The Political Economy of Sovereign Debt: Global Finance and Electoral Cycles

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Abstract

Political economy theory expects politicians to use budget deficits to engineer an election-timed boom, known as the political business cycle. We challenge and contextualize this view by incorporating the financial constraints faced by governments into an electoral framework. We argue theoretically that the extent of ownership dispersion among creditors has important effects for governments' policy autonomy. Specifically, we contend that when highly indebted governments become more reliant on international bond markets—as opposed to traditional bank lending—politicians alter the way they respond to domestic constituents. In an econometric test of 16 Latin American countries, from 1961 to 2011, we show that financial decentralization breeds austerity. More specifically, we find that politicians exhibit more fiscal discipline when they fund a greater share of their spending through decentralized bond markets. Furthermore, we find this disciplining effect to be particularly strong during election periods.

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