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Elections and Economic Turbulence in Brazil: Candidates, Voters, and Investors

***Anthony P. Spanakos
Lucio R. Renno***

ABSTRACT

The relation between elections and the economy in Latin America might be understood by considering the agency of candidates and the issue of policy preference congruence between investors and voters. The preference congruence model proposed in this article highlights political risk in emerging markets. Certain risk features increase the role of candidate campaign rhetoric and investor preferences in elections. When politicians propose policies that can appease voters and investors, elections may have a limited effect on economic indicators, such as inflation. But when voter and investor priorities differ significantly, deterioration of economic indicators is more likely. Moreover, voter and investor congruence is more likely before stabilization, when an inverted Philips curve exists, as opposed to following stabilization, when a more traditional Philips curve emerges.

Political business cycle theories predict that inflation should increase in an electoral year and that the incoming president should begin his or her administration by tightening monetary policy to constrain inflation. Annualized inflation in the quarter following Brazil's 2002 presidential election was close to 40 percent, a significant increase from the previous year; and the incoming president, Luís Inácio Lula da Silva, did indeed increase interest rates as a response. The rise in inflation occurred despite the historic anti-inflation policy stand of President Fernando Henrique Cardoso, Lula's predecessor; and Lula's support for higher interest rates went against his equally historic critiques of his predecessor's monetary policy as too constrictive. The immediate conclusion to be drawn is that both Cardoso and Silva behaved opportunistically—each abandoning his longstanding position in pursuit of political gain.

Similarly, and less cynically, Lula's decision to increase interest rates may be seen as "responsible" policy, according to Karen Remmer's political capital model (1993). But closer analysis suggests that neither Cardoso's nor Lula's macroeconomic policies can be adequately understood in terms of either political business cycle or political capital models. Both arguments ignore the agency of candidates, "investors," and "voters" and

the effects they can have irrespective of government policy stance.¹ A preference congruence model that examines elections as a dynamic negotiated process wherein candidates must address the preferences of both voters and investors can better explain the effect of elections on macroeconomic performance in Latin America's new democracies.

The policy preferences of these two groups are most likely to overlap before stabilization, when an increase in inflation is associated with a decrease in growth. With stabilization, however, particularly when it is accompanied by slow growth and moderate to high unemployment, voter and investor policy preferences are likely to diverge. That divergence creates incentives for candidates to court the former with proposals that frighten the latter. This can lead to capital flight, speculative attacks against a currency, rapid increases in inflation, and the deterioration of short- and medium-term debt profiles. Other political economy approaches focus on either the incumbent or the incoming government and do not pay enough attention to the effect that candidates, and their negotiation between pressures from popular actors and investors, can have on macroeconomic indicators. The preference congruence model aims to address this, offering a more comprehensive approach to the relationship between elections and macroeconomic policy in emerging market democracies. Furthermore, incongruence can bring about conditions that increase the likelihood of policy switches (see Stokes 2001b).

This article argues that the congruence between policy preferences of voters and investors produces good effects, while the lack of congruence can lead to very deleterious effects on key economic indicators.² After examining relevant literature on political business cycle and political capital models and the issue of voter investor congruence, the article analyzes the economic effects of Brazil's 1994, 1998, and 2002 presidential elections to explore why the 2002 contest differed so significantly from the earlier two. A more thorough analysis of the 2002 presidential campaign challenges expectations in the existing literature and makes the case for the importance of the agency of candidates and the preference congruence between voters and investors. Finally, the relevance of a preference congruence model is considered.

POLITICAL BUSINESS CYCLE AND POLITICAL CAPITAL MODELS

The political business cycle literature and its critics place great emphasis on the role of the incumbent and incoming administrations and ignore the impact of candidates' strategies and investors' preferences on elections. The main theoretical claim here is that the literature on elections and markets in Latin America also needs to pay attention to the growing role that investors play in elections.

William Nordhaus (1975) argues that politicians behave "opportunistically," loosening monetary policy before an election so as to reap the benefits of faster growth and increased employment before inflation becomes visible, only to tighten monetary policy once elected. In the process, they create a "political business cycle" (see also MacRae 1977; Fair 1978). Although most research on political business cycles has looked at the developed world (where the evidence appears to be mixed; see Alesina et al. 1997; Persson and Tabellini 2000), in the past decade, a number of studies have looked at political business cycles in emerging markets, particularly Latin America.

Shifting the model to Latin America requires certain adjustments. Barry Ames finds that politicians do increase spending during an electoral year, but also that they continue to do so during the first year of their administration (Ames 1987). Additionally, where prices are not stabilized, there is less incentive for postelectoral constrictions in monetary policy. In Brazil, increases in spending, growth, and inflation often take place during the "honeymoon period," when traditional political business cycle approaches would expect rational actors to be more austere.

In a multicountry study of the political economy of democratizing countries in 1980s Latin America, Remmer finds little, if any, evidence of a traditional political business cycle (1993).³ Challenging assumptions that increased demands encourage politicians to behave opportunistically, Remmer argues that democracy has not brought indiscipline to Latin American political economy. High levels of inflation before elections were accompanied by recession, not growth, contradicting the expectations of the political business cycle explanations. Inflation was a consequence not of expansionary policies but of incumbent mismanagement of the economy, policy failure, and political fatigue. Newly elected administrations, with bulky political muscle, would attempt to address longstanding problems in the economy and, in doing so, would implement stabilization plans immediately after elections (Remmer 1993, 405).

Remmer refers to this as the political capital model. The basic idea of this model is that a weak incumbent loses control of the economy, generating hyperinflation and recession. Newly elected politicians then galvanize their recent electoral success and popularity to enact dramatic, often draconian, economic stabilization plans, which are necessary to make fundamental long-term changes. Such plans are responsible reactions to the economic environment they encounter once in office. This reinforces Remmer's argument that elections breed fiscal responsibility.

Remmer takes her cases primarily from the 1980s, in the shadow of the Debt Crisis, a period she acknowledges as unique in Latin American history. In so doing, she can dismiss business cycle claims about reelection, because only two parties won reelection, and virtually all incumbent parties lost seats. During the 1980s, inflation was high enough that

an inverted Philips curve existed, in which increases in inflation were linked to contractions in growth and employment. The situation was different in the 1990s, as presidents who stabilized prices were resoundingly reelected, producing incentives for opportunistic behavior.

In another multicountry study, Susan Stokes finds that once price stability exists, voters behave as though they are under a Philips curve (Stokes 2001a, 30), with a clear trade-off between inflation and employment. As the moment of stabilization becomes more distant, voters tend to privilege the latter over the former. The popular demands for growth in poststabilization Latin America differ from those that Remmer examines. Remmer's political capital model shows how politicians sought to redress "intractable economic problems" in prestabilization Latin America and, in doing so, chose economic orthodoxy, or at least fiscal constraint (Remmer 1993, 405). Constraining monetary growth under conditions of high inflation has positive short-term effects on economic growth, and therefore is both popular and "responsible." Once price stabilization is consolidated, however, a new government's choice of inflation-constraining policies is intended not to bring structural change but to attenuate an increase in short-term inflation. This has an immediately negative effect on growth, and can be achieved because of the "political capital" of a honeymoon period, as Remmer suggests.

Remmer's defense of democracy and the possibility that elections can lead to greater discipline leads her to contend that elections are not "disruptive events that interfere with otherwise rational patterns of macroeconomic management" (1993, 405). While she is correct in criticizing political business cycle research in this area, she overstates her case, because elections can indeed be "disruptive," not only because of macroeconomic management, but because of investor responses to electoral campaigns. This is exactly where a broader definition of the actors involved in the electoral process becomes necessary to understand better how elections may generate economic turbulence.

THE PREFERENCE CONGRUENCE MODEL

Latin America, like the rest of the developing world, is capital dependent. The need for private financing—whether foreign or domestic—requires the inclusion of investor perception and behavior in the analysis of business cycles and policy choice in countries with emerging markets. The literature in political economy has long recognized the importance of investors in affecting domestic policy (Mahon 1996; Mosley 2003), but it has not yet incorporated the interaction between investors and elections. This is not surprising, considering that so many political economy models are tailored to suit the developed world, a world in which the space for the interference of financial actors is

reduced and, thus, investor impact is limited (Mosley 2003). But the same cannot be said about investors and elections in emerging markets, where lack of confidence in one candidate can spur a run against a currency, leading to a rapid deterioration of the country's debt profile, which is exactly what happened in the 2002 presidential elections in Brazil.

Investor perception is critical because, as Juan Martínez and Javier Santiso write, "probably the most relevant definition of an emerging market is an economy whose political outcomes and uncertainties (such as a presidential election or a cabinet reshuffle) tend to have high impacts on financial variables and therefore on stock markets" (Martínez and Santiso 2003, 365). The increased perception of risk has serious potential consequences. Nelson Barbosa Filho argues that 9 percent of Brazil's growth between 1966 and 2000 can be explained by changes in domestic liquidity, while as much as 40 percent is linked to international liquidity (Barbosa 2001). Liquidity is highest when there is confidence in markets. When political events undermine confidence, markets become less liquid. But all political events undermine confidence and, as Remmer (1993) proposes, elections can reinforce sound macroeconomic policies. This article argues that electoral risk is neither random nor accidental; political risk is greater under conditions with considerable divergence between investor and voter preferences.

Preference congruence between voters and investors regarding the need for inflation-constraining policies is more likely to occur following periods of combined high inflation, high enough that it is simultaneous with recession. This situation can be seen in prestabilization Latin America. Further, while preferences between voters and investors may begin to drift after stabilization, they should still be close in the electoral period immediately following stabilization, when the experience of high inflation still looms in popular memory. As price stability becomes normalized, a more traditional Philips curve emerges, pushing inflation and unemployment in different directions, increasing the likelihood that a political business cycle will occur and the likelihood of preference divergence. Voters are more likely to feel reform fatigue and frustration with slower rates of growth, while investors are more attentive to inflation creep and signals of possible loosening of reform resolve. Presidential campaigns can highlight this difference, providing incentives for candidates to propose expansionary policies, for voters to reward antiliberal policies, and for investors to retreat, leading to downward pressure on exchange rates and growth and upward pressure on inflation, stimulating an inverted Philips curve.

Elections, thus, can be mimics. This recalls the basic proposition of political business cycle literature, in which elections weaken macroeconomic policy stands. Contrary to traditional political business cycle literature, however, this article argues that elections can worsen economic

Table 1. Summary of Models

	Political Business Cycle	Political Capital	Preference Congruence
Agent(s)	Incumbent president/prime minister	Incoming president/prime minister	Incumbent government, relevant candidates, voters, investors
Electoral effect on the economy	Incumbent loosens monetary policy, incoming government tightens policy, regardless of ideology	Incoming government implements structural reforms during honeymoon to address long-term problems	Candidates negotiate between voters and investors; divergence between the latter two increases economic risk
Methodological tools	Interest rates, inflation, growth and unemployment rates	Interest rates, inflation, growth and unemployment rates	Interest rates, inflation, growth, unemployment, exchange rates, cost of government borrowing
Explanatory effect	Cyclicalities of growth rates, inflation, unemployment; nonimpact of partisan identity on macroeconomic policymaking	How democracy gives incentive for responsible policymaking; how elections empower government to pursue reform	How elections affect value of money, government debt, growth; predicts policy switches of incoming government

indicators even when incumbents do not behave opportunistically. The openness of emerging markets and the perception of political risk therein allow preelectoral runs on the currency or inflationary pressures that are linked not to current but to possible future macroeconomic policy. In other words, agency cannot be limited to incumbents but to candidates relevant enough to effect investor perception of risk. Table 1 summarizes

the differences between the political business cycle model, the political capital model, and the preference congruence model.

ECONOMIC CONSEQUENCES OF ELECTIONS IN BRAZIL

Inflation and foreign exchange rates are internal and external indicators of the value of money. They are critical for Brazil, given that 80 percent of its public debt is linked either to the exchange rate, inflation, or the interest rate. The deterioration of these indicators produces a groundswell in public indebtedness. Because Brazil dabbled with currencies in the 1980s and 1990s, the use of any long-term data on foreign exchange is less than perfect. Nevertheless, the data used here come from the Brazilian government's Institute of Applied Economic Research (IPEA), the standard source in the field. The institute has standardized the past 50 years of currency exchange by making historical rates for the exchange of reals and dollars.

The 1994 and 1998 elections show weakening of the exchange rate but control over inflation from previous trends, whereas the 2002 election witnesses a rapid deterioration in both. This study examines interest rates during the pre- and postelectoral period in each of the three elections to address whether the incumbent government behaved opportunistically. Because interest rates do not help explain the "electoral effect," or lack thereof, congruence is discussed.

Table 2 shows that the three elections produced significant deterioration in the real exchange rate. More specifically, of the 19 monthly data points used between October 1993 and April 1995, 14 show a decrease in value against the average value for the time period between 1991 and April 1995. Furthermore, all points from March 1994 until April 1995 are above the trend, with most falling between 0.8 and 0.95. This shows a progressive weakening of the currency, beginning during the campaign. Inflation, on the other hand, breaks its long-term upward trend. While average monthly inflation for the 12 months leading up to the 1994 elections is higher than the long-term trend, by July of 1994, monthly inflation drops precipitously to 7.75 percent, and from August 1994 on, monthly inflation does not exceed 3 percent. Thus, while only 10 of the 19 points are below the average, these 10 points are continuous, and emerge during the campaign. The election of Fernando Henrique Cardoso thus coincided with a radical break from the previous trend of acceleration of inflation, producing a very positive net effect on the economy. At the same time, the election saw the real, the one-year-old currency, weaken throughout the period. Even at its weakest, in April 1995, however, it was still the equivalent 0.91 U.S. dollars.

Table 2. Inflation and Exchange Rate Movements
Around the Brazilian Elections (averages)

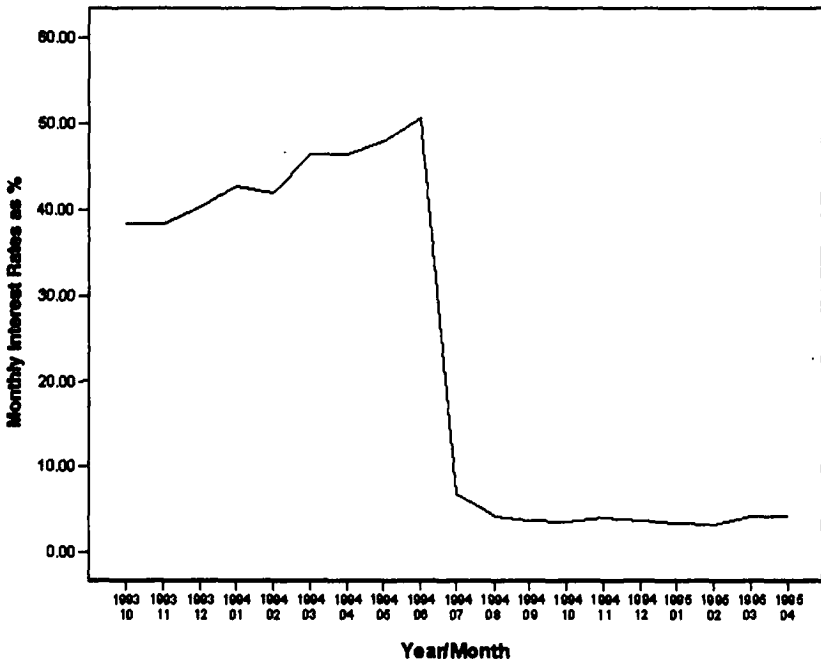
	Inflation	Exchange Rate
1994 Election		
1991–April 1995	21.732	0.231
October '93–October '94	29.623	0.639
April '94–April '95	12.22	0.831
1998 Election		
1995–April '99	0.755	1.106
October '97–October '98	0.249	1.145
April '98–April '99	0.329	1.385
2002 Election		
1995–April 2003	0.785	1.718
October '01–October '02	0.828	2.8
April '02–April '03	1.428	3.247

Source: IPEA.

The election of 1998 shows a similar weakening of the real exchange rate and a downward trend in inflation until early 1999, when the Brazilian government shifted its currency regime and allowed the real to float freely. Eighteen out of 19 data points show a real exchange rate that is weaker than the average of the period 1995 to April 1999.⁴ At the same time, inflation is well below the long-term average at all but one point in the preelectoral period and two points in the postelectoral period. But the average for both of these periods, even considering the change in currency regime, is still well below the long-term trend.

The 2002 elections show a more accelerated deterioration of the real and a very significant negative effect on monthly inflation. Much as with the 1998 elections, the value of the real deteriorates over the course of the campaign, with all 19 points standing well above the long-term average; but the degree of this deterioration is more intense. Additionally, between July 2002 and April 2003, all but one of the points are above three reals to the U.S. dollar, and six more points have a rate of R\$3.5 or more to the dollar. Unlike 1994 and 1998, the 2002 electoral periods witness an average monthly inflation well above the long-term average. This is especially true of the second period, which gives more emphasis to the campaign itself and its immediate after-effects. In this period, monthly inflation is nearly double its seven-year average, which suggests that the 2002 elections had a very powerful effect on inflation.

Figure 1. Interest Rate Fluctuation Around the Presidential Election, 1994

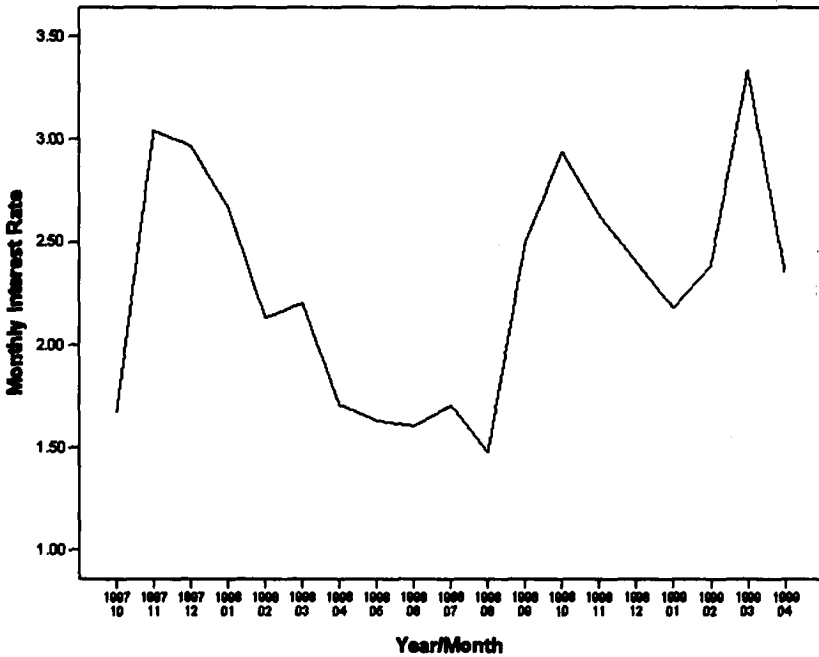


Source: Interest rates in figures 1, 2, and 3 based on the Taxa de juros—Over / Selic—Mensal—(% a.m.)—BCB Boletim/M.Finan.—Bm12_TJOVER12 on IPEA website.

Literature examining the effect of elections on economic performance rightly begins by looking at the policies pursued by the government before and during the election, because government is the political institution most likely to have an effect on short-term rates and trends in terms of inflation, foreign exchange, growth, and unemployment. Political business cycle research assumes not only that government has the ability to manipulate these indicators, but because of reelection concerns, it has the incentive. Remmer's political capital model suggests that politicians will pursue contractionary policies following elections not because they are behaving opportunistically, but in order to deal with long-term macroeconomic problems. Interest rates are fundamental to both arguments. Figures 1 to 3 show monthly interest rates from October of the year preceding each election until April of year following the election.

As figure 1 clearly shows, interest rates increased consistently for the nine months preceding the 1994 elections. Not only is this contrary to political business cycle expectations, but monthly interest rates of 50

Figure 2. Interest Rate Fluctuation Around the Presidential Election, 1998

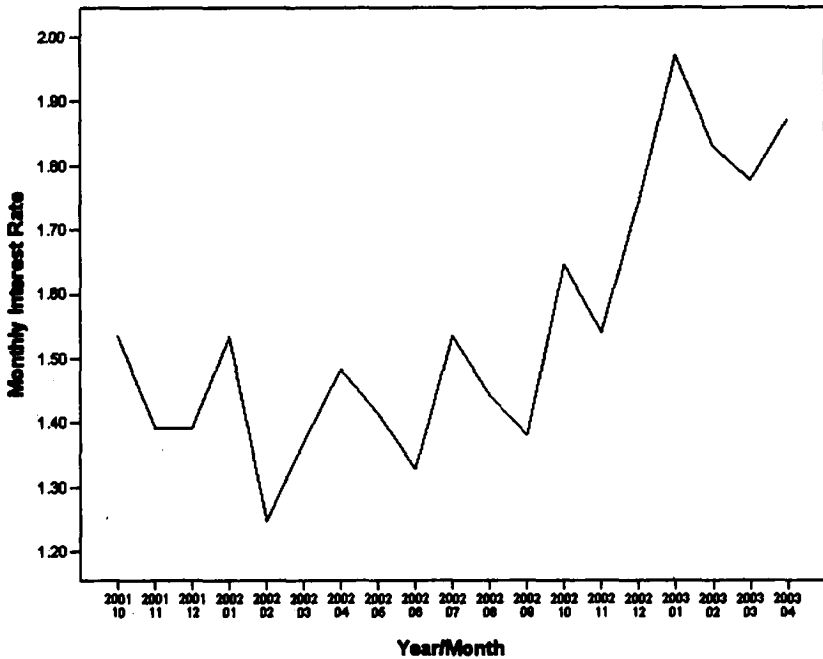


percent can hardly be considered pro-growth. The political capital model is more useful in explaining the increase in interest rates because the Finance Ministry, under candidate Cardoso's regents, saw inflation (inertial and otherwise) as the result of structural problems that had to be addressed. But the pursuit of high interest rates during a campaign is not expected by Remmer's model, which sees the election as conferring political capital. Instead, the deceleration in inflation gave the government tremendous political capital even before the election, explaining the pre-electoral increases in interest rates. The decrease in inflation eventually made it possible to reduce interest rates responsibly.

When inflation rates are very high, moreover, a policy aimed at short-term reduction can bring real, tangible benefits across society, and can therefore be employed by opportunistic politicians. Certainly, this was the case for the stabilization plans in Brazil before the Real Plan, all of which were short-term and ultimately unsuccessful. The Real Plan differs in that it dealt a permanent blow to inflation.

The 1998 elections, when President Cardoso ran for reelection, may look like a classic example of a political business cycle. Figure 2 shows how monthly interest rates sharply fell throughout the campaign until September 1998, when they began to rise. The political business cycle

Figure 3. Interest Rate Fluctuation Around the Presidential Election, 2002



literature expects such a monetary loosening to spur growth before a postelectoral pullback. But the decrease in interest rates corresponded to a period in which inflation was decreasing, not increasing. Because of the overvaluation of the real, Brazil was facing certain deflationary pressures in 1998, which necessitated lowering interest rates. Clearly, Cardoso did not rush to devalue during the campaign, so as not to lose political support; but his use of interest rates was not what would traditionally be considered opportunistic. Following the election, inflation increased and interest rates did, too.⁵ This is not entirely incomprehensible to a political capital model, in which the politician recognizes a major problem—in this case, an overvalued exchange rate—and waits until the election is past to address it.

Cardoso behaved “opportunistically,” but not the way political business cycle theories would predict, because he promoted policies that stunted growth and inflation before the election. Because political business cycle theories assume price stability, they do not envision such an activity—that is, constraining growth—as being potentially opportunistic. Returning to the political capital model and the need for a politician in a honeymoon period to address longstanding problems, the one addressed following the 1998 election is considerably narrower than the

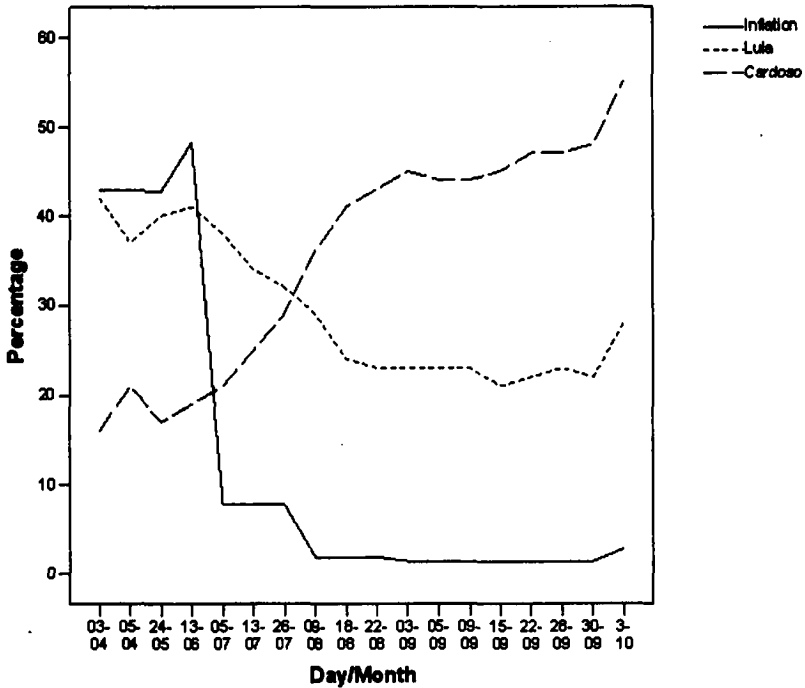
one in the previous election. Whereas in 1994, wholesale changes were needed, the post-electoral change in 1998 was an important but much more specific reform: flexibilization of the exchange rate. Also, contrary to the political capital model, whereas the 1998 change was postelectoral, as the political capital model expects, the 1994 reforms began in the preelectoral period.

As already indicated, the 2002 elections produced significantly deeper effects on the exchange rate and a radically different direction in inflation. These results are expected by political business cycle theories. Though Cardoso was not a candidate himself, a member of his government, José Serra, was. But even the most casual glance at interest rates over the period leading up to the election challenges the idea that President Cardoso used monetary policy as a way to stimulate Serra's candidacy (see figure 3). The political capital model helps explain the direction of the incoming Lula government, which raised interest rates (throughout 2002) in order to constrain inflation. But this decision was quite different from the high interest rates in 1994, intended to eliminate high inflation, or the slight increase in interest rates in 1999, which aimed to support the new floating currency. The constriction in monetary policy in 2003 aimed not to address "intractable problems" but to contain the pressures that had been allowed to develop during the 2002 campaign by all candidates, principal among them the incoming president.

A critical distinction can be made between the 1994, 1998, and 2002 elections. While the first two had positive effects on inflation, the last had quite the opposite, even though interest rates decreased in the first two cases and increased in the last. The effect was not produced solely by government macroeconomic policy, however, as the traditional political business cycle assumes. When policy proposals of the leading candidate were supported by both voters and investors—definitely the case in 1994 and slightly less so in 1998—future government policy was predictable, and the policy environment could be described as consistent and less risky. In 2002, voters, tired of slow growth and less concerned about inflation, demanded growth-oriented policies from their politicians, while investors were concerned about inflationary pressures. The divergence of interests led to greater perception of risk, a drying up of Brazilian markets, higher inflation rates, and deterioration of Brazil's debt profile.

In 1994, voters were concerned about inflation more than unemployment, as Cardoso's first-round victory and the massive volatility in vote intentions make clear (see figure 4). Voters clearly backed Cardoso mostly for the success of the Real Plan and quickly switched their vote intentions in favor of Cardoso in July, when the plan was implemented. According to Meneguello (1996) and Rua (1997), the Real Plan was the defining factor of the 1994 elections, and it was so successful because it spoke directly to voters' demands for curbing inflation. This is important

Figure 4. Vote Intention for Lula and Cardoso and Inflation Level, 1994



Source: Inflation based on INPC—Mensal—(% a.m.)—IBGE Outras/SNIPC—Precos 12_INPCBR12 available on the IPEA website. Data from Datafolha, IBOPE, IPEA.

because it shows that Latin American voters may place concerns about inflation above desires for growth and employment, especially when living under conditions that approximate hyperinflation.

Inflation, especially in emerging markets, is indicative of instability and risk for investors. While moderate levels of inflation can foster growth and can make for arbitrage opportunities, the uncertainty in a market characterized by extremely high inflation is very undesirable to most investment banks and pension funds, and certainly to rating agencies. Inflation decreases the value of money, discouraging investment and weakening long-term growth. It also increases the risk of policy volatility, particularly in terms of currency regimes, interest rates, and capital controls. Such effects are not encouraging, either for potential investors in firms that operate in such an environment or for potential purchasers of public or private debt. For this reason, financial analysts identified the stabilization of the economy as the most important task for the future president in 1994. Cardoso's tenure in the Finance Ministry, and his administration's team in the Central Bank and the Finance

Ministry, reassured market analysts and investors that the antishock, exchange rate stabilization plan would continue and that inflation would be reduced to single digits.

Candidate Cardoso's pragmatism signaled that a future Cardoso presidency would be able to count on the support not only of his own party but also the parties of the center and right (the PMDB and PFL, respectively, in addition to his own PSDB).⁶ The governability that such support ensured meant that Cardoso would be able to push through many of the liberalizing reforms that were favored by investors. Lula's oppositionist and antimarket stances appealed to more radical sectors of the population; but the vast majority of voters, to say nothing of investors, saw his policy proposals—such as defaulting on international obligations—as utopian criticism at best, and irresponsible populism at worst. Not surprisingly, Lula's decline in popularity and Cardoso's resultant rise reassured investors. Also, as Cardoso's proposed program represented a continuation and expansion of what was already government policy—which would be directed by known personalities, such as Pedro Malan, who had been renegotiating Brazilian debt with the IMF, and supported by a significant legislative majority—investors had a clear idea of what a Cardoso presidency might look like. This reduction of uncertainty is fundamental to risk management and cannot be overstated.

The election of Cardoso allowed for the continuation of the anti-shock stabilization program that was so popular among voters and investors. This continued growth was facilitated by the increase in capital inflows and the privatization revenues, which reflected the considerable support the financial community gave to Cardoso and his government. Thus, the very significant overlap of preferences of voters and investors led to the electoral victory of a mutually acceptable candidate; and this explains the positive effects on the economy.

In 1998, the major candidates in the presidential elections were again Cardoso and Lula.⁷ Cardoso, as a result of a controversial amendment passed during his mandate, was the first president who would campaign for reelection. Lula, for his part, had made his peace with Leonel Brizola, his competitor on the left, establishing his candidacy as the unified position of the opposition. Also, for the first time since the return of civilian rule in 1985, the incumbent administration had governed during a period of economic and policy stability. As a result, the government candidate had a very clear program with which he could be identified, and the opposition could more easily identify its objections. This situation should not be overlooked, because Brazilian political institutions, particularly parties, are often seen to have a minimal "brand" effect, giving only limited information to voters (Mainwaring 1995). This branding is equally important to investors, who, like voters, search for information to piece together possible future policy positions of different candidates.

Cardoso was in a fairly strong position in 1998. While the average rate of inflation from 1989 to 1998 was 861.87 percent, average annual inflation during Cardoso's government (1995–98) was only 9.7 percent. Growth was not especially impressive, but the average growth during the Cardoso government of 2.57 percent was virtually identical to that of the period 1989–98 (2.52 percent). The deep reduction in inflation without a simultaneous drastic recession was critical for Cardoso. While growth had slowed considerably in 1998 and the current account deficit had ballooned to 8 percent of GDP, inflation was only 0.13 percent, and the stability of the real was a powerful symbol. The emphasis on the currency was especially important following the Tequila crisis in 1995, the Asia crisis in 1997, and the Russian default in 1998. Each of these crises wore away investor risk tolerance, particularly for emerging market instruments. On the domestic side, however, all these crises were linked to exchange rate policies, and many to forced devaluations and the fear of a return of inflation.

The international crises led to increased pressure on the real. Cardoso's response was to protect the real, sacrificing growth for the sake of price stability. The protection of the real placed inflation at the forefront of the 1998 campaign. With low inflation that year, expectations might be that voters in such an environment might support growth-oriented policies (such as those supported by Lula). However, the recent memory of high inflation and the imminent threat of the return of inflation if policies of economic austerity were not maintained explain much of Cardoso's support in public opinion polls. Cardoso also blamed the international environment for the harsh but "necessary" measures implemented and for the slowing down of the economy. Indeed, voters thought that the incumbent administration, because of its experience and previous success in stabilizing the economy, was more capable of dealing with the international crisis than was the opposition.

Investors, at a moment of tremendous international turbulence, also preferred policies that favored the reduction of instability and the risk of inflation. Cardoso, the incumbent president, had given more than enough signs during his administration that he was in tune with the expectations of investors, both by pushing liberalizing economic reforms and by responsibly maintaining price stability. Therefore, 1998 saw a situation of minor instability, caused not by voter and investor preference disjunction but by turbulence in the international arena.

THE PRESIDENTIAL CAMPAIGN OF 2002

During the six months prior to the 2002 elections, the Brazilian economy reacted in a way that appears to be consistent with expectations generated by political business cycle research. Monetary supply (M1)

increased consistently from R\$45,981 million in March 2002 to R\$55,690 million in October 2002, monthly inflation went from 0.62 percent in March of that year to 3.39 percent in November, and the real weakened from 2.35 per U.S. dollar on March 15 to 3.93 on October 17. All of this would suggest weakening monetary resolve as a means of priming the pump for electoral gain.

But neither growth nor unemployment bore the fruits that a loosening of monetary policy would imply or political economists might ordinarily expect. Notably, unemployment increased from 7.6 percent in March 2002 to 8.1 percent in October 2002. The lack of improvement in these indicators is explained in that monetary policy did not actually loosen during the electoral period. Monthly interest rates trended upward, from 1.37 percent in March 2002 to 1.65 percent in October 2002 (see figure 3). Additionally, monthly interest rates in 2002 were between 4 and 25 percent higher than for the same months in 2001, with the exception of only one month. This evidence is critical, because the political business cycle literature expects interest rate manipulation to be the primary proof of opportunistic behavior. In relation to the 2002 Brazilian elections, interest rates did not move in the expected direction, though inflation and monetary supply did.

Inflation and M1 increased and the real lost value not because of loose monetary policy, but because investors viewed the electoral ambit as full of ambiguity, and the demand for Brazilian assets decreased accordingly. As the clearest measure of investor willingness to invest in Brazilian bonds, Brazil risk increased from 686 basis points on March 18, 2002 to 2,296 bps on October 15, 2002.⁸ The increase in the cost of borrowing and its effect on the exchange rate led to the increase in inflation. This result was a consequence of investor concerns about policies of potential future governments. The increased scarcity of capital forced high interest rates and negatively impacted growth and employment, while simultaneously contributing to the deterioration in the value of money (both internal and external, as attested by inflation and the foreign exchange rate). The role of investor perception, therefore, is critical to understanding the unexpectedly poor economic indicators of 2002. Additionally, investor perception of the risk of the Brazilian market was linked not to the policies of the Cardoso government but to those of its potential successor, and that shifted attention away from President Cardoso in favor of the various pretenders.

Lula was the frontrunner for the 2002 elections. He received only brief challenges from José Serra, the government's health minister, and, more briefly but intensely, from former Ceará governor Ciro Gomes. Lula had been the most vocal critic of the government for many years, but he had begun to moderate his rhetoric. He was challenged from the left by candidates who were also critical of the Cardoso government's liberal

economic policies, and this competition prevented him from adopting a moderate position, such as the one he has adopted since being elected.

Lula's public relations team designed a new image, "Lula light" (or "diet Lula"), which had him abandon his Everyman outfits and his public style of bellowing into a microphone and blaming capitalism for Brazil's woes. The freshly manicured Lula now wore Armani suits, spoke softly, proposed a partnership between industry and labor, and even chose an industrialist from a right-wing party (the Liberal Party) as his running mate. This was to show that capitalists need not fear a Lula government, that the PT was no longer a pure opposition party, and that there was broad consensus that the government's economic strategies (e.g., high interest rates) were asphyxiating the Brazilian economy.

While many voters and investors welcomed the new vision of the PT and Lula, few could be sure whether this was simply electoral rhetoric, whether there had been a true shift within the PT and Lula's thinking, or some combination of both. Ambiguity was inherent in the campaign from the beginning. The man who, 13 years earlier, had spoken of a desire to establish a socialist government in Brazil now was courting the same investors he had lambasted for the "savage" capitalism they imposed on Brazil. While many argued that Lula, like all Brazilians, had changed since his first campaign for the presidency, his and the PT's antimarket rhetoric was not abandoned to the distant past. When asked about the riots in Argentina in December 2001, Lula said, "The people are robbing to eat, because for ten years, the IMF robbed Argentina" (*Veja* 2001). A PT document drafted a little earlier spoke of capping debt payments (*Economist* 2002).

At the same time, Lula was trying to distance himself from his previous criticism of the Real Plan, admitting that it had brought down inflation, which was certainly a gain for the Brazilian worker. However, he insisted, the Real Plan relied on high interest rates, which prevented growth. He proposed altering the country's "economic model" to permit robust growth with low inflation. The clues he gave in his speeches suggested a state-oriented economy that would push growth and be more flexible with inflation. To highlight this, Lula insisted that, in contrast to the Cardoso government, the Ministry of Finance and the Ministry of Planning would be equally important. At the same time, he quoted growth for 2003 as potentially 7 percent, which he later reduced to 5 percent, and then spoke of an average growth of 5 percent per year for his term as president. When asked what an acceptable rate of inflation was, since such growth was likely to raise inflation, he responded zero. Not surprisingly, neither voters nor investors could be sure how a Lula government would change the "government economic model."

The Serra candidacy was confused from the beginning. Serra was an economist with UNECLACL who, while a member of the Cardoso gov-

ernment, had criticized its economic policies. The internal criticism and his personal *jeito* (style) alienated many members of the Cardoso coalition, as well as most of the major leaders in his own PSDB party.⁹ Serra's discourse was also marked by an essential ambiguity: it was unclear whether he was the candidate of the incumbent administration or its critic who vowed to create 8 million jobs. Though his proposals were less state-centered and based more on export-led growth, his uncertain position in relation to the government he had been part of for eight years further contributed to the ambiguity of the electoral environment.

Ciro Gomes, for his part, was a smooth-talking Northeastern politician who could show the success of his administration in the state of Ceará, establishing his credentials as experienced in government (unlike Lula) but still part of the opposition (unlike Serra). He proposed an alternative model, which would reduce dependence on international capital without threatening price stability, allowing for growth more consistent with the years of the Brazilian Miracle. As details became available, however, investors began to feel that a *Ciro* presidency would be less predictable than a *Lula* presidency. One of his chief reform proposals was that monetary policy should be determined by setting growth targets, though the economic adviser he chose, a University of Rochester-trained monetarist, Alexandre Scheinkman, disagreed and thought abandoning the inflation-targeting scheme would be a mistake. This further muddied the predictability of future policy and contributed to the increased perceived risk in Brazilian markets.

Candidates do not make criticisms and policy proposals in a vacuum, and the preferences of voters were critical in encouraging the discussion of changing the government "economic model." Voters had very clearly expressed their support for low inflation in the 1994 and particularly in the 1998 elections, when they overwhelmingly reelected a president during a year in which economic growth was statistically negligible. At the same time, with inflation apparently stabilized (inflation between 1999 and 2002 had averaged 8.68 percent), the electorate became increasingly preoccupied with growth (average growth during the same period was only 2.1 percent).

In a national public opinion poll published November 11, 2002, conducted by IBOPE (the Brazilian Institute of Public Opinion), 43 percent of Brazilian voters expected the new government to invest in growth and generating jobs, followed by 29 percent who said controlling inflation should be the main goal (IBOPE 2002). The same document states that, since 1999, more than two-thirds of all Brazilians have consistently mentioned unemployment as one of the worst problems facing the country. Though Brazilians ranked inflation as only the tenth most mentioned problem in 2001, it jumped to fifth position in 2002. This indicates that the acceleration of inflation in the election year

increased popular concern about it, but not enough to displace unemployment as the main problem.

Accordingly, candidates—including the government candidate—criticized the Cardoso era as deficient in terms of economic growth and job creation, and all emphasized that growth under their watch would resume at much higher rates (most made comparisons with the Kubitschek era or the military government). Lula especially criticized the high interest rates, which served as a brake on growth. Brazilians, who in their daily lives saw the difficulty of getting credit and the very high cost thereof, sympathized with the argument and supported the idea of lowering interest rates.

Little discussion took place in public forums, however, regarding how interest rates would be lowered without inviting inflation. Not only was this a reasonable concern based on standard Philips curve expectations (Stokes 2001a, 30), but it was empirically critical, given the acceleration of inflation. Voters saw only the slightest signs that inflation was not totally removed from the economy, but investors witnessed increased inflationary pressures and, eventually, the effect of these on inflation. In many publicly released documents, investors asked all candidates, but especially the PT candidate, to be more explicit in their proposals for government (Schwartzman 2002, 1; Gustavo Loyola, in Alcântara 2002). PT emissaries were sent to Wall Street and São Paulo to meet with investment banks and to project the party's new, pragmatic vision of international finance; some went so far as to reassure analysts that the speeches about growth were "just electoral rhetoric" and that they would follow the path of the Cardoso government.¹⁰

There was nonetheless considerable reason to doubt this promise.¹¹ It was not simply that Lula was proposing two very different policies (increased social spending and growth; no change in inflation and reduction of indebtedness), but also that tremendous pressures within the PT and within any potential governing coalition might force the government to respond in a way inconsistent with its promises to the financial community. Moreover, only in private meetings was there discussion of maintaining the inflation-targeting policy fundamental to monetary policy. The few official public statements that addressed inflation spoke of broadening the range of "acceptable" inflation but gave no clear targets or ranges.

During 2002, the majority of voters clearly favored a discussion of economics that gave little attention and priority to inflation and that emphasized their frustration with the sluggish growth associated with the poststabilization Cardoso era. Investors saw things quite differently as they worried that inappropriate or ill-conceived growth strategies could reignite inflationary pressures. This fear led to the drying up of Brazilian capital markets, the deterioration of the value of the real, and

a rise in inflation. Thus, the increase in inflation during the electoral period in Brazil resulted less from government monetary policy and more from voters' preference for candidates whose policy proposals were perceived by investors as ambiguous or misguided. The political business cycle model cannot explain this outcome because it does not devote appropriate agency to candidates, nor does it consider the potential fragility of stabilization and the importance of congruence of voter and investor perception thereof.

Similarly, while the political capital model allows for postelectoral constriction of monetary policy, it explains this as the result of a vision to address structural, long-term macroeconomics, not short-term, opportunistic behavior. The 2002 elections produced ambiguous results for this, however. Four years after his election, Lula continues to speak of social programs, but his government has produced higher primary surpluses than those of his predecessor and has raised interest rates to meet inflation targets. There has been little policy reform, which would suggest that the change in Lula's rhetoric was to address "intractable" or even long-term problems. Instead, however, all evidence suggests that Lula "switched" positions and that his policies represented small-scale adjustments within a political economy vision.

Lula's choice to pursue inflation-constraining policies was strongly influenced by the conditions that emerged from the divergence between voter and investor preferences during the presidential campaign, the response of the candidates, and the resulting economic wreckage. These conditions placed considerable constraints on Lula's administration, and he responded in a manner not inconsistent with that of his predecessor or of policy advisers from the same banks that were critical of his campaign. His policy switch could very well be the result of responsible behavior, as Remmer might suggest, though without the deep structural changes. It could just as well be a response to his not-so-responsible behavior—for example, sending mixed policy signals during the campaign.

THE RELEVANCE OF THE CONGRUENCE MODEL

Analysis of the 1994, 1998, and 2002 presidential elections confirms the hypothesis that elections can act as "critical" moments that can significantly affect key economic indicators, such as inflation and the real exchange rate. On balance, there seems to be little evidence of opportunistic behavior, as measured by interest rate manipulation. Changes in economic indicators, furthermore, whether for better or worse, seem to be linked not only to current government policies but especially to the potential policies of candidates.

Neither of these results is expected by political business cycle research. Political business cycles also rely on Philips curve preference expectations of voters, which can be validated in Latin American public opinion data, but only after stabilization (Stokes 2001b). This latter point is critical, because prestabilization conditions can create incentives to produce shocks to inflation, not growth, during electoral periods, as seen in Brazil in the mid-1980s until the Real Plan.

Remmer's political capital model, in its shift away from unscrupulous, opportunistic politicians and its endorsement of the possibility of good macroeconomic management policies under democratic governance, offers improvements to the political business cycle model. But it was conceived during a period before stabilization, when incentives for business cycles were inverted and "intractable" structural problems needed to be addressed in order to bring back price stability.

With price stability, the concern has become sustainable growth. In such an environment, postelectoral inflation constraint appears to be responsible behavior, which works best when political capital is at its highest, during the honeymoon period. But this strategy makes no further attempt to impose severe changes or to address long-term problems in the economy. Instead, poststabilization macroeconomic policy seems conservative—to preserve price stability—rather than radical—aiming at wholly new policy.

The limitations of these approaches can be addressed by including candidates and investors as agents. As the Brazilian elections of 2002 make clear, candidates can increase investor perceptions of risk and can have a negative effect on inflation, even when an incumbent government increases interest rates. The 1994 elections produced no such result, and the 1998 elections, given the "Asian flu" and the Russian default, had only a mildly negative effect on Brazilian economic indicators.

It is possible to argue that economic turbulence is linked not so much to preference congruence as to partisan attitudes, with market analysts preferring right-wing candidates. The elections of 2000 in Mexico, which produced the first president who was not a member of the PRI, did not have an appreciably negative effect on that country's macroeconomic indicators. But neither did the election of a Socialist, Ricardo Lagos, in Chile the same year. In both these cases, as well as the 1994 and 1998 presidential elections in Brazil, considerable overlap existed between the policy preferences of voters and investors; and politicians with predictable macroeconomic policies were elected, generating positive or only slightly negative effects on economic indicators.

The 2002 presidential elections in Brazil produced quite the opposite result. The 2006 elections, furthermore, involved virtually no political risk, as no viable candidate offered any challenge to the basis of Brazilian economic policy, primary fiscal surplus, floating exchange rate,

and inflation targeting. Though questions persist about Lula's appetite for further reform and the PMDB's reliability as a governing partner, there is little ambiguity about fundamental economic positions, and therefore little risk, from the perspective of investors. Voters, for their part, may be disappointed with the corruption associated with the Lula government, but they overwhelmingly will vote for a candidate who brought moderate economic growth while maintaining low inflation.

As early as 2005, business analysts calmly supported the Lula government while it was attacked by very high-reaching claims of corruption. As U.S. Treasury Secretary John Snow explained, "The situation, however you care to characterize it, has not had a major impact on the economy. . . . That's a reflection of confidence in the basic institutions" (Rohter 2005). More important, it is a reflection of confidence in the government's maintenance of a macroeconomic position that analysts consider credible and appropriate. The need to protect the president from impeachment, however, suggests that there was a fear of panic or speculation that might occur should Vice President José Alencar or Chamber of Deputies President Severino Cavalcanti come to power. In other words, confidence is neither guaranteed nor permanent.

The 2002 election is also interesting for political economy research because it is a very prominent example of what Stokes calls a "policy switch" (2001). Stokes's groundbreaking study on the subject looks at how politicians, following elections, have imposed "neoliberalism by surprise." Examples abound in Latin America from the late 1980s and early 1990s: Alberto Fujimori in Peru, Carlos Menem in Argentina, Carlos Andrés Pérez in Venezuela. Policy switching is neither uncommon nor surprising in an arena in which information is asymmetrical and parties are clientelistic. This tendency increases under coalitional government (Stokes 2001b, 91). However, Stokes argues, strong parties "induced governments to reveal their policy intentions in campaigns, and once in office to follow through on these intentions"; therefore, strong parties were the most serious obstacle to switches (2001, 21). This finding is expected, because such parties punish backbenchers who break ranks, and partisan voters are more likely to punish such parties if they do not do so, which provides substantial disincentives for party indiscipline.

This makes the PT government's macroeconomic policy stand even more surprising, given the party's high levels of discipline and clear ideological boundaries. That a party with a brand name (see Downs 1957) and a deep, participatory political base, a party that opposed liberalism and policies that generate "social exclusion," could switch policies offers a powerful challenge to Stokes's otherwise complete treatment of the subject. Analysis of policy switches would be improved by considering the congruence between investor and voter preferences during elec-

tions, because this could help explain why even such a disciplined party, with a consolidated brand name, might switch.

When investors and voters perceive a need to reduce inflation, it is easier for politicians to act consistently, and no policy switches are necessary, because candidates campaign on a policy agreeable to both groups. When growth is sluggish but warnings of increased inflation appear, investors and voters are likely to place very different demands on politicians and their respective parties. The need to win an election requires that politicians favor growth-oriented policies or remain non-committal about their policy intentions. This ambiguity spooks investors, which leads to capital flight, downward pressure on exchange rates, and upward pressure on interest rates. By the time a growth-oriented politician is elected president, he or she may face short- and medium-term economic indicators that are considerably worse than those when the campaign began, increasing pressure to switch policy directions. A disciplined party might find itself with the unenviable choice between maintaining ideological consistency and risking higher inflation, or switching and losing ideological consistency. The post-2002 policy switch of Lula and the PT cannot be understood without looking at threats to price stabilization and the incongruence between voter and investor demands. When such considerations are added to policy switch literature, they can offer a more robust explanation for policy paths of politicians in emerging-market democracies.

What the three Brazilian elections analyzed in this article, and the other cases mentioned in this section, suggest is that extant political economy literature examining electoral politics, macroeconomic policy, and their effects on economic indicators in emerging markets could be strengthened by including analysis of candidate agency and of the preference congruence between voters and investors. Because the preference congruence model examines the negotiations between candidates, voters, investors, and the government, many frameworks can be used. One could be a revised version of Robert Putnam's 1988 two-level game, wherein candidates are theorized to play a two-level, two-stage game in which they must appeal to both voters and investors (levels I and II) but where the priority of each group differs depending on the stage of the game (voters take greater priority during stage I, the election, and investor preference becomes increasingly important especially in stage II, the postelectoral period).

NOTES

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1. While investors are often identified as "foreign," extensive interviews with financial market analysts and consultants revealed no discernable difference in analysis that could be attributed to country of birth or residence. There is diversity among investors, as there is among voters, but it would be misleading to argue that foreign investors abandoned Brazilian capital markets in 2002, or any other year, and domestic investors did not. In this study, "investors" include all private individuals, institutions, and corporations that, through the purchase of property, license, title, bonds, or other assets, invest in Brazilian markets. The most important and visible of these investors participate in Brazilian capital markets; particularly, though not limited to, government bond issues.

2. An analogy with Putnam's two-level game (1988), wherein political actors in international arenas have to deal with both domestic and international pressures, helps explain the dilemma candidates face when dealing with investors' and voters' preferences. When the preferences of actors in domestic and international arenas are discrepant, it is much harder for policymakers to reach a consensus. Negative outcomes are more likely when there is preference dissonance. Similarly, when investors and voters disagree about what the country needs, economic turbulence, a clearly negative outcome for a developing country, is more likely to occur.

3. Two recent articles offer contradictory positions on this issue. Hallerberg and Marier (2004) do not find a negative relationship between elections and public deficits in Latin America; Amorim Neto and Borsani's 2004 statistical study finds that elections do have an effect on deficits in Latin America.

4. The starting date of 1995 is used for the 1998 and 2002 elections because of the very significant impact of stabilization. If this adjustment were not made, average monthly inflation between 1991 and April 1995 would be almost 5 percent, which is not representative of the trend that inflation took beginning in 1995.

5. This rise is linked not only to efforts to "protect" the real but also to speculation following crises in Indonesia and the Russian government's debt default, factors that were outside the power of the incumbent government.

6. The Party of the Brazilian Democratic Movement and the Liberal Front Party.

7. Ciro Gomes was also a candidate. While his support was impressive, given the resources available to him, his campaign in 1998 was clearly only a preparation for his candidacy in 2002. He ran as a candidate of the Popular Socialist Party.

8. One hundred basis points is the equivalent of one percentage point. The C bond is the primary instrument the Brazilian government uses for borrowing, and the price that investors are willing to pay for it represents their perception of the risk that the Brazilian government will renege on its commitments. "Brazil risk" is the spread of the effective coupon rate paid by the Brazilian C bond

when compared to a bond issue of similar maturity issued by the U.S. Treasury. U.S. government bonds are used as a benchmark because the perceived probability that the U.S. government will not pay its obligations is considered to be zero. The spread entails subtracting the rate offered on U.S. government bond issues with similar maturity from that of the Brazilian C bond. This spread is calculated in basis points, with one hundred basis points equal to 1 percent.

9. Serra's own poor relations with the PFL (the government's main ally for two mandates) and his supposed involvement in the torpedoing of PFL precandidate Roseana Sarney led him to choose a running mate, Rita Camata, from the PMDB. This choice weakened the governing coalition and Serra's support among PFL politicians and their constituents, which was critical, given the complimentary nature of PSDB and PFL voting bases.

10. This was conveyed to one of the authors in a private conversation with the chief economist for Brazilian debt markets in a bulge bracket investment bank.

11. One analyst remarked, "We still do not know which PT will govern the country" (Grinbaum 2002).

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