December 1993)
Pérsio Arida*	BNDES President / BCB President (exit in May 1995)
Gustavo Franco	Sub-Secretary of Political Economy (*Fazenda*) / BCB
Clóvis Carvalho	Executive Secretary (*Fazenda*) / *Planalto*
Winston Fritsch	Secretary of Political Economy (*Fazenda*) (exit in January 1995)
Murilo Portugal	Secretary of the Treasury (*Fazenda*)
Francisco Lopes	BCB

Source: Author's interviews with Franco, Lara Resende, Arida, Bacha and R. M. do Prado.
* Arida, Bacha and Lara Resende had been members of the *Cruzado* team. Only Fritsch and Bacha were affiliated members of Cardoso's PSDB and had served as policy advisors to Mario Covas.

Table 33: Brazilian Currencies and Conversion Rates, 1990-2006

Cruzeiro	1990-1993	1 *cruzeiro* = 1 *cruzado novo*
Cruzeiro real	1993-1994	1 *cruzeiro real* = 1,000 *cruzeiros*
Real	1994-	1 *real* = 2,750 *cruzeiro reais*

After preliminary fiscal adjustment via the Social Emergency Fund (FSE) in December 1993, the second phase began on 1st March 1994 with the introduction of the *Unidade Real do Valor* (Reference Value Unit – URV).[4] The URV co-existed with the *cruzeiro*

[3] Their revised diagnosis understood inflation as resulting from a combination of inflationary inertia and serious imbalances in public finances and proposed a twofold stabilization strategy of addressing inertial *and* public finance aspects. The *Cruzado* episode emphasised the necessity of a restrictive monetary policy. They opposed wage increases as illustrated by their opposition to the *Lei Paim*, which President Franco ultimately vetoed in June 1993 (Fiuza 2006: 108).

[4] *Medidas Provisórias* Nos. 434/457/482, converted into *Lei* 8,880/94 on 27th May 1994. *Medidas Provisórias* (provisional decrees – MPs) are institutional devices that allow the president to enact new legislation without congressional approval. If Congress fails to act within 30 days, the decree automatically goes to the top of the legislative agenda. Only in very few cases have MPs been rejected by Congress (e.g., only in 2.4% of cases during 1995-1998). The Supreme Court tolerated this practice as long as presidents did not reintroduce decrees, which Congress had specifically rejected. In September 2001, an

real as an indexed unit of account with the purpose of stopping inflation while preserving distributive neutrality (Franco 1995: 49; 2000: 10). In essence, this index represented the official *cruzeiro real*-US$ exchange rate and was fixed daily by the BCB to approximately US$1:1URV (Guilhoto and Hewings 2001: 40). This meant that prices that had been indexed to the URV were effectively shadowing the US$ exchange rate (**Table 34**). Conforming to constitutional requirements, Cardoso passed on his ministerial post to Rubens Ricúpero in April 1994 after his nomination by a PSDB-PFL alliance to run for president. This however did not disrupt the ongoing preparatory work, and by June 1994 it was decided that the time was right for new legislation, which would herald the final stage and introduce the *real* (Filgueiras 2000: 105).[5]

Table 34: US$-CR$ Exchange Rate and the URV in 1994

	January 1994	**February 1994**	**March 1994**	**April 1994**	**May 1994**	**June 1994**
Buying Rate*	458.65	637.27	913.34	1,302.26	1,875.25	2,612.50
Selling Rate*	458.66	637.28	913.35	1,302.28	1,875.27	2,750.00
URV**	458.16	637.64	931.05	1,323.92	1,875.82	2,750.00

Source: Guilhoto and Hewings 2001: 41.
Note: Figures for the last day of the month; CR$ per US$. * Average of day's trade. ** Fixed by BCB. CR$ per URV.

Institutional Change: The Reform of the Conselho Monetário Nacional

In addition, this decree radically reformed the *Conselho Monetário Nacional* with major repercussions for exchange rate policymaking (Chapter II of *Lei* 9.069). Parallel to the stabilisation effort, the team had thus shifted its attention to re-organising the institutional setting of macroeconomic policymaking and to breaking the Vargas-style corporatist tradition, which it criticised for its dubious democratic legitimacy and its incommensurability with the envisaged structural reform agenda.

As outlined in Chapter VI, the CMN membership had traditionally included twenty members from various societal and sectoral interest groups as well as representatives from several public banks and government ministries. Since *'abertura'* in the early 1990s and given its central constitutional status in macroeconomic policymaking, the CMN had once again become the *locus* of entrenched and highly politicised debate about Brazil's economic policy course and, as a result, had become *de facto* paralysed (Fiuza 2006: 100). From the outset,

accord between Congress and President Cardoso amended Article 62 so as to limit presidents to a single reissue of a lapsed decree. This amendment also specifies issue-areas in which the executive may not resort to decrees.

[5] *MP* 542 of 30th June 1994, converted into *Lei* 9.069/95 on 30th June 1995. Symbolism played an important role insofar as the name 'Real' was chosen in reference to Brazil's first national currency (*'Rei'* and *'Réis'*), and it also motivated the design of the new banknotes in terms of size, colour scheme and images (Ribeiro 1996: 13; Fritz 2002: 179). Also http://www.bcb.gov.br/Pre/CMN/Capitulo_II__Lei9069.asp [accessed 17th May 2007].

Cardoso and his team had therefore regarded the council not only as a *"crazy and inefficient talking shop filled with vested interests"* (Interview Cardoso) but also as a major obstacle to the *Plano Real* (Interview Franco).[6] The team's first proposal for reform therefore suggested a BCB-dominated membership formula.[7] Only after this had been rejected by President Franco the team settled for a compromise solution, which restricted membership to an executive-only 'council of three' with, in theory, two cabinet members (the Ministers of Finance and Planning) outweighing the voice of the BCB (Loureiro 1997: 110-111; R. M. do Prado 2005: 268 + 281-282 + 288; Franco 2006: 285-286).[8] Although driven by technocratic objectives, this reform explicitly preserved the presidential prerogative and thus also put an end to the economists' initial plans of formalising the autonomy of the BCB (R. M. do Prado 2005: 181; Franco 2006: 269). Hence, although these institutional changes increased the autonomy of the CMN and the BCB in exchange rate policy matters from societal interests by eliminating the CMN's corporatist element, the agencies' policy autonomy from interference 'from above' remained limited (Interview Lara Resende, Cardoso in Pompeu de Toledo 1998: 66; Pio 2001a).[9]

Determining the Exchange Rate Policy Framework for the Plano Real

Internal discussions on the exchange rate strategy to underpin the stabilisation had continued unabatedly until May 1994. Indeed, in contrast to the ease with which agreement was reached on other measures, the team struggled to establish consensus in this respect (R. M. do Prado 2005; Fiuza 2006), and Cardoso recalls that *"with respect to the exchange rate policy, we had more doubts than mature decisions"* (2006b: 171). Having been pushed 'to the limits of cordiality' over the exchange rate, the team saw itself forced to reach a decision by May 1994 due to the upcoming presidential elections (Interview Cardoso, Filgueiras 2000: 92; Fiuza 2006: 128). In a situation marked by the absence of open dissent rather than the presence of a strong consensus (Cardoso 2006b: 181), an asymmetrically floating exchange rate was adopted (Interview Franco, R. M. do Prado 2005: 301; Cardoso 2006b: 181).

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[6] For an account of pre-1994 CMN meetings, see Fiuza 2006: 97-102.

[7] This formula included the Ministers of Finance and Planning, the President of the BCB and its directors, the President of the *Comissão de Valores Mobiliários* (CVM) and the Secretary of the Treasury (*Tesouro Nacional*) (Interviews Cardoso, Franco).

[8] In practice, it was the Ministry of Planning, which was effectively sidelined from key CMN decisions due to a strengthening of the *Fazenda*-BCB nexus (**Figure 38**) (Interviews Franco, Arida).

[9] In June 1995 (*Lei* 9,079) the Technical Commission of Money and Credit (*Comissão Técnica da Moeda e do Crédito* (COMOC)) was created as a wider advisory committee to the CMN. It is composed of the BCB President, the President of the *Comissão de Valores Mobiliários,* the Executive Secretaries of the Planning and Finance Ministries, the Secretaries for Economic Policy and National Treasury of the Finance Ministry as well as four BCB directors appointed by the BCB President.

The circumstances and pragmatic motivations surrounding the adoption of the asymmetric band suggest that the notion of the exchange rate as the key 'anchor' to the *Plano real*, as it established itself in public consciousness later on, was not dominant at the outset (Interviews Lara Resende, Arida). Nevertheless, the image of a 'credible anchor' was heavily used in the public presentation of the exchange rate strategy and in the wording of the associated decree. For instance, statements by Ricúpero[10] emphasised the element of fixity of the *real*'s exchange rate whilst underplaying the regime's discretionary aspects. Additionally, MP542 suggested the adoption of a rather fixed exchange rate course insofar as Article 3 stipulated that the *real* would be tied to international reserves (§ 1) and to the US$ at a parity of 1:1 (§ 2). Yet these commitments were loosened by § 4, which stated that both conditions could be revised *at any time* by the CMN under presidential approval (also Cardoso 2006b: 180).[11] In short, the president together with the executive-dominated CMN could simply change the reserve and parity rules at a whim.

A month later, on 1st July 1994, the *real* was put in circulation at R$1:1URV. Against a sizable reserve buffer of US$40 billion, the BCB provisionally set the *real* equivalent to US$1 (or to 2,750 *cruzeiro reais*), i.e. to the pre-established ceiling of the asymmetric float (Filgueiras 2000: 108). As planned but surprising those who had expected a fixed regime,[12] the BCB then withdrew from the foreign exchange market and let the currency appreciate under conditions of a very restrictive monetary policy (Filgueiras 2000: 108; Garofalo Filho 2005: 146; Fiuza 2006: 155-157).[13]

7.2.2 Caught by the Fear of Floating – Foreign Exchange Market Interventions (October 1994) and the Adoption of a Crawling Band (March 1995)

Rapid appreciation in the second half of 1994 was thus explicitly used as a stabilisation instrument insofar as it exerted additional downward pressure on tradable goods prices in a context of further commercial liberalisation (Franco 1995: 59; Fritz 2002;

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[10] Ricúpero announced on 1st June 1994 that *"[t]he exchange rate will remain stable for an indetermined period of time after 1st July 1994; this means that the selling rate of the BCB for the real vis-à-vis the US dollar will be one-to-one"* but purposefully omitted a definition of the BCB's buying rate (quoted in R.M. do Prado 2005: 254-255).

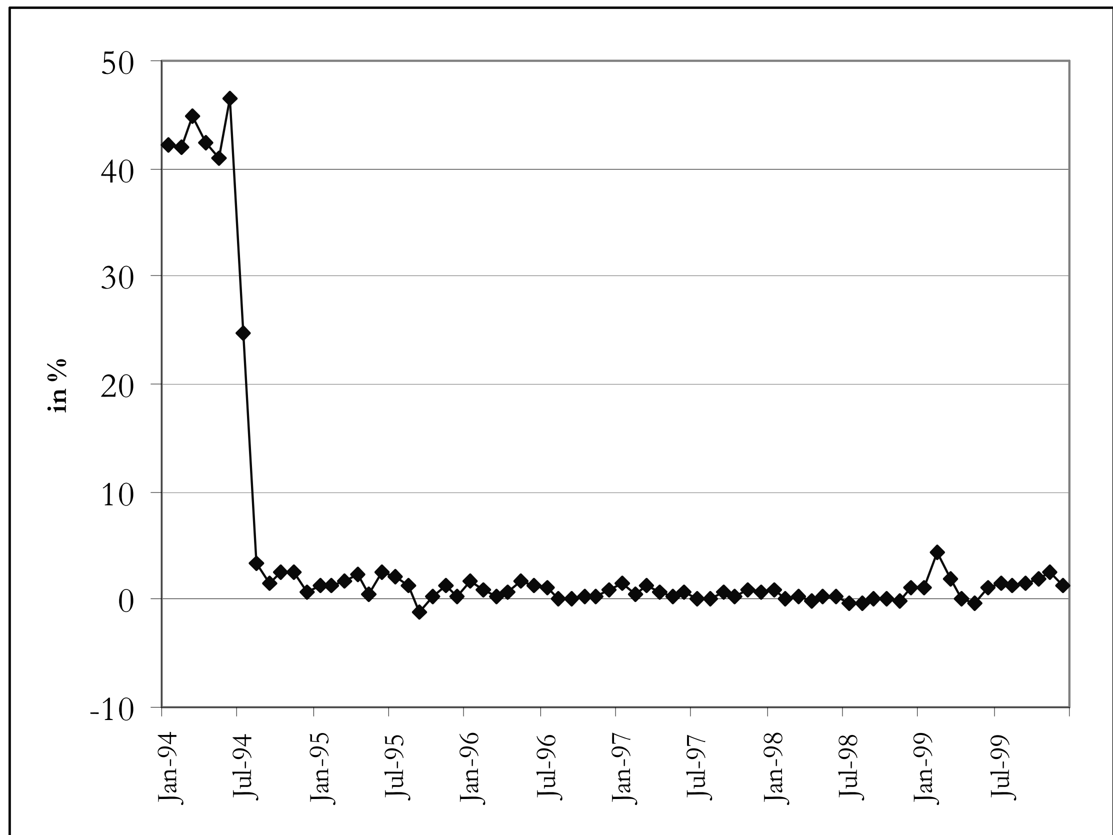
[11] The 'Explanation of Motives of the Decree of the *Real* Plan of 30th July 1994 (*E.M. Interministerial No. 205/MF/SEPLAN/MJ/MTb/MPS/MS/SAF*) states: *"The exchange rate will be US$1 = R$ 1 for an undetermined period of time. With the aim of not fixing the exchange rate by law, which would have obvious negative implications for the sovereign exercise of exchange rate policy in a world economy characterized by rapid transformations, it has been decided that the Finance Minister will present for presidential approval the criteria to which the National Monetary Council will obey with respect to the ties of the Real, temporary emissions and the administration of the reserves that make up the tie as well as modifications to the parity.* (§39)

[12] This was due to a 'leak' to the FSP on 25th June 1994, which suggested an administrated exchange rate (Fiuza 2006: 153).

[13] The monetary policy restrictions included short-term limits on export finance, 100% reserve requirements on new deposits, the imposition of a limit on the expansion of the monetary base of R$7.5 billion until September 1994 (revised to R$9 billion in August) and a policy of high interest rates to control consumption (Amann and Baer 2000).

von Mettenheim 2004). This strategy proved to be very successful as the rapid fall in monthly inflation rates from 25% in July 1994 to 3.3% in the following month illustrates. Fuelled by short-term capital inflows attracted by the interest rate differential, the *real*'s nominal value rose by 16% in the second half of 1994 and reached the unprecedented level of R$0.83 per US dollar in October 1994 (Portugal and Galvão 1996: 99; Falção Silva 1999; Saad-Filho and Mollo 2002)(**Figure 32** on p. 223).

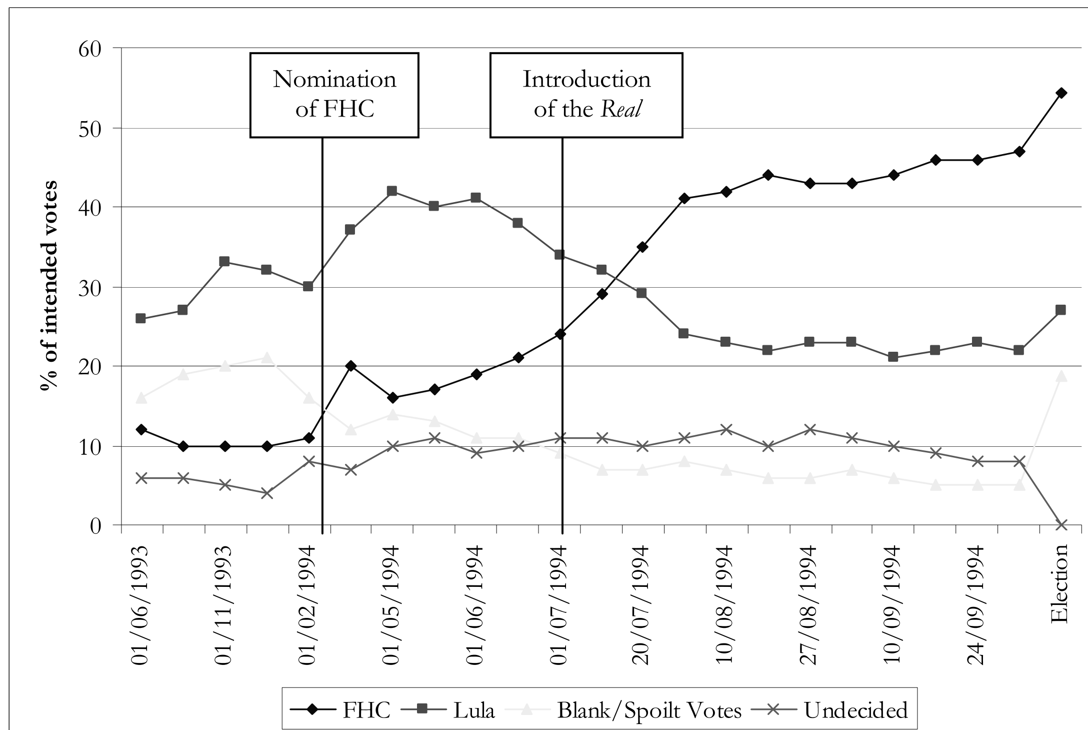
Figure 30: Monthly Inflation Rates in Brazil, 1994-1999



Source: Various Issues of *Conjuntura Econômica.*

Exceeding the economic team's most optimistic expectations, the Brazilian public embraced the new currency with unprecedented enthusiasm (Fiuza 2006: 216). Cardoso and his political adversaries concur that the immediate disinflationary success of the *Real* Plan – described as *"the most efficient social policy"* ("Plano Fernando Henrique Cardoso" 1993: 116) – accelerated Cardoso's dramatic catch-up in the polls (Interviews Mendonca, Figueiredo, Montero 1999; Filgueiras 2000: 92; Fritz 2002: 176-177; Bacha 2003: 194-195). After trailing behind the PT candidate da Silva by 15-20% for the first half of 1994, Cardoso's ratings experienced a sudden upturn and then sustained a 20-25% lead until the elections on 3rd October 1994, which Cardoso won in the first round (**Figure 31**).

Figure 31: Brazilian Presidential Election 1994 - Evolution of Vote Intentions



Source: Data from Sensus and CBPA, as quoted in Jorge Almeida (1998). *Como Vota o Brasileiro: Perfil ideológico do eleitor e evolução do voto nas pesquisas de opinião de 1994*. São Paulo (Brazil): Xamã.

Parallel to the *real*'s appreciation and the rapid decline of the trade surplus due to the consumption-fed import boom, executive-internal disputes about the exchange rate, especially between Gustavo Franco and BNDES President Arida, had re-emerged. Although both shared the impression that *"the strengthening of the newborn currency was a sign of confidence in the new stabilisation effort"* and therefore *"crucial in the fight against hyperinflation"* (Interview Arida, Franco 2000: 5), they disagreed about the desirable extent of the appreciation, whether producers would be able to compensate for the rapid appreciation through productivity increases, whether the resulting impact on the trade balance was sustainable and, most importantly, how best to address the tendency towards excessive overvaluation without endangering the stabilisation efforts and Cardoso's electoral prospects. While Arida's proposal for decisive BCB intervention to establish a lower floor to the *real*'s fluctuation fell on deaf ears at the height of the electoral campaign (Lopes 2003: 37; R. M. do Prado 2005: 495-499), Franco was hesitant about capital account liberalisation and reverting from the free floating course. He increasingly appreciated the anti-inflationary power of the strengthening *real,* which conveniently reinforced the stabilisation agenda as 'market forces' (rather than time-consuming and politically costly negotiations)[14] forced producers to lower prices. Instead,

[14] These price adjustment negotiations, often combined with threats of tax fraud investigations in case of non-cooperation, were known as *'dallarisação'* after Milton Dallari, the head of the Special Secretariat for Supply and Prices (Bacha 2003: 16).

Franco proposed further import liberalisation of export inputs, the reduction of barriers to capital outflows and the imposition of 'market-friendly' capital inflow controls to dampen appreciation (Franco's paper of 20th August 1994 in R. M. do Prado 2005: 500).

In addition to internal criticism of the BCB's readiness to let the *real* appreciate indeterminately, public disapproval grew, albeit yet at a low level (Fiuza 2006: 211). Complaints by exporters, from journalists and economists as well as from the PT, whose leadership had chosen to target the exchange rate strategy during their campaign, even provoked a congressional debate of the issue (R. M. do Prado 2005: 244; Fiuza 2006: 217). However, these criticisms remained ineffectual insofar as exchange rate policy decisions had been concentrated in the hands of DIREX director Franco (Lopes 2003: 37), who remained convinced of the strategy in place and also enjoyed the explicit support of BCB President Malan and soon-to-be President Cardoso.

October 1994 – Return to a 'Dirty Float'

Whereas pressures for a strategy change had previously been contained, this changed in the aftermath of the October elections. For one, the struggle for and subsequently the allocation of ministerial posts in Cardoso's cabinet reduced team solidarity as *"the mechanics of decisionmaking changed completely and hierarchical relations emerged"* (Interview Franco; R.M. do Prado 2005: 382). Direct competition between Arida and Franco for the BCB presidency fuelled their dispute vis-à-vis the exchange rate. The issue was also hijacked by *Paulista* PSDB politicians, entrepreneurs and economists, who hoped to regain influence by discrediting the economic team (R. M. do Prado 2005: 382 + 390). Internal pressure to address the continued appreciation thus grew. In response to Franco's proposal, on 19th October 1994, the reformed CMN reacted to these circumstances and approved eleven capital account measures aiming at alleviating the upward pressures on the *real* by facilitating the exit of capital while imposing entry restrictions (Williamson 1999). As this initiative proved largely ineffectual, the BCB began to intervene in the foreign exchange market (Lopes 2003: 38; R. M. do Prado 2005: 398-399), and through its actions established an implicit floor stopping the *real* from falling below R$0.83 per US$ (Franco 2000: 38). In conjunction with the legal ceiling defined in June 1994, the *real* was therefore floating within an informal band and at reduced volatility. Franco had thus succeeded in diverting political pressures for a more fundamental exchange regime change by limiting further appreciation, without bowing to demands for an outright devaluation and without relinquishing anti-inflationary discipline (R. M. do Prado 2005: 408).

The Struggle around the Real's Exchange Rate Policy: January-March 1995

The informal band was maintained throughout the presidential transfer period until January 1995 – a period marked by the contagion of the Mexican crisis. Although high foreign reserves granted some latitude to the BCB, the rapid turnaround in capital movements and the sudden downward pressure on the *real* soon demanded a re-evaluation of the exchange rate strategy (Portugal and Galvão 1996: 96; Cardoso 2000: 79; Fritz 2002: 190). Concerned about the impact of further depreciation on inflation under conditions of yet incomplete de-indexation, Franco decided to prevent erratic *de*preciation by means of further interventions that aimed at stipulating a ceiling of a narrow informal band at R$0.86 per US$ (as opposed to R$1 per US$)(Franco 2000: 38; Bacha 2003: 208). Despite these efforts, the 'Tequila Crisis' put the exchange rate strategy into the spotlight insofar as market actors and commentators began to draw parallels to Mexico's crisis-prone stabilisation programme and questioned the *Real* Plan's sustainability (e.g., Netto in GM 6th January 1995; Malan in Público 19th April 1999; R. M. do Prado 2005: 421).

This episode also directed Cardoso's attention to the exchange rate (Kingstone 1999: 202; Cardoso 2006b: 339). Given that a devaluation prior to his inauguration had been ruled out as too risky in this context of financial instability, Cardoso was determined to see the excessive valuation of the *real* addressed. The issue thus took centre stage in meetings with his increasingly divided economic team from late January 1995 onwards (Lopes 2003: 39; Cardoso 2006b: 339-340). In an attempt to set the agenda as the official directly responsible for exchange rate operations, Franco circulated a proposal, which combined the formalisation of the practiced intervention band strategy with a very gradual depreciation by proposing bands of R$0.86-0.92 with BCB intervention taking place in a smaller interband (Franco in R. M. do Prado 2005: 510-515). Newly appointed BCB President Arida, whom Cardoso had favoured over Franco, and BCB director Lopes, in turn, favoured a 10% devaluation prior to the adoption of a wider band (R$0.92-1.00), which would gradually widen to eventually let the currency float. The team's common denominator was thus a short-term preference for an exchange rate band (*'sistema de bandas')*, which would allow for a *"more realistic rate without sacrificing the exchange rate as an anchor on the currency"* (Kingstone 1999: 202-203). However, no consensus on the detailed characteristics and long-term purpose of such band could be reached (R. M. do Prado 2005: 425). As Cardoso's concerns about the team's indecision grew, the two sides finally agreed on a compromise: On 6th March 1995, the BCB officially adopted a band with a ceiling of R$0.86 and a floor at R$0.90 (*Comunicado No.* 4.479 of 7th March 1995) and announced that this band would be widened to R$0.86-0.98 on 2nd May 1995 so to

prevent *"an expressive current account deficit"* insofar as *"the new exchange rate strategy would give the government the flexibility to avoid problems on the external front"* (BCB President Arida in FSP 7th March 1995, R. M. do Prado 2005: 426; Cardoso 2006b: 344).

Table 35: Overview – Proposals for Exchange Rate Policy Change (March 1995)

Gustavo Franco (BCB DIREX)	No devaluation but formal band (R$0.86-0.92)
Pérsio Arida (BCB President) and **Francisco Lopes** (BCB DIPOM)	10% devaluation, then band (R$0.92-1.00) with gradual widening formula
Preliminary Compromise (by L.C. Mendonça de Barros, 6th March 1995)	Band (R$0.86-0.90) – widening to R$0.86-0.98 on 2nd May 1995
Amended Strategy (by G. Franco, 10th March 1995)	Band (R$0.88-0.93) with narrow mini-band with a monthly depreciation rate of about 0.6%

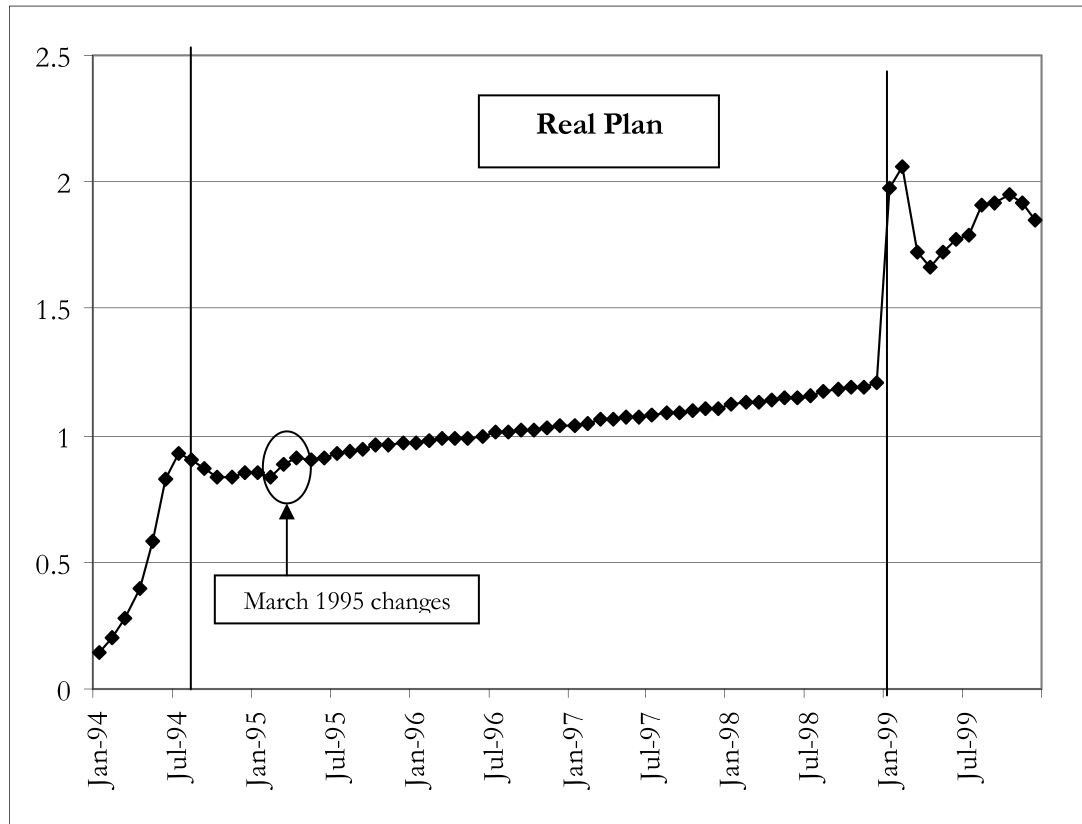
However, recognising the deep divisions in the BCB directorate, a severe attack on the *real* followed. In an emergency meeting on 9th March 1995, Franco, with support from Malan, put forward an eighteen point list of immediate and rather aggressive measures, including the introduction of a new band (R$0.88-0.93) and a sharp interest rate hike to 65% to re-establish market confidence, which the CMN adopted after much discussion (R. M. do Prado 2005: 428; Fiuza 2006: 205 +208-209). A narrow mini-band – established through the BCB's daily foreign exchange auctions – would promote small but successive devaluations, amounting to a monthly depreciation rate of 0.6% (Fritz 2002: 191). Within this mini-band, the exchange rate 'floated' and was determined by participants in the interbank market (*Comunicado* No. 4,492 of 10th March 1995). Although the move disappointed Congress, these measures eventually stabilised the foreign exchange market (Kingstone 1999: 203).

BCB President Arida, whose advice in favour of a more flexible regime had been overruled by Cardoso, resigned as a consequence (OESP 2nd June 1995). Beyond the rhetoric, the new exchange rate regime amounted to a rather fixed arrangement. The March 1995 changes therefore shifted the *Plano Real* significantly closer to the rigid strategy adopted in Argentina in 1991 and paved the way for the return to uncompromising disinflation and structural reform efforts. As Amann and Baer (2002: 21) argue,

> [a]lthough the exchange rate anchor did not figure as a major instrument in the original conception of the *Real* Plan, it became an increasingly central component of the stabilisation policy mix from late 1994 onwards.

Yet, Cardoso's support for Franco's strategy to exact the modernisation of Brazilian industry by exposing firms to overvaluation-cum-liberalisation was not unconditional as is illustrated by his choice of Gustavo Loyola, rather than Franco, as BCB president, and by his approval of significant increases in selected consumer durable tariffs (Portugal and Galvão 1996: 96).

Figure 32: Monthly Nominal Exchange Rates in Brazil, 1994-1999
(R$ per US$)



Source: Monthly Bulletins of the BCB.

Table 36: Adjustments of the *Plano Real*'s Crawling Band 1995-1999

Date of Adjustment	Comunicado No.	Superior Limit	Inferior Limit
6th March 1995	4,479	R$ 0.90	R$ 0.86
10th March 1995	4,492	R$ 0.93	R$ 0.88
22nd June 1995	4,645	R$ 0.99	R$ 0.91
30th January 1996	4,987	R$ 1.06	R$ 0.97
18th February 1997	5,505	R$ 1.14	R$ 1.05
20th January 1998	6,002	R$ 1.22	R$ 1.12
15th January 1999	6,563	Suspension of crawling band system followed by a maxi-devaluation	
18th January 1999	6,565	Extinction of the crawling band; *real* is floated	

Source: Adaptation from Garofalo Filho 2005: 147-149.

7.2.3 Policy Inertia and the Exchange Rate Trap (*'Armadilha Cambial'*) (1996-1998)

After initial market turmoil had subsided, the crawling band was periodically adjusted in order to administer a gradual nominal devaluation without endangering disinflationary efforts (Portugal and Galvão 1996: 98). These adjustments, however, could not prevent significant overvaluation and due to their reduced frequency after 1995 the regime eventually lost much of its virtuous flexibility (**Table 36**). Indeed, some commentators argue that the

regime turned into a crawling *peg* (Ferreira and Tullio 2002: 143). Persistent overvaluation and its detrimental effect on Brazil's industrial fabric, as well as its implications for Brazil's trade balance and dependence on foreign finance exacerbated tensions inside the cabinet, especially between the liberal-minded *Fazenda*-BCB nexus and the more developmentalist Ministry of Planning, and provoked growing criticism from wider society and opposition parties from 1996 onwards (Filgueiras 2000: 131).

The Petrification of the Crawling Band Regime (1996-1997)

Already prior to his nomination to the BCB presidency as Loyola's successor, Franco had almost exclusive control over Brazil's exchange rate stance and had institutionalised the exchange rate 'anchor' as the central reform device. His promotion further insulated the BCB's exchange rate policy from growing criticism by business associations and congressional opposition but also from internal critics, such as Lopes, who was now formally subordinated to his former pupil, and PSDB critics, such as Serra and Motta (Cardoso 2006b: 372 + 374).

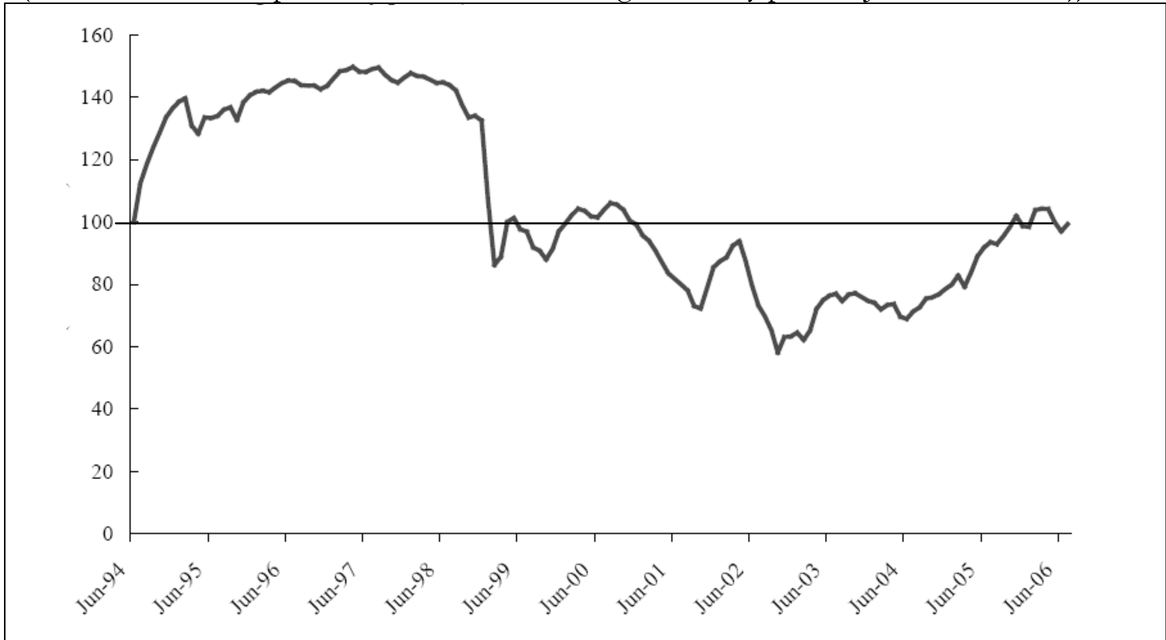
During 1996-1997, critics and sectoral representatives (such as textiles and agriculture) that had become severely exposed to the upsurge in imports and lost significant market shares in domestic and world markets struggled to construct a coherent critique of the exchange rate course (Cardoso 2000: 81). After the 1995 slump, the economy had recovered remarkably and optimism prevailed as 1996 produced unprecedented levels of FDI, annual growth rates exceeding 3% GDP and low inflation. In June 1997, Brazil even succeeded in issuing a 30-year bond demonstrating the high level of international confidence. The abundance of capital inflows – US$ 33 billion in 1996 and US$26 billion in 1997 – attracted by the interest rate differential and especially the ongoing privatisation programme gave further credibility to the BCB position and allowed for the accumulation of a reserve cushion.

With the benefit of hindsight, most analysts agree that the Brazilian authorities let some benevolent moments go by for a 'non-crisis exit' during this period, which would have allowed shifting from stabilisation to a more encompassing long-term economic policy agenda (Baumann 2000: 40; Cardoso 2000; Filgueiras 2000: 187; Ferreira and Tullio 2002).[15] Instead, the authorities held on to the increasingly rigid exchange rate band, under which significant real exchange rate appreciation was taking place, disregarded several internal exit proposals (e.g., by Lopes in December 1996 (Cardoso 2000: 80; R. M. do Prado 2005: 443 + 527-533)) and also appeared immune to the vociferous demands for an end to the 'deadly' combination

[15] Eliana Cardoso (2000: 85) points out, *"most economists would agree that the Real has been overvalued since the launch of the Real Plan"*. Widely reported comments by Dornbusch in June 1996 estimated the level of overvaluation at 40%, while Netto argued it was at 15%, and even the Bank of International Settlements expressed concerns (Kingstone 1999: 218).

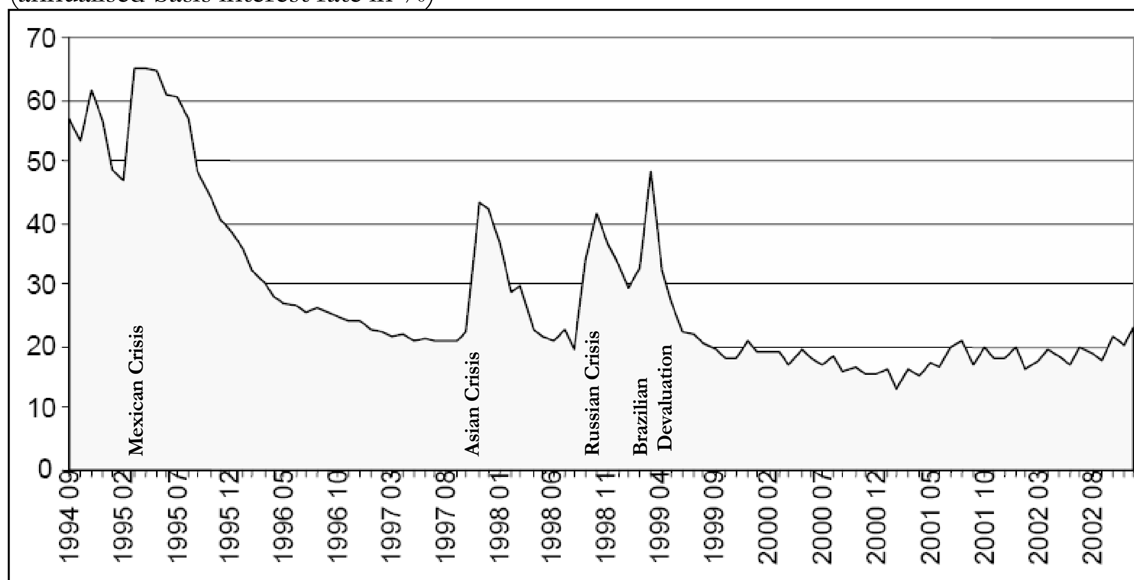
of an overvalued *real* and high interest rates on the part of various increasingly well-organised interest groups (Bolten 2007).

Figure 33: The Evolution of the Real Exchange Rate in Brazil, 1994-2006
(based on consumer prices – Index: units of foreign currency per R$ (June 1994 = 100))



Source: BCB and Weisbrot and Sandoval 2006: 7. *Note:* The REER used here is based on the consumer price index, IPCA.

Figure 34: The Evolution of the Brazilian SELIC rate, 1994-2002
(annualised basis interest rate in %)



Source: Ipea data as presented in Saba Arbache 2004: 24.

Impact of the Asian Crisis – The Illusion of Stability

The Asian Crisis in mid-1997 again highlighted Brazil's external vulnerability and represented, even in Franco's eyes, *"a watershed in the thinking on exchange rate regimes, capital flows,*

and crisis management in emerging economies" (2000: 42), insofar as the events motivated a shift in economic thought against intermediate exchange rate regimes (such as Brazil's crawling band). Yet not even the crisis' contagion effects proved sufficient to convince the Brazilian government to change course. Instead, when contagion hit the Brazilian economy with a combined attack on the *real* on 28th October 1997 and on the São Paulo Stock Exchange, the authorities defended the exchange rate anchor at the cost of approximately US$10 billion and implemented a series of resolute reform measures (Fritz 2002: 194): Through the *Copom* (Monetary Policy Committee) annual interest rates were raised from 20.7% to 43.41% and an ambitious fiscal emergency package, the *'pacote 51',* was submitted for legislative approval on 10th November.[16] These *ad hoc* adjustments appeased financial markets and led to the turnaround in the capital account by December 1997. International reserves recovered to reach record levels of US$74.7 billion by April 1998 making for a surprisingly rapid recovery (Filgueiras 2000: 137; Fritz 2002: 194).

Table 37: Annual Depreciation of the *Real*'s Market Rate

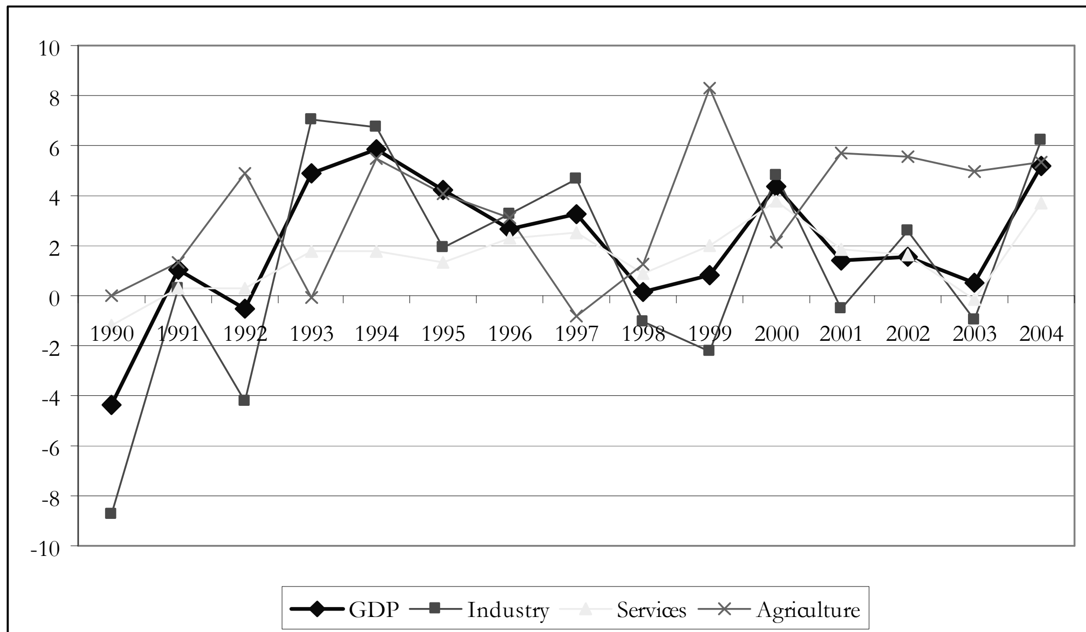
Period	Annual Depreciation
December 1994 – December 1995	13.9 %
December 1995 – December 1996	7.1 %
December 1996 – December 1997	7.3 %
December 1997 – December 1998	8.3 %

Source: Adaptation from Ferreira and Tullio 2002: 143.

Despite this apparent stability, the exchange rate strategy faced a notable decline in credibility from late 1997. Nevertheless, the economic authorities – especially Malan and Franco – were determined to implement an orderly and gradual flexibilisation without running the risk of resurgent inflation rather than opting for an outright devaluation. The announced acceleration of the band's depreciation on 26th June 1998 exemplified this course of action (**Table 37**; GM 26th June 1998). Simultaneously, the BCB tried to dispel all doubts about the regime's sustainability by issuing exchange rate-indexed bonds. Raising the costs to the Brazilian state in case of a devaluation, the share of these bonds increased steadily from 10% in late 1997 to above 20% of all bonds by late 1998 (equivalent to 8.9% of GDP or 166.6% of international reserves)(Fritz 2002: 196-197).

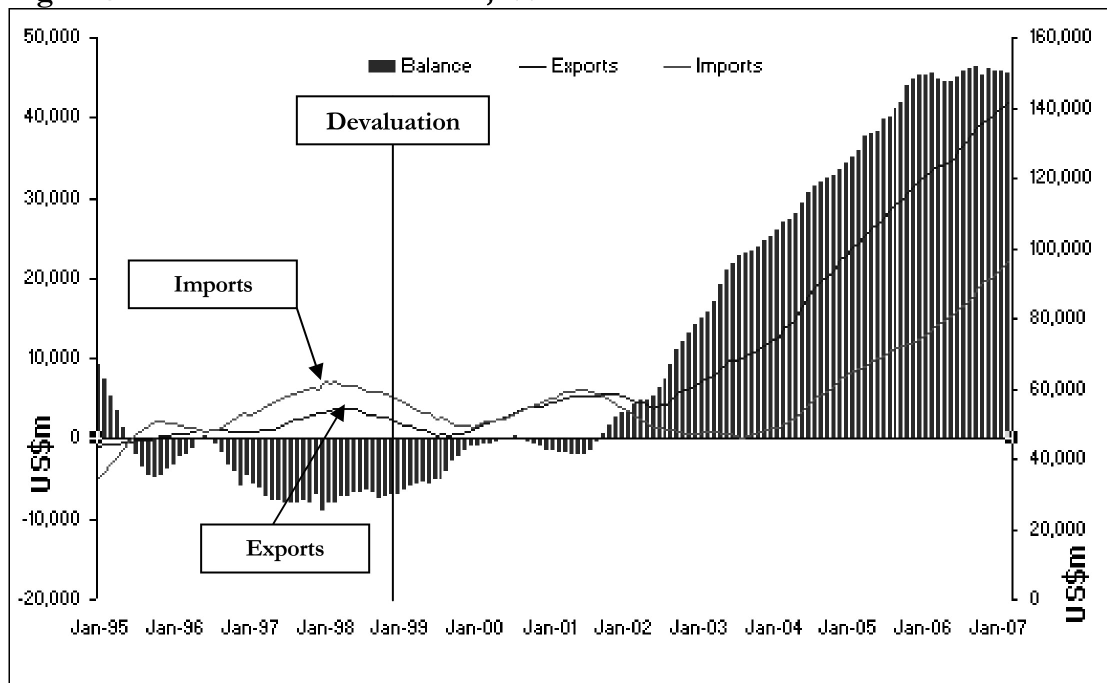
[16] The 'Fiscal Adjustment and Competitiveness Measures' included the cut of 33,000 civil service jobs and significant tax increases as well as the extension and acceleration of the privatisation programme (Fritz 2002: 194).

Figure 35: Annual Growth Rates of GDP and its Components in Brazil, 1990-2004 (in %)



Source: IBGE; IPEA.

Figure 36: Brazil's Balance of Trade, 1995-2007



Source: LatinFocus 2007 based on data from the *Ministério da Indústria, do Comércio e do Turismo*. Available at http://www.latin-focus.com/latinfocus/countries/brazil/bratrade.htm [cited 26th April 2007].

7.2.4 *"Chega de Âncora Cambial!"* – Exit from the Crawling Band and the Shift to Inflation-Targeting

The illusion of stability was ruptured by the Russian crisis in August 1998. Although financial market conditions had improved, Brazil's real economy had not sufficiently recovered. Persistent fiscal imbalances presented an even greater liability. Although the

adjustment measures of November 1997 (*Emenda Constitucional* No. 17 of 22nd November 1997) had aimed at reducing the federal deficit by 2%, this package had failed to lay the foundations for long-term fiscal sustainability as illustrated by the expansion of federal government expenditures by 22% in 1998 (Franco 1999; Ferreira and Tullio 2002: 144). Although a significant share of this spending went towards debt service costs, the lion's share corresponded to an excessively expansive fiscal policy accumulating a budget deficit of 7% of GDP in the run-up to Cardoso's second-term candidacy in October 1998 (Fritz 2002: 195). In view of the worsening fiscal accounts, the *Plano Real* relied on the exchange rate for maintaining price stability. This presupposed an elevated interest rates, which in turn exacerbated fiscal disequilibria (Saba Arbache 2004: 23). In short, the arrangement became increasingly unsustainable.

The Russian Crisis (1998)

As doubts about the sustainability of the exchange rate regime persisted due to stalling fiscal adjustment, the Russian default-cum-devaluation once again precipitated market volatility in Brazil and brought the country to the brink of a major crisis. Between August and September 1998, Brazil lost US$30 billion in reserves in defense of its crawling band. Unwilling to devalue prior to the elections and fearful of resurgent inflation, *Copom* implemented another interest rate hike to 49.75% p.a. in September 1998 (Baer 2001: 216). Yet, unlike in 1997 when heightened crisis sentiment had led to the adoption of significant, albeit short-term, fiscal tightening, the political class' reluctant response in 1998 suggested that further adjustment would, if at all, only be forthcoming in the aftermath of the elections (Fiuza 2006: 266-267). Eager to 'defend the current macroeconomic model', Cardoso risked the announcement of further fiscal adjustment efforts (*'Programa de Estabilidade Fiscal'*) backed by negotiations with the IMF in September 1998 (R. M. do Prado 2005: 464-465); and after his comfortable re-election a precautionary IMF package of US$ 41.5 billion provided some preliminary breathing space (Franco 2000: 6; Phillips 2006: 175).

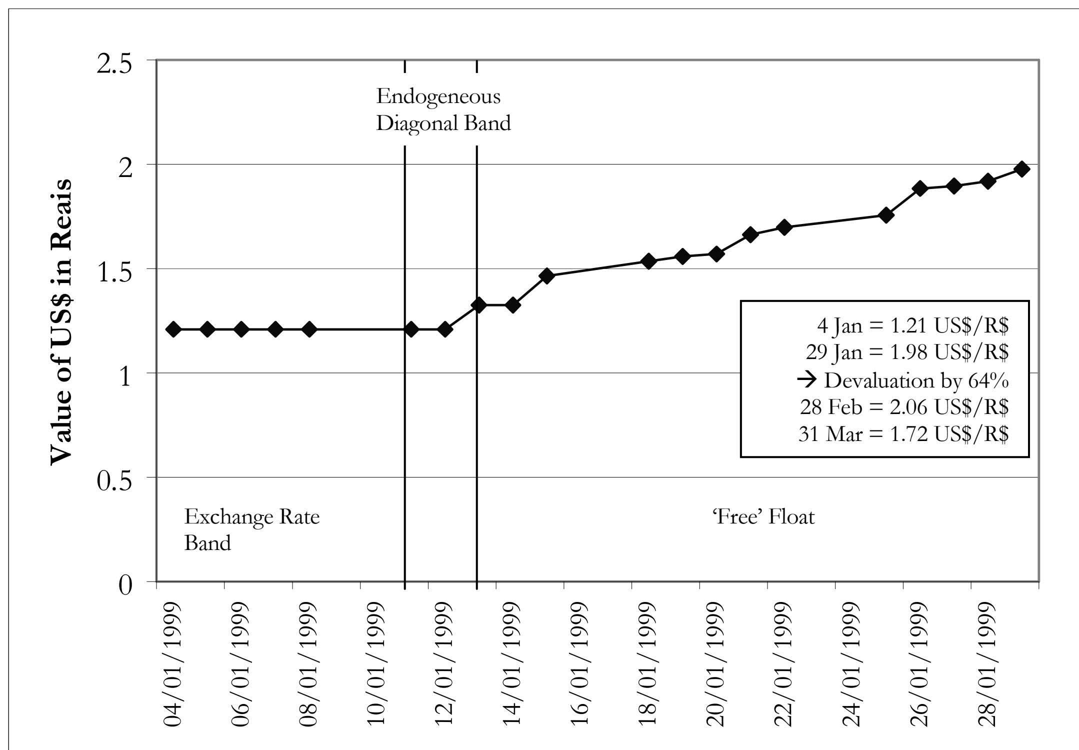
Abandoning the Crawling Band in January 1999

After a brief period of respite thanks to congressional approval of about 60% of the fiscal adjustment measures by mid-December, it however only took the coincidence of the government's legislative defeat on pension reforms with a federal debt moratorium declared by several state governors for capital outflows to, once again, threaten international reserves, which declined to US$35 billion (Cardoso 2000: 85; Baer 2001: 215-216). Strong and

increasingly well-organised resistance to record-high interest rates in the business community and growing demands for the correction of the overvalued exchange rate (e.g., mass demonstration organised by *Fiesp*) led Cardoso, in his own words, *"to re-think the tactic of gaining time to change the exchange rate policy"* (2006b: 406).

On 13th January 1999 and breaking earlier promises to the IMF, the crawling band was abandoned (*Comunicado* No. 6,563). Having failed to convince the BCB President to conduct this policy revision himself, Cardoso decided to overrule Franco by replacing him with his long-term rival Lopes, whose proposal of a so-called 'endogenous diagonal band' that would accelerate the *real*'s depreciation had appealed to Cardoso (Cardoso 2006b: 407). However, hopes for an orderly exit were disappointed. After a devaluation by 8.2%, speculative pressures pushed the currency against the ceiling of the new band, which the BCB initially tried to defend (Filgueiras 2000: 187-188). By 15th January 1999, the authorities resigned to letting the currency float, which sparked a steep devaluation and provoked the accumulation of substantial inflationary pressures in the economy.

Figure 37: Evolution of the Exchange Rate in Brazil in January 1999



Source: BCB data quoted in Filgueiras 2000: 188. *Note:* Exchange rate quotes represent average of daily quotes by BCB.

As market instability and crisis sentiment persisted and Cardoso's popularity ratings as well as confidence in Lopes' leadership plummeted, Cardoso opted for another change in the BCB leadership (Interview Cardoso, Phillips 2006: 177). Recommended by Malan and by Lara

Resende for his financial market credentials, Armínio Fraga replaced Lopes on 2nd February 1999 (Power 2002: 629; Fiuza 2006: 302). Fraga's crisis management and his and Malan's concerted efforts to re-engage with the IMF to address the pressing problem of debt sustainability given the *real*'s volatile depreciation paid off when a revised agreement was completed in March 1999.[17] This *rapprochement* and the approval of radical fiscal adjustment measures not only prevented default but greatly contributed to the gradual return of short-term capital by April 1999 (Bruno and Chudnovsky 2003: 59-60). The progressive stabilisation of the floating *real* throughout 1999 eventually enabled the authorities to adopt an inflation-targeting regime in June 1999 (MP 3,088 of 21st June 1999, Carstens and Jácome 2005: 10) and therefore to finally shift the responsibility for 'anchoring' price stability away from the exchange rate to monetary policy. Premised on a commitment to fiscal discipline as enshrined in the 'Fiscal Responsibility Law' (*Lei de Responsabilidade Fiscal* – LRF),[18] this macroeconomic regime has proven remarkably successful in stabilising inflation at low rates (Holland 2005: 5). The exchange rate, in turn, has since then remained inherently subordinated to monetary policy goals. Although it is, in principle, market-determined, the regime more closely resembles a 'dirty float' as recurrent BCB interventions reflect concerns about the costs of excessive exchange rate volatility (Garofalo Filho 2005: 151).

7.3. Explaining Exchange Rate Policy Choices in the 1990s

Choices about the exchange rate had to be made in connection with the complex and overlapping agendas of stabilisation and reform, not to mention the uncertainties naturally involved in a process of profound economic change occurring under unstable external conditions

Franco (2000: 4)

This section advances an explanation for the policy choices made in the four key episodes of the *Real* Plan. In particular, I will focus on the role of three factors in each phase:

- the **role of the executive** and in particular the role of the president against the institutional background of exchange rate policymaking in Brazil;
- the **role of societal interests** in influencing the decisionmaking, interacting with the executive and influencing the wider discourse on exchange rate policy as reflected in the media and wider public opinion; and

[17] Federal debt had risen to 52% of GDP by the end of January 1999 (Fritz 2002: 198).

[18] The Supplementary Law 101 (of 4th May 2000) established limits for expenditures on payroll and public deficit as well as a set of punishments to enforce these limits. Additionally, the LRF imposed the 'golden rule' insofar as new debt issues are limited to the amount of capital spending.

- the **role of external agents** and especially the influence of the IMF.

7.3.1 The Role of the Executive

As shown in the historical section, dynamics internal to the executive were dominant in shaping exchange rate policy choices. The executive enjoyed considerable autonomy and policymakers at the core of exchange rate decisions – much more than their predecessors in the *'Equipe do Cruzado'* – benefited from a remarkable degree of insulation from influences originating beyond the executive sphere. I argue that this sheltered position represented the combined result of institutional reform and arrangements of 'negotiated insulation'. In a second step, I show how this setting generated dynamics within the executive that strongly affected exchange rate policy decisions and yet are not captured by the institutionalist literature (e.g., Simmons 1994; Bernhard and Leblang 1999) nor by analysts focusing on the role of societal interests (e.g., Frieden 1994; 1997; 2000).

Institutional Insulation of the Executive

As section 7.2.1. showed, the crafting of the new institutional framework and especially the reform of the CMN in 1994 was crucial for the *Real* Plan's success (e.g., Franco 2006: 280; Sola and Kugelmas 2006: 96). The economic team had convinced sceptics, such as President Franco, of the urgency of these measures by appealing to the notion of 'crisis' and the desperate need

> to control the inflation 'monster' […] and to deal with external vulnerability and its technically complex nature, which demand[ed] the exclusive competence of specialists and, therefore, [could not] […] be open to competition among political forces (Loureiro 2005: 40-41).[19]

In this light, the reforms aimed to concentrate macroeconomic decisions in the Ministry of Finance and the BCB and to expand the technocratic space in exchange rate policymaking by means of eliminating the 'undue influence' of non-executive interests from the CMN (**Table 38**). This exclusion of all other ministers, public bank representatives and societal interests by the CMN reform was defended insofar as other ministers' contributions to monetary stability and fiscal equilibrium *"had not always been positive"* (Franco 1995: 68-69). According to the executive team, public bank representatives, in turn, were no longer 'desirable' CMN

[19] Also see §43-50 of the *E.M. Interministerial No. 205/MF/SEPLAN/MJ/MTb/MPS/MS/SAF.*

members because *"they should not be part of committees that also regulate them"* (ibid.), and societal interests were rightfully excluded in the eyes of the technocrats because they had

> distorted the character of the council as a public institution […] [and because] the CMN would otherwise involve interested parties in decisions where the public interest and a commitment to a stable currency ought to prevail (ibid., also see Bacha 2003: 187).

Table 38: Prior to the Reform: The 20 Members of the Conselho Monetário Nacional

Rubens Ricupero	**Finance Ministry**
Benedito Clayton Veras Alcântara	**Planning Ministry**
Pedro Sampaio Malan	**BCB**
Élcio Álvares	Industry and Commerce Ministry
Synval Sebastião Duarte Guazzelli	Agriculture Ministry
Marcelo Pimentel	Labour Ministry
Sérgio Cutolo dos Santos	Social Security Ministry
Thomás Tosta de Sá	*Comissão de Valores Mobiliários* (CVM)
Pérsio Arida	BNDES
Alcir Augustinho Calliari	*Banco do Brasil*
José Fernando de Almeida	*Caixa Econômica*
Anivaldo Juvenil Vale	*Banco da Amazônia S.A.* (BASA)
João Alves de Melo	*Banco do Nordeste do Brasil S.A.* (BNB)
Antônio Machado Guimarães	Nominated Member (entrepreneur, PMDB member)
Arthur Antônio Sendas	Nominated Member (retail entrepreneur – *Grupo Sendas*)
Alcides Lopes Tápias	Nominated Member (banker – Bradesco, President of Febraban)
Carlos Antônio Rocca	Nominated Member (academic economist – USP)
Paulo Guilherme Aguiar Cunha	Nominated Member (entrepreneur – *Grupo Ultra*, Fiesp executive board member)
Pedro de Camargo Neto	Nominated Member (agricultural entrepreneur, president of the *Sociedade Rural Brasileira* 1990-1993)
Lourenço Ferreira do Prado	Working Class Representative (CGT member, President of CONTEC (*Confederação Nacional dos Trabalhadores nas Empresas de Crédito*))

Source: Own elaboration based on documentation provided by the BCB.
Note: Members as of 29th June 1994. Post-1st July 1994 only those marked in bold maintained their membership.

The 'Presidency-Fazenda-BCB-Triangle' in Exchange Rate Policymaking

An understanding of the reform's purpose and impact from this perspective, which exclusively emphasizes the technocratic notions of efficiency, technical expertise and party-political impartiality, understates the wider political motivations and repercussions of this depoliticisation initiative (Santos and Patrício 2002). Additionally, it underplays the role of Brazilian presidentialism and the influence wielded by a directly elected politician given that the council continued to operate

> under criteria approved by the President of the Republic […] [and] in accordance with the guidance of the President of the Republic [*Lei* 9.069/95 Art. 3 §4 and Art. 4 §4 and *Lei* 9.649/98].

The continued formal presidential dominance in macroeconomic policy matters is also illustrated by the abandoned reform of the BCB.[20] As the only central bank in South America that, even today, lacks formal independence, the BCB remained superseded in its governing norms by the CMN and is vulnerable to presidential intervention (Carstens and Jácome 2005; Franco 2006: 285).[21] Therefore, rather than focusing exclusively on the operational agents of exchange rate policymaking, it is more accurate to speak of a 'Presidency-*Fazenda*-BCB-triangle', within which exchange rate policy decisions were made. Indeed, although the CMN had increased its formal autonomy from societal interests as a result of the 1995 reforms and had emerged as the *"principal nucleus of power of [Cardoso's] presidential cabinet"* (Loureiro and Abrucio 1999: 70), it is key to acknowledge that the council's *formal* autonomy from presidential interference remained very limited.

'Negotiated Insulation'

Yet, both the mode of decisionmaking in the run-up to the *Real* Plan and Cardoso's toleration of Franco's exchange rate policy course in 1998-1999 suggest that, irrespective of this formal dependence, policymakers in the CMN and especially at the BCB were remarkably successful in ensuring and indeed deepening their 'operational autonomy' within this triangle (da Nóbrega and Loyola 2006; Sola and Kugelmas 2006).

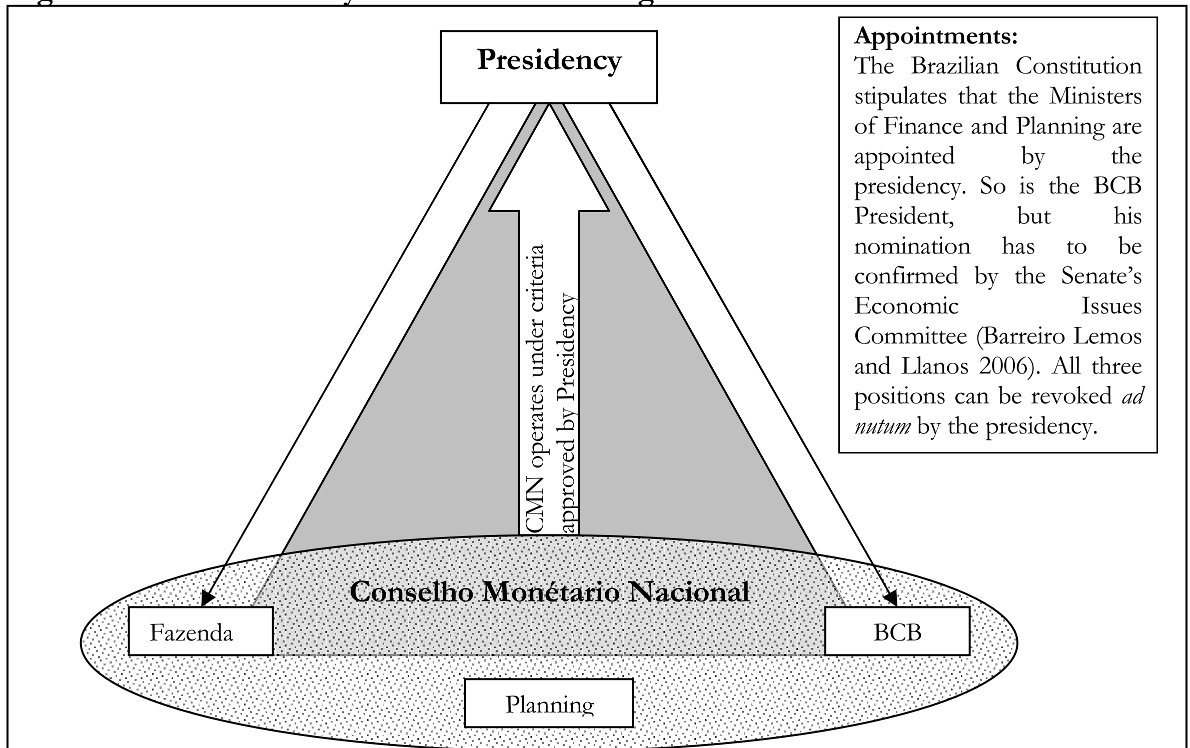
Given that formal institutional norms cannot accurately capture this degree of *de facto* autonomy in formulating and executing monetary and exchange rate policy, I argue that it stemmed from informal rather than formal institutional norms and, in particular, from the Brazilian tradition of guaranteeing the insulation of the technocracy by means of personal support from an institutionally empowered president (Interview Cardoso, also see Geddes 1990; Sikkink 1991; Power 2002; Guimaraes 2005): In the preparatory phase of the *Plano Real* and prior to Cardoso's ascendancy to the presidency, the relative autonomy of his economic team relied solely on a 'gentlemen's agreement' between him and President Franco (Interview

[20] President Franco's hostility and Cardoso's fading support once he run for presidency put an end to these efforts. The extensive debate on the degree, nature and desirability of an independent BCB cannot be addressed in depth. Suffice it to acknowledge that some scholars argue that the BCB's current 'operational independence' is preserved by a favourable 'social consensus', which has been sufficiently strong to force even President da Silva to respect its autonomy (Sola, et al. 2002; Carstens and Jácome 2005; da Nóbrega and Loyola 2006). It remains to be seen how robust this consensus is and how this interpretation can be reconciled with evidence for sustained public criticism of the BCB.

[21] The BCB's operational independence – and especially its financial autonomy – has since been reinforced by the LRF and by the amendment of Art. 192 of the Constitution in 2003, which opened the way for a reform of the mandate structure but has not yet established fixed mandates for the directorate. These developments lead Franco to assert that only a reform of directors' mandates and a formal transfer of monetary policy competencies from the CMN to the BCB is lacking on its path to full independence (Interview).

Cardoso, Power 2002: 622-623).[22] Once in power, Cardoso himself granted the economists – and especially Finance Minister Malan and the BCB leadership – informal autonomy from both PSDB influences and other pressures under his presidential 'umbrella', which allowed for the CMN to define the exchange rate policy and for the BCB to *"work just* as if *it were independent"* (Franco 1999 - original emphasis; also Sola, et al. 2002: 128).

Figure 38: The Presidency-Fazenda-BCB Triangle



This arrangement of 'negotiated insulation' had two sets of implications: First and crucial for the subsequent section 7.3.2, the presidency represented the primary, albeit not exclusive, entry point into the exchange rate policymaking process for voices from the governing PSDB-PFL coalition, from Congress and also for societal interests, which were unable to otherwise influence technocratic decisionmaking. Secondly, this informal mode of insulation enabled policymakers at the BCB to pursue a policy course that could diverge (if only in the short run) from Cardoso's preferences and was therefore vulnerable to being driven by technocrats' own set of politico-strategic motivations. In this sense, this setting did not only foster the open academic-technocratic discussion style that characterised the run-up to the *Real* Plan, but it eventually also precipitated the emergence of a *Fazenda*-BCB nexus,

[22] Interviews confirm that the team's autonomy was only marginally affected by Cardoso's departure from *Fazenda* in April 1994 insofar as his replacements Ricúpero and Gomes respected the team's status and focused primarily on the communication of policy measures (e.g., R.M. do Prado 2005; Fiuza 2006).

which effectively insulated this field from presidential interference and allowed for the emergence of an 'exchange rate dogmatism'.

Cardoso's motivation for granting his team this degree of freedom stems from a combination of the political and economic benefits of apparent non-interference in monetary and exchange rate policy matters given an international context, in which the norm of technocratic independence was purported to be a key prerequisite for policy credibility, and the fact that he trusted 'his' technocrats whom, after all, he had carefully selected for their professional credentials and precisely because they converged with his conception of a new socio-economic model (Interviews Lara Resende, Cardoso, Arida, Loureiro and Abrucio 1999: 83). With formal central bank independence having been ruled out, both sides gained from 'talking up' the degree of technocratic autonomy insofar as it allowed Cardoso to dodge the political costs of the restrictive macroeconomic policy course by 'scapegoating' the CMN and the BCB (Interviews Cardoso, Lara Resende and Franco), while the BCB's *perceived* 'operational autonomy' usefully increased its financial market credibility.[23] Finally, Cardoso was only too aware of his constitutional power as federal president to, albeit at a cost, unilaterally impose a policy change should he wish to do so.

Cardoso's Failed Balancing Act: The Emergence of the Fazenda-BCB Axis

Precisely in order to avoid having to incur the costs associated with this 'back-up' option of interference, Cardoso sought to limit the decisionmaking autonomy of individual team members and to institutionalise an on-going debate on aspects such as the exchange rate so to prevent the emergence of inflexible, monolithic thinking (Interviews R.M. do Prado, Franco, Lara Resende, Fiuza 2006: 128). In marked contrast to later periods, the team's discussions in the run-up to the *Real* Plan were academically-minded and consensus-seeking in character (Interviews Arida, Franco, Lara Resende, R. M. do Prado 2005; Cardoso 2006a: 185; Fiuza 2006: 128). Yet, with respect to the exchange rate, these discussions initially failed to generate consensus (Interview R.M. do Prado). This was in part due to the 'Larida Plan's' inconclusive stance given that the team's 'mind map' had been drawn up for a closed economy (see Chapter VI). Moreover, by the mid-1990s precisely the exchange rate question had pushed its joint authors, Lara Resende and Arida, into opposing camps in the academic

[23] Part of this strategy was the creation of the *Copom* in 1996 (*Circular* 2.698), which from then onwards set interest rates in formalised monthly meetings. This initiative intended to confer greater credibility to monetary policy by establishing a more transparent 'ritual' and granting ever greater informal weight to the BCB (Fritz 2000: 210-211). However, as its first members note, its *de facto* 'independence' remained weak given that its legal basis was a mere BCB *Circular* that could easily be revoked by the presidency and due to continuous *Fazenda* attempts to 'influence decisions' (Franco in VE 13th September 2004; Fiuza 2006: 279).

debate on how best to balance the needs for 'credibility' and 'discretion' in stabilisation programmes and therefore on the usefulness of hard exchange rate pegs as solutions to inflationary dynamics (R. M. do Prado 2005: 122-123). While Lara Resende believed that, as a transitional instrument, nothing but a fiscal 'straitjacket' could break Brazil's deeply-rooted tradition of financing government spending through inflation and thus proposed a Brazilian *'Plan de Convertibilidad'* (R. M. do Prado 2005: 84-85 + 124; Cardoso 2006b: 180; Fiuza 2006: 127),[24] such 'hypercommitment' was strongly opposed by his colleagues Arida, Malan and Franco. The proposal was also rejected by Cardoso (Fiuza 2006: 129) and confronted *"very concrete political obstacles"* in Brazil's wider political class (Franco 2000: 35). The shared principled belief in the value of monetary sovereignty and the *"unwillingness to surrender the idea of a national currency"* and to grant a key role to a foreign currency was therefore strong in the economic team and beyond from a very early point (Franco 2000: 35; Cardoso 2006b: 175; also see Franco 2006: 573-575). As Cardoso (2006b: 146) notes,

> [a]lthough the easiest way [for establishing the plan's credibility] would have been to transcribe everything into US dollars, […] this procedure was associated with various inconveniences. Hence the decision to use a currency invented by us [the URV] as a comparative term, which would be a substitute for the dollar as reference point.

Acknowledging the need for executive discretion, the 'indexed money' strategy also appealed because, unlike dollarisation or a currency board, *"it preserved room for manoeuvre for the implementation of a non-traumatic devaluation at some [later] point"* (2006b: 175). Given that *"Brazil had not experienced the degree of monetary and financial decadence that one saw in Argentina"* (Franco 2000: 35), the team's consensual position was that the widely praised Argentine strategy of 'hypercommitment' was unnecessarily constraining (Kingstone 1999: 195; Corden 2002: 174; R. M. do Prado 2005: 174+180; Cardoso 2006b: 148). Indeed, in contrast to Argentina, the economists – although highly critical of Brazil's state institutions and its political class and determined to *"reshape the structure of the state and the relationship between the state and society"* (Cardoso 1996: 7) – believed in the state as a *"positive, high-quality political instrument"* (ibid.: 12) and regarded the state – or indeed government – not only as an obstacle to economic development but also as a solution (World Bank 1994: 64). This position was incommensurable with the sacrifices of policy autonomy entailed by a currency board. 'Hard peg' strategies were thus ruled out as early as December 1993.

[24] His article *"A Moeda Paralela Conversível: Para Evitar a Dolarização"* was published in the *GM* in June 1991 (R. M. Do Prado 2005: 124). Unlike Cavallo, Lara Resende always objected to incorporating a currency board into the Constitution.

This consensus against a hard peg, however, did not make the decision on the *Real* Plan's exchange rate strategy any easier. The modalities of the final decision in May 1994 highlight the importance of professional credentials, pragmatism and academic argument at this initial stage, which superseded formal institutional roles (Cardoso 2006b: 346). The decision against a conventional peg and in favour of an asymmetric band was driven by its offering an equilibrium between rules and room for discretionary action: Its fixed ceiling would generate crucial credibility, while the upward flexibility of the *real* would reinforce the anti-inflationary trend without sacrificing the room for manoeuvre that the team regarded as key for building and sustaining the legislative coalitions necessary for the long-term programme of structural reforms (R. M. do Prado 2005: 223-225). Interestingly, this idea had first been suggested by BNDES President Arida and only then was embraced, shaped and ultimately implemented by DIREX Director Franco.

Aware of Franco's growing influence and polarising attitude, Cardoso sought to curtail his unchallenged control over the exchange rate, retain the initial open-mindedness of the debate and to create a counterweight to Malan at *Fazenda* by appointing Arida to the BCB presidency in January 1995 (R. M. do Prado 2005: 410+424; Cardoso 2006b: 339-346). But rather than institutionalising a productive debate, this move fuelled internal divergence and tensions vis-à-vis the asymmetric float: While Arida regarded the market-driven appreciation of the *real* as a short-term tool, Franco and Malan came to appreciate a 'strong exchange rate' as a powerful political instrument. The utter failure of Cardoso's balancing endeavour and the defeat of Arida's perspective became manifest with Arida's resignation after Franco's crawling band had been adopted in March 1995 and with the institutional strengthening of the Malan-Franco nexus as a result of Franco's appointment to the BCB presidency in 1997. This allowed for the consolidation of a rigid exchange rate policy course within the CMN, where the duo monopolised decisionmaking by marginalising the Ministry of Planning.[25]

More worryingly for Cardoso, the exchange rate stance also became increasingly immune to informal presidential pressures given the duo's decisive appeal in international markets, which afforded them protection by raising the costs of the presidential 'back-up option' insofar as a presidential intervention against the *Fazenda*-BCB axis risked precipitating the resignation of both economists and thus a major jitter in financial markets (Loureiro 2005: 39; Cardoso 2006b: 370).[26] In this setting, likened by some to a *"feudal organisation",* open

[25] In a largely ineffectual effort to improve legislative oversight of the 'Presidency-*Fazenda*-BCB-triangle', Congress created the *Comissão Mista de Moeda e Crédito* (Loureiro 1997: 111).

[26] Franco's credentials were reinforced by several prestigious awards (e.g., Economist of the Year 1997 by the *Ordem dos Economistas de São Paulo* and Euromoney's Central Banker of the Year in 1998) and by invitations to the World Economic

discussions of alternatives even within the BCB were precluded (Lopes 2003: 37; JR Mendonça de Barros in R. M. do Prado 2005: 453), and criticisms of the concentration of exchange rate policy in the hands of unelected technocrats became commonplace (Loureiro 1997: 111; Centeno and Silva 1998; Diniz 2000: 28; Pio 2001b: 41; Loureiro 2005: 40-41).[27]

In short, once Cardoso's attempts to neutralise any dominant elements within the economic team had failed, the *Fazenda*-BCB nexus' policy course was no longer dependent on the presidential 'umbrella' nor on the president's respect for some norm of 'technocratic autonomy' but was quite simply protected by the duo's international standing, which afforded them extra-normal decisionmaking power (Loureiro 1997: 114; 2005: 35-36). Indeed, Cardoso's *modus operandi* once he decided to force an exchange rate policy change chimes with this interpretation (Power 2002: 628): Given the high reputational costs of a *forced* resignation, he resorted to informal threats rather than openly exploiting his constitutional powers and eventually obtained Franco's 'voluntary' resignation in January 1999.

The Exchange Rate as a Political Strategy Tool

Accounting for the petrification of the crawling band in the late 1990s, many commentators argue that the government was 'stuck' in or unwilling to escape from an 'exchange rate trap' (*armadilha cambial*)(Loureiro, et al. 1998: 76; Corden 2002: 175). In contrast, I hold that the strategic *political* use of exchange rate decisions by Franco and Malan and their perception of the anchor's continued political benefits motivated the continuation of the regime. Other than the traditional appeal of an exchange rate-based stabilisation with a view to electoral effects (Schamis and Way 2003: 51), I further argue that the duo particularly valued the use of the exchange rate as a disciplinary device that would provide constant impetus towards fiscal and other structural reforms in a political system in which reform efforts tended to stall in the medium term (Franco 2000: 5).[28] Cardoso's appreciation of this discipline was considerably more opportunistic. Accordingly, it faded rapidly when the strategy's economic and political costs rose and its effectiveness in propelling the Brazilian political system towards reform declined.

Electoral considerations were thus only of subordinate importance with respect to regime choice. However, the *timing* of the *real*'s introduction in 1994 was driven by the

Forum as well as support from renowned economists, such as Fishlow ("It is not necessary to change the exchange rate policy" – *GM* 20th May 1996), Dornbusch ("Devaluation would be a mistake" *GM* 3rd February 1997) and Cavallo (*GM* 25th February 1997).

[27] Lopes' proposal of an 'Exchange Rate Policy Committee' similar to *Copom*, which would re-introduce an element of collective decisionmaking to the exchange rate policy process, failed to obtain support (R.M. do Prado 2005: 534-545).

[28] Gomez Mera (2005: 121) makes a similar argument about *Fazenda*'s commitment to Mercosur.

electoral calendar and therefore at least partially confirms the hypotheses of the political business cycle literature (Interview Lara Resende; Filgueiras 2000: 105). With a view to the positive potential impact of disinflation-cum-appreciation on consumption, the team chose to launch the new currency earlier than originally envisaged so to optimise Cardoso's prospects (Interviews Arida and Franco, Cardoso 2006b: 203). The sheer strength of the impact on real salaries and, most importantly, on his poll ratings was not lost on Cardoso and certainly explains his initial complacency with respect to the *real*'s rapid appreciation (Cardoso in Moreira Salles 2007: 4).[29] Conversely, concerns about a devaluation's impact on Cardoso's chances for re-election represented an additional factor that discouraged regime change, that is non-crisis exit, in 1998.

The Exchange Rate Anchor: A Weapon Against Political Complacency?

A more important political motivation was the realisation that once the sentiment of inflationary crisis would be overcome much of the impetus towards structural reforms and fiscal equilibrium, which had enabled the executive to push through a set of initial reforms in 1994 and 1995, would be lost. Unwilling to relive the collapse of the *Plano Cruzado,* the economists were determined to avoid this loss of political momentum and the resulting fiscal laxity (Interviews Arida, Lara Resende, Bacha, Filgueiras 2000: 100; Bacha 2003; Sola and Kugelmas 2006: 90). In Franco's words, the team was acutely aware of the fact that

> [a] major enemy of stabilisation […] was complacency. We had to find ways to prevent politicians to declare victory on inflation too soon; if they were allowed to do so and earn the associated political dividends, no further effort would be put into the unpopular measures necessary to make stabilization sustainable. […] We knew we had to innovate in building a plan […] which would be regarded as precarious in the eyes of the politicians. In these circumstances, politicians would feel constantly forced to deliver the reforms that would make stabilisation sustainable (Franco 1999).

In a context of international financial market discipline and, as it happened, recurrent crises, the exchange rate anchor represented a tool for maintaining this sensation of 'precariousness' among Cardoso's wide centre-right alliance of the PFL, PMDB, PPB, PTB and the PSDB, which had *"united […] behind the defence of the Real Plan"* (Kingstone 1999: 199). It was a constant reminder of the need to reform the Brazilian state and economy insofar as

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[29] This is illustrated by Cardoso's recollections of a campaign event where *"[t]he Real was the star of the show. 'It's worth more than a dollar!' people yelled - people who had never seen a US dollar before in their life, but they were proud nonetheless. Eleven days after the introduction of the new currency! Their perceptions and the relationship between the population and the currency had completely changed. Our currency was now something positive, no longer that old piece of junk, that worthless thing you threw in the trash"* (2006a: 199).

> the foreign-exchange 'anchor' heightened the importance of fiscal discipline as the ultimate factor in sustaining stabilisation and forced the political establishment to work toward this goal (Franco 2000: 5).

This way, *"an [exchange rate] regime with 'rigidities' helped a lot […] to frame the congressional agenda towards reforms"* (Franco 1999). Especially Franco and Malan – and to a certain extent also Cardoso himself – subscribed to this (in hindsight wishful) thinking that likened the rigid exchange rate band to a welcome 'thumbscrew' for congressional politicians, while not sacrificing all monetary policy autonomy (Franco 1999, Interview Cardoso).[30] Of particular instrumental value was the fact that, under the crawling band, the widespread desire for interest rate reductions among politicians, businessmen and the wider public was translated into a political impetus towards fiscal restructuring (see Minella 1995: 98):

> Pressure was constant on the political authorities to move ahead with fiscal reforms: the faster politicians moved with fiscal balance, the quicker the easing in monetary policy. Simplistic as it may look, this was a powerful formula to mobilise society for reform to an extent difficult to conceive otherwise (Franco 1999).

While retrospectively it is easy to condemn this perspective as politically naïve, the initial rewards proved considerable and rendered a path of exchange rate overvaluation and external debt-driven development not only sustainable but also placed Brazil at the centre of international praise and investor attention thanks to the combination of an extraordinary interest rate differential with an implicit guarantee inherent to the exchange rate regime (Shambaugh 2004: 285). Moreover, the strategy was initially proven right with respect to its stabilisation and de-indexation success and also insofar as structural reforms progressed, such as the privatisation of state-owned companies (*Programa Nacional de Desestatização* – PND) and deregulation (Saba Arbache 2004). The desired 'thumbscrew' effect seemed to also have been successfully leveraged when congressional support was mobilised for the so-called *'pacote 51'* of radical fiscal emergency measures in response to the Asian Crisis in December 1997. Indeed, the Asian Crisis conveniently reactivated the exchange regime as a catalyst for reforms after some backsliding in 1996, and Franco and Malan were determined

> to seize the Asian Crisis as an opportunity to advance with the reform agenda based on the argument that Brazil was vulnerable *because it was late with reforms* and that there was no reason to depart from the gradual devaluation of the

[30] For the literature on the dispersion of political power and its impact on the maintenance of fiscal discipline in Brazil, see Kingstone and Power 2000.

> *Real* (Franco 1999 - original emphasis).

By 1998, the exchange rate policy duo felt vindicated by the relative ease with which Brazil had emerged from the Mexican and especially the Asian Crisis. Cardoso himself suggests that this speedy recovery created an illusion of an invincible exchange rate anchor, which

> maybe led us to miss the opportunity to review the exchange rate question during the first quarter of 1998 when it would have been possible to do so. […] [W]ith the recent memory of overcoming the crisis, the motivation for a shift disappeared. Instead, […] the resistance to fundamental changes grew – not due to 'exchange rate populism' and in order to secure electoral victory but for fear that the politico-electoral nervosity would be contagious to markets and that a modification of the exchange rate regime […] would provoke the return of inflation (Cardoso 2006b: 388).

Cardoso's final point suggests that fear of resurgent inflation and ballooning public debt constituted another reason for continuing the regime. Malan, Franco and Cardoso repeatedly referred to this possibility and its implications for Brazil, and interviewees suggest that this reflected as much a personal conviction as a political strategy to generate political support for further reforms (Interviews R.M. do Prado, Arida, Franco). In Cardoso's words, as the crisis subsided, the temptation to continue using the exchange rate so to keep inflation under control and to stabilise the political edifice of the *Plano Real* proved irresistible (2000: 82).

Yet, with our present knowledge of the deterioration of public accounts in 1995-1998 and of the pre-electoral fiscal profligacy in 1998 (Giambiagi and Ronci 2004; 2006), the economic team effectively failed to create a fiscal backbone sufficient to make the *Plano Real*'s exchange rate strategy sustainable in the long run. It is thus interesting to juxtapose the prevailing understanding of the political use of the exchange rate 'anchor' with Arida's perspective, which had been marginalised by 1995. Both conceptions shared the objective to deepen the structural reform agenda and a fear of 'political complacency'. Nevertheless, they advocated opposing long-term exchange regime choices: Whilst the ultimately dominant vision regarded the exchange rate anchor as

> creating the political conditions, which would allow the government to advance its reform agenda and improve the fiscal side, the other vision suggested that the exchange rate anchor was dispensable […] Indeed, while a fixed exchange rate would generate complacency in the political system – if everything is going well, it's unnecessary to confront the fiscal problems – under a floating regime depreciations have the virtue of publicly signalling the need to deepen reforms (Arida in *Valor Econômico* 30th June 2004).

In addition to Arida's conviction that a relatively fixed exchange rate would precisely generate the political complacency among Brazilian legislators, which Franco and Malan tried to prevent, Arida's hesitation about pegs stemmed from his observation that policymakers struggle to optimally time exchange regime decisions and tend to delay exits at great costs (Interview Arida, also see R. M. do Prado 2005: 125-126). Franco and Malan's political intuition proved insufficient not only to acknowledge this danger inherent to their stabilisation-cum-reform strategy but they also failed to foresee how effectively the exchange rate debate would be in dividing the executive team and ultimately also in undermining presidential support and thus the underpinnings of their orthodox economic policy course.

Internal Power Struggles: The Exchange Rate as the 'Chosen Battleground'

The exchange rate's instrumentalisation in power struggles both within the executive and in the wider political landscape represented the third key aspect that shaped decisions. Having already pointed to the tensions among otherwise like-minded technocrats generated by divergent exchange rate stances, other actors in Brazil's public sphere quickly identified the exchange rate as the battleground for attacks on the economic authorities.

The exchange rate policy process was particularly sensitive to politicisation *within* the executive but beyond the immediate economic team. Anticipating the allocation of cabinet positions in October 1994, economists and PSDB politicians who had been on the margins of Cardoso's economic team (e.g., Serra, J.R. Mendonça de Barros and Lopes) chose to take their criticisms of the exchange rate policy stance to the core of intra-executive debates. Their aim was to undermine technocrats' claims to key economic policy positions and to position themselves as more developmentalist-minded representatives at the centre of the new administration (R. M. do Prado 2005: 382 + 390). Yet, due to the euphoria at the time Cardoso ignored this critique and opted for technocrats at both *Fazenda* and the BCB whilst Serra was merely assigned control of the Ministry of Planning. While the distribution of influence favoured the orthodox line, this constellation could not stop the exchange rate dispute from becoming the 'chosen battleground' in the struggle for influence over the wider economic policy agenda between the orthodox-technocratic 'Malan-Franco axis' and PSDB politicians of a more developmentalist conviction, represented in the CMN by Serra. In this sense, the March 1995 decision in favour of Franco's crawling band was of much greater political importance than this minor policy shift may otherwise suggest. As Fiuza states,

> [e]veryone present knew that what was on the table ultimately was not the exchange rate. It was the decision about which side would lead the Brazilian

economy from then onwards (2006: 179).

These considerations began to influence exchange rate decisionmaking insofar as decisions were no longer driven by economic optimality objectives but rather served goals of strategic positioning. Indeed, once the policy field had become thoroughly polarised and personalised, space for reasoned debates on the issue became inexistent.

Over the course of the 1990s Cardoso thus became increasingly caught in between his economic team and PSDB politicians on whom he relied for legislative support and who represented the party's core constituency from Brazil's urbanised industrial heartlands, where industrial firms struggled to compete partly due to an overvalued currency. In 1998, when electoral concerns took on greater weight in Cardoso's calculations, the equilibrium eventually shifted towards appeasing these interests by signalling a shift to a more developmentalist second term agenda.[31] However, fearful of a devaluation or indeed of the market impact of a cabinet reshuffle, Cardoso held on to Malan and Franco and fostered a 'parallel economic team' consisting of the Mendonça de Barros brothers, Lara Resende and Lopes as well as Serra. This dual strategy, he hoped, would keep his post-election macroeconomic options open. One of the tasks he set for this secretive group was to formulate alternative exchange rate options (Interview Cardoso, R. M. do Prado 2005: 458). However, this 'exit project' experienced setbacks: First, the Russian crisis highlighted Cardoso's dependence on Malan's and Franco's crisis management skills. Secondly, Lara Resende's and the Mendonça de Barros brothers' resignations[32] in November 1998 deprived the re-elected President of several 'chessmen' for his second term strategy (Cardoso 2006b: 405). Nevertheless, by Cardoso's own account, it was now a foregone conclusion that a shift in the exchange rate strategy towards greater flexibility would be implemented to recreate discretionary policy space (Cardoso 2006b: 388-389). Acknowledging that the implementation of such policy change under the auspices of the duo Malan-Franco was not an option due to Franco's obstinacy, and pushed into action by deteriorating economic data, Cardoso decided to play his last trump: Lopes' exit proposal – the 'endogenous diagonal band' (R. M. do Prado 2005: 563-564). However, the negative market reaction and the ensuing need to cooperate with the IMF ruled out the envisioned re-orientation towards developmentalist objectives. Instead, recognising growing tensions between the BCB and *Fazenda* and determined to retain Malan as Finance Minister, Cardoso eventually conceded to Malan's demands and replaced Lopes

[31] Cardoso announced e.g., his intention to establish a 'Ministry for Production' (R. M. do Prado 2005: 465).

[32] Lara Resende was BNDES president, Luiz Carlos Mendonça de Barros was the Minister for Communications and José Roberto was Foreign Trade Secretary.

with Armínio Fraga, implying a return to the orthodox line.[33]

7.3.2 The Role of Societal Interests

Dynamics internal to the highly insulated executive environment – often likened to a secretive 'bunker' (Loureiro 1997: 109; e.g., Loureiro 2005; R. M. do Prado 2005; Fiuza 2006) – played a decisive role in driving exchange rate decisions throughout much of the 1990s. Although the nature of these internal dynamics changed over time, this decisionmaking monopoly was in principle held up throughout the period under investigation – and indeed beyond. Especially the decision to initially float the new currency and the details of the crawling band adopted in 1995 were largely unaffected by interest group activity, unlike what Frieden and others would want to argue (e.g., Frieden 1991b; 1994). Societal interests, who were strongly affected by the distributional implications of the *cambio valorizado* strategy, and indeed the political class were largely disregarded[34] and did not play any role in shaping exchange rate policy at these stages. However, as presidential support for the exchange rate policy course pursued by the *Fazenda*-BCB nexus faded in the face of the strategy's growing politico-economic costs and its reduced effectiveness as a reform catalyst, the presidency – as the key entry point for non-executive preferences – became increasingly open to the concerns of societal interests. This section hence argues that societal interests' limited influence in the early stages of the *Plano Real*'s exchange rate lifecycle was not only the product of the structural insulation of the executive, but that it also resulted from actors' own inability to identify their respective exchange rate policy interests in a timely fashion, to see beyond the paralysing impact of rapid trade liberalisation and disinflation as well as to overcome hurdles within their representative organisations so to effectively mobilise around these issues.

1993-1995: Institutional Exclusion and Disorientation

In a context of heightened institutional insulation, the composition of Cardoso's economic team, driven by criteria of technical competence, party membership and personal connections rather than interest group ties (Kingstone 1999: 201; Loureiro and Abrucio 1999: 77), posed an additional hurdle for societal interests who sought to influence exchange rate

[33] Lopes unfortunate role in this transition is documented by the fact that he does not even appear on the BCB website since he – although confirmed by the Senate's Economic Affairs Commission on 26th January 1999 – was replaced prior to his official inauguration.

[34] The PSDB leadership's reaction, summarised by Senator Covas as follows*: "You economists are as important to the party as we are; if this is the only way you think possible to proceed, ok, we will follow you… to the precipice!"* (in Bacha 2003: 187), illustrates the autonomy the party granted to the economic team.

policy. Moreover, the technical complexity and the academic nature of policy discussions effectively marginalised non-academic input from corporate or indeed party representatives: Both team members and interest group representatives confirm that no consultations of outside experts or interests on issues related to the exchange rate stance took place, and representatives from across the economic spectrum tell of their surprise and utter unpreparedness with respect to the rapid appreciation in the second half of 1994 under conditions of commercial liberalisation (e.g., Interviews Rebelo, Soares, Troster).

However, their lack of influence on exchange rate decisions during this time was not solely a function of their institutional exclusion but also stemmed from societal interests' struggle to adjust to ever-changing economic and political circumstances. While individual firms were overburdened with adjusting to the double impact of disinflation and heightened international competition in a context of high systemic costs (Kingstone 1999: 208),[35] representative associations struggled to adapt to their new roles as traditional corporatist arrangements gave way to new forms of organized influence (Neves Costa 2003: 147; Levitsky and Murillo 2005: 10). In short, businesses and their political representatives alike appeared politically disoriented, felt 'attacked from all sides' and succumbed to an individualised self-help attitude, which precluded coordinated mobilisation (Interview Rebelo, Bianchi Mendez 2004: 209). In part, this was due to the on-going reform agenda affecting their interests along several dimensions. Given resource restraints and the need to identify priority areas for political action, the exchange rate then tended to take a backseat relative to lobbying to counter, for instance, radical cuts in subsidised credits for agricultural producers (Baumann 2000: 37), to react to tariff reductions or to obtain fiscal exemptions.

To the extent that businesses did criticise the continued appreciation of the *real* and *"were up in arms against the uncomfortable losses imposed on them by the exchange rate policy"* and *"complained about the detrimental effect on exports and about the effects of growing competition through cheaper imports"* (R. M. do Prado 2005: 25), these critics still remained isolated, and their complaints were easily dispersed by a two-thronged executive response.[36] On the one hand, the government aggressively rejected all criticisms of the exchange rate stance and depicted demands for a devaluation as illegitimate requests advanced by *"the old industrial establishment together with segments of organised labour […] against the interests of the silent majority"* (Franco 2000: 5), who was benefiting greatly from the stabilisation-induced recovery of their purchasing power. Especially Franco accused non-competitive businesses of having failed to induce sufficient

[35] Brazil's uncompetitive costs (*custo Brasil*) derived from a very high tax burden on production, payroll costs and infrastructure inefficiencies (Kingstone 1999: 209-210).

[36] The commercial sector enthusiastically supported commercial opening, see Szajman 1994.

productivity increases, ridiculed critics as *'atrasados'* (retards) and 'myopic rent-seekers' and repeatedly denied the reality of overvaluation (Dornbusch 1997: 385; Power 2002: 624; R. M. do Prado 2005: 376).[37] On the other hand, the executive decided to implement various compensatory measures *"to support the industrial sector and stimulate exports"* (including preferential credit arrangements for exporters via BNDES and indirect tax exemptions for exporters of primary and semi-manufactured goods) as early as August 1994 in order to alleviate some of the transitional costs and to balance Franco's confrontational course (Kingstone 1999; Cardoso 2000: 81; Phillips 2004: 197). From March 1995 onwards, the commercial liberalisation course was also partially reversed and gradual tariff increases on key consumer goods were implemented (Portugal and Galvão 1996: 96; R. M. do Prado 2005: 325; Leitão 2006).

In the absence of an electoral alternative to Cardoso and overwhelmed by general enthusiasm, this cooptation strategy succeeded in containing complaints on the part of exporters and other businessmen, and influential representative associations chose to focus on other areas. The behaviour of Fiesp is a case in point insofar as its president Moreiro Ferreira, whose election in 1992 had polarised the entity's membership (Bianchi Mendez 2004: 231-261), decided to embrace the reform project and its underlying exchange rate strategy in spite of the visible reduction of industrial firms' domestic market shares and a sharp fall in profits (Hay 2001; Bianchi Mendez 2004: 267). Commending the '*successful battle against inflation with increases in production and salaries*' (FSP 2nd July 1995), Moreiro Ferreira decided to focus lobbying efforts on a 'positive agenda' of deepening the reforms so to remove 'internal inefficiencies', improving access to credit and accelerating state reform (Interview Bernardini). Although individual sub-sectors were severely exposed to the exchange rate (e.g., electrical goods, electronic equipment, footwear, clothing and textiles (Diniz and Boschi 2005: 10)), the issue did not represent a priority in Fiesp's lobbying hierarchy. Efforts to influence the economic team were thus reduced to individual negotiations about selective compensations.[38]

During this early period, societal pressures thus only played a role insofar as business complaints legitimated critical positions vis-à-vis the *real*'s excessive overvaluation inside the executive team and as they directed Cardoso's attention to the exchange rate issue. However,

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[37] Fiesp was still struggling with the consequences for its public image of having been singled out by President Collor as the national symbol for corruption and privilege (Kingstone 1999: 126).

[38] Fiuza (2006: 218) records a meeting between Fiesp entrepreneurs and Franco in September 1994 during which a proposal for the *'Adiantamento de Contrato de Cambio'* was made (i.e. an anticipation in *reais* of what exporters would sell in US dollars), which would have implied the transfer of the exchange rate risk to the state. While Franco refused to confirm this incident, he emphasised that he was repeatedly the subject of such 'hopeless attempts'.

the policy solution to this situation formulated by the economic team, i.e. the introduction of the crawling band in March 1995, remained entirely unaffected. Once again, this manifests the degree to which exchange rate policy decisions were sheltered from outside pressures.

1996-1998: Growing Opposition and Mobilisation

After Arida's exit from the BCB, Franco's strategy of exacting the modernisation of Brazilian business by means of the exchange rate anchor provoked growing opposition from businesses transcending sectoral lines and forced firms and representative organisations alike to re-evaluate their vulnerability to and position on the exchange rate (Filgueiras 2000: 131). Confronting significant losses in market shares both at home and abroad as productivity increases could not sufficiently compensate for the loss of competitiveness caused by the strong *real* and hampered in their capital investment strategies due to extortionate interest rates (Moreira 1999: 303), industrial businesses represented by the CNI and Fiesp were at the forefront and expressed their complaints in mass protests, such as the historic 'March to Brasília' on 22nd May 1996 (Kingstone 1999: 215; Bianchi Mendez 2004; Fiuza 2006: 217).[39] They received backing from various public figures, such as PT economist Maria de Conceição Tavares and the former Finance Minister and PMDB politician Delfim Netto (Fiuza 2006: 211). The heightened perceived importance of the exchange rate in this period is also confirmed in interviews with union representatives, who observed that the exchange rate argument took on a growing presence in wage negotiations from late 1995 onwards with employers arguing that the overvalued currency ruled out wage adjustments or indeed presupposed wage cuts or working hour extensions if competitiveness was to be maintained (Interviews Lúcio and Figueiredo, DIEESE 1995b; 1995a; Bolten 2007).

As efforts to affect exchange rate policy revisions repeatedly rolled off the well-sheltered and equally intransigent macroeconomic policy *équipe*, industrialists once more united to demand an acceleration of structural reforms so to reduce the *'custo Brasil'* and to render a reduction of interest rates sustainable. In other words, they precisely followed the logic proposed by Franco and Malan and increased the pressure on Congress to legislate for the deepening of the reform agenda – especially with a view to fiscal reform and deregulation.

In parallel, efforts on the part of various business organisations intensified to directly

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[39] Moreira (1999) reports import penetration ratios for 49 sectors, which suggest a process of 'regressive specialisation' insofar as economic activity became concentrated in sectors of low dynamism characterised by labour- and natural resource-intensitivity. Import penetration of industry rose from 4.5% in 1989 to 19.3% in 1998 with the most affected sectors being technology and capital-intensive sectors, such as electronics (12.6% to 160.7%) and machinery and industrial equipment (14.2% to 100.8%).

transmit their concerns to the government in meetings and via policy briefs so to create awareness of the damage inflicted on Brazil's industrial fabric by the rigid exchange rate course (Interview Cardoso, Bianchi Mendez 2004: 277-278). However, these initiatives mostly ended in mere talk. Indeed, the 'formal-informal-insulation arrangement' provided an ideal environment, which allowed Cardoso to play a sophisticated double game. He would consult societal interests and give them the impression of 'being listened to' and thus took some of the political antagonism out of the equation without acting on their requests or indeed passing on any of the political demands to the technocrats (Interviews Cardoso, Franco, Rebelo). Simultaneously, compensatory initiatives were implemented to placate producers threatened by imports and exporters, such as the expansion of the Office of Unfair Trade (Decom), tariff increases and the stipulation of minimum prices for sensitive sectors hit by dumping practices, such as textiles and toys, as well as the introduction of fiscal credits to compensate exporters' tax payment on the circulation of goods and services (ICMS) and payrolls (PIS/PASEP and COFINS)(Kingstone 1999: 221). These measures exacerbated the fragmentation witnessed in the business community during this period, brought about by the distinct set of winners and losers of the yet incomplete reform agenda (Payne 1994):

> Any firm or businessperson who could obtain dollars abroad stood to gain […]. On the opposite side, domestic producers too small to secure very low cost financing or too dependent on the domestic market suffered tremendously. Thus, small- to mid-size producers in sectors such as textiles, machine tools and equipment, and auto parts bore the brunt of Cardoso's policies (Kingstone 1999: 225),

while banks, pension funds and securities firms joined multinationals and importers as beneficiaries.[40] This re-organisation of national industry affected inter-sectoral relationships and hence the internal workings of business organisations (Bianchi Mendez 2004: 278). Moreover, Cardoso's administration used evidence of overall economic recovery in 1996 and international praise for the stabilisation success to marginalise its critics and disadvantaged sectors. Moreover, by fuelling popular fears of a return of inflation in case of a failure of the exchange rate band, those interests in Brazilian society that had greatly benefited from structural changes since 1994 were mobilised.

[40] Mergers and acquisitions by foreign companies contributed to extensive shifts in ownership in sectors like auto parts, consumer electronics and agroindustry after 1995 (Kingstone 1999: 249-250; Bianchi Mendez 2004: 276).

1998 Elections: An Opening for Societal Interests

As reforms once again stalled in spite of interest groups' sustained and concerted lobbying efforts and with interest rates having been raised to unprecedented levels in defence of the exchange rate band during the Asian Crisis, the attention once again turned to the exchange rate strategy. Indeed, a change in the exchange rate regime was widely believed to allow for interest rates to be lowered so to shift Brazil onto a growth path (Cardoso 2006b). This strategic re-orientation was spearheaded by the new Fiesp president Horacio Lafer Piva, a young PSDB-related business man with developmentalist convictions who was eager to differentiate himself from his predecessor whom he and other Fiesp members regarded as *'in a state of political coma'* (Semler 1996; Bianchi Mendez 2004: 279). Lafer Piva's argument (1998) that *"[i]t has become impossible in Brazil to protect the [value of the] currency and at the same time to defend industry, employment and economic activity"* was quickly embraced by other representative organisations such as the CNI (1998), the IEDI as well as the *Paulista* sections of the governing PSDB. Hence from early 1998 onwards, Fiesp increasingly targeted the macroeconomic policy regime implemented by Franco, who became known as the most hated man on the *Avenida Paulista* (Interviews Franco; Rebelo 24th January 2006, Soares 9th January 2006). Plugging into the wider ideologically entrenched controversy on the optimal mode of global economic insertion for Brazil, Fiesp now focused in particular on the combination of high interest rates and the overvalued *real* (Kingstone 1998: 87; Diniz and Boschi 2005: 18). Working in loose cooperation with PSDB politicians from the developmentalist wing and coordinating an increasingly broad cross-factor alliance including the CUT and the *Força Sindical* in the context of the *'Pacto pela Produção e pelo Emprego'* (OESP 18th December 1998), Piva increased the political pressure on Cardoso in the run-up to the presidential elections and certainly contributed to the president's re-evaluation of the exchange rate policy stance over the course of the year.

In addition to this increasingly organised opposition to the macroeconomic model both in Brazilian society and in the PSDB, Cardoso could no longer ignore the country's heightened external vulnerability after the Russian crisis and became increasingly receptive to suggestions that a policy change was inevitable given the negative impact overvaluation was having on considerable segments of Brazil's industrial landscape as well as on other electorally important variables such as trade and unemployment statistics (Franco 1999; Cardoso 2006b: 388).[41] However, it is key to emphasise that – in stark contrast to Argentina where industrial

[41] Unemployment had increased to 7.6% in 1998 from levels of under 5% in 1994 as employment growth in commerce and services no longer compensated for losses in industry after 1997 (Ferreira and Tullio 2002: 147; Baumann 2000: 35).

pro-devaluation interests took on a key role in formulating the modalities of the exit from the currency board – societal pressures exerted on Cardoso did not in and of themselves drive the manner nor indeed timing of the devaluation that eventually took place in 1999 but rather accentuated, reinforced and accelerated ongoing dynamics within the executive.

7.3.3 The Role of External Factors

Similar to societal interests, dynamic international constraints determined the wider parameters of the exchange rate policy decisions taken by the Brazilian administration. Some of these, such as international capital market conditions, were market-driven in nature, while others obeyed a decidedly political logic. In this respect, the IMF played a particularly important role.

The IMF and the Adoption of the Plano Real

After the antagonism of the 1980s, Brazil's relationship to the IMF underwent a process of normalisation over the course of the 1990s. The attitude of Cardoso's administration towards the IMF should thus be described as 'friendly' but critically distanced and eager to minimise constraints on policy autonomy (R. M. do Prado 2005: 464; Sola and Kugelmas 2006: 90 + 94). Similar to the Argentine case, the IMF played a subordinate (or even obstructive) role with respect to the adoption of the *Plano Real*. Although Brazil stood in no contractual relationship with the Fund after August 1993, the authorities actively sought approval of the stabilisation plan in order to benefit from the credibility effect in international markets and because they took such agreement to be a pre-condition for Brazil's participation in the Brady Plan.[42] Already in September 1993, Franco, next to Malan the key interlocutor with the Fund throughout Cardoso's presidency, therefore tried to convince IMF staff of the merits of the *Real* Plan (Bacha 2003: 187-188; Franco 2006: 538-539; Sola and Kugelmas 2006: 107). But IMF staff rejected stabilisation based on an indexed currency and thus intentionally endangered Brazil's participation in the Brady Plan (Filgueiras 2000: 141; R. M. do Prado 2005: 151; Cardoso 2006b: 163). Unwilling to budge on the stabilisation measures, this quagmire was eventually solved by the continued surge in capital inflows in 1993-1994, which enabled the Brazilian authorities to directly – and under strict secrecy – purchase the

[42] The US government had made the purchase of US Treasury zero coupon bonds as collateral for Brady Plan debt restructuring conditional on IMF approval. Moreover, without IMF support Brazil did not possess sufficient reserves to cover the US$ 2.5 billion expense (R.M. do Prado 2005: 157; Cardoso 2006b: 161-163; Fiuza 2006: 22-23).

necessary US Treasuries (de Almeida 2004).[43] Having been pushed into this audacious manoeuvre by IMF scepticism, Brazilian policymakers highlight the fact that the IMF, *"which had supported most of the misinformed previous stabilisation attempts never formally approved of the Plano Real"* (Franco 2006: 540; also Cardoso in Pompeu de Toledo 1993: 71).[44]

Similar to the Fund's re-positioning vis-à-vis Argentina's Convertibility Plan, its official attitude towards the *Plano Real* changed once it exhibited the first signs of disinflationary success, popularity and politico-economic sustainability. This radical turnaround is illustrated by comments by Camdessus, who after opposing the plan until mid-1994 stated in October 1995 that *"[t]he Real Plan is one of the greatest successes of the last years"* (Camdessus in OESP 6th October 1995). Supporting the Brazilian reform strategy, the IMF leadership added that the *Real* Plan's *"progress in combating inflation has been spectacular, but [that] inflation continue[d] to exist and [could] […] return at any moment"* (Camdessus) and that in spite of *"a lot of political pressure […] the government must not give in"* (Fischer).

The IMF's role in postponing exit from the *Real* Plan's increasingly rigid exchange rate element must be seen as minor compared to its role in explicitly encouraging the maintenance of the Convertibility Regime in Argentina. Similar to the Argentine case, however, the IMF provided consistent external support for the overvalued exchange rate and therefore did contribute to reinforcing the legitimacy of the underlying strategy and of the policymakers involved in its implementation. Statements such as Camdessus' remarks in September 1996, when he praised the authorities' determination to further structural reforms, were commonplace (Camdessus 1997a). Interestingly given Fischer's view on bipolar solutions, the IMF's deputy also endorsed the exchange rate regime's in-built flexibility and discretion (Fischer 1998). As late as September 1998, Fischer reassured markets about Brazil's exchange rate regime insofar as

> Brazil will again be willing to defend its currency if it is attacked. That is an important reassurance that the markets should have, based on last year's experience (IMF 1998b).

Similarly explicit support for the regime's maintenance had been forthcoming from the IMF Executive Board in March 1998, which *"generally supported the authorities' policy of seeking a gradual depreciation of the real exchange rate within the current band system"* and *"felt that, in the present unsettled*

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43 The US authorities discovered Brazil's actions in March 1994 by which point the BCB had purchased bonds for approx. US$2 billion. The US chose not to further obstruct Brazil's participation in the Brady Plan, which ultimately happened on 1st April 1994 (Fiuza 2006: 26-27). According to Franco, the Brazilian government offered the IMF an agreement without loan so as to harness its signalling effect but this was rejected (Franco 2006: 539).

44 Cardoso claims that Fischer even proposed a temporary freeze (in Pompeu de Toledo 1998: 71).

market conditions, any significant modification of exchange rate policies could be misinterpreted and could lead to a loss of confidence" (Staff Report April 1998 in IMF 1998a: 175).

In contrast to the Argentine case, it should be noted that there were also some more critical voices to be heard in public, which repeatedly cautioned against the authorities' interpretation of the *real*'s appreciation as driven by productivity increases rather than exhibiting structural imbalances and overvaluation (IMF 1998c). However, such public criticism was usually very measured, made special mention of the authorities' best intentions to deepen reforms and thus rarely made the headlines as a critique of the exchange rate strategy *per se* (Camdessus 1997b).

The IMF and the Exit from the Plano Real

As the crisis deepened, the IMF and key countries, such as the United States, stood close to Brazil's government and gave further credence to the authorities' *"firm commitment to their current exchange rate regime"* (Cardoso 2000: 85) by means of a 'precautionary' package approved on 2nd December 1998 (Camdessus and Fischer 1998).[45] Failing to detect the growing internal tensions between their interlocutors Malan and Franco and Cardoso's 'parallel team' nor the crumbling consensus vis-à-vis the exchange rate stance, the IMF authorities believed as late as 13th November 1998 that

> [t]he exchange rate regime will continue. […] It has a basic rate of crawl of about 7.5% […]. That will mean a continuing rate of real devaluation of about 7.5% a year. Also, the Brazilians […] have been gradually broadening the band around the central crawling rate, and that broadening of the band will also continue (Fischer in IMF 1998d).

Brazil's commitment was also confirmed in its Letter of Intent (Interview Lara Resende, Franco 1999; IMF 1999b; Filgueiras 2000: 187). It therefore did not come as a surprise that IMF staff – and the twenty governments that had contributed to the 'precautionary package' – responded with great displeasure to Brazil's devaluation in January 1999 (IMF 1999c; Sallum Jr. 2004). The IMF adopted a more cooperative course only once Malan had committed to a post-devaluation agenda on 18th January, which paved the way for the renegotiation of the 1998 agreement (Ferreira and Tullio 2002: 148). However, over the course of these negotiations, the IMF's reticent attitude repeatedly fuelled fears of Brazil being pushed into

[45] The November 1998 package totalled US$ 41.5 billion (including contributions by the IMF, the IBD, the WB and the G7, which were all governed by IMF conditionalities). The IMF portion consisted of a traditional SBA (five years at 4.25% interest p.a.) combined with an emergency SRF (18 months at 7.25% interest p.a.).

accepting convertibility *à la* Argentina (FSP 24th January 1999; Interview Franco).[46] These fears only subsided once the preliminary targets, enshrining fiscal and monetary austerity during the transition to inflation-targeting, were agreed in June 1999 (Filgueiras 2000: 189).

In summary, although external players only played a subordinate role at the outset of the *Plano Real*, the evidence suggests that the IMF and key members, such as the US, exacerbated the tendency towards policy inertia by propping up an increasingly fragile arrangement through financial support and repeated praise, by dispersing criticisms of the *real*'s overvaluation and by explicitly advising against measures to reform the exchange regime (e.g., IMF 1998d). Finally, although the 1999 episode demonstrated how IMF influence increases in crisis periods, the Brazilian case shows that even in such trying circumstances governments can retain a degree of freedom in exchange rate regime decisions.

7.4. Concluding Remarks

The exchange rate turned into a politico-economic chess piece for President Lula just as it had done for the former President Fernando Henrique [Cardoso] – even though the exchange rate regime of FHC's first mandate was fixed whereas nowadays it is floating. For different reasons and via different paths, they reached the same point: A weak dollar reduces goods' prices, which increase less than inflation, or even fall. This fuels popularity.

Leitão (2006)

Given that Brazil had been singled out by the World Bank as the one country in the region that *"had not seen a sizable appreciation in its real exchange rate"* prior to 1994 (Portugal and Galvão 1996: 99), the experience of overvaluation and the traumatic exit from the rigid crawling band in 1999 deserves special attention. In line with the argument put forward in Chapter III, this chapter showed that exchange rate decisionmaking in the 1990s was strongly determined by the dynamics internal to the executive and particularly some policymakers' acute awareness of the political uses of the exchange rate. Not only did the exchange rate offer an anchor to domestic prices and a policy tool for manipulating the business cycle, but it also provided the reform-minded factions of the government with an initially very powerful disciplinary device that generated the necessary impetus and political support for structural reforms. Additionally, I showed that non-executive interests – whether domestic or international actors, such as the IMF – were ineffectual in the initial stages of exchange regime change and only gained limited influence in the run-up to elections and as a source of external finance during crisis situations.

[46] According to R.M. do Prado (2005: 477), Camdessus and Fischer suggested that Brazil adopted a currency board on 16th January 1999. Only after Cardoso's refusal, the float was accepted (Interviews Lara Resende and Cardoso).

C H A P T E R   V I I I

CONCLUSIONS: EXCHANGE RATE POLITICS IN MIDDLE-INCOME EMERGING MARKETS IN LATIN AMERICA

8.1. Introductory Remarks

Since the breakdown of the Bretton Woods system and the adoption of the Second Amendment of the IMF's Articles of Agreement in 1978, the question of exchange regime choice has undergone an extraordinary evolution. Having previously been circumscribed by the prevailing norms of the international monetary system, exchange regime choice became a matter of country preferences permitting national executives to opt for a wide variety of regime types – culminating in a similarly broad range of successes and failures. In emerging markets, this broad range of regimes has been particularly impressive – and the depth of policy failure provoking tremendous politico-economic crises equally worrying. Especially the much-noted tendency towards a petrification of exchange rate arrangements, resulting in real appreciation, deteriorating current accounts and debilitating debt burdens, has had devastating effects for these countries' efforts towards sustainable economic development.

The cases of Argentina and Brazil are but two prominent examples in this respect. On the basis of an in-depth engagement with these two countries spanning 30 years, it was this thesis' overarching objective to trace the decisionmaking process so as to analyse, theoretically and empirically, those *political* factors that shape exchange rate policymaking. It sought to account for the glaring gap between economists' recommendations and actual policy choices. In response, this thesis offered an explanation of exchange regime choice in middle-income emerging markets in Latin America and of exchange rate petrification in particular, which centers on intra-executive dynamics at the domestic level and in particular on the role of executive 'policy entrepreneurs' with reformist ambitions as crucial determinants of policy outcomes. Indeed, Chapters II and III argued that once structural reform plans had gained currency within executives, these 'policy entrepreneurs' recognised the need to construct coalitions, which would enable and legitimate their endeavours. With exchange regime choice being increasingly framed by credibility concerns, exchange rate commitments were

deliberately employed to build and discipline such coalitions.

This thesis' novel focus on coalitional arrangements, on executive-society relations that develop against the background of such coalitions and on the role of international actors in exchange rate policy matters does not only shed light on the *adoption* of a particular regime. It also holds the key to understanding the prolonged *maintenance* – or petrification – of a regime insofar as governments seek to maintain coalitions, whose stability becomes increasingly dependent on the continuance of the exchange regime itself. In turn, fear of reform reversal in case of coalitional break-up motivates governments to hold on and defend the regime at growing costs. This coalition-building dynamic thus harbours the very risk of exchange rate petrification. Meanwhile, external actors such as the IMF fuel existing petrification tendencies. They do so by continuously exerting reform pressure on national governments and thus empowering reformist technocrats, while at the same time continuing to provide external validation to the exchange regime.

The purpose of this concluding chapter is threefold. Its first part, section 8.2., reviews recent exchange rate developments in Argentina and Brazil. The second part, section 8.3., draws together the thesis' four key insights of the explanatory framework and relates these findings to the existing literature. Particular attention is drawn to this thesis' conception of credibility (8.3.1.) combined with an enhanced emphasis on executive entrepreneurship and coalition-building in exchange rate politics (8.3.2.). Moreover, its critical appraisal of the role of international actors, especially the IMF (8.3.3.), and its closer analysis of the phenomenon of exchange rate petrification (8.3.4.) are highlighted. The third part, section 8.4., details the implications of these findings for policymaking and sets out an agenda for future research. Section 8.5. rounds off this chapter and the thesis with concluding thoughts on the future of exchange rate politics in emerging markets and in the Southern Cone in particular.

8.2. Recent Exchange Rate Political Developments in Argentina and Brazil

This first section traces the politics around the exchange rate in Argentina and Brazil since 2003 and on the basis of this thesis' conceptual framework maps out the evolution of those political dynamics that have been analysed in prior chapters. Although the countries' policy paths have once more diverged in the aftermath of the respective crises and the exchange rate political dynamics differ markedly in reflection of, among others, the countries' distinct historical experiences, governmental rhetoric and institutional structures of organised society, the exchange rate issue has remained a prominent and equally divisive one in both polities.

8.2.1 Argentina: From Devaluation to a 'Strong Dollar Policy'

In popular discourse, Argentina's recovery since 2002 and the rapid expansion thereafter represent a direct consequence of national exchange rate policy choices. Indeed, especially President Kirchner has successfully framed the 'Convertibility crisis' as the inevitable result of Menem's structural reforms, whilst conflating the post-crisis revival with his industrialist *'proyecto nacional'* – a strategy, which stands in marked contrast to the more orthodox stance pursued since 1999 by neighbouring Brazil. Its central pillar, a 'competitive exchange rate', was officially adopted in mid-2003 when President Kirchner and MECON minister Lavagna decided to preserve *"a stable and competitive real exchange rate"* (Epstein and Pion-Berlin 2006: 3; Frenkel and Rapetti 2007: 21). Although no specific target was identified, both the BCRA and the Treasury (via the *Banco de la Nación*) were to intervene in the foreign exchange market in order to establish an implicit floor to currency fluctuation first at ARG$3/US$ and, from late 2006 until mid-2008, at ARG$3.15/US$. Presented as the result of Argentina having learnt her lesson from experiments with excessive rigidity and overvaluation and as a crucial policy tool for incentivising tradable and import-substituting activities, this 'dirty float' remains in place (e.g., Frenkel and Rapetti 2007: 35; Redrado 2007).

Figure 39: Evolution of the Nominal ARG$-US$ Exchange Rate, 2004-2009

Source: www.yahoo.com (accessed 19th February 2009).

By increasing the relative profitability and output of a wide range of tradables, including agro-industries, manufacturing and services ranging from tourism to call centers (Unión Industrial Argentina 2006), the weak currency has arguably stimulated structural change towards higher-productivity tradables. Indeed, some have hailed this policy as an example of *"the magic of sustained currency undervaluation"* (Rodrik 2007b; 2008). Contrary to the 1990s, growth rates of 8.7% p.a. between 2004 and 2007 were not fuelled by external

borrowing but by a global commodity boom and strong productivity growth, supported by high gross national saving rates, exceeding 26% GDP in 2007. On the basis of this growth record, Kirchner built a political support alliance (*'Frente para la victoria')* that allowed him to act increasingly independently from PJ party structures and with great executive discretion. This was possible due to Kirchner's popular appeal – thanks to substantial populist spending, his popular perception as Argentina's saviour who turned the page after the Menemist era (e.g., by taking a harsh course against privatised firms, foreign investors and IFIs), and also thanks to the cooptation of opposition politicians (*'Radicales K'*)(Russell and Tokatlian 2006: 259). This fortunate constellation allowed the president to accommodate growing strains in his relations to both business associations and certain trade unions, which rejected the monopolisation of decisionmaking by Kirchner's inner circle and its refusal to effectively consult established societal groupings (Etchemendy and Berins Collier 2007; Levitsky and Murillo 2008).

In exchange rate policy matters, the executive regained almost exclusive control thanks to this exclusionary and opaque policy style, and Kirchner successfully cut industrialists' influence that had evolved under Duhalde (Interviews Rial, Massuh, Bolten forthcoming in 2009). This strong presidential position, embedded in a circle of close advisors, was notably achieved at the expense of institutional transparency and democratic accountability. MECON, for instance, remains increasingly constrained by the *Casa Rosada* and other ministries – with cabinet conflicts bringing down three ministers since 2005 (Lavagna, Peirano and Lousteau). Similarly, the BCRA leadership, although formally independent since 1992, is known to act under the presidency's 'guiding influence'.[1] Furthermore, Kirchner's intention to formalise this executive influence motivated proposals to revise the entity's mandate to incorporate the goal of 'economic development' and to 'better coordinate' BCRA activities with the executive (*Proyecto de Ley 1218-D-2007* of 30th March 2007). Although this proposal was eventually withdrawn, *de facto* governmental control over BCRA decisions remains strong – belying its supposed independence.

The Strong Dollar Policy: A Death Foretold?

However, since the 2007 election of Cristina Fernández de Kirchner, whom many regard as a mere façade for her husband's continued reign, tensions have intensified as price stability objectives increasingly conflicted with the exchange rate and growth path: In

[1] The non-renewal of Prat-Gay's appointment as BCRA president in 2004 and his replacement with the loyal Martín Redrado provided first indications of Kirchner's intention to centralise economic policymaking in his hands.

Argentina's overheated economy inflationary pressures were rapidly accumulating motivating the IMF to recommend that Argentina's *"monetary policy be more concentrated on prices, on stability, [rather] than on [the] exchange rate"* (de Rato 2007b). Yet, thanks to the policymaking autonomy afforded by more than US$50 billion in international reserves (**Table 39** on p. 261) that enabled Argentina to, among others, pay off its IMF debt in 2006, this advice went unheeded. Instead, whilst maintaining an undervalued exchange rate, recent administrations have failed to generate the necessary savings surpluses to render the *status quo* sustainable in the medium and longer run (*The Economist* 21st August 2008). In the absence of a coherent anti-inflationary strategy or a long-term vision of how the Argentine economy will sustain competitiveness in the face of inevitable real appreciation, the authorities have focused on *ad hoc* macro and micro measures including timid interest rate increases, selective price controls and foreign exchange interventions as well as Chilean-style capital controls (e.g., Frenkel and Rapetti 2007). Perhaps most controversially, recent administrations re-introduced export taxes of both a fixed and sliding scale variety. Fuelled by booming world prices, the buoyancy of Argentina's export sector created an invaluable opportunity for re-introducing this targeted and yet highly distortive fiscal revenue tool (Tanzi 2007: 149). The political appeal of *retenciones* resides in the fact that this form of tax revenue (approx. US$12 billion a year) is not shared with the provinces. Instead, it contributes directly to the federal fiscal surplus thus allowing the Kirchner administrations to produce primary surpluses of 3-4% GDP whilst orchestrating vote-generating public spending programmes. The risks of this strategy, however, have been unveiled by the global commodity price crash underway since mid-2008: Not only do exporters struggle under the tax burden but Argentina's fiscal position has become inherently dependent on international price developments.

The political shortcomings of this economic governance model are similarly apparent and threaten its medium-term sustainability. The government's confrontation with rural interests in mid-2008 over increases in the sliding scale taxes on grain and oilseeds exports and the bill's subsequent defeat in Congress as well as a rapid fall in Fernández de Kirchner's popularity illustrate this only too clearly.[2] Nevertheless, accumulating evidence for an approaching politico-economic crisis, the *peso*'s nominal plunge since late 2008 and the associated build-up in inflationary pressures as well as worrisome stocks of public debt have not yet undermined Fernández de Kirchner's commitment to her husband's 'strong dollar

[2] Three general strikes in March-July 2008 provoked drastic food/fuel shortages. Surprisingly, these rural protests also found allies in urban areas. As a result, Fernández de Kirchner saw herself forced to submit the bill to Congress, where it was defeated. Export taxes were eventually fixed at 35% for soy, 28% for wheat and 25% for maize.

policy', which she credits with having *"facilitated Argentina's repositioning in the world"* (2008).[3] Although the BCRA temporarily abandoned the accumulation of foreign reserves and instead shifted to selling US dollars to support the *peso,* its central goal of maintaining a 'competitive exchange rate' has remained unchanged and remains largely unchallenged. To the contrary, the popular reaction and that of organised interests to the process of real appreciation, underway despite recent bouts of nominal depreciation and fueled by domestic inflation consistently exceeding international rates, has been to propose an acceleration of the on-going depreciation so to obtain *"an improvement of the real exchange rate"* (Lascurain in Infobae 19th October 2008, Unión Industrial Argentina 2008).

Against this background, even timid steps towards an anti-inflationary stance have provoked widespread opposition by exporters and import-substituters (*La Nación* 25th November 2008). While it remains to be seen how the administration will handle this policy trade-off, past events suggest that a return to an anti-inflationary exchange rate stance appears unlikely. The UIA made its strong opposition to such policy shift widely known and successfully revived its ties to the opposition (Unión Industrial Argentina 2006: 31). More importantly, the Kirchners themselves have rejected an anti-inflationary programme and have even forced MECON minister Lousteau to resign as differences on this issue surfaced (*La Nación* 25th April 2008). In turn, the exchange rate stance *per se* has remained surprisingly unquestioned when considering the range of conflicts between recent administrations and different societal interests as well as cabinet-internal struggles, and the notion of an undervalued *peso* continues to command strong support in Argentine society and government circles alike. For now, it seems, as Néstor Kirchner rightly acknowledges, that *"exchange rate stability guarantees political tranquility"* (*Clarín* 20th February 2009). Unsurprisingly, Fernández de Kirchner therefore declared that *"the exchange rate strategy will not be touched"* (*ibid.*). Hence, as long as inflation does not accelerate markedly and the rural sector's protests against the current economic model remain outweighed by loyal supporters from popular and industrial circles, Fernández de Kirchner will not gamble her already falling popularity ratings by revising the exchange rate strategy.

Nevertheless, given the track record of erratic decisions taken in the Kirchners' *Casa Rosada*, the situation remains one of great uncertainty. Regrettably, exchange rate decisions have increasingly been monopolised by the presidential couple and insulated within its inner circle of advisors, known as the *"mesa chica"* (small table), with little respect for institutional

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[3] Marginal changes have been discernable, e.g., efforts to regain investor confidence by announcing repayment of US$6.7 billion in defaulted debt to the Paris Club and the possible re-opening of negotiations with '2005 hold-outs'.

transparency or democratic accountability. The bypassing of institutional structures, repeated interference with statistical data, and the undermining of BCRA autonomy (*Clarín* 15th May 2008) as well as repeated changes to the rules of the foreign exchange game (*La Nación* 10th November 2008) are but three aspects of the current exchange rate strategy, which undermine confidence. Worse, the persistent influence of the presidential spouse and PJ leader Néstor Kirchner, in violation of all principles of democratic legitimacy, exacerbates this sense of distrust precisely at a time when Argentina desperately needs to rebuild confidence in its currency and economic governance model.

8.2.2 Brazil: From Devaluation to 'Dutch Disease'?

Brazil's exchange rate policy experience since 1999 has followed a considerably different path: To many commentators' surprise, the administration of President 'Lula' da Silva, the first PT president in Brazil's history, maintained the broad tenets of the monetary and exchange rate policy strategy adopted by President FH Cardoso: an inflation-targeting regime combined with an administered floating exchange rate (*'câmbio sujo'*). Thus, whilst Argentina targeted the exchange rate so as to keep the *peso* weak, da Silva's administration has pursued an inflation target by means of a tight monetary and fiscal policy. Against this background, Brazil's economy underwent a remarkable recovery as its productive sector was well-positioned to take advantage of a favourable international environment, FDI inflows grew and growth rates recovered to rates exceeding those of the last decade (Paiva 2006: 5). Reflecting these positive developments, Brazil's sovereign debt received 'investment grade' in April 2008 and much praise from the international financial community (e.g., IMF Art. IV consultations 2008).

Brazil's distinct policy course is borne out by the evolution of its nominal exchange rate vis-à-vis the US dollar, which contrasts markedly with that of Argentina (**Figure 40**): Market jitters prior to the 2002 presidential elections – the so-called 'Lula effect' – let the *real* drop to almost R$4/US$ and forced the BCB to intervene to decelerate the growth of Brazil's dollar-denominated debt burden (Goldstein 2003; Garofalo Filho 2005: 152). Only an IMF agreement in conjunction with the PT's commitment to maintaining the economic policy agenda of the Cardoso administration (*'Carta ao Povo Brasileiro'*) eventually calmed down markets and led to the *real*'s stabilisation at a rate of R$3.50/US$ in late 2002 (Mollo and Saad-Filho 2006: 113). In the aftermath of this episode, the *real* has appreciated almost continuously, leading observers to describe *"the ongoing real exchange rate appreciation as Brazil's principal short term problem"* (Corrêa de Lacerda in *Terra Magazine* 3rd May 2007) and to caution

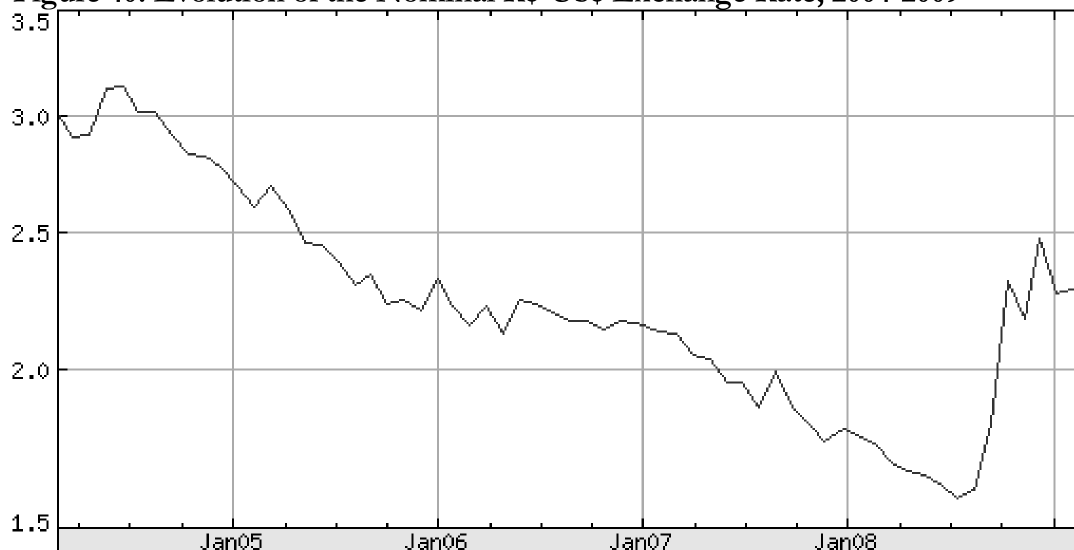
against the risk of falling victim to the so-called 'Dutch disease' (Gala 2006). Accompanied by growing competitiveness concerns, the exchange rate broke the psychological R$2/US$ barrier in May 2007 and reached another high of R$1.56/US$ in July 2008. Throughout this period, the BCB bought US dollars to rein in real appreciation and to expand foreign reserves, which as a result reached record highs of US$194 billion in late 2008. It was only under the impression of the current financial crisis that this trend was reversed, provoking a dramatic fall to R$2.53/US$ in December 2008 and forcing the BCB to sell US dollars for the first time in five years (*FSP* 4th December 2008). While alarming in its drastic nature and volatility, this drop usefully corrected some of the accumulated overvaluation. Moreover, thanks to the retirement of Brazil's dollar-denominated debt, depreciation no longer put the national balance sheet at risk but rather reduced liabilities.

Table 39: International Reserves in Argentina and Brazil, 2003-2007

	Argentina	**Brazil**
	International Reserves (US$ bn)	*International Reserves (US$ bn)*
2003	14.2	49.1
2004	18.9	52.7
2005	27.2	53.6
2006	30.9	85.6
2007	41.6	162.6
2008	44.9 (Oct)	208.6

Source: IFS and IMF.

Figure 40: Evolution of the Nominal R$-US$ Exchange Rate, 2004-2009



Source: www.yahoo.com (accessed 19th February 2009).

These long bouts of overvaluation as well as episodes of major currency volatility are the side-effects of an inflation-targeting regime under which *"the level of the exchange rate becomes an issue only to the extent that it affects inflation"* (Rodrik 2006: 23). The decision to subject

exchange rate policy to monetary policy objectives has led some to claim that since 1999 *"[t]he exchange rate regime [has] lost its political importance"* (Franco 1999). However, against the background of the analysis presented in previous chapters, I disagree. While one could argue that, replacing the exchange rate anchor, fiscal policy has become Brazil's new anchor and that therefore *"internal conflicts were dislocated from the exchange rate question to fiscal issues"* (Sallum Jr. 2004: 72), this does not mean that the exchange rate *per se* has become depoliticised. Indeed, on recurrent occasions since 2000, the exchange rate issue has attracted substantial public and media attention, generated societal cleavages and forced the government and its central bank into action (e.g., industrial policy package announced in mid-2008 compensating exporters affected by appreciation). If anything, the *real*'s rapid appreciation since 2002 showed that Brazil's 'exchange rate problem' had not been conclusively solved by switching to a float. Instead, this upward pressure (caused by surging capital inflows as macroeconomic fundamentals improved and high interest rates persisted while market confidence recovered) repeatedly forced the BCB to intervene in foreign exchange markets in order to preserve competitiveness (Garofalo Filho 2005: 151; Weisbrot and Sandoval 2006: 6) and provoked widespread concern about the likely consequences for Brazil's industrial fabric and export competitiveness (e.g., Bolten 2007).[4] The exchange rate even took on a surprisingly central role during the 2006 presidential campaign when Lula's opponent Geraldo Alckmin (PSDB) turned the issue of overvaluation into a key campaign topic (e.g., *FSP* 19th June and 21st August 2006; *The Economist* 2nd September 2006: 48). Tellingly, Lula's electoral performance in Brazil's South where industry (especially textiles) had greatly suffered from appreciation was clearly below average. The exchange rate issue also provoked government-internal divisions and led to the resignation of the Secretary for Economic Policy at *Fazenda,* Julio Sérgio Gomes de Almeida, in April 2007.[5]

There is thus little doubt that the exchange rate remains a politically controversial topic, which continues to be vividly discussed by the same societal actors that pressurised Cardoso into action in late 1999. The target of their criticism continues to be the BCB and its high interest rate policy. Continuing its trajectory of the 1990s, the BCB has become one of the most operationally independent central banks in international comparison, implementing an unusually strict monetary policy against sustained criticism from both the federal government and civil society. Although cabinet members' criticism of the BCB's rigid interest rate policy strengthened during da Silva's second term, the president has to date – and unlike

[4] For an example of industry's recent attempts to publicise the effects of overvaluation on Brazil's industrial fabric, see IEDI publication, available at http://www.iedi.org.br/admin_ori/pdf/20070816_cambio_ind.pdf [accessed 15th October 2008].

[5] BCB Director Azevedo's departure was also due to divergent exchange rate policy stances (*JB Online* 11th April 2007).

his Argentine counterparts – refrained from openly interfering with *Copom* decisions or indeed with the BCB's staff politics. He thus continues the 'informal independence' arrangement practiced so successfully by his predecessor (Interview Mendonça): The illusion of independence allows the government to use the BCB as a 'scapegoat' so to shelter from leftist critics who demand a loosening of monetary policy whilst collecting praise from market actors and IFIs for granting operational autonomy to its technocrats. However, the pressures from da Silva's own party grassroots to revise policy objectives towards developmentalist goals continue to grow and make for a hostile environment for the BCB:

> For the opposition, and here I include not only the opposition parties, the BCB is part of the government and therefore can be attacked. In turn, for the government, the BCB is autonomous and therefore does not need to be defended (BCB President Meirelles in *Valor Econômico* 2nd June 2006).

Attempts to curtail the BCB's autonomy thus continue – albeit not in governmental quarters.[6] For instance, proposals for re-expanding the CMN to include representatives of other societal interest groups have resurfaced since 2003 (see p. 215) and have found support among isolated congressmen (e.g., Marcelo Curado and Marcelo Passos (both PPGDE/UFPR), Fiesp and IEDI (*Carta IEDI* Nr. 156 of 20th May 2005). While so far fears of an international financial market backlash and a resilient societal consensus in favour of price stability have halted such proposals, they highlight the fragility of the operational autonomy currently enjoyed by the BCB. In the absence of formal guarantees it cannot be ruled out that at some point the presidency will exploit its constitutional power to interfere with monetary and exchange rate policy choices (e.g., Franco 2006: 269-270). These questions will thus remain on the agenda. Indeed, demands for a monetary policy reversal to render Brazilian products more competitive might even intensify as external accounts deteriorate further in 2009, as Brazilian exporters struggle on a recessionary world market. No doubt, the exchange rate issue will thus continue to remain a challenging political battlefield in Brazil – and may become even more salient once the campaigns for the 2010 presidential elections are underway.

8.2.3 The 'De-Dollarisation' Project

Paralleling these developments, some timid efforts were made to foster greater exchange rate coordination within Mercosur. Indeed, the crises' spill-over effects had brought

[6] The BCB's operational independence was strengthened by the *Lei de Responsabilidade Fiscal* (2000) and the amended Art. 192 of the Constitution (2003). Yet, turnover at the BCB remains among the highest worldwide, and efforts to implement fixed directoral terms have again stalled (Carstens and Jácome 2005: 19-20; da Nóbrega and Loyola 2006: 73).

home that the customs union could only survive if a minimum of coordination of exchange rate and macroeconomic policies was achieved, while simultaneously highlighting the difficulties of precisely such endeavour (Phillips 2001; Carranza 2003: 84; Gomez Mera 2005: 121). This challenging context did not discourage newly elected President da Silva to call for deeper integration and to propose a common currency in order to revive the struggling regional arrangement.[7] Soon after, Presidents Duhalde and da Silva announced plans to create a *"Mercosur currency"* and to found an *Instituto de Cooperación Monetaria del Mercosur* (*FSP* 15th January 2003; Phillips 2004: 132). However, Uruguayan opposition and a pronounced gap between these visionary pronouncements and the *de facto* political will in a context of renewed exchange rate volatility and vociferous Brazilian complaints about Argentina's depreciation strategy meant that the subject quickly disappeared from the bilateral stage (Phillips 2004: 131; Malamud 2005: 432).

Given this track record, the most recent bilateral project, once more presented as *"a first step towards a regional currency"* (Mantega in *FSP* 8th September 2008), must be viewed with scepticism.[8] Paralleling its predecessor programs, the Argentine-Brazilian project to partially 'de-dollarise' bilateral trade (*'Sistema de Pagamentos em Moedas Locais'* or *'Sistema de Pagos en Monedas Locales'* (SML)), implemented in October 2008, is accompanied by a more ambitious discourse of regional monetary integration than it merits (*OESP* 27th April 2007).[9]

At its core, the SML seeks to address a problem typical for South-South trade, i.e. the fact that Argentine-Brazilian trade is conducted in US dollars via third country banks.[10] Notwithstanding the growing volume of bilateral trade (amounting to US$25 billion in 2007) and the countries' geographical proximity, a foreign exchange market for their respective currencies remains almost inexistent (INTAL 2006). This status quo generates high transaction costs for trading parties. Worse, these unevenly distributed costs especially hurt the export prospects of SMEs as *"the spread [i.e. the difference between the sell and buying exchange rate] depends on the volume of transaction"* (BCRA representative in *La Nación* 4th September 2007). The proposed solution is to provide a voluntary method of payment for bilateral trade in local currencies that complements existing US dollar payment methods.[11] Yet, high hopes were

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[7] Menem proposed regional dollarisation in 1997. In 2000, Cardoso and De la Rúa had discussed but then discarded the possibility of a common currency (*peso real*), which was once more revived by Cardoso in 2002 (*Reuters* 21st August 2002).

[8] For the agreement, see http://www.comisionmercosur.hcdmza.gov.ar/documentos/seminario/ConvenioSML.pdf [2nd November 2008].

[9] See Appendix IV for a timetable tracing the evolution of the SML.

[10] Or via the *Convenio de Pagos y Créditos Recíprocos* operated by the *Asociación Latinoamericana de Integración* (ALADI).

[11] An Argentine importer pays for Brazilian imports in *pesos* to the SML administered by the BCRA. At the heart of the SML, the two central banks then compensate each another for any disequilibria in bilateral accounts. This daily clearing is conducted in US dollars. The Brazilian exporter then receives payment in *reais* from the BCB (Bolten 2008).

dashed by the current financial market turbulences: The SML is currently 'virtually paralysed' as firms prefer to bet on the US dollar rather than exposing themselves to *pesos* or *reais,* and cost reductions of 2-3% have so far proven insufficient to challenge this attitude and increase SML take-up (Wasilevsky 2008).

This project reflects executive motivations that are rooted in the domestic political economies. Indeed, one of the most notable characteristics of this project is the utter lack of civil society or business engagement, which is now also reflected in the low participation rate.[12] The SML was of particular appeal to the Kirchners as it chimes with their rhetoric of production-centred development and stimulates export activities of SMEs, which represent a crucial backbone to their government. In turn, for da Silva, the *desdolarização* project seems to have been a welcome opportunity to be seen to be 'doing something' to reduce costs for exporters in times of overvaluation. Interestingly, both governments have presented the SML, this 'de-dollarisation' device, as a means for reducing upward pressures on their currencies and volatilities stemming from US dollar movements (e.g., FT 21st September 2007; Mantega in OESP 24th July 2006). Perhaps more decisively, the SML was driven by a shared desire to attenuate tensions in bilateral relations after Argentina's decision to take Brazil to the WTO Dispute Settlement Body (2006) and Venezuela's Mercosur accession (Bizzozero 2003: 135). Yet, as the current state of the SML highlights, presenting it as an embryonic form of a common regional currency is misleading. *Per se,* this arrangement does not solve the problem of macroeconomic dissonance within Mercosur or even between Argentina and Brazil. Much greater political will than is currently discernable to institutionally embed policy coordination within Mercosur is necessary to achieve greater macroeconomic convergence and eventually monetary union (Malamud 2005; Bolten 2008).

8.3. Contribution to the Literature: Exchange Rate Politics in Middle-Income Emerging Markets

In response to its guiding research question *'What are the political determinants of exchange regime choices in middle-income emerging market economies?'* and on the basis of tracing the process of exchange rate policy formulation in Argentina and Brazil since the 1980s, this thesis generated four central conceptual insights that, responding to Jameson's call (2002: 127), integrate domestic political demands, international pressures and executive motivations. These insights

[12] See Fiesp (http://www.fiesp.com.br/agencianoticias/2006/09/04/7784.ntc) and Ciesp (http://www.ciesp.org.br/pdf/CIESPNEWS_julho_2007.pdf). The UIA has not defined a public position on the SML. This desinterested posture may be due to the fact that for companies with diversified commercial operations, the administrative cost of adjusting to the SML outweighs the actual cost reductions in trade with Brazil.

will be highlighted in the subsequent sub-sections as this study's central contribution to the literature on exchange rate politics in middle-income countries in Latin America.

8.3.1 A New Conception of Credibility in Exchange Rate Politics

A core concept in the literature on exchange rate politics, which is also at the centre of this thesis' argument, is the notion of (policy) credibility. Yet, this thesis' conceptualisation differs markedly from the literature's institutionalist reading of credibility insofar as it seeks to remedy some of the latter's flaws, as outlined in section 2.2.2.. The conventional reading does not only fail to capture the prevalent lack of institutional stability in Latin American emerging markets and hence executives' short time horizons and ignores non-institutional sources of emerging markets' credibility deficits but, more importantly, it also leaves the mechanism by which credibility is generated by exchange rate regime choice underdetermined. Distinct from the literature's restricted notion of *institutional credibility,* generated by 'commitment devices' in insulated technocratic and non-discretionary decisionmaking contexts (e.g., Keohane and Milner 1996; Broz 2002), this thesis advanced a more encompassing conception – *political* credibility. This concept regards the wider societal context in which exchange rate pegs are embedded and in particular socio-political coalitions as crucial for the establishment of credibility (also Acheson and Chant 1972; Granovetter 1992). In this novel reading, a peg's instrumental value with respect to credibility-building stems from the way it can strengthen a government's ability to democratically legislate and implement the structural reforms by helping to build and manage reformist coalitions.

The credibility of a government's economic programme fundamentally depends on the programme's political feasibility. According to institutionalists, an exchange rate peg constitutes an institutional commitment device, which by disciplining monetary policy strengthens the likelihood of the government attaining its anti-inflationary promises – and therefore its credibility. However, as the case studies of Argentina and Brazil show, building and sustaining credibility in a democratic society demands considerably more than just a quick institutional fix. The notion of *political credibility* captures this challenge by highlighting that the successful legislation and implementation of an ambitious economic agenda in a democracy presupposes a durable support coalition that binds those interests, which oppose aspects of the programme, by offering overall compensation and benefits, such as low(er) inflation. In the medium and long run, policies will only be politically sustainable – and thus credible – if they generate a broad societal consensus on their overarching goals, such as the durable stabilisation and reform of an economy. Ultimately however such process, centring on

mechanisms of political accountability, responsiveness and legitimisation, is complex and cumbersome in nature and tends to thwart the *rapid* structural change envisaged by reformers.

This thesis suggested that exchange rate pegs constitute invaluable instruments in this process by providing focal points around which such support coalitions can be built. Societal actors thus converge on an exchange rate peg, which embodies an underlying consensus in favour of low inflation, generating a 'credibility dividend' in the short and medium term. However, as the case studies clearly show, without complementary measures that strengthen the legitimacy of the wider economic reform agenda in the longer run when the real constraints of such commitment become apparent, pegs remain little more than transitional fixes. When they are successful in maintaining and disciplining a societal coalition, this is thus largely due to a variety of supplementary deals that compensate distinct groups of actors. In this sense, institutionalists' praise for exchange rate-based stabilisation as a form of depoliticisation and rules-based governance is mistaken. Instead, this thesis highlights that it is precisely the contrary; it is the preservation of policymakers' discretionary space in combination with an appearance of depoliticisation that enabled policymakers to attain, what this thesis refers to as, *political credibility*. Indeed, only with a minimum of political discretion could they accommodate evolving politico-economic conditions so to contain distributional struggles, prevent polarisation and ensure the legitimacy, support for and therefore also credibility of the economic framework.

The credibility of the peg therefore resides in the compromise at the core of the coalition-dynamics that develop around the exchange rate peg rather than in the peg *per se* (see also Stasavage 2003: 3). It is determined by the robustness of the coalitional structures that governments construct around the exchange rate peg. In other words, the ability of an exchange rate peg to generate long-term price stability and growth in democratic or democratising societies will depend on a more encompassing form of credibility and crucially on the economic agenda's legitimacy in the eyes of the public. Institutionalists' belief in hard pegs, currency board arrangements and dollarisation as remedies for countries with irresponsible fiscal institutions thus exhibit a naïve optimism about pegs' ability to establish greater credibility by adopting institutions that depoliticise and insulate the policy process 'over night', combined with a deep-seated scepticism of developing country governments' to commit to a credible policy path by other means. Worse, given the dramatic consequences of a peg's collapse for national economies as illustrated especially by the Argentine case, this approach is anything but costless. Indeed, as the next sub-sections highlight, it is the coalition-building aspect of exchange rate pegs that enhances 'political credibility' – but also harbours

the risk of a petrification in the exchange rate stance and of an eventually highly destabilising devaluation.

8.3.2 A New Emphasis on Executive Entrepreneurship and Coalition-Building in Exchange Rate Policy

A second aspect highlighted by this thesis, elucidated by its empirical chapters and central to its theoretical argument is the role of executive entrepreneurship in determining exchange rate outcomes – especially with respect to efforts to build solid support coalitions. This emphasis on the role of discretionary space is tantamount to a move away from deterministic structural accounts of exchange rate politics, such as those which dominate the societal interest group literature (e.g., Frieden 1994; 1997; Schamis 1999: 243; 2000). It also overcomes institutionalists' narrow conception of the executive as merely re-election-seeking. Indeed, as this study showed, exchange rate policy decisions cannot simply be inferred from structural variables, such as a country's production profile (also Bolten 2007; forthcoming in 2009). Nor is executive behaviour pre-determined by institutional constraints and electoral pressures. Instead, this thesis' emphasis on executive entrepreneurship, that is – borrowing Schneider and Teske's expression (1992: 737) – policymakers' ability to change the direction and flow of exchange rate politics within the constraints emanating from both the domestic and the international political sphere, opens analytical space for taking into consideration the role of personalities, the influence of professional networks, the impact of ideational factors (such as competing economic theories) as well as instances of policy learning in determining exchange rate policy decisions taken by a group of executive actors usually located within a 'presidency-central bank-finance ministry'-triangle (see **Figure 38** on p. 234).

Supporting evidence for the importance of these factors in influencing exchange rate policy decisions has been borne out by all four case studies. The thesis thus confirms assertions by authors such as McNamara (1998) and Blyth (2002), who emphasise the role of judgment biases, framing and persuasion in the preference formation process and in the context of decisionmaking dynamics. This decisive impact of non-structural factors is nicely captured by Cardoso (2006b: 346), who recalls that

> [o]n the table, there are theoretical alternatives, mixed with personal positions (emotional, of legitimate interest, of 'personal power', of self-esteem – after all, these are decisions taken by human beings). […] Underlying it all, there is the basic truth that it is necessary to take a decision without knowing whether the chosen path will be successful. Who decides in these hours, decides 'in the dark'. He thus needs at least a lantern […]. It is necessary to know, or at least estimate, which one is a possible path. And there are always several paths.

In exchange rate policy matters, these 'lanterns' are often provided by theoretical economic frameworks that have either become accepted as 'best practice' in the international sphere or have proven successful in the past. In this sense, Cavallo referred to the historical precedent of the *Caja de Conversión*, whilst Franco (1999) mentions Williamson's 'crawling bands' and the painful lessons from the collapse of the *Plano Cruzado* as key inspirations (Filgueiras 2000: 100; Pio 2001b: 41; Bacha 2003; Sola and Kugelmas 2006: 90).

Cardoso's statement also points to the crucial relationship at the core of the exchange rate decisionmaking process – between politicians and technocrats – as highlighted in section 3.2.1.. Indeed, due to policymakers' dependence on their expert judgment, technocrats like Cavallo and Franco are particularly able to influence executive debates by setting the agenda with the help of such theoretical 'lanterns' (Cardoso 2006b: 345). Notwithstanding this role, I showed that it is mistaken to depict policymakers as at the mercy of technocrats. To the contrary, institutionally empowered presidents like Cardoso and Menem have known how to use technocrats with a view to pursuing their very own political aims. Indeed, they willingly ensured technocrats' 'negotiated insulation' under their presidential umbrella and explicitly granted these actors a great degree of technocratic autonomy. In this respect, the study therefore confirms the insights of an extensive literature on technocratic influences on public policy (e.g., Haggard and Kaufman 1995; Dominguez 1997; Teichman 1997; Huneeus 1998; Williams 2002; Corrales 2004) and contributes a new analytical perspective on the role of these agents in the field of exchange rate policy. Furthermore, this thesis showed that it was against this backdrop that these reformist technocrats advocated exchange rate pegs to their political superiors as disciplinary devices that would allow the executive to discipline complex political systems and power constellations and thus facilitate the pursuit of reforms (3.2.2.). This is best captured by Franco (1999), who states that

> [t]he formulation of the [exchange rate] regime had to consider what system best helped the efforts to address the fiscal problem and to initiate reforms, and as it turned out, a regime with "rigidities" helped a lot to frame congressional agendas towards reforms.

In particular, as propositions 1 to 3 (**Table 40**) argued, technocrats were convinced that a rigid exchange regime would be instrumental in enabling them to manage and, when necessary, to discipline a support coalition and thus speed up the process of reforming the economy in a democratic setting. In section 3.3.2., I showed at length how exchange rate pegs prove useful in converting an electoral coalition into an effective governing coalition

supportive of liberalising economic policies. This focus on the process of building, maintaining and disciplining coalitional arrangements around exchange regimes constitutes another core contribution of this study. Indeed, recently Etchemendy bemoaned that only *"few have looked at the coalitional basis that helped the [Argentine Convertibility] system remain in place for so long"* (2005: 81). This thesis addressed precisely this gap in the literature and developed an explanatory model regarding the coalitional basis of exchange rate policymaking in Argentina, as well as testing it in Brazil. In doing so, the thesis confirmed that the construction and maintenance of coalitions was not only crucial for implementing economic reforms in democracies (e.g., Gibson 1997; Etchemendy 2001; Murillo 2001) but that such coalitions played a crucial role in determining the adoption and sustainability of exchange rate pegs.

8.3.3 An Elucidation of the Role of Systemic Pressures in Exchange Rate Policy Choices

Another conceptual insight, which represents the third contribution, is its elucidation of the role of systemic factors and especially of the IMF in exchange rate policymaking. Although this thesis' analysis focused primarily on the determinants of exchange regime choice at the domestic level, it did so while explicitly acknowledging the systemic context and its impact on the domestic decisionmaking process. Indeed, Chapter II was devoted to elucidating the peculiar constraints on executive policymakers in Latin American emerging markets emanating from the economic structural context. These countries' reliance on fickle capital inflows, the so-called 'original sin' problem affecting their debt portfolios and their fragile macroeconomic settings as well as the fact that the logic of export-led growth runs counter to the logic of debt sustainability are all of particular relevance and distinguish these countries from those in OECD contexts.

In turn, these structural vulnerabilities and the economies' continued crisis potential turned emerging market economies into prime targets of IFIs and bilateral political pressure. The role of the IMF, as the central actor in exchange rate matters on the international stage, was analysed with particular care. Complementing Boughton's general historical account (2001), this thesis focused on the nature of the IMF's influence on national governments' exchange rate decisions, on the evolution of its exchange rate policy advice over time, and on the problematic conflation of the Fund's reformist impetus with this advisory role, which contributed to the institution's problematic role in perpetuating tendencies towards exchange rate petrification. The case studies have shown that, similar to other areas of activities investigated in the literature (e.g., Maxfield 1990; Biersteker 1995; Odling-Smee 2004; Woods

2006), the IMF's role in exchange rate matters has historically oscillated between, on the one hand, that of a coercive enforcer and, on the other hand, that of an outside authority that is limited to deploying its 'soft power' by e.g., setting the intellectual framework for policy formulation by cultivating a network of and relying on like-minded government insiders and by offering its 'stamp of approval' to reformist governments in its function as a 'reputational intermediary' (Broome 2008). In particular, I showed that the IMF's ability to impress its recommendations in this particular field of public policy is strongly conditioned by the cyclical availability of alternative sources of finance and by the extent to which the exchange rate paradigm advocated at the time by the IMF is underpinned by a consensus within academia and indeed within the institution itself. Bureaucratic politics and an institutional culture that discouraged open discussions of policy alternatives further undermined the Fund's ability to pursue its aim of exchange rate surveillance.

Of particular interest to this thesis was the way in which the Fund's exchange rate policy stance has, in part, evolved in reflection of its reformist agenda. When exchange rate discipline seemed to foster structural reforms in client economies such as Argentina, hard pegs were advocated enthusiastically and earlier studies of the inherent risks of such regimes with respect to overvaluation were sidelined (also Gala 2006: 118-119). Indeed, staff's single-minded focus on public accounts and on the progress (rather than the mid-term sustainability) of a wide range of structural reforms arguably laid the foundation for a series of exchange rate surveillance failures. Fear of reform reversal in the case of an exchange regime change meant that support, for instance, for the Argentine Convertibility regime became deeply entrenched at the IMF.

Finally, on a critical note, there is little doubt that the influence of the IMF and other IFIs in exchange rate matters deserves further research. Indeed, this thesis' insights on the role of the IMF in exchange rate politics in client economies were largely limited to insights gained from national policymakers' recollections and published statements by IMF representatives. The picture provided here could thus have gained in detail and accuracy if further interviews had been conducted with IFI representatives themselves (also see 8.4.2.).

8.3.4. A Closer Look at Exchange Rate Petrification

The fourth conceptual insight concerns this thesis' analysis of the phenomenon of exchange rate petrification through a decidedly political lens and therefore complements the existing economic-technical surveys (e.g., Eichengreen 1998; Asiçi and Wyplosz 2003; Asiçi, et al. 2005; Detragiache, et al. 2005). The study showed that exchange rate petrification, that is

the postponement of exchange rate flexibilisation until a disorderly exit becomes inevitable, has four principal sources.

The first source, discussed at some length in section 8.3.2., are coalition-building and maintenance motivations on the part of the executive. Indeed, the very coalitional dynamic that underpins the credibility-generating characteristic of exchange rate pegs is also a primary impetus for governments to refrain from flexibilising the exchange rate arrangement. This is due to the fact that in many cases the chosen exchange rate regime represents the very coalitional compromise on which the support alliance hinges. Fear of destabilising this carefully assembled coalition of actors thus motivates the continued maintenance of the exchange rate peg – despite rapidly growing costs.

Closely related to the coalitional argument is a second source of exchange rate petrification, which may be referred to as 'petrification from below' insofar as particular constellations of societal interests may significantly raise the likelihood of petrification (also Bolten forthcoming in 2009). As the literature has shown, the institutional structure of organised interests and political dynamics within e.g., business associations play a decisive role in determining the nature and strength of societal lobbying efforts (see e.g., Schneider 2004; Duckenfield 2006). In turn, these institutional structures may neutralise or even outweigh lobbying efforts by those sectors that are negatively affected by the continued maintenance of the exchange regime and the accompanying overvaluation. As a result, national governments do not experience the degree of lobbying pressure actually present in the society and are more likely to maintain the status quo.

Especially the Argentine case highlighted the role of dollar-denominated debt as a third motivation for exchange rate petrification insofar as it leads to postpone in the short run what are in the long run unavoidable adjustment costs. This driver of exchange rate petrification operates both on the executive level and at the level of societal actors. National governments may postpone flexilisation for fear of its impact on the national debt portfolio. Of particular interest, however, is the way in which the level of individual actors' liability dollarisation may be crucial. Indeed, dollarised contracts, debts and credits may in the short run neutralise other exchange rate interests (such as those favouring depreciation) and instead may force actors to look for measures to increase competitiveness *within* the context of the existing exchange rate regime.

A fourth (albeit indirect) source of exchange rate petrification, to which I alluded briefly in the previous sub-section, relates to the role of the IMF. With its actions and advice, the IMF has in the past created very fertile environments in which tendencies towards

exchange rate petrification remained unchecked – in violation of its exchange rate surveillance duties. It did so primarily by exerting substantial pressure on governments to legislate and implement wide-ranging market-oriented reforms whilst providing consistent external support and therefore reinforcing the legitimacy of an increasingly fragile and economically as well as socially costly overvalued exchange rate arrangement. At times, IMF staff even advised explicitly against reforms of the exchange regime.

In sum, the political determinants of exchange rate petrification are manifold and inter-related. Usually, this phenomenon stems from an executive's reluctance to surrender the exchange rate peg, seen as a powerful disciplining instrument with regards to its support coalition, for fear of risking reform reversal. This predisposition towards maintaining the regime is compounded by societal actors, who lobby in favour of the status quo regime – due in part to dollarised liabilities. If this setting coincides with a failure of exchange rate surveillance at the IMF, the status quo arrangement is highly likely to undergo petrification – until a crisis exit forces the government to confront the politico-economic realities.

Table 40: Overview of Propositions

Proposition 1: For coalition-building purposes, policymakers find exchange rate pegs useful as these pre-determine the economic policy agenda and therefore serve to dampen distributional struggle around other aspects of economic policy via their depoliticisation.
Proposition 2: Once adopted, reform-oriented policymakers use exchange rate pegs as disciplinary, legitimating and rhetorical instruments to push through those market-oriented reforms that are presented as necessary to preserve the exchange rate peg.
Proposition 3: Reform-oriented policymakers use exchange rate pegs as useful devices for building and disciplining coalitions of societal actors in order to facilitate market-oriented reforms.
Proposition 4: Exchange rate petrification is the result of the reluctance of the executive – and especially of technocrats at the core of the executive – to surrender the exchange rate peg, this powerful disciplining instrument, and to risk reform reversal by destabilising coalitional arrangements that have become increasingly reliant on the continuance of the arrangement.
Proposition 5: International actors, especially the IMF, generate circumstances in which emerging market governments feel compelled to enact structural reforms and thus resort to exchange rate pegs. IFIs' external validation for the regime then contributes to its petrification.

8.4. Contributions to the Policy Debate and Avenues for Further Research

This pen-ultimate section details the implications of my findings for policymaking and, subsequently, sets out an agenda for future research.

8.4.1 Implications for Policymaking

As the previous sections showed, this thesis makes several important contributions to the academic literature. Additionally, it engages with several aspects of crucial relevance to the policy debate on exchange rate policymaking in middle-income emerging markets across Latin America. Therefore, policymakers in emerging market economies – in Latin America and possibly elsewhere – and international policymakers working in IFIs, especially at the IMF, constitute two additional audiences. The primary contribution this thesis seeks to make to the policy debate applies to both spheres: It aims to alert policymakers to the inherently political dimension of exchange rate policy decisions, which their econometric models and technical analysis (often) fail to do justice to, and to the associated economic costs of overlooking these dynamics when formulating policy. Moreover, as the level of economic integration increases, political contest around exchange rate policy decisions will intensify. Thus, in order to successfully manage this politicisation process, policymakers have to understand its inherent logic and dynamic. Additionally, by raising awareness of the risk of exchange rate petrification, this thesis highlights the inherent flaw in technocrats' logic of using exchange rate policy as a powerful thumbscrew for the democratic process on the path to reforms.

Implications for Domestic Policymakers

With regards to the domestic sphere, it is crucial that politicians and especially technocratic policy advisors supplement their understanding of exchange rate policy in terms of 'technical solutions to a technical economic problem' with an appreciation of the intensely political environment in which this policy decision takes place and of the medium- and long-term political dynamics such decision (may) generate. The role of interest groups, mass public opinion and electoral as well as governing coalitions – in a word, politics – cannot be assumed away. Indeed, as this thesis' case studies clearly show, *"[r]ecommendations that ignore the political economy of policy implementation can have disastrous outcomes"* (Frieden 2007: 345). This applies in particular to hard peg policies that risk becoming petrified with delayed exits taking place at great socio-economic and indeed political cost. Few examples illustrate this risk as powerfully as the Argentine crisis in 2001-2002.

The chosen cases also usefully highlight another aspect of growing importance and complexity that confronts domestic policymakers: In addition to stabilisation considerations, exchange rate policymakers have to take into account the interactive effects between currency policy and trade relations. This trade-off is particularly crucial when, paralleling stabilisation, the deepening of regional integration constitutes a key goal. In this sense, recurrent political

backlashes and retaliatory spirals following the divergent exchange rate policies pursued by Brasília and Buenos Aires over the last fifteen years have brought home the need for Mercosur's members to coordinate their exchange rate (and macroeconomic) policies if the regional integration project is to succeed. Current developments in the region, however, illustrate that such coordination will remain elusive for as long as domestic short-term priorities trump these longer term efforts.

Implications for International Policymakers

Responding to the IMF's failing to fully meet its surveillance responsibilities in recent years, the IMF's Independent Evaluation Office demanded in 2007 that, among other things, *"a lack of understanding of the role of the IMF in exchange rate surveillance"* and an *"absence of an effective dialogue between the IMF and many […] countries"* be addressed (IMF - IEO 2007: 5). By putting forward a more comprehensive understanding of exchange rate decisionmaking processes over the course of an arrangement's life cycle and clarifying how these political dynamics constrain the IMF's surveillance duties, this thesis directly responds to these requests.

The implications for international policymakers at IFIs are thus straightforward. First, this thesis' bottomline goal is to alert international technocrats to the inherently political dynamics on the domestic front, which surround and, to a large extent, drive exchange rate policy choices and to the *"importance of drawing on commitment mechanisms that embrace broader segments of society"* (World Bank 2004: 50). Therefore, analysing regime sustainability and providing useful and applicable policy advice presupposes much greater political acumen than has been acknowledged to date. Complementing the recent surge in economists' interest in governance and institutional structures (e.g., Bates 1999; Rodrik 2007a), political scientists can thus make a valuable contribution to international agencies' understanding of and their effective engagement with national governments. This trend has already begun to shape the World Bank's human resources policy but has so far been resisted by the IMF (e.g., Phillips 2006: 248).

A second implication of this thesis for international policymakers concerns the problem of exchange rate surveillance. Recent crises have spurred efforts to strengthen the Fund's surveillance practices (*'Decision on Bilateral Surveillance over Members' Policies'* in June 2007). These amendments aimed at ensuring that the client dialogue becomes *"more focused, more candid, and overall more effective"* by drawing up four guiding principles that would structure consultations (IMF 2008).

This thesis' insights into the role of the IMF in exchange rate decisionmaking processes over the lifecycle of an exchange regime provide an invaluable perspective for estimating the likely effectiveness of these changes. Indeed, from this perspective, the primary innovative aspect of the amended guidelines – a stronger emphasis on exchange rates' effects on external stability (Mussa 2007) – is unlikely to address the obstacles to surveillance identified in the four case studies. As long as disagreements about optimum exchange regime choice persist within the organisation, divide its staff along departmental lines and feed off a persistent lack of consensus in academic circles, the IMF will struggle to find a coherent position on what constitutes exchange rate malpractice. Similarly, failed surveillance in Brazil and especially in Argentina was not due to inappropriate guidelines. It was rooted in the failure to assiduously *apply* the existing principles and was due to structural changes in international financial markets that undermined the IMF's influence. Another persistent problem consists of the interactive effect between surveillance and lending decisions, which has in the past tended to undermine the *"quality, legitimacy and impact"* of the Fund's surveillance (UNCTAD 2006: 221-222). Neither these problems nor the fact that the IMF's disciplining powers are heavily circumscribed if governments have access to alternative sources of finance will be overcome by a mere change in the guidelines or the threat of issuing a 'badge of shame' for exchange rate misalignment. Alternative channels for influencing exchange rate decisions therefore need to be developed to prevent instances of exchange rate mismanagement and especially petrification. A greater willingness and capability on the part of the Fund to engage with national governments in a politically astute manner and to sensibly inform the domestic debate on the exchange rate of the risks and long-term implications is thus key (Mussa 2007: 16; Frieden 2008; IMF 2008).

8.4.2 Avenues for Future Research

Having outlined this thesis' contribution both to the academic discussion and to the policy debate on exchange rate politics, this section outlines several broad streams of future research, which arise from our analysis. A first stream of future research builds upon this thesis' findings regarding the role of economic paradigms and ideas in exchange rate policymaking. As such, it would investigate in greater detail the evolution of exchange rate policy paradigms – such as the shift towards and away from the 'bipolar view' – and its implications for decisionmaking in national executives and in IFIs. In terms of methodology, such analysis could parallel studies of the impact of ideas and of the role of norm entrepreneurs at the IMF that combine quantitative and qualitative methods, such as those

undertaken by Chwieroth (2006; 2007c; 2007a) and Leiteritz (2005; forthcoming).

A second stream of further study concerns the undertaking of additional, more focused studies, which take different aspects of this thesis as a starting point. For instance, additional qualitative research into the behaviour and strategies of different organised (or collective) actors, paralleling the study of European business' attitudes towards EMU by Duckenfield (2006) seems promising. Such studies would build onto this thesis' case study sections on the role of societal interests, which provided an overview of the policy constraints arising from these groups' positions for executive actors at a given time. Similarly, this thesis' insights on the pattern of exchange rate politicisation in middle-income emerging economies constitute a useful basis for further research into the nature and evolution of individual exchange rate policy interests, beliefs and attitudes with which policymakers have to contend. This could be achieved by employing survey material, a methodology employed for the first time in this field by Broz et al (2007) and Cleeland (2007).

A third stream of future research concerns the need for extrapolation from this thesis' studies of exchange rate politics in Argentina and Brazil. Surpassing this research project's practical and financial limitations and its resulting focus on Latin American emerging markets, a geographic extension of this thesis would generate further empirical data and thus generate additional opportunities for complementing and assessing this thesis' insights on the use of exchange rate pegs for reform and coalition-building purposes. Indeed, in order to grant further explanatory weight to this thesis' arguments, its comparative utility should be tested against the experience of other middle-income emerging economies within and outside the region, such as Chile and Turkey, but also Indonesia and Thailand. Such comparative endeavour would further highlight the – perhaps distinct – nature of the roots of exchange rate petrification in other regions of the world. Similarly, a methodological extension, in line with a growing practice in international political economy, appears appealing. By complementing this thesis' qualitative analysis with econometric methods additional core insights could be contributed to the literature on exchange rate politics.

8.5. Concluding Thoughts

After five years of rapid growth in Latin America, the region is once more waking up to find out that the party is over: Since mid-2008, capital inflows have been cut, stock markets have struggled and local currencies have lost in value. While it remains too early to analyse the global crisis' likely implications for the region and for Argentina and Brazil in particular, one

can safely conclude that the region's vulnerability to external events continues to determine the boundaries within which national executives have to define their policy responses to these external challenges. As this thesis showed, exchange rate policy represents a particularly challenging field in this respect. Although there is a tendency for the exchange rate to only make the headlines in times of crisis, the political dynamics around this most important price in an open economy are ever-present and have become increasingly controversial, complex and conflictual.

The phenomenon of exchange rate petrification and the painful exit experiences of countries like Argentina and Brazil have placed into bold relief the necessity to better understand the *political* determinants of such developments in emerging market economies. Only a politically astute perspective on exchange rate policy decisions will be able to bridge the glaring gap between the policy recommendations offered by economists and actual policy choices. Similarly, only policy recommendations that acknowledge the – economic *and* political – constraints on national policymakers in the field of exchange rate policy stand any chance to succeed in performing an effective form of exchange rate surveillance.

Indeed, in many respects, countries' struggle to formulate an appropriate and sustainable exchange rate strategy reflects the wider difficulties faced by these relatively new democracies: In a context of structural reforms, they need to build institutions that are sufficiently flexible to accommodate evolving political demands and needs at the domestic level, while at the same time granting a certain predictability – or credibility – to market actors worldwide. Similarly, while such institutions ought to embody principles of accountability and democratic control, they do require some level of insulation so to avoid falling victim to interest group capture. The belief that this circle could be squared by using exchange rate rigidity as a thumbscrew for the domestic reform process was as powerful as it was hopefully short-lived. Indeed, somewhat paradoxically, the support of the very coalition of interests that – in the short term – rendered a rather rigid and disciplinating exchange regime legitimate and thus politically feasible undermined the government's ability to respond pragmatically to the economic necessities of the exchange rate peg and, more generally, to the political demands of their citizens in the longer run. The countries' policy performances since the crises at the turn of the millennium, though following divergent exchange rate paths, suggest that this lesson has been learnt. However, as the current economic crisis highlights, vulnerabilities persist and – especially with a view to the upcoming elections in both countries – continue to demand a sustainable policy response that will satisfy both the demands of local populations and key societal actors *and* the expectations of ever-cautious international investors.

APPENDIX I: LIST OF INTERVIEWEES

I would like to express my sincere gratitude to all interviewees for their time, openness and critical interest in my research.

ARGENTINA

Dr. Roberto T. Alemann, Minister of the Economy (1961-1962 and 1981-1982). Buenos Aires, Argentina – 5th April 2005

Lic. Roberto Arano, President of the Department of Economics of the *Unión Industrial Argentina* (UIA). Buenos Aires, Argentina – 17th October 2005

Lic. Nora P. Balzarotti, Department of Economics at the Embassy of the United States of America in Buenos Aires. Buenos Aires, Argentina – 7th October 2005

Dr. Eduardo Basualdo, Professor of Economics at FLACSO-Buenos Aires. Buenos Aires, Argentina – 7th April 2005

Dr. Mario I. Blejer, Director of the Centre for Central Banking Studies at the Bank of England; President of the BCRA (January – June 2002), Deputy Governor of the BCRA (2001-2002); IMF Economist, among other roles, as Senior Advisor at the Monetary and Exchange Affairs Department (1980-2001). Personal communication by email on 15th November 2006

Lic. Leonardo Bleger, Economic Advisor to the Board of Directors of CREDICOOP. Buenos Aires, Argentina – 11th October 2005

Dr. Miguel Braun, Director of the Fiscal Policy Department at CIPPEC. Buenos Aires, Argentina – 13th April 2005

Dr. Luis B. Bucafusco, Executive Director of ABAPPRA. Buenos Aires, Argentina – 20th October 2005

Alicia Castro – *Deputada Federal* for *Frente para el Cambio* (2001-2005) and Vice-President of the Transport Comisión (1997-2001 as member of Frepaso); Argentine Ambassador to Venezuela (2006 onwards). Secretary-General of the *Asociación Argentina de Aeronavegantes* (Argentine Association of Airline Workers – AAA) during the 1990s. Buenos Aires, Argentina – 12th April 2005

Dr. Domingo F. Cavallo, *Deputado Nacional* for the City of Buenos Aires for *Acción por la República* (1997-2002); Minister of the Economy (1991-1996 and in 2001); Minister of Foreign Affairs (1989-1991); Independent *Diputado Nacional* for Córdoba (1987); President of the *Banco Central de la República Argentina* (BCRA – 1982). Buenos Aires, Argentina – 12th October 2005

Dr. Mario Damill, Senior Researcher at CEDES and Professor of Economics at the *Universidad de Buenos Aires* (UBA). Buenos Aires, Argentina – 30th March 2005

Lic. Adriano De Fina, Executive Director of AIERA. Buenos Aires, Argentina – 27th October 2005

Lic. Alejandro Delfino, Director of the *Instituto de Estudios Económicos* of the *Sociedad Rural Argentina* (SRA) and Vice President of the International Federation of Agricultural Producers (IFAP). Buenos Aires, Argentina – 20th October 2005

Dr. Hernán Del Villar, Economic Advisor to the Executive Director of ABAPPRA and Partner at *Alpha – Estudio de Economía y Negocios S.A.*. Buenos Aires, Argentina – 20th October 2005

Dr. Juan Carlos De Pablo, Partner at *De Pablo Consult S.A.*. Buenos Aires, Argentina – 20th April 2005

Lic. Carlos Doglioli, Buenos Aires, Argentina – 29th March 2005 and 14th October 2005

Dr. Sebastián Etchemendy, Assistant Professor Universidad Torcuato Di Tella, Buenos Aires, Argentina. Personal communication by email on 20th June 2007

Lic. Angel Herrera, Press Officer at the *Auditoria General de la Nación*. Buenos Aires, Argentina – 14th October 2005

Dr. Daniel Heymann, ECLAC – Office Buenos Aires. Buenos Aires, Argentina – 29th March 2005

Dr. Saúl Néstor Keifman, Professor of Economics at the *Universidad de Buenos Aires* (UBA). Buenos Aires, Argentina – 29th March 2005 and 19th April 2005

Lic. Norberto Liubitch, Vice President of the Department of Economics of the *Unión Industrial Argentina* (UIA). Garín (Province of Buenos Aires), Argentina – 13th October 2005

Dr. José Luis Machinea, Executive-Secretary of ECLAC (Santiago de Chile) (2003-); Minister of the Economy (1999-2001); President of the Argentine Foundation for Development with Equity (*Fundación Argentina para el Desarollo con Equidad*) (1998-1999); President of the *Banco Central de la República Argentina* (BCRA)(1980s); Director of Research of the Industrial Development Institute of the *Unión Industrial Argentina* (UIA) (1992-1997); Undersecretary of Political Economy (1980s); Undersecretary of Planning (1980s). Telephone Interview – 31st March 2005

Deputada Marta Maffei, *Deputada Nacional* for ARI (2003-) and Deputy Secretary General of CTA (1995-), General Secretary of CTERA (1994-2003), Founding Member of CTA (1991), CGT Section Neuquén (1985-1990). Buenos Aires, Argentina – 28th March 2005

Dr. Luis Garcia Martinez, Academic President of the National Academy of Economics of Argentina. Buenos Aires, Argentina – 5th April 2005

Lic. Héctor Daniel Massuh, Vice President of the *Unión Industrial Argentina* (UIA) (2002 onwards); President of the *Unión Industrial Argentina* (UIA) (2001-2002). Buenos Aires, Argentina – 14th April 2005 and 19th October 2005

Dr. Josef Oehrlein, Foreign Correspondent for Latin America for *Frankfurter Allgemeine Zeitung*. Buenos Aires, Argentina. Personal communication by email 7th and 12th August 2007

Dr. Norberto Peruzzotti, Executive Director of ADEBA. Buenos Aires, Argentina – 18th April 2005

Dr. Pedro Pou, President of the *Banco Central de la República Argentina* (BCRA)(1996-2001). Buenos Aires, Argentina – 18th April 2005

Lic. Juan Puigbó, Senior Researcher at the *Fundación de Educación y Capacitación para los Trabajadores de la Construcción*. Buenos Aires, Argentina – 4th April 2005

Lic. Osvaldo Rial, President of the *Unión Industrial* of the Province of Buenos Aires (UIPBA), President of Herrametal, President of the *Unión Industrial Argentina* (UIA) (1999-2001). Buenos Aires, Argentina – 27th October 2005

Dr. Alexandre Roig, Professor of Economics at the *Universidad del Salvador* (USAL). Buenos Aires, Argentina – 28th March 2005

Dr. Martín Schorr, FLACSO – Office Buenos Aires. Buenos Aires, Argentina – 7th April 2005

Sergio Serrichio, Analyst and journalist writing for e.g., *Clarín* and *La Voz del Interior* – 24th October 2005

Senador Rodolfo Terragno, UCR, Senator of the City of Buenos Aires (2001-2007); *Jefe de Gabinete de Ministros* under De La Rúa (1999-2000); Member of the 'Group of Five' of the *Alianza* (1997-1999); President of the UCR (1995-1997); *Diputado Nacional* (1993-1995 and 1997-1999). Buenos Aires – 27th October 2005

Lodewijk Verdeyen, General Manager of the operational companies of Suez Energy International in Chile and Argentina. London, United Kingdom – 12th September 2007

Lic. Damián Wilson, Senior Researcher at ABA. Buenos Aires, Argentina – 19th April 2005

Dr. Carlos Winograd, Professor of Economics at DELTA *Université Paris-Jourdain*; Secretary for Competition and Consumer Affairs (1999-2001). Buenos Aires, Argentina – 16th April 2005

Lic. Cristóbal Zimmermann, Department of Agriculture at the Embassy of the Federal Republic of Germany in Buenos Aires. Buenos Aires, Argentina – 21st April 2005

Interviewees in Argentina who opted for anonymity:

Member of Executive Board of the CGE. Buenos Aires, Argentina – 15th April 2005

Two Members of the CEA. Buenos Aires, Argentina – 16th April 2005 and 20th April 2005

BRAZIL

Dr. Pérsio Arida, Member of Economic Teams of *Plano Cruzado* and *Plano Real*; Senior Advisor and Member of the Administrative Council of Banco Itaú and Visiting Researcher at the Centre of Brazilian Studies at the University of Oxford 2005-2006; President of the Banco Central do Brasil (BCB) (1995); President of the National Bank for Economic and Social Development (BNDES) (1993-1994); Secretary for Economic and Social Coordination at the Ministry of Planning (1985); Director at the Banco Central do Brasil (BCB) (1986). Oxford, United Kingdom – 2nd May 2006 and London, United Kingdom – 23rd May 2006

Dr. Octavio Amorim Neto, Professor of Political Science at EPGE at the *Fundação Getúlio Vargas* (FGV-RJ). Rio de Janeiro, Brazil – 19th December 2005

Dr. Joaquim Pinto de Andrade, Professor of Economics at the *Universidade Nacional de Brasília* (UnB). Brasília, Brazil – 21st November 2005

Dr. Edmar Lisboa Bacha, Senior Advisor to *Banco BBA Creditanstalt*, São Paulo; Senior Advisor to the Minister of Finance (May 1993-December 1994); President of the National Bank for Economic and Social Development (BNDES) (January-November 1995). Rio de Janeiro, Brazil – 7th December 2005

Dr. Monica Baer, Senior Economist at *MB Associados*. São Paulo, Brazil – 5th January 2006

Mario Bernardini, Director of the Department of Competitiveness and Technology (Decomtec) of Fiesp (2000-2004); Director of the Department of Economics of Fiesp (mid-1990s). São Paulo, Brazil – 10th January 2006

Dr. Renato Coelho Baumann das Neves, Head of the Brasília Office of ECLAC. Brasília, Brazil – 16th November 2005

Dr. Marco Bonomo, Professor of Economics at EPGE at the *Fundação Getúlio Vargas* (FGV-RJ). Rio de Janeiro and Brasília, Brazil and London, UK – 30th November 2005, 16th December 2005, 5th December 2006

Prof. Fernando Henrique Cardoso, *Instituto Fernando Henrique Cardoso* (IFHC); President of Brazil (1994-2002); Minister of Finance (1993-1994); Minister of Foreign Affairs (1992-3). São Paulo, Brazil – 30th January 2006

Dr. Carlos Eduardo Ferreira de Carvalho, Professor of Economics at PUC-SP; Coordinator of the PT's electoral campaign (1989). São Paulo, Brazil – 26th January 2006

Dr. Claudio Couto, Professor of Political Science at PUC-SP, Visiting Researcher at Columbia University, 2005-2006. New York City – March 2006

Dr. Alexandre Barros da Cunha, Professor of Economics at the Ibmec Business School – Rio de Janeiro. Rio de Janeiro, Brazil – 14th December 2005

Dr. Susan M. Cunningham, Researcher for Oxford Analytica – Latin America/Caribbean. Oxford (UK) – 23rd June and 10th September 2005

Mr. José Estanislau do Amaral, Advisor for International Affairs at the *Instituto Fernando Henrique Cardoso* (IFHC). São Paulo, Brazil – 30th January 2006

Maria Clara R. M. do Prado, Journalist and Columnist, Director of *Comunicação Inteligente* (CIN), Head of Communications of the *'Plano Real'* economic team (1993-5). Since January 2007, do Prado writes a daily blog available at http://mariaclaradoprado.blig.ig.com.br. São Paulo, Brazil – 19th January 2006

Dr. Maria Luiza Falção Silva, Professor of Economics at the *Universidade Nacional de Brasília* (UnB) and CGEE. Brasília, Brazil – 21st November 2005

Ademir Figueiredo, Coordenator of Research & Development at *Departamento Intersindical de Estatística e Estudos Sócio-Econômicos* (DIEESE). São Paulo, Brazil – 23rd January 2006

John Fitzpatrick, Journalist and founder of 'Brazil Political Comment' and Celtic Comunicações. São Paulo, Brazil – 13th January 2006

Dr. Gustavo Henrique de Barroso Franco, President of the *Banco Central do Brasil* (BCB) (1997-1999); Director of Department of International Affairs (DIREX) at the BCB (1993-1997); Deputy Secretary of Economic Policy at the Ministry of Finance (1993). Rio de Janeiro, Brazil – 6th December 2005

Dr. Clemente Ganz Lúcio, Technical Director of Development at the *Departamento Intersindical de Estatística e Estudos Sócio-Econômicos* (DIEESE – 2002 onwards), Member of the Council for *Desenvolvimento Social*. São Paulo, Brazil – 23rd January 2006

Dr. Geraldo José Gardenali, Professor of Economics at EASP at the *Fundação Getúlio Vargas* (FGV-SP); Consultant to Federation of Brazilian Banks (Febraban); President of *Nossa Caixa* (1994-2001); President of *Associação Brasileira de Bancos Estaduais e Regionais* (ASBACE – 1999); Executive Director of *Pão de Açucar*, Secretary of State in *Fazenda* during Collor government. São Paulo, Brazil – 19th January 2006

Dr. Emilio Garofalo Filho, Consultant for Exchange Transactions in the Department of International Relations and Foreign Trade, International Relations and Foreign Trade Department at the Federation of the Industries of the State of São Paulo (Fiesp); Director of the Departments of Administration (DIPAD) and International Affairs (DIREX) at the *Banco Central do Brasil* (BCB) (1992-1993). São Paulo, Brazil – 9th January 2006

Dr. Ilan Goldfajn, Partner at *Gávea Investimentos Ltda.* and Professor of Economics at PUC-RJ; Founding Member of *Casa das Garças*; Deputy Director for Economic Policy at the *Banco Central do Brasil* (BCB) (2000-2003); IMF Economist (1996-1999). Rio de Janeiro – 20th December 2005

Dr. Eduardo Kugelmas, Professor of Political Science at the *Universidade de São Paulo* (USP). São Paulo, Brazil – 16th January 2006

Dr. André Lara Resende, Member of Economic Teams of *Plano Cruzado* and *Plano Real*; President of the National Bank for Economic and Social Development (BNDES) (May-November 1998); Special Advisor to the President of Brazil FH Cardoso (August 1997-April 1998); External Debt Negotiator for Brazil (1993). São Paulo, Brazil – 31st January 2006

Miriam Leitão, Journalist with CBN, Globo News and TV Globo and economics columnist with Rede Globo; Winner of Maria Moors Cabot Prize for Journalism awarded by Columbia University in 2005 for 'outstanding explanatory journalism'. Personal communication by email 14th January 2006

Dr. Maria Rita Garcia Durand Loureiro, Professor of Sociology at EASP at the *Fundação Getúlio Vargas* (FGV-SP) and at FEA at the *Universidade de São Paulo* (USP). São Paulo, Brazil – 6th January 2006

Dr. Sergio Mendonça, Secretary of State at the Ministry of Planning (2002-); Technical Director at the *Departamento Intersindical de Estatística e Estudos Sócio-Econômicos* (DIEESE) (1990-2002). Brasília, Brazil – 23rd November 2005

Dr. Luiz Carlos Mendonça de Barros, Economic Advisor to PSDB's Presidential Candidate Geraldo Alckmin; Chief Economist of *Quest Investimentos* (2004-); Minister of Communications (May-Nov 1998); President of BNDES (April-May 1998). São Paulo, Brazil – 31st January 2006

Dr. Ary C. Minella, Professor of Sociology; Coordinator of the *‚Núcleo de Estudos Sociopolíticos do Sistema Financeiro'* at the Department of Sociology and Political Science at the *Universidade Federal de Santa Catarina* at Florianópolis, Brazil. Written Communication – 28th November 2005

Dr. Maria de Lourdes Rollemberg Mollo, Professor of Economics at the *Universidade Nacional de Brasília* (UnB). Brasília, Brazil – 10th November 2005

Dr. Lecio Morais, Political Advisor to the PCdoB at the Chamber of Deputies of the National Congress. Brasília, Brazil – 8th November 2005 and 25th November 2005

Dr. Dércio Munhoz, Professor of Economics at the *Universidade Nacional de Brasília* (UnB). Brasília, Brazil – 28th November 2005

Carlos Mussi, Economist at ECLAC-Brasília. Brasília, Brazil – 10th November 2005

Dr. Antônio Delfim Netto, *Deputado Federal* (1987-2007), Minister of Planning (1979-1985), Minister of Agriculture (1979), Ambassador of Brazil to France (1975-8), Minister of Finance (1967/1976), Minister of Finance of the State of Sao Paulo (1966-7). Brasília, Brazil – 24th November 2005

Dr. Carlos Pio, Professor of International Relations at the *Universidade Nacional de Brasília*

(UnB). Brasília, Brazil – 18th November 2005 and 3rd December 2005

Sonia Racy, Journalist and economics columnist with the *O Estado de S. Paulo*. Personal communication by email 20th January 2006

Dr. André Rebelo, Head of the Department of Economic Research and Economic Advisor to the President of the Federation of the Industries of the State of São Paulo (Fiesp). São Paulo, Brazil – 24th January 2006

Dr. Isney M. Rodrigues, Director of the Exchange Clearing at the *Bolsa de Mercadorias & Futuros* (BM&F) at São Paulo. São Paulo, Brazil – 20th January 2006

Bernardo Rothe, General Manager *Banco do Brasil* New York branch. London, United Kingdom – 13th September 2007

Dr. Alfredo Saad-Filho, Professor of Economics at the School of Oriental and African Studies (SOAS). London, UK – 27th August 2005

Bruno Walter Coelho Saraiva, Senior Staff at the Ministry of Finance. Brasília, Brazil – 8th November 2005

Wilson Roberto Soares, Trade Operations Coordinator, International Relations and Foreign Trade Department, Federation of the Industries of the State of São Paulo (Fiesp). São Paulo, Brazil – 9th January 2006

Dr. Lourdes Sola, Professor of Political Science at the *Universidade de São Paulo* (USP) and Consultant at *MB Associados*. São Paulo, Brazil – 24th January 2006

Dr. Roberto Luis Troster, Chief Economist of the Federation of Brazilian Banks (Febraban). São Paulo, Brazil – 11th January 2006

Dr. Carlos A. Vidotto, Professor of Economics at the *Universidade Federal Fluminense* (UFF). Rio de Janeiro, Brazil – 16th December 2005

Bernhard Graf von Waldersee, Minister at the Embassy of the Federal Republic of Germany in Brasília. Brasília, Brazil – 30th November 2005

APPENDIX II: OVERVIEW OF THE ADMINISTRATIONS IN ARGENTINA AND BRAZIL

ARGENTINA

Presidents, Ministers of the Economy and Presidents of the BCRA, 1976-1989

Presidency	Minister of the Economy	President of the BCRA
Juan D. Perón (12.10.1973-01.07.1974)	José B. Gelbard (25.05.1973-21.10.1974)	Alfredo Gómez Morales (29.05.1973-02.09.1974)
María Estela Martínez de Perón (01.07.1974-24.03.1976) [Ítalo A. Luder (13.09.1975-16.10.1975)]	Alfredo Gómez Morales (21.10.1974-02.06.1975) Celestino Rodrigo (02.06.1975-22.07.1975) Pedro J. Bonanni (22.07.1975-14.08.1975) Antonio Cafiero (14.08.1975-03.02.1976) Emilio Mondelli (04.02.1976-24.03.1976)	Hernán A Aldabe (11.10.1974-29.10.1974) Ricardo A. Cairoli (29.10.1974-17.07.1975) Emilio Mondelli (01.08.1975-03.02.1976) Eduardo Zalduendo (04.02.1976-24.03.1976)
Jorge Rafael Videla (29.03.1976 – 29.03.1981)	Joaquín de Las Heras (24.03.1976-29.03.1976) José A. Martínez de Hoz (30.03.1976-27.03.1981)	Alfredo Cassino (24.03.1976-02.04.1976) Adolfo Diz (02.04.1976-27.03.1981)
Roberto Eduardo Viola (29.03.1981 – 11.12.1981) [Carlos A. Lacoste (11.12.1981-22.12.1981)]	Lorenzo Sigaut (27.03.1981-21.12.1981)	Julio J. Gómez (31.03.1981-01.06.1981) Egidio Iannella (01.06.1981-02.07.1982)
Leopoldo Fortunato Galtieri (22.12.1981-18.06.1982)	Roberto Alemann (22.12.1981-02.07.1982)	
Reynaldo Bignone (01.07.1982-10.12.1983)	José M. Dagnino Pastore (02.07.1982-24.08.1982) Jorge Wehbe (25.08.1982-07.12.1983)	Domingo F. Cavallo (02.07.1982-26.08.1982) Julio C. González del Solar (26.08.1982-07.12.1983)
Raúl Alfonsín (UCR) (10.12.1983 – 08.07.1989)	Bernardo Grinspun (10.12.1983-18.02.1985)	Enrique García Vázquez (10.12.1983-18.02.1985)
	Juan Vital Sourrouille (19.02.1985-30.03.1989)	Alfredo Concepción (19.02.1985-25.08.1986) José Luis Machinea (26.08.1986-31.03.1989)
	Juan Carlos Pugliese (04.04.1989-26.05.1989)	Enrique García Vázquez (01.04.1989-08.07.1989)
	Jesús Rodríguez (27.05.1989-08.07.1989)	

Presidents, Ministers of the Economy and Presidents of the BCRA, 1989-2008

Presidency	Minister of the Economy	President of the BCRA
Carlos Saúl Menem (PJ) (08.07.1989-10.12.1999)	Miguel A. Roig (08.07.1989-15.07.1989)	Javier González Fraga (09.07.1989-23.11.1989) Egidio Iannella (27.11.1989-19.12.1989) Rodolfo C Rossi (20.12.1989-22.01.1990) Enrique Folcini (23.01.1990-27.03.1990) Antonio E González † (20.03.1990-13.06.1990)
	Néstor Rapanelli (15.07.1989-15.12.1989)	
	Antonio E González † (15.12.1989-31.01.1991)	
	Domingo F Cavallo (31.01.1991-02.08.1996)	Roque B Fernández (31.01.1991-28.07.1996)
	Roque B Fernández (02.08.1996-10.12.1999)	Pedro Pou (29.07.1996-25.04.2001)
Fernando De la Rúa (UCR – Alianza Government) (10.12.1999-20.12.2001)	José L Machinea (10.12.1999-05.03.2001)	
	Ricardo López Murphy (05.03.2001-20.03.2001)	
	Domingo F Cavallo (20.03.2001-20.12.2001)	Roque Maccarone (25.04.2001-18.01.2002)
Ramón Puerta (PJ) (20.-21.12.2001)	Nicolas V Gallo (20.12.2001-21.12.2001)	
Adolfo Rodríguez Sáa (PJ) (21.-22.12.2001)	Jorge M Capitanich (21.12.2001-22.12.2001)	
Eduardo Camaño (PJ) (23.12.2001-07.01.2002)	Rodolfo Frigeri (23.12.2001-07.01.2002)	
Eduardo A Duhalde (PJ) (07.01.2002-25.05.2003)	Jorge L Remes Lenicov (07.01.2002-26.04.2002) Roberto Lavagna (26.04.2002-29.11.2005)	Mario I Blejer (28.01.2002-25.06.2002)
Néstor Kirchner (PJ) (25.05.2003-10.12.2007)	Felisa Miceli (29.11.2005-16.07.2007) Miguel Peirano (17.07.2007-10.12.2007)	Aldo Pignanelli (25.06.2002-11.12.2002) Alfonso Prat Gay (11.12.2002-23.09.2004) Martín Redrado (23.09.2004-
Cristina Fernández de Kirchner (PJ) (10.12.2007-	Martín Lousteau (10.12.2007-25.04.2008) Carlos Fernández (25.04.2008 -	

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Presidents, Ministers of the Economy and Presidents of the BCB and the BNDES, 1979-1992

<table>
<tr><th>President of the Nation</th><th>Minister of the Economy</th><th>President of the BCB</th><th>Presidents of the BNDES</th></tr>
<tr><td rowspan="2">João Baptista de Oliveira Figueiredo
(15.03.1979-15.03.1985)

[Aureliano Chaves (23.09.1981-12.11.1981 and 14.07.1983-26.08.1983)]</td><td>Karlos Heinz Rischbieter
(16.03.1979-17.01.1980)</td><td>Carlos Brandão
(15.03.1979-17.08.1979)
Ernane Galvêas
(17.08.1979-18.01.1980)</td><td rowspan="2">Luiz Antônio Sande de Oliveira
(15.03.1979-05.09.1983)

Jorge Lins Freire
(05.09.1983-14.10.1984)
José Carlos de Perdigão Medeiros de Fonseca
(15.10.1984-15.03.1985)</td></tr>
<tr><td>Ernane Galvêas
(18.01.1980-14.03.1985)</td><td>Carlos Geraldo Langoni
(18.01.1980-05.09.1983)
Affonso Celso Pastore
(05.09.1983-14.03.1985)</td></tr>
<tr><td rowspan="4">Tancredo Neves (PMDB)
(15.03.1985 †)

José Sarney (PFL)
(15.03.1985-15.03.1990)

Coalition: PMDB-PFL</td><td>Francisco Oswaldo Neves Dornelles
(15.03.- 26.08.1985)</td><td>Antonio Carlos Braga Lemgruber
(15.03.-28.08.1985)</td><td>Dilson Domingos Funaro
(15.03.-25.08.1985)</td></tr>
<tr><td>Dilson Domingos Funaro (PMDB)
(26.08.1985 – 29.04.1987)</td><td>Fernão Carlos Botelho Bracher (28.08.1985 – 11.02.1987)
Francisco Roberto André Gros (11.02.1987 – 30.04.1987)</td><td rowspan="3">André Franco Montoro Filho (25.08.1985-24.01.1987)
Màrcio João de Andrade Fortes
(25.01.1987-30.09.1989)

Ney Fontes de Melo Tàvora
(01.10.1989-14.03.1990)</td></tr>
<tr><td>Luiz Carlos Bresser Gonçalves Pereira (PMDB)
(29.04.1987 – 21.12.1987)</td><td rowspan="2">Fernando Milliet de Oliveira (05.05.1987 – 09.03.1988)
Elmo de Aráujo Camões
(09.03.1988 – 22.06.1989)
Wadico Waldir Bucchi
(25.10.1989 – 14.03.1990)</td></tr>
<tr><td>Maílson Ferreira da Nóbrega (independent)
(02.01.1988 – 15.03.1990)</td></tr>
<tr><td rowspan="2">Fernando Alfonso Collor de Mello (PRN)
(15.03.1990-29.12.1992)

Coalition: PRN-PFL-PDS-PTB</td><td>Zélia M. Cardoso de Mello
(15.03.1990 – 10.05.1991)</td><td>Ibrahim Eris
(15.03.1990 – 17.05.1991)</td><td rowspan="2">Eduardo M. Modiano
(15.03.1990-02.10.1992)

Antônio Barros de Castro
(02.10.1992-01.03.1993)</td></tr>
<tr><td>Marcílio Marques Moreira
(10.05.1991 – 02.10.1992</td><td>Francisco R. A. Gros
(17.05.1991 – 16.11.1992)</td></tr>
</table>

Presidents, Ministers of the Economy and Presidents of the BCB and the BNDES, 1992-2008

President of the Nation	Minister of the Economy	President of the BCRA	President of the BNDES
Itamar Franco (PMDB) (02.10.1992-01.01.1995) **Coalition (1992): PFL- PMDB-PTB-PSDB-PSB** **Coalition (1993): PFL-PMDB-PTB-PSDB-PP**	Gustavo Krause Gonçalves Sobrinho (02.10.– 16.12.1992)	Gustavo Jorge Laboissière Loyola (17.11.1992 – 25.03.1993)	Antônio Barros de Castro (02.10.1992-01.03.1993)
	Paulo Roberto Haddad (16.12.1992 – 01.03.1993)		
	Elizeu Resende (01.03.-19.05.1993)	Paulo Cesar Ximenes Alves Ferreira (29.03.-09.09.1993)	Luis Carlos Delben Leite (01.03.-31.08.1993)
	Fernando Henrique Cardoso (19.05.1993 – 30.03.1994)	Pedro Sampaio Malan (09.09.1993 – 31.12.1994) [Interim: Gustavo Henrique de Barroso Franco (31.12.1993-11.01.1994)	Pérsio Arida (01.09.1993-10.01.1995)
	Rubens Ricúpero (31.03. – 05.09.1994)		
	Ciro Ferreira Gomes (06.09. – 31.12.1994)		
Fernando Henrique Cardoso (PSDB) (01.01.1995-01.01.2003) **Coalition: PFL-PMDB-PTB-PSDB-PPB**	Pedro Sampaio Malan (01.01.1995 – 31.12.2002)	Pérsio Arida (12.01. – 13.06.1995) Gustavo Jorge Laboissière Loyola (13.06.1995 – 20.08.1997) Gustavo Henrique de Barroso Franco (20.08.1997 – 04.03.1999 – resigned: 12.01.1999) [Francisco Lopes: 12.01. – 04.03.1999)] Arminio Fraga Neto (04.03.1999 – 01.01.2003)	Edmar Lisboa Bacha (11.01.-30.11.1995) Luiz Carlos Mendonça de Barros (30.11.1995-15.04.1998) André Lara Resende (04.-11.1998) José P. Borges de Castro Filho (11.1998-07.1999) Andrea S. Calabi (07.1999-02.2000) Francisco R. A. Gros (02.2000-01.2002) Eleazar de Carvalho (01.2002-01.2003)
Luiz Inàcio Lula da Silva (PT) (01.01.2003- **Coalition: PT-PMDB**	Antônio Palocci Filho (01.01.2003-27.03.2006)	Henrique de Campos Meirelles (02.01.2003-	Carlos Lessa (01.01.2003-18.11.2004) Guido Mantega (19.11.2004-26.03.2006)
	Guido Mantega (27.03.2006-		Demian Fiocca (27.03.2006-20.04.2007) Luciano Coutinho (20.04.2007-

APPENDIX III: OVERVIEW OF THE MANAGEMENT OF INTERNATIONAL FINANCIAL INSTITUTIONS

Managing Directors and First Deputy Managing Directors of the IMF and Presidents of the World Bank, 1980-2008

Managing Director	First Deputy Managing Director	President of the World Bank
Jacques de Larosière (France) (17.06.1978-15.01.1987) **Michel Camdessus (France)** (16.01.1987-14.02.2000) **Horst Köhler (Germany)** (01.05.2000-04.03.2004) **Rodrigo de Rato y Figredo (Spain)** (07.06.2004-31.10.2007) **Dominique Strauss-Kahn (France)** (01.11.2007-	**William Dale (USA)** (01.03.1974-30.06.1984) **Richard D. Erb (USA)** (01.07.1984-31.08.1994) **Stanley Fischer (USA)** (01.09.1994-31.08.2001) **Anne O. Krueger (USA)** (01.09.2001-31.08.2006) **John Lipsky (USA)** (01.09.2006-	**Robert Strange McNamara (USA)** (01.04.1968-30.06.1981) **Alden Winship Clausen (USA)** (01.07.1981-30.06.1986) **Barber Conable (USA)** (01.07.1986-31.08.1991) **Lewis Preston (USA)** (01.09.1991-31.05.1995) **James D. Wolfensohn (USA)** (01.06.1995-30.06.2005) **Paul Wolfowitz (USA)** (01.07.2005-30.06.2007) **Robert Zoellick (USA)** (01.07.2007-

APPENDIX IV: THE ARGENTINE-BRAZILIAN LOCAL CURRENCY SYSTEM

24th July 2006	Argentina and Brazil announce intention to study 'de-dollarisation' of bilateral trade.
1st September 2006	BCRA and BCB present idea of a SML to the Meeting of Mercosur Finance Ministers.
15th December 2006	Advances towards a SML are presented to Mercosur Ministers. Letter of intent is signed by the Finance Ministers and the Central Bank Presidents of Argentina and Brazil. *Consejo del Mercado Común* (CMC) issues Decision 38/06 in support of the project and the letter of intent.
28th June 2007	CMC approves Decision 25/07, which orders the creation of a SML for intra-Mercosur trade allowing member states to opt in or out. CMC instructs the creation of the SML under the legal umbrella of the ALADI as *Acuerdo de Complementación Económica No 18*.
21-23rd February 2008	Presidents of Argentina and Brazil agree on timetable ('Casa Rosada Declaration')
1st May to 30th June 2008	IT tests run between the central banks and their respective banking system
31st May 2008	Finalisation of the necessary legislative changes
23rd June 2008	Signature of the Framework Agreement between the BCRA and the BCB
6th October 2008	SML in Operation

Source: Own elaboration based on ministerial websites (http://www.fazenda.gov.br/portugues/releases/2006/r151206.asp) and http://www.mre.gov.br/portugues/imprensa/nota_detalhe3.asp?ID_RELEASE=5159[accessed 20th December 2007]), media reports and exchanges with bureaucrats and diplomats.

APPENDIX V: OTHER FIGURES AND TABLES

Major Characteristics of Different Exchange Rate Regimes

Regime	Main Characteristics and Principal Issues
Dollarization	*Key feature*: A foreign currency acts as legal tender. Monetary policy is delegated to the anchor country. *Potential benefits*: Dollarization reduces the time-inconsistency problem (subject to the perceived probability of a re-introduction of domestic money) and real exchange rate volatility). *Potential drawbacks:* Under dollarization external shocks cannot be buffered by exchange rate movements, imposing costs if business cycles are asynchronous; while seignorage revenues decline. *Issues:* The lender-of-last-resort function must be shifted to the fiscal authority.
Currency Boards	*Key feature*: A fixed exchange rate regime (mostly enshrined in law) is complemented by a minimum backing requirement for domestic money in foreign currency. *Potential benefits*: The time-inconsistency problem is reduced (subject to the perceived probability that the regime is abandoned) and real exchange rate volatility is diminished. *Potential drawbacks*: External shocks cannot be buffered by exchange rate movements, imposing costs if business cycles are asynchronous. The scope for lender of last resort activity is restricted to excess reserve holdings and fiscal mechanisms. Requires high reserve holdings. *Issues:* Lender of last resort limits, exit strategy if used as a transitory regime.
Monetary Union	*Key feature*: A group of countries using a common currency issued by a common regional central bank. *Potential benefit*: A monetary union reduces the time inconsistency problem by requiring multinational agreement on policy, and reduces real exchange rate volatility. *Potential drawbacks*: Member countries suffering asymmetric shocks lose a stabilization tool. The cost depends on the extent of asymmetric costs and the availability and effectiveness of alternative adjustment tools. *Issues:* Unknown responsiveness of wage/price setting behavior and migration/investment pattern to the altered regime. Potential sensitivity of voting equilibria to distribution of shocks.
Traditional Peg	*Key feature*: Fixed rate against a single currency or a currency basket. *Potential benefits*: The time inconsistency problem is reduced through commitment to a verifiable target. Devaluation option provides potentially valuable policy tool in response to large shocks. Reduces real exchange rate volatility. *Potential drawbacks:* Provides a target for speculative attacks. Avoids real exchange rate volatility but not necessarily persistent misalignments. Does not by itself place hard constraints on monetary and fiscal policy, and thus provides only a partial solution against time inconsistency problem; the credibility effect depends on accompanying institutional measures and record of accomplishment. *Issues:* Doubts about sustainability in the presence of full capital mobility.
Crawling Peg	*Key feature:* A rule-based system for altering the par value, typically at a predetermined rate or as a function of inflation differentials. *Potential benefits*: An attempt to combine flexibility and stability. Often used by (initially) high inflation countries pegging to low inflation countries in an attempt to avoid trend real appreciation. *Potential costs*: At the margins, a crawling peg provides a target for speculative attacks. Among variants of fixed exchange rates, it imposes the least restrictions, and may hence yield the smallest credibility benefits. The credibility effect depends on accompanying institutional measures and record of accomplishment. *Issues:* Exit strategy, either to harder peg, or greater flexibility.
Bands	*Key feature*: Exchange rate is flexible within a preset band; endpoints defended through intervention, typically with some intra-band intervention. An attempt to mix market-determined rates with exchange rate stabilizing intervention in a rule based system. *Potential benefits*: Provides a limited role for exchange rate movements to counteract external shocks and partial expectations anchor, retains exchange rate uncertainty and thus motivates development of exchange rate risk management tools. *Potential drawbacks*: On the margin, a band is subject to speculative attacks. Does not by itself place hard constraints on monetary and fiscal policy, and thus provides only partial solution against the time inconsistency problem. The credibility effect depends on accompanying institutional

	measures, record of accomplishment, and the characteristics of the band (firm or adjustable, secret or public, width, strength of intervention requirement).
Float with discretionary intervention	*Key feature*: Exchange rates are determined in the foreign exchange market. Authorities can and do intervene, but are not bound by any intervention rule. Often accompanied by a separate nominal anchor, such as an inflation target. *Potential benefits:* The arrangement provides a way to mix market determined rates with exchange rate stabilizing intervention in a non-rule-based system. *Potential drawbacks*: Does not place hard constraints on monetary and fiscal policy. Absence of rule conditions credibility gain on credibility of monetary authorities. Limited transparency.
Pure Float	*Key feature*: The exchange rate is determined in the market without public sector intervention. *Potential benefits:* Adjustments to shocks can take place through exchange rate movements. Eliminates the requirement to hold large reserves. *Potential drawbacks*: Does not provide an expectations anchor. Exchange rate regime places no restrictions on monetary and fiscal policy; time inconsistency problem arises unless addressed by other institutional measures.

Source: (Ghosh, et al. 2002: 3-4)

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