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Interest Groups and Exchange Rate Policy Choice in Brazil and Venezuela: Incorporating the Workers

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Interest Groups and Exchange Rate Policy Choice in Brazil and Venezuela:

Incorporating the Workers

James L. Suggett

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Master’s Thesis
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ABSTRACT

Why did Brazil and Venezuela choose different exchange rate policies in 2003? Brazilian President Luiz Inácio “Lula” da Silva chose to maintain the managed float established by his predecessor; Venezuelan President Hugo Chávez chose to switch to a fixed exchange rate. Economic explanations typically consider structural factors drawn from Optimum Currency Area (OCA) theory as well as macroeconomic indicators such as level of reserves and inflation. Political explanations examine regime type, parliamentary structure, and interest groups. This study further explores the role of interest groups in determining exchange rate policy choice. Existing research on interest groups focuses primarily on major economic sectors such as agriculture, manufacturing, finance, and multi-national corporations while downplaying the average worker. This study proposes a theory of exchange rate policy preferences that takes into account the average person’s dual role as employee and consumer. It tests the hypothesis that the balance of interest groups reflected the governments’ actual exchange rate policy choices in 2003. It tests this hypothesis first without taking into account the workers and second after taking them into account. It finds that the hypothesis is rejected in the case of Brazil and confirmed in the case of Venezuela, and in neither case did the inclusion of the workers change the result. This implies that the proposed theory about the exchange rate preference of the workers could be flawed. It also implies that interest-group theories of exchange rate policy choice, in light of being applied to the most recent era of the rise of the New Left in Latin America, need more revision and clarification.
In 2003, Brazilian President Luiz Inácio “Lula” da Silva decided to maintain the floating exchange rate policy and inflation-targeting monetary framework of his predecessor and long-time political opponent, Fernando Henrique Cardoso. The same year, President Hugo Chávez announced that Venezuela would switch from floating rates to a fixed exchange rate with capital controls. Why did these two governments, both part of Latin America’s progressive wave known as the New Left, choose different exchange rate policies?

The question of whether to fix or float the exchange rate appears simple, but explaining the choice is perplexing. Empirical evidence shows that both fixed and floating rates have been associated with financial crises, financial stabilization, and a range of political regimes. The fixed exchange rate was part of the neoliberal stabilization programs in Argentina in 1991 and Brazil in 1993, but it has also been part of Venezuela’s drive toward 21st Century Socialism. Conversely, the floating exchange rate was a key part of Venezuela’s neoliberal stabilization program in 1989, yet floating rates have long been associated with instability in the region, leading many countries with floats to continue intervening heavily in currency markets because of a so-called “fear of floating” (Calvo and Reinhart, 2002). The political ideology of the government appears irrelevant, as well. Governments on the political right and left in Latin America use the same exchange rate policy: Panama and Ecuador use the dollar, Honduras and Nicaragua use the crawling peg, Colombia and Brazil use the managed float, and Mexico and Uruguay use the free float. Within the New Left, Brazil is considered more conservative and Venezuela more radical, but this distinction only leads to further confusion regarding
exchange rate policy. This is because the more radical government chose the exchange rate policy that is normally associated with international financial interests, monetarism, austerity, and stability, whereas the more conservative government chose the policy associated with instability, countercyclical government intervention, and inflation.

This study examines the role of interest groups in determining exchange rate policy choice. Evidence suggests that manufacturers and agricultural producers involved in trade prefer floating exchange rates in order to remain competitive in global markets, and that international financial interests as well as capital-intensive industries tend to prefer the stability, low inflation, and appreciation associated with fixed rates. Existing interest group theories, however, downplay the important role played by the average people who work, consume, and vote, but do not own large businesses, make major investments, or exert inordinate political influence. This group is referred to in this study interchangeably as the workers, popular sectors, and lower classes. Members of this group are usually considered in one of two ways. As workers, they are assumed to share the exchange rate policy preference of their employer. Alternatively, as consumers and voters, they are assumed always to prefer a stronger currency and to lure governments toward irresponsible policies that lead to currency appreciation prior to elections. Either way, the general public is considered peripheral to the choice of exchange rate policy.

Integral to the rise of the New Left in Latin America has been the increased political engagement of the popular sectors. Indeed, the election of Chávez, Lula, and many others reflected the growing power of new social movements clamoring for broader and deeper democracy. Therefore, theories of interest group politics need to take into
account the populations that were long marginalized by Latin America’s authoritarian regimes and populist republics.

This study proposes a theory of the lower classes’ exchange rate policy preference. Its premise is that individuals are both workers and consumers simultaneously. Higher unemployment motivates workers to support a floating exchange rate to allow for economic stimulus; higher poverty and inequality motivate consumers to favor fixed exchange rates to guard their real incomes and savings. Since unemployment, poverty, and inequality often rise simultaneously, the balance-tipper is the level of enfranchisement, or the feeling of security and protection in one’s workplace and polity. Enfranchisement, which rises with union density and the size of the formal economy, increases tolerance for the uncertainty and inflation associated with floating rates. This study posits that it is possible to discern the lower classes’ policy preference by finding the net balance of all of these factors.

In order to find out whether taking into account the popular sectors’ exchange rate policy preference makes a difference in explaining exchange rate policy choice, this study tests its hypothesis first without considering the popular sectors, then it tests the same hypothesis after including the popular sectors in the assessment of the interest groups. The hypothesis, drawn from existing interest-group theories, is that the configuration of interest groups in Brazil and Venezuela in 2003 reflected the governments’ exchange rate policy decisions.

Usually, research on this topic employs a longitudinal analysis of a large-N sample of cross-country data. This study, in contrast, employs a cross-sectional analysis using case studies. It uses both descriptive statistics and detailed qualitative description to
assess the balance of interest groups at the time each government chose its exchange rate policy in early 2003.

The study finds that the hypothesis holds in the case of Venezuela and is rejected in the case of Brazil. In both cases, the consideration of the workers’ policy preference does not change the result. This carries four implications for future research: cross-sectional case studies should accompany large-N longitudinal analyses, researchers should continue seeking an accurate concept of the popular sectors’ policy preferences, the eight postulates taken for granted in this study should be further interrogated, and more consideration should be given to institutional context and government ideology.
CHAPTER TWO: LITERATURE REVIEW

The Latin American New Left

The rise of Latin America’s New Left ran contrary to conventional wisdom. When the Cold War ended, observers of global affairs, most notably Francis Fukuyama (1989), declared triumphantly that western-style capitalism was the unrivaled model for economic development and was destined to proliferate across the globe. The prediction appeared to be coming true by the mid-1990s, when every Latin American country except Cuba had declared its intention to step into line with the US-led agenda for a Free Trade Area of the Americas (FTAA) (Smith, 2002). Just a few years later, however, Venezuela elected President Hugo Chávez, and over the subsequent decade progressive presidents were elected in Argentina, Bolivia, Brazil, Chile, Ecuador, El Salvador, Nicaragua, Paraguay, and Uruguay. Even before this rising progressive tide had reached its peak, observers were asking whether the US had “lost” the region (Hakim, 2006).

Although the wave of elected governments elected after 1998 were mostly left or center-left, some argue that the Latin American New Left has differed little from the past. Queirolo (2013), for example, argues that voters have always focused on results, not specific policies, and they have rejected governments that fail to improve their lives, regardless of ideology. From this perspective, the so-called New Left is merely a string of governments, most but not all leftist, riding waves of popular discontent. The weakness in Queirolo’s argument, however, is that it does not adequately distinguish between the negative consequences of market reforms during the 1990s and the market reforms themselves, so the contention that voters rejected the results but not the policies stands on weak ground.
Castañeda (2006) also downplays the significance of the New Left. He divides the so-called new-left governments into two camps. One is called the “right left”, which includes Chile, Brazil, and Uruguay. It is “right” in Castañeda’s view because its leaders, who are former leftists, have matured and learned not to be leftist anymore: they embrace capitalist markets, accept strong US influence in the hemisphere, and curtail programs that would empower and improve the living standards of the poor. The other camp is called the “wrong left”, which includes Argentina, Venezuela, and Bolivia. These countries are “nationalist, strident, and close-minded” (p. 29), and they are simply rehashing policies that are “about as close to traditional Latin American populism as one can get” (p. 41). In Castañeda’s view, a country can be leftist and cling to failed past ideologies, or it can be “right”. Either way, the implication is there no such thing as a “new” left. Despite its popularity, Castañeda’s analysis is simplistic as well as inaccurate: it ignores the similarities between his two camps, the differences between the New Left and previous populist governments, and the unique qualities of each country’s experience (Cameron, 2009; Young, 2014; Ciccariello, 2014).

The New Left exists and has complex tendencies within it (Vilas, 2006; Barret et al., 2008; Cameron and Hershberg, 2010; Flores-Macias, 2012; Levitsky and Roberts, 2011; Webber and Carr, 2013; Ellner, 2014). Most research acknowledges unique features in every new-left government while also categorizing these governments. One broad approach to categorization focuses on policies and institutions. For example, most scholars note that new-left governments are similar in that they have abdicated armed revolution and adopted the peaceful, electoral path to power. These governments differ, however, in the institutional context of their rise to power. Specifically, as Levitsky and
Roberts (2011) describe in detail, new-left governments differ on whether authority is centralized or decentralized, whether they came to power from within an institutionalized political system or from outside the establishment, and the unique historical trajectories of the movements that brought them to power. These institutional factors lead to distinct policy choices, which are generally organized along a scale that slides from liberal to radical. More liberal governments, such as Brazil, accept market principles to a larger degree, use a limited toolbox of redistributionist income support programs, and have representative democratic institutions; more radical governments, such as Venezuela, support more economic coordination, use a broader array of social programs, promote egalitarian relations in the workplace, and push for a participatory democracy with new avenues of engagement for social movements.

Another broad approach to the New Left is to focus on the power dynamics among different social groups. In this view, exemplified by many of the authors in Webber and Carr (2013) and by Ciccariello (2014) and Beasley-Murray (2010), the policies and institutions of new-left governments are “constituted power,” which is epiphenomenal to “constituent power,” also referred to as the correlation of social forces. That is to say, the shift in relative power among economic actors such as industrial capitalists, financiers, and the working class drives change in economic and political structures. This power interplay is inherently unstable: a dominant group may for a time achieve the illusion of a social pact, but eventually the pact will be shaken by the self-assertion of new social groups. For example, as Ciccariello and Beasley-Murray point out, the spontaneous, leaderless, mass demonstrations against neoliberal reforms in Venezuela in 1989, known as the Caracazo, were indicative of a new shift in constituent
power, a precursor to the rise of Chávez to the presidency. And as Katz (2013) describes, during the 1990s, neoliberal reforms weakened industrial capitalists, banking crises weakened financiers, and wars in the Middle East distracted the U.S., opening space for a new array of social movements led by indigenous peoples, rural laborers, women, and the marginal urban poor. Most authors acknowledge that in Latin America these diverse sectors have united to some extent to support new-left governments, in what has come to be known as the “pobretariado” – a fusion of the words “poor” and “proletariat” (Barret et al., 2008, p. 7). From this broad approach, the central question is how these new social actors can retain autonomy from the state while also influencing and changing state power, and how to balance the alacrity of centralization and unity with the principled authenticity and organic democracy of pluralist autonomy.¹ Authors writing from this perspective, such as Cameron and Hershberg (2010), see the cross-country comparisons among Venezuela, Ecuador, and Bolivia, and cross-movement comparisons as well, as more important than the dichotomy between the policies and institutions of Brazil and Venezuela.

**Exchange Rate Policies**

Exchange rate policy is highly relevant to any discussion of economic policy in Latin America. The exchange rate bears direct influence on a nation’s ability to trade, invest abroad or receive foreign capital, and adjust smoothly to international economic fluctuations. The government’s exchange rate policy – its decision to use fixed or floating exchange rates – is an essential tool for maintaining external and internal economic balance. When combined with other macroeconomic policies, exchange rate policy is a

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¹ Several chapters in the collections edited by Ellner (2014) and by Webber and Carr (2013) state these questions in different forms.
core feature of a country’s economic development model and its mode of insertion into the international system. In Latin America particularly, exchange rates were central to the Import Substitution Industrialization (ISI) model of development that was carried out roughly between 1930-1970. The phenomenon known as the “Dutch disease,” where countries that specialize in exporting basic commodities face structural blockages to industrialization, is closely related to the movement of real exchange rates. Throughout Latin America’s debt crises of the 1980s and financial crises of the 1990s, likewise, exchange rates were central to the policy discussion. Exchange rates are even more relevant in the age of globalization, since protectionist trade policies are being rolled back at the same time as global capital movements are increasing in volume and velocity.

The exchange rate is the price of a currency in terms of other currencies, and it influences the prices of all other goods and services in open economies. In the event of an imbalance of trade between nations, the exchange rate helps determine how much liquidity is available to finance deficits, and who will bear the costs of re-balancing trade. Exchange rate policies include hard pegs, soft pegs, and floating rates (see Table 1). These are closely intertwined with capital controls, monetary policy, and fiscal policy in a complex interplay known as the “trilemma,” which says governments cannot simultaneously maintain stable exchange rates, free capital movement, and monetary autonomy.²

IMF members annually report their official exchange rate policy, known as the de jure policy. The IMF then makes a de facto classification based on its own assessment of empirical evidence, which sometimes differs from the de jure policy (IMF 2014).

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² The trilemma, also known as the irreconcilable trinity, is discussed in a variety of major texts related to international economics, including Franko (2007), Todaro and Smith (2009), and Gilpin (2000).
Researchers have proposed alternative methods of de facto classification in efforts to better capture the complexity of contemporary exchange rate policies. For example, Reinhart and Rogoff (2002) propose a method that accounts for parallel market transactions and adds a category titled “freely falling,” which is reserved for any economy with annual inflation above 40 percent. The authors urge greater attention to de facto policies over de jure policies, alleging that official pegs are often de facto crawling pegs or floats, and official floats may sometimes behave more like pegs.

Although scholars generally agree on what the exchange rate policy alternatives are, they offer diverse interpretations of global trends in exchange rate policy choices. The “fear of floating” theory says countries are gravitating toward soft pegs, also known as intermediate exchange rate policies (Poirson, 2001). In contrast, the bipolar theory says intermediate policies have proven unsustainable and countries are gravitating toward the extremes of hard pegs and free floats (Fischer, 2001; Papaioannou, 2003).

Eichengreen, Garcia, and Corsetti (2006) say both of these theories are correct to an extent: developed countries are moving toward the extremes, developing countries are moving toward soft pegs, and emerging economies are choosing both intermediate and managed floating policies. Frankel (1999) and Yagci (2004) emphasize the uniqueness of each country’s political context, arguing that “no single exchange rate regime is best for all countries or at all times.” Others have concluded that exchange rate policies are irrelevant. Rose (2011) concludes that the choice of exchange rate policy is as trivial as the choice between coffee or tea; Obstfeld and Rogoff (1995) call fixed exchange rates a “mirage,” since global capital markets have become so powerful that they render
government intervention ineffective. All in all, existing research is inconclusive, and
further work is needed.

Table 1. Exchange Rate Policy Types

<table>
<thead>
<tr>
<th>Policy Type</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hard Pegs</td>
<td></td>
</tr>
<tr>
<td>No National Currency/Monetary Union</td>
<td>A foreign currency, such as the U.S. dollar, is the legal tender. The government sacrifices the ability to print currency, be a lender of last resort, or set interest rates. Another form is a monetary union such as the Eurozone.</td>
</tr>
<tr>
<td>Currency Board</td>
<td>The government declares an official rate of exchange with a designated foreign currency or basket of currencies, then commits to exchange domestic currency at this rate upon demand and not to print currency unless backed by the designated foreign currency.</td>
</tr>
<tr>
<td>Conventional Peg</td>
<td>The government declares an official rate of exchange with a foreign currency or basket of currencies, then it commits to intervene in currency markets to maintain the exchange rate. This intervention may take many forms, among them open market transactions, controls on capital flows, and taxation. Fiscal deficits must be avoided.</td>
</tr>
<tr>
<td>Stabilized Arrangement</td>
<td>The effect a conventional peg – maximum fluctuations of plus or minus two percent in spot markets – is achieved without a formal declaration of a conventional peg or a legal commitment to maintain that rate.</td>
</tr>
<tr>
<td>Soft Pegs</td>
<td></td>
</tr>
<tr>
<td>Peg with Horizontal Bands</td>
<td>The government commits to a fixed rate as in a conventional peg, but it commits to maintain that rate within a range greater than plus or minus two percent, allowing greater leeway to devalue or revalue the official rate as needed.</td>
</tr>
<tr>
<td>Crawling Peg</td>
<td>The government establishes a fixed exchange rate but declares its intent to adjust this rate according to publicly known guidelines and parameters such as inflation parity with trading partners or domestic macroeconomic indicators. The rate may be set deliberately above or below the market rate.</td>
</tr>
<tr>
<td>Crawl-like Arrangement</td>
<td>The effect of a crawling peg is achieved without a formal declaration of a crawling peg or a set of guidelines for rate adjustment.</td>
</tr>
<tr>
<td>Floating Rates</td>
<td></td>
</tr>
<tr>
<td>Managed Float</td>
<td>Market transactions determine the exchange rate, but the government intervenes periodically – without a regular schedule – to respond to crises or prevent destabilizing market fluctuations.</td>
</tr>
<tr>
<td>Free Float</td>
<td>Market transactions determine the exchange rate, and government interventions last fewer than three days and occur less than three times per six months.</td>
</tr>
</tbody>
</table>

Sources: IMF, 2014; Habermeier et al., 2009; Sozovska, 2004
Explanations of Exchange Rate Policy Choice

There are two broad approaches to explaining exchange rate policies: the economic approach, which assumes rational market conditions and looks at economic variables, and the political approach, which assumes a power struggle among conflicting interests and looks at political variables. Both approaches present some robust findings. However, as Klein and Shambaugh (2010) assert in their summary of the existing literature, “there is little that can contribute to our understanding of when a country pegs rather than floats” (p. 95).

The economic approach to explaining exchange rate policy choice begins with efforts to deduce the ideal exchange rate policy, given free market conditions. Fixed rates are thought to have several advantages: they facilitate trade by reducing price uncertainty and transaction costs; lower inflation by disciplining fiscal and monetary policies and controlling import prices; and compel structural adjustment to trade imbalances. The drawbacks of fixed rates are the costs of maintaining the credibility of the policy, which include sacrificing monetary policy autonomy and suffering through the contraction of the real economy (Klein and Shambaugh, 2010, p. 17-20; Poirson, 2001, p. 26; Frank, 2007, p. 120; Bird 1998; Setser 2007). Floating exchange rates, in contrast, allow the external sector to absorb the impact of adjustment, thus avoiding real economic contraction, loss of reserves, or monetary tightening (Friedman, 1953; 1967; 1970). However, floating rates are vulnerable to speculative attack. They also lead to higher inflation, allow countries to postpone necessary structural adjustment, and discourage trade because of their volatility, according to critics. Advocates of intermediate exchange rate policies, such as crawling pegs and crawling bands, claim they combine the stability
of fixed rates with the flexibility of the float (ECLAC, 2012; Sunkel, 1993; Williamson, 2000; 2010); others argue that intermediate policies combine the vices of both floating and fixed rates and contributed to the financial collapses of the 1990s (Fischer, 2001; Kiguel and O’Connell 1995).

To explain exchange rate policy choice, one common set of independent variables is drawn from Optimum Currency Area (OCA) theory (Mundell, 1961). According to this theory, fixed exchange rates are most viable within areas where there is full mobility of the factors of production, and trade across these areas should be carried out with floating rates. Overall, OCA theory expects smaller, more open countries with diverse export products to peg their currencies with countries that are geographically proximate and experience similar external shocks and business cycles (Collins, 1995; Papaioannou 2003; Poirson, 2001; Sozovska, 2004; Yagci, 2001). One of the most consistent findings in the economic literature is that fixed rates are positively correlated with proximity to the peg country or former colonial relationship (Klein and Shambaugh, 2010).

Some macroeconomic indicators appear to influence exchange rate policy. Those bearing consistently robust results are inflation and the real exchange rate, with fixed rates being associated with lower inflation and real appreciation (Jameson, 2002; Poirson, 2001; Bleaney and Francisco (2007). Studies differ on whether fixed or floating rates have an impact on GDP (Papaioannou, 2003; Bleaney and Francisco 2007). Most hypotheses predict that fixed rates will be chosen in countries with higher levels of reserves, capital controls, and foreign debt liabilities; lower volatility in the terms of trade and the current account; and a controlled money supply (Papaioannou, 2003; Piragic and
Jameson, 2005; Sozovka, 2004; Yagci, 2001). However, empirical results are mixed (Jameson, 2002).

In summary, the economic approach has been unable to discern the ideal exchange rate policy and the determinants of exchange rate policy choice. All authors cited above acknowledge that in addition to economic factors, politics influence exchange rate choice to some degree.

Several scholars who take the political approach have criticized the economic approach for treating the government as a discrete unit with an exogenous exchange rate policy preference (Frieden, Ghezzi, and Stein, 2001, p. 6; Leblang, 1999, p. 601; Bernhard and Leblang, 1999, p. 72-73). They claim to correct this flaw by showing that economic policy decisions result from power struggles rather than rational market principles. The government, rather than being neutral and welfare-maximizing, is a political battleground contested by actors whose interests conflict.

A classical version of the political approach is Marxian historical materialism, which says that dialectical class contradictions within the institutional structure based on the “social relations of production” drive historical change (Peet & Hartwick, p. 91-107). The political approach is also present in the realist school. For example, Kirshner (2003), writes that money and politics are hinged: “money rules” but is subservient to “political masters” (p. 657). The process of making rules to govern money always involves tradeoffs among the interests of social groups. According to Gilpin (2000), just as the trilemma represents the tradeoffs among economic objectives, distributional conflict among interest groups represents the tradeoffs among political forces integral to any global monetary framework (p. 121-122).
Latin American structuralism, developed by the Economic Commission for Latin America and the Caribbean (ECLAC) in the 20th Century, has contributed greatly to exchange rate politics in the region. Structuralist authors posit that Latin American countries face structural blockages to industrialization because of declining terms of trade as a result of dependence on primary commodity exports; this colonial legacy creates a duality of modern and traditional practices that can only be overcome through active political intervention (Prebisch, 1950; Singer, 1970). The structuralists have prescribed a range of fixed, crawling, and multiple exchange rates combined with direct state participation in production, trade, interest rates, and labor intermediation in order to channel investment toward secondary-sector production for the domestic market. Structuralists have also examined interest group configurations specific to Latin American countries, including distinct types of capitalist classes, rural elites, and labor organizations (Furtado, 1965). Cardoso, the sociologist and future Brazilian president, in his theory of historical structuralism, emphasizes the unique conditions in each country, specifying economic structures and interpositions of exporters, importers, financiers, landowners, industrialists, professionals, and popular sectors (Cardoso and Faletto, 1979). More recently, Latin American theorists have developed neostructuralism to revive the systemic and structural critique while recognizing a balanced role for both state intervention, export-based growth, and rational market principles (Sunkel, 1993; ECLAC, 2012).

Research in the past two decades has examined the impact of interest groups on exchange rate policy (Hefeker, 1996; Frieden and Stein, 2001; Frieden, Ghezzi, and Stein, 2001; Jameson, 2003; Hira and Dean, 2004; Piragic and Jameson, 2005; Broz,
Frieden, and Weymouth, 2008; Frieden, 2015). In the most recent work, Frieden argues that unlike some policies that can benefit all stakeholders, exchange rate policy is “entirely [original italics] the result of political economy factors,” since it has no general welfare effect and always yields winners and losers (2015, p. 8). It is fundamentally a choice between fixed rates, which yield policy credibility, stability, and appreciation; and floating rates, which yield policy flexibility and price competitiveness due to depreciation. Even though interest groups may see benefits and drawbacks in both policies, they ultimately prefer one or the other, according to Frieden. For example, manufacturers that trade care about both stability and competitiveness, but ultimately their sensitivity to real appreciation prevails (Broz, Frieden, and Weymouth, 2008, p. 440). These preferences vary according to the tradibility of inputs and outputs. Producers who use nontradable inputs to produce tradable outputs will prefer a depreciated currency; those that use tradable inputs to produce nontradable outputs will prefer an appreciated currency. For example, mining firms that depend on imported capital goods prefer currency appreciation (Frieden, Ghezzi, and Stein, 2001, p. 18-19). Similarly, investors with foreign-denominated assets prefer a depreciated currency; those with foreign-denominated debts prefer an appreciated currency. Interest group preferences are also influenced by “pass-through,” or the extent to which a change in the exchange rate affects prices in their industry. Exporters of primary commodities such as wheat or iron, in which pass-through is complete because the market is highly competitive and demand is relatively elastic, will prefer depreciation in order to remain competitive. In contrast, exporters of high-technology goods, the demand for which is relatively inelastic, prefer stable, fixed rates, and the value of the currency is less important (Frieden, 2015, p. 35).
Most scholars agree that the expansion of democracy changes interest-group dynamics by enfranchising new social groups that place demands on the government. However, scholars disagree on the exchange rate preferences of these new groups. One hypothesis is that newly enfranchised voters are mainly concerned with inflation, which reduces real incomes, so policymakers seeking re-election will feel pressure to choose fixed, appreciated exchange rates (Hefeker, 1996; Bonomo and Terra, 2001; Frieden, Ghezzi, and Stein, 2001; Frieden, 2015). As Bonomo and Terra explain, the public is larger in number and dispersed and the business interests that would lose competitiveness are small and concentrated, so it is easier to accede to the public on exchange rate policy and compensate the business sector through other targeted mechanisms. One robust finding suggests that the public’s preference does prevail around election time, since real exchange rates tend to appreciate in the months preceding elections and then depreciate after the election (Frieden, Ghezzi, and Stein, 2001).

An alternative view, argued by Leblang (1999), is that fiscal and monetary policy are key tools for winning votes, so policymakers competing for re-election will prefer floating rates, which allow more policy flexibility. Implicit in this argument is that voters are concerned less with inflation than with employment and government services, which can be expanded using counter-cyclical monetary and fiscal policies.

Another political factor that may affect exchange rate policy is whether the electoral system is majoritarian or proportional representation. The key factors at play are the amount of competing demands made on the government and the costs of losing power. Proportional representation systems increase the competing demands on the government but decrease the costs of electoral defeat, since the opposition is more
included in power. Majoritarian systems decrease the competing demands on the government but increase the costs of defeat, since opposition parties are more excluded from power. Leblang (1999) finds that in developing countries, proportional representation systems are associated with floating exchange rates. This suggests that politicians react to increased demands by seeking to preserve their policy autonomy. However, Bernhard and Leblang (1999) find that in industrial democracies, majoritarian systems are associated with floating exchange rates. This suggests incumbents in winner-take-all elections seek to avoid the high cost of electoral defeat by maintaining policy discretion.

Some studies suggest that policymakers are concerned with the sustainability of their exchange rate policies. They are more likely to choose fixed exchange rates when they have sufficient power, resources, and control to sustain the peg. If this is true, then fixed exchange rates should positively correlate with political stability, level of foreign reserves, policymakers’ ability to control electoral timing, the level of fragmentation of the opposition, and the number of seats the governing party holds in the legislature (Collins, 1995; Edwards, 1996; Poirson, 2001; Papaioannou, 2003; Piragic and Jameson, 2005). An alternative view is that electoral competition blinds politicians to the sustainability of their policies. Frieden (2015) points out that elections motivate policymakers to simultaneously enact fixed exchange rates and expansionary fiscal and monetary policy, which leads to real appreciation and delayed but painful devaluation (p. 242-244).

Exchange rate policy matters greatly to people’s lives, as anyone who has lived through a currency crisis in Latin America can attest. No single hypothesis reviewed here
provides a conclusive answer to what determines exchange rate policy. However, several hypotheses concerning the role of interest groups open a promising path forward and provide the framework for the remainder of this paper.
CHAPTER THREE: ARGUMENT AND RESEARCH DESIGN

Existing research over-simplifies the exchange rate policy preferences of the popular sectors. Whereas the dominant economic groups are assumed to face complex tradeoffs between the prices of inputs and outputs and the value of assets and liabilities, the lower classes are treated as an exogenous variable that is mainly relevant during election cycles. Some assume that workers share the interests of their employers and thus have the same exchange rate policy preference as the economic sector in which they work (Hefeker, 1996, p. 366; Frieden, 1991, p. 438). Others, including Frieden (2015), assume that the lower classes mainly want an appreciated currency to bolster their real incomes. In Leblang’s theory, dominant political actors juggle tradeoffs among public demands, the risk of electoral loss, and policy sustainability; yet it is taken for granted that the average voter simply wants to reap the benefits of expansionary monetary and fiscal policy.

This study proposes a more nuanced assessment of the workers’ exchange rate policy preference. It builds on the research outlined so far, and it follows in the tracks of Walter (2008), who tries to add more complexity and nuance to the theory of dominant economic groups’ preference formation. Walter argues that major economic groups take into account more than just the price competitiveness of their products: they also worry about their balance sheets. Their policy preference ultimately reflects their “overall vulnerability,” or the balance of their vulnerabilities to the various policy options (p. 407). For example, a depreciated currency improves the price competitiveness of exports but may adversely affect corporate balance sheets. Exporters, therefore, will account for

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3 One exception is Hira and Dean (2004), who articulate the preferences of informal workers and labor regarding dollarization.
both of these factors before forming a policy preference. The lower classes’ preferences should be viewed similarly, since they participate in the economy as both consumers and employees. As consumers, they benefit from currency appreciation and low inflation, so they prefer a fixed exchange rate; as employees and job-seekers, they benefit from expansionary monetary and fiscal policy, so they favor the policy flexibility that comes with floating rates.

Four factors are at play in the formation of policy preferences by workers: unemployment, enfranchisement, poverty, and inequality. Unemployed people – those seeking work who are without a job in either the formal or informal sector – are expected to prioritize their immediate need for employment over their concern about inflation. Frenkel and Ros (2006) show that real exchange rate depreciation can lead to greater levels of employment by increasing demand for exports, labor-intensiveness of the tradables sector, and foreign exchange earnings available for investment. They argue that exchange rate appreciation in many Latin American countries during the 1990s contributed to significant shifts in the economy, including greater unemployment. Building on this, the present study expects higher unemployment to correspond to a greater preference for floating rates, which allow for exchange rate depreciation as well as the policy autonomy necessary to stimulate employment.

Another important factor is the level of enfranchisement. One level of enfranchisement is formal-sector employment, which often provides some degree of social protection, such as severance and overtime pay, regulations on safe working conditions, more secure contracts, and sometimes the right to short-time work rather than firing during cyclical downturns. Another level of enfranchisement is union membership.
Although research on the exchange rate policy preference of unions is scarce, some research shows that labor unions increase or moderate their wage demands under different exchange rate policy regimes. In open economies with fixed exchange rates, which allow no devaluation buffer or monetary policy autonomy, labor unions face the tradeoff between higher wages and employment, therefore they are more restrained in their wage demands than under floating rates. From this we can infer that workers who enjoy a higher level of enfranchisement support floating exchange rates, which allow for both wage adjustments and secure employment.

Workers in the informal sector do not enjoy the benefits of enfranchisement. However, many in the informal sector are, indeed, employed as wage earners without a formal contract, so some do stand to gain from an expansion of aggregate demand spurred by countercyclical fiscal and monetary policy (ECLAC, 2015). In addition, informal-sector workers often run their own small-scale merchant operations and have complete control over pricing, so they can adjust their prices to the rate of inflation, which would make them more open to accept floating exchange rates. Nonetheless, those working in the informal sector typically own few foreign assets and are primarily occupied with their capacity to purchase needed goods and services, so their principal concern is likely to be the protection of their real income. Thus, a higher rate of informalization is expected to be associated with support for fixed exchange rates.

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4 See Gruner and Hefeker (1999) for a review of literature on this topic. Most studies draw empirical evidence from European countries and focus on the debate over what is now the Eurozone.

5 Another level of enfranchisement goes beyond basic social protections and unionization to include various forms of democracy in the workplace, which Venezuela has promoted through Social Production Enterprises, cooperatives, and worker control of state-owned companies. For an overview see El Troudi (2010) and Ellner (2008, p. 121-129); for a critique, see Purcell (2011; 2014).
Poverty and inequality also influence the general public’s preference. Poverty and inequality overlap with issues of employment and enfranchisement, but for the sake of simplicity, in this study they are considered matters of income distribution. People can work full time and still be in poverty because the fruits of society’s labor are distributed unequally. As a result, poverty and inequality threaten people’s security as consumers, their ability to buy what they need. So, higher poverty and inequality are expected to correspond to a greater preference for fixed exchange rates.

More powerful interest groups have more mechanisms of influence at their disposal than the popular sectors: lobbying directly, launching high-profile issue-based campaigns, using the media, contributing money through licit or illicit channels, landing representatives in important positions in the government, and aligning with political parties. Large firms, industry associations, and established parties are able to do all of these things with greater clout. In addition, economic groups can massively disrupt production by the flip of a switch, or they can subtly demonstrate their power by changing investment decisions enough to indicate to policymakers how they might respond to one or another policy decision. The lower classes, in contrast, are relatively unorganized. Most individuals and small organizations have little disposable time and money to dedicate to campaigns, own little property, and have little sway in the media and political parties. The vote, the strike, and the public demonstration are their main mechanisms of power.

The rise of the New Left has substantially altered the power dynamic among interest groups because the popular sectors wield more power than in the past. New-left governments give the poor more of a voice in the agenda. Leaders are more receptive and
sympathetic and sometimes appoint representatives drawn from grassroots social movements to high-level government posts. New-left governments have re-drawn constitutions with greater human rights protections, enacted new labor laws, and expanded social programs meant to benefit marginalized populations by redistributing income, assets, and access to vital services. Formerly marginalized people now feel they have a place in society and deserve protection of their rights. All of this augments the importance of the general public in the overall balance of interest groups.

To summarize, this paper’s argument is that workers’ exchange rate policy preference is the result of the interplay among diverse factors related to their roles as employees and consumers. Higher unemployment is expected to increase the public’s preference for floating rates; higher rates of poverty and inequality are expected to increase the public’s preference for fixed rates. In the case of simultaneous unemployment, poverty, and inequality, the balance-tipper is enfranchisement, which is expected to increase the public’s preference for floating rates. Workers’ relevance as an interest group is permanent and not limited to election cycles.

Independent Variable

The independent variable is the average policy preference of the relevant interest groups. This is measured cross-sectionally, not longitudinally. Frieden uses a longitudinal method to test whether interest-group size covaries with exchange rate policy choice over time. He uses statistical techniques that control for the effect of other interest groups and various macroeconomic and structural variables. In contrast, in this study, the independent variable is the net balance of interest groups when the policy decision took place in 2003.
There exists no easy way to calculate the net balance of interest groups. Many measurements indicate the absolute size of an interest group, but none adequately captures the relative size or influence of interest groups. To illustrate, if foreign debt is equal to 50% of GDP and manufacturing accounts for 25% of GDP, it does not mean that foreign debt holders as an interest group are twice as strong as the manufacturing sector as an interest group. If the financial sector employs five percent of the workforce and the agricultural sector one fifth, the latter is not four times as strong as the former. The popular sectors are the majority of the country, whether measured in terms of employees as a portion of the workforce or household consumption as a portion of GDP, but average workers and voters do not have preponderant control of policy decisions. No standardized measures clearly predict which interest group ultimately tips the policy decision in its favor. The net balance of interest groups must be teased out by combining contextual evidence with imperfect proxy measurements drawn from descriptive statistics.\(^6\)

This study accepts the following postulates. The first seven are drawn from Frieden’s (2015) argument, and the eighth is based on the this study’s argument.

P1. Fixed rates are associated with stability, low inflation, and appreciation.

P2. Floating rates are associated with exchange rate fluctuation, higher inflation, and depreciation.

P3. Interest groups prefer one policy over the other.

P4. This preference is conditioned by trade exposure, tradability of inputs and outputs, and pass-through.

\(^6\) The Research Methods section below elaborates on the difficulties of measuring interest group influence.
P5. Fixed rates are preferred by import merchants, importers dependent on tradable inputs (mining, for example), international investors, and exporters of high-technology goods.

P6. Floating rates are preferred by import-competing industries, investors with net foreign-currency assets, and exporters of agricultural and manufactured goods.

P7. An interest group’s size is commensurate with its level of political influence.

P8. The policy preference of the lower classes is the result of the interplay among six variables: the unemployment rate, the poverty rate, the Gini coefficient, the distribution of national income by quintiles, union density, and the size of the informal sector as a portion of the workforce. Unemployment and enfranchisement motivate people to prefer floating rates; poverty and inequality motivate people to prefer fixed rates.

Dependent Variable

The dependent variable is the country’s chosen exchange rate policy in 2003. This study uses the Reinhart-Rogoff de facto classification system for the sake of consistency with Frieden, but this doesn’t really matter because in Brazil and Venezuela after 2003 the de jure, IMF official de facto, and Reinhart-Rogoff de facto classifications are the same (Reinhart and Rogoff, 2002; Palma, 2011; IMF, 2014; Reinhart, 2016).

Lula’s choice upon taking office in 2003 was to maintain the managed floating rate that he inherited. Starting in 1999, Brazil moved from a soft peg to a floating exchange rate with an inflation-targeting monetary framework. In this system, the government commits to use fiscal and monetary policy to keep the inflation rate within designated limits. This is expected to stabilize the money supply and aggregate demand,
which helps stabilize the exchange rate. This policy is a relatively conservative form of
the managed float because it curtails the government’s fiscal and monetary autonomy as a
fixed exchange rate would, although to a lesser degree. Throughout Lula’s two terms, real
interest rates averaged close to 40% (World Bank, 2016) and the public sector primary
surplus averaged 3.5% of GDP (ECLAC, 2016). These policies led to real appreciation;
the overvaluation of the Brazilian real reached as much as 80% when Lula left office
(Nassif, Feijo, and Araujo, 2011; ECLAC, 2016). The conservatism of Brazil’s managed
float matters because it suggests the policy was designed to serve the interests of diverse
groups by balancing the effects of floating and fixed rates.

Chávez’s choice in 2003, almost four years after taking office, was to switch from
a crawling band to a conventional peg.7 The bolivar was fixed to the dollar, and a system
called Cadivi controlled all dollar sales. These capital controls were expected to grant the
government more policy autonomy, and indeed, Chávez did not restrain monetary and
fiscal policy. Real interest rates averaged negative five percent throughout the rest of
Chávez’s time in office. The money supply and aggregate demand grew rapidly because
of a problematic process called “double monetization” in which dollars of oil revenue
were converted into bolivars twice: once when sold to the Central Bank and again when
spent by National Development Fund (Palma, 2011, p. 53). The capital controls were
gradually subverted by a thriving parallel dollar market. The official rate was devalued by
20% in 2004, by 12% in 2005, and by 21% and 100% in 2010 when it became a dual
fixed rate system. On the whole, Venezuela’s conventional peg after 2003 was far from
credible and stable.

7 Palma (2011) reveals the little-known fact that President Chávez enacted a floating exchange rate in
February 2002. The de facto classification, however, remained a crawling band.
To summarize, the dependent variables in this study are Brazil’s choice of a managed floating exchange rate, and Venezuela’s choice of a conventional peg. However, Brazil’s policy has been implemented conservatively and Venezuela’s has been implemented loosely, which has implications for the interest group dynamics behind the policies.

Hypothesis

The hypothesis is that the average interest-group preference reflects the government’s exchange rate policy choice. This hypothesis is tested twice. First, it is tested while taking into account P1-P7 above, omitting P8. Second, it is tested while taking into account all eight postulates, including the popular sectors’ policy preference.

If the outcome changes between the first and second tests, it means the workers’ exchange rate preference mattered in some way. If the hypothesis is rejected in the first test and confirmed in the second, then it indicates that the government might have taken into account the lower classes. If the hypothesis is confirmed in the first test and rejected in the second, then it indicates the government might not have considered the lower classes, or that this study’s theory of the lower classes’ preference is flawed.

Research Design

This paper uses the case study method. This method allows more attention to detail, which is necessary to operationalize the cross-sectional independent variable. To discern the net balance of interest groups requires both descriptive statistics, which represent the size and composition of the interest groups, and a qualitative assessment of the interest groups’ political influence. The case studies combine broad trends with specific, contextual analysis. Ultimately, we will know the net balance of interest groups
by looking at a combination of the historical trajectory of interest groups, developments during the decade before the policy choice was made, and contextual political factors.

The case study method may also help to overcome the shortcomings in Frieden’s theory that Frieden and his colleagues acknowledge (Broz, Frieden, and Weymouth, 2008, p. 432; Frieden, 2015, p. 215). One is endogeneity. Exchange rates and interest groups are co-dependent: a powerful manufacturing sector compels the government to choose flexible rates, but flexible rates also contribute to the rise of the manufacturing sector, so the causal direction is ambiguous. Another form of endogeneity appears if political institutions affect exchange rate policy choice, interest groups, or both, directly or indirectly. A case study helps make sense of this amalgam of interrelated factors by picking apart the details to interpret which variable caused which outcome in what order.

Existing research has also shown how difficult it is to measure interest groups. Basing a sector’s strength on its portion of GDP implies that the intensity of that sector’s lobbying rises with its role in the economy, yet it is fully possible that a sector’s decline amidst unfavorable exchange rate policies could motivate it to exert power more forcefully over decision makers. In such a case, the smaller the sector’s portion of GDP, the greater the pressure it exerts in favor of its preferred policy – the opposite of what most models predict. In another interpretation, the rise or fall of a sector as a portion of GDP could simply reflect the precipitous rise or fall of another sector. This is where case studies can provide a closer look and expose signs of the strength of a sector’s lobbying despite its smaller size, or vice versa. To illustrate, in 1999, when Brazil switched to floating rates, the manufacturing sector had experienced a multi-year decline. Judged purely by its size as a portion of the economy, the manufacturing sector was weaker than
it had been a decade earlier. However, as Frieden and others note, Brazil’s manufacturing sector was so powerful prior to the 1990s that a temporary downturn could not have knocked it out entirely. Also, the sector had the powerful incentive of regaining its lost status. Case studies help with measurement difficulties by reducing the need for standardized measurements and allowing for contextual interpretation.

The case studies trace each country’s main interest groups during the entire development experience of the 20th century. This is important because in Latin America the foundational and path-defining experiences with exchange rates and interest groups took shape over the course of the century. The case studies also detail the contours of these interest groups during the entire decade before the New Left came to power, with the intention of accurately articulating the configuration of social forces in the lead up to 2003.

The cases of Venezuela and Brazil were chosen for several reasons. First, these two cases are widely cited as representing two distinct tendencies within the New Left. Understanding their distinct interest-group compositions and exchange rate policy choices can help scholars better understand the rise of the New Left. Also, the two cases have a mixture of similarities and differences that make the outcome of the study hard to predict. They both have among the highest in GDPs in the region and are highly exposed to trade, benefitted from an export boom in the early years, suffered from the Dutch Disease, and are now in crisis. But their interest group configurations have important differences, not least of which is the presence of a powerful agricultural sector in Brazil. Given their general political affinity and economic similarities and differences, why did they choose different exchange rate policies?
CHAPTER FOUR: BRAZIL

Brazil is one of the major economic and political powers in Latin America. With a $2.25 trillion GDP (in current U.S. dollars), it is the world’s seventh-largest economy and a member of the bloc informally known as the BRIC nations – Brazil, Russia, India, and China.\(^8\) It is also the largest Latin American country, with a population of approximately 200 million and an abundance of natural resources. Despite its wealth, however, Brazil remains one of the most unequal countries in the world. Vast portions of the population inhabit the impoverished hillsides around the most prosperous cities, and even larger portions of the rural population struggle to fulfill their basic needs. Any analysis of interest groups in Brazil must navigate the contradictions of Brazil’s dual identity as a poor and wealthy nation.

Brazilian Interest Groups and Exchange Rate Policies in the 20\(^{th}\) Century

Interest groups have influenced economic policies, including exchange rate policy, throughout modern Brazilian history.\(^9\) In the early 20\(^{th}\) century, agricultural exporters controlled the state. Import merchants and a small group of professionals linked to the export sector also influenced policy. Policymakers prioritized international comparative advantage over industrialization. The export economy, however, was highly vulnerable to periodic downturns in external demand, leading to oversupply and declining terms of trade. Debates over monetary, fiscal, and exchange rate policy took center stage, as two rival factions formed around distinct responses to the external shocks: the *papelista* policy, in which the government stimulates the economy and devalues the

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\(^8\) The BRICs are nations that have GDPs above $1 trillion but remain outside the Organization of Economic Cooperation and Development (OECD).

\(^9\) For general background on economic interest groups in Latin American economic history, see Bértola and Ocampo, 2012; Cardoso and Faletto, 1979; Bulmer Thomas, 2003; and Skidmore and Smith, 2005.
currency through inflationary counter-cyclical measures, and the *metalista* policy, which prioritizes exchange rate stabilization, monetary restraint, and the payment of debts (Singer, 2009, p. 60-61).

The Great Depression was an external shock so deep and enduring that it opened an opportunity for a new configuration of economic groups to coalesce around policies known as Import Substitution Industrialization (ISI). Industrial capitalists and urban laborers gained power relative to the agricultural exporters, financiers, and import merchants. One major political battleground was access to foreign exchange, which agricultural exporters controlled and the burgeoning industrial sector coveted. Thus an intricate system of policies was established to protect and balance the interests of both sectors: price subsidies buoyed agriculture, tariffs and quotas protected domestic producers from foreign competition, a fixed exchange rate stabilized export prices and facilitated capital goods imports, and inflationary monetary policy stimulated investment. The national-populist state built the necessary political coalitions, created sector-specific bureaucracies to coordinate production, regulated prices, invested in large-scale infrastructure, and established state-owned firms.\(^\text{10}\)

During the ISI era, which lasted through the 1960s, the general public advanced slowly toward basic rights and economic protection. Brazil was a republic with semi-competitive elections, and the first laws were passed to protect the rights of industrial and rural labor. In 1943, a corporatist labor system was consolidated, featuring a unitary national labor administration, a single union for each economic sector, and a streamlined financing structure with a mandatory contribution of one day’s wages per year (Hall, 2009, p. 151; Singer, 2009, p. 75). Due to the enduring power of the rural landowners,

\(^{10}\) For more on the interest group politics behind Brazil’s version of ISI see Furtado (1965).
rural labor rights trailed behind industrial labor until the Rural Workers Statute of 1963 established wage protections, work contracts, and severance benefits (Garcia and Palmeira, 2009, p. 38). In spite of these laws, workers continued to face repression, abuse, and exploitation. Likewise, broader voter enfranchisement in 1946 was diluted by systematic voter suppression through barriers to voting such as literacy tests, which excluded half of the electorate (Pinheiro, 2009, p. 193).

The configuration of economic groupings shifted once again in the 1970s when foreign capital increased its role in the economy through joint ventures with the state and domestic industrialists. Brazil’s manufacturing sector had become a powerhouse, and industry was double the size of agriculture as a portion of GDP, but the ISI model based on internal savings was breaking down because of compounding problems of inflation, trade deficits, and debt.11 Furthermore, according to Cardoso (1979), “the export sectors never ceased to protest state intervention in exchange control and multiple exchange rates” (p. 152). Three important shifts occurred. First, these export interests prevailed, and industrial policies shifted toward export promotion rather than production for the internal market. Second, the economy relied more on foreign savings, particularly FDI by Multi-National Corporations (MNCs), which provided the advanced technology and capital goods necessary to continue expanding production. The state continued to participate directly in production, and it still accounted for more than half of all investment in the early 1980s (Economist, 1983), but the alliance of interest groups transformed from a national-populist ISI configuration to a “dependent capitalist” state (Evans, 1979). This state “fused” with domestic and foreign firms in joint ventures that succeeded in further developing industry (Cardoso and Faletto, 1979, p. 150-159).

11 See Baer (1972) for a full account of the unsustainability of the ISI model.
Domestic producers bifurcated between the industries that had arisen under ISI and the new industries that concentrated on capital goods and high-technology manufacturing (Cardoso and Faletto, 1979; Frischtak, 1986). The third major change was that a coup d’état in 1964 ushered in a brutal dictatorship that violently broke the national-populist political coalition by banning political parties, repressing labor, suppressing wages, and conducting a dirty war of disappearances and state-sanctioned murder (MacLachlan 2003, p. 160).

External and internal forces pressured the dependent capitalist state, leading to the next shift in the balance of power among interest groups. Externally, the oil shocks of the 1970s created a foreign payments imbalance. The dictatorship responded with heterodox stabilization programs that were based on continued papelista stimulus and a crawling peg exchange rate policy, but the economy never fully adjusted (Lamounier and Moura, 1986, p. 170-174; MacLachlan 2003, 140-150). Internally, labor unions used their leverage in the strategic large-scale export industries to resurge in the 1980s. Led in part by Lula, the future president, and the Workers Party he helped found in 1980, labor unions resisted the dictatorship and shaped the transition to democracy marked by the new 1988 constitution. General strikes rocked the country in 1989, and the number of labor unions multiplied (Antunes, 2013).

With strong labor and a strong capitalist state, and no group willing to bear the costs of economic adjustments, Brazil lacked the political coalitions necessary to bear the financial shock induced by the hiking of interest rates by the U.S. Federal Reserve in the early 1980s. Brazil’s exchange rate entered a de facto free-fall that culminated in hyperinflation in the early 1990s (Reinhart, 2016). Several stabilization plans failed
before the Real Plan of 1993 succeeded by combining a fixed exchange rate, a new currency, de-indexation of wages, and fiscal austerity enacted by President Cardoso.

With this new configuration of interest groups, the dependent capitalist state turned into a neoliberal political coalition. This was marked by a shift in the balance of power among the three pillars of the dependent capitalist state: the state retreated, so domestic capital lost much of its protection, and foreign capital gained the upper hand. The policy consensus became what Bresser-Pereira (2009) calls “conventional orthodoxy,” which combined “foreign exchange populism” with “rentiers and the financial system that benefit from high interest rates” as well as “multinational enterprises and rich countries’ interests represented by the multilateral agencies that benefit from an overvalued local currency” (p. 16). By the mid-1990s, Brazil had privatized many state-owned companies and banks, reformed the banking sector, de-indexed wages and savings accounts, raised interest rates, lifted price controls, and reformed key parts of the corporatist labor apparatus (MacLachlan 2003, 208-210; Coes, 2009; Singer 2009, 82-89). Brazil also moved to liberalize trade through the GATT-WTO, the Latin American Free Trade Agreement, and other regional trade blocs (MacLachlan 2003, 185-188).

The neoliberal political coalition shaped the configuration of interest groups in the decade prior to Lula’s decision to maintain the floating exchange rate. The following section provides details of the contours of that configuration.

Brazilian Interest Groups and Exchange Rate Policy 1993-2003

Lula took office amidst growing trade, implying greater pressure in favor of a fixed exchange rate. In tandem with the economic reforms under the Cardoso
administration, trade rose from 15.2% of GDP in 1990 to 27.6% in 2002, then remained around a quarter of GDP during Lula’s administration. Even though this was small compared to the regional average for trade, which hovered between 37 percent and 52 percent of GDP during the same time period, the increase was substantial. Measured in terms of volume, Brazil’s exports grew almost every year between 1990-2013 (World Bank, 2016).

Inflation was also a continuing concern when Lula took office. This would have made fixed exchange rates unsustainable, pushing policy makers toward floating rates, but it also suggests greater concern about the stability of the external sector, which would increase pressure for fixed exchange rates. The Real Plan lowered annual inflation from nearly 3000% in 1990 to 3.2% in 1998, but it did not completely restore Brazilians’ or foreign investors’ confidence in the currency. Creeping real appreciation was worsened by the Mexican and East Asian financial crises, which spooked investors. President Cardoso implemented the float in January 1999, leading to devaluation and an increase in inflation to 8.5% in 2002. It was widely expected that Lula’s election would make international investors even more wary, and indeed, inflation spiked to 14.7% the year he took office. So, when Lula was deciding on his initial exchange rate policy, he was under great pressure to continue to facilitate trade and to control inflation.

The productive sector declined during the 1990s and was beginning to recover when Lula took office. During the period 1993-2002, the sum of agriculture, mining, and manufacturing as a portion of GDP declined from 25.2 percent to 19.6 percent. The decline occurred mostly in the manufacturing sector, which dropped from a quarter of GDP to 14.4 percent. Agriculture declined from 7.6 percent to 6.4 percent, and the
mining sector held steady as a portion of GDP and even rose slightly as a portion of exports (World Bank, 2016).

Another development in the productive sector was the reprimarization of exports. This process was underway when Lula took office, and it continued throughout his term. The primary and secondary sectors essentially switched places as a portion of total exports. From 1993 to the end of Lula’s administration, agriculture and mining grew from around 40 percent to nearly two-thirds of total exports, while manufactures dropped from close to 60 percent to a little over one-third of exports. To put this in context, primary exports as a portion of total exports had declined steadily from 97% in 1962 to a low of 41.1% in 1993. The process of reprimarization has essentially reverted the Brazilian productive apparatus to the same primary-to-secondary ratio as it had in the late 1970s and early 1980s (ECLAC, 2016). It also marks a turn backward toward the pre-1930s liberal free trade model based on comparative advantage, rather than the state-directed industrialization model.

Reprimarization was accompanied by a rise in high-technology manufactures and capital-intensive agriculture. High-technology manufactures increased from four percent of manufactured exports in 1993 to 16 percent the year Lula was elected, and they remained above ten percent throughout his administration. The main signal that agriculture became more capital-intensive is that employment dropped from 27.4 percent to 20.7 percent of total employment between 1993-2003, even while crop and food production rose steadily, and food exports rose as a portion of total exports. Cereal production rose from 32.5 million metric tons in 1990 to 50.9 million tons when Lula took office, and by 2013 it had topped 100 million metric tons (World Bank, 2016). Both
of these changes would have increased pressure for a fixed exchange rate, because external demand for high-technology goods is less elastic, and capital-intensive agriculture benefits from an appreciated currency to import needed inputs. Both prioritize stability as their exposure to trade increases.

One might expect Brazil’s financial sector to be weak when Lula took office, given that the financial sector was officially in crisis until 1998, according to the World Bank. However, the sector recovered quickly and globalized before and during Lula’s government. Financial system deposits were equal to 23.1% of GDP in 1993, 42.5 percent in 2003, and 55.7 percent in 2013. Foreign banks accounted for 22 percent of all banks in 1995, 34 percent in 2003, and 40 percent in 2013 (World Bank, 2016). Foreign debt had already fully recovered when Lula took office: it dropped from 36.2 percent of GDP in 1993 to 20.7 percent in 1996, but then it steadily rose to 41.3% in 2002. This debt was mostly privately held, with the public sector owning 38 percent of it the year Lula took office (ECLAC, 2016).

FDI by MNCs, one of the three pillars of the dependent capitalist class alliance, continued to grow in the late 1990s. Stocks of Foreign Direct Investment (FDI) rose from 6.2 percent of GDP in 1994 to one fifth in 2002, then continued to grow to 33.3 percent in 2013. In volume, FDI stock rose steadily from $54.6 billion in 1993 to $132.8 billion in 2003 and $747.9 billion in 2013. Net FDI inflows in Brazil grew from about a third of one percent of GDP in 1993 to more than 5 percent of GDP in 2000, then dropped and averaged just over two percent during Lula’s government (World Bank; UNCTAD).

The lower classes felt both positive and negative effects of the changes after 1993. The national poverty rate decreased over the decade prior to the Lula administration, as
the Real Plan’s success in ending hyperinflation increased real incomes. Brazil’s official figures show poverty dropping from 43 percent in 1993 to 35.8 percent in 2003 (ECLAC, 2016; World Bank, 2016). ECLAC calculations show poverty dropping from 45.1 percent in 1993 to 38.7 percent in 2003. One caveat to the decline in poverty overall is that rural poverty, which also declined, was approximately 50% higher than the national poverty rate. Rural poverty was 62.9 percent in 1993 and 54.6 percent in 2003.

One of the costs of controlling inflation in the 1990s, however, was high unemployment. The unemployment rate increased from from 5.4 percent in 1993 to 12.3 percent in 2003. Meanwhile, the Gini coefficient rose from 0.62 in 1993 to 0.64 in 1999, then returned to .62 in 2003 when Lula took office. The richest quintile increased its share of the national income from 57 percent in 1992 to 63 percent in 2002. The next four quintiles suffered percentage-point declines of 2.73, 1.85, 1.04, and .23, respectively (ECLAC, 2016).

Moreover, Brazil’s informal sector grew from 44.8 percent of non-agricultural employment in 1992 to 46.6 percent in 2001 (World Bank, 2016). Employment in the service sector grew from 50.8 percent of total employment in 1993 to 58.7 percent in 2003, which included an increase in employment in financial services from three to seven percent of the workforce. This was mirrored by both agricultural employment, which shrunk from 28.3 percent in 1992 to 20.6 percent in 2002 (World Bank, 2016), and manufacturing employment, which declined from 14.6 percent of total employment to 13.7 percent between 1993-2003. These shifts in the structure of employment corresponded to further urbanization, as Brazil’s rural population declined from a quarter of the population in 1990 to less than one fifth in 2000 (ECLAC, 2016).
Labor, after its resurgence in the 1980s, did not completely lose steam under neoliberalism: union density increased from 24.8 percent in 1992 to 26 percent in 2001 (IBGE, 2002, p. 29), and Brazil’s real manufacturing wage index grew by almost 30 percentage points between 1992-2002 (ILO, 2003). Despite this increase in union density, however, other factors suggest unions actually lost power during the 1990s. First, union density had been ten percentage points higher the previous decade: it increased from 34.8 percent to 38.1 percent during the 1980s before falling in the early 1990s (Blanchwater, 2006). Second, the average number of members per union declined from 2,149 in 1991 to 1,720 in 2001 (IBGE, p. 31). This suggests that the reform of the corporatist labor system allowed more unions to form, but the cost was less effective coordination among unions. Third, the unionization rate was highest in rural areas: it rose from 45 percent to 63 percent between 1991 and 2001, whereas urban union density remained constant at 17 percent during that decade. This suggests union density could drop if the decline in agricultural employment and the shift toward urban, service-sector employment continue.

Interpretation

The evidence presented above indicates that the hypothesis is rejected in the case of Brazil, whether or not the popular sectors are taken into account.

Before taking into account the popular sectors, the net balance of interest groups in Brazil in 2003 falls on the side of fixed exchange rates. The macroeconomic environment of growing trade and resurgent inflation would have motivated the entire external sector to prefer a more stable exchange rate, even though sustaining a fixed rate amidst high inflation is difficult. The main proponents of floating exchange rates, manufacturers and agricultural producers involved in trade, were weak and only
beginning to recover. Moreover, high-technology manufacturers and capital-intensive agriculture were growing, suggesting that these sectors were becoming more amenable to fixed exchange rates. And the mining sector, already reliant on imported capital goods and thus more favorable to a fixed exchange rate, did not decline as the other sectors did. Meanwhile, the financial sector expanded rapidly and became more foreign-owned. All of these factors would have built up pressure for exchange rate stability and currency appreciation, which are associated with fixed exchange rates.

When the lower classes are taken into account, the net balance of interest groups in Brazil in 2003 still falls on the side of fixed exchange rates. The increase in unemployment and the decrease in poverty indicate pressure for floating rates, but the increase in both inequality and informality indicate pressure for fixed rates. Union density is ambiguous: although it increased slightly, it was still low relative to the past, and reforms to the corporatist labor system weakened labor in other ways. Overall, it appears that a substantial portion of Brazil’s workforce would have preferred floating rates and another substantial portion would have preferred fixed rates. From such an ambiguous configuration, it is hard to discern the net preference of the popular sectors. Even if we conclude that the net preference of the workers was for floating rates, this would not counterbalance the decisive preference for fixed rates resulting from the decline of manufacturing, the growth of agro-export industry, and the surge of the financial sector.

Why was the hypothesis rejected? Lula’s widely-circulated “Letter to the Brazilian People” in 2002, when he was a presidential candidate, may help answer this question. The broad message of the letter is that both state-directed industrialization and
neoliberalism have failed to bring development with social justice in Brazil. Brazilians, the president writes, are tired of the clash of ideologies and want a new and inclusive way forward. This new path will be characterized by the reconciliation among interest groups, “a broad national negotiation that should lead to an authentic alliance for the country, a new social contract, capable of ensuring growth with stability.” The letter addresses each major interest group, attempting to assuage the group’s concerns while urging pragmatism. To the financiers and multi-national investors, Lula promises to maintain fiscal discipline and pay all public debts, but he explicitly denounces the “speculative attack” and “artificial overvaluation” of the currency that hurt the economy in the 1990s. To the productive sector, he says the path forward must include export-driven expansion as well as strategic import substitution, but this cannot entail high inflation, and exporters must submit to a rational system of taxes and customs. His message to the lower classes is more complex. On the one hand, he acknowledges that the lower classes have always been excluded from the development process, and he repeatedly calls for social justice. On the other hand, he emphasizes that due to economic structural pressures beyond his control, “the margin of political maneuvering in the short term is small.” He makes the modest pledge to avoid crisis, restore stability by controlling inflation, resume economic growth, and make government more efficient and transparent – things he casts as being in the interest of the popular sectors.

Overall, Lula’s letter is a call for balance. “Another path is possible,” he writes, playing on the slogan of the World Social Forum. “That is the path of economic development with stability and social responsibility” – indeed, a program that balances the interests of producers, financiers, the lower classes. His choice of exchange rate
policy could be interpreted through this lens. Although the balance of interest groups tipped toward stability and fixed rates, Brazil’s perennial inflation problem and investors’ lack of confidence made it doubtful a fixed exchange rate could be sustained for long. As Lula said, he had little space to maneuver, so he attempted to make the floating exchange rate as stable and predictable as possible through zealous fiscal and monetary restraint, while still preserving the flexibility to have a competitive exchange rate conducive to export expansion and employment.

This interpretation has two important implications. One is that it casts doubt on the postulate that fixed exchange rates are the most stable. In Brazil and other emerging and developing economies, which are more vulnerable to capricious financial speculation, the fixed exchange rate might be even less stable than a well-managed floating exchange rate. The second implication is that the developments in Brazilian manufacturing during the 1990s raise the question of endogeneity. The neoliberal reforms that hurt manufacturing were enacted when manufacturing was relatively strong, and the switch to floating rates that helped manufacturing occurred when the sector was relatively weak. This presents a conundrum: did the manufacturing sector influence exchange rate policy, or did exchange rate policy influence manufacturing? Future research should address this question.
CHAPTER FIVE: VENEZUELA

The interest groups in Venezuela are similar to those in Brazil: rural landowners, financiers, import merchants, domestic industry, multi-national companies, unions, and the urban poor. However, the interplay among these groups and their influence on exchange rate policy followed a different trajectory, mainly because of the predominant role of oil in the Venezuelan economy.

Venezuelan Interest Groups and Exchange Rate Policies in the 20th Century

Perhaps the most significant shift in the interest-group configuration in Venezuela in the 20th Century was the decline of agricultural exporters. Before the expansion of the oil economy, the Venezuelan economy was mostly agricultural, and coffee and cacao were the principal exports. The turn toward minerals began with the extraction of asphalt and the production of kerosene in the 1870s and 1880s. Oil concessions were granted between 1907 and 1912, mainly to domestic companies that were later acquired by foreign companies such as Royal Dutch Shell (Rodríguez Araque, 2007, p. 40-41). Oil production increased greatly after the discovery of a major oil well in 1922. By 1950, oil accounted for nearly all export revenue, while agriculture declined from one third to one tenth of GDP (Wilpert, 2007, p. 10).

Parallel to the decline in agriculture was the gradual centralization of power. In the 19th century, political power was brokered regionally through caudillos, or charismatic strongmen. In the early 20th century, the dictator Juan Vicente Gómez consolidated power in a national army and established a sovereign, unified state with the capacity to tax, control the territory, and, most importantly, administer mining concessions (Hellinger, 1991, p. 36).
Without a powerful agricultural exporter group, Venezuela’s political landscape differed markedly from that of its South American neighbors. This sector’s weakness had both political and economic ramifications. It was the state, not the rural or industrial elites, that controlled the modern sector of the economy. This landlord state charged rent on access to the subsoil, and the struggle over this rent was the hub of politics. At first, the Gómez dictatorship and the rural landowners struggled over two alternative systems for allocating ground rent: either the private landowners had the right to the subsoil, or the state had control, or some compromise had to be reached. Although the early mining laws granted some subsoil rights to the private landowners, the state eventually prevailed and established a monopoly on the subsoil (Hellinger, 1991, p. 41), then it used this leverage to negotiate higher taxes and royalties on foreign oil companies. In contrast to the Brazilian national-populist state, which had to negotiate with agricultural exporters for access to foreign exchange earnings, the Venezuelan landlord state had a steady supply of foreign exchange earnings that were sufficient to sustain an appreciated exchange rate over the long term. This led to what is sometimes called a “Dutch disease,” where the influx of foreign earnings and the appreciated currency boost demand and cheapen imports, which diverts consumption toward imports, investment toward the oil sector, and economic activity toward import commerce, while the less profitable domestic industries wane.¹²

Even though business groups in Venezuela neither dominated the state nor led the development process, these groups retained a powerful role in society. By some measures, business was booming: as the world’s top oil exporter for several decades,

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¹² Saad-Filho and Weeks (2013) argue this was a policy error, not a “disease”, but they do not deny the effect of the appreciated currency on domestic producers, which is the main concern of this study of interest groups and exchange rate policy.
Venezuela’s GDP growth was among the highest in the region. The rural landowners started family-based business empires in diverse sectors including finance, import commerce, communications, food manufacturing, utilities, transportation, and construction. These industry groups relied on close relationships with state bureaucrats to obtain capital and imported inputs, and private business interests competed with one another for access to state funds (Ortiz, 2004, p. 75). Business leaders formed the Federation of Chambers of Commerce and Production of Venezuela (FEDECAMARAS) in 1944, a group that six decades later would play a crucial role in Chávez’s exchange rate policy decision.

Workers, peasants, and the middle class also entered the political game during Venezuela’s rise as an oil economy. A major driver of this change was urbanization fueled by the investment of oil revenue in urban infrastructure: urban areas were home to the majority of the population by 1950 and three quarters of the population by 1975 (ECLAC, 2016). Labor unions in the oil sector launched a major strike in 1936, the year the first labor law was passed, and soon after the Confederation of Venezuelan Workers (CTV) was formed – another group that would later clash with Chávez. The rural poor were also active in demonstrations and land occupations, calling for the confiscation of lands accumulated by Gómez during his rule. In addition, middle-class professionals tied to the oil sector, public bureaucracies, small-scale crafts, construction, and domestic service increased as a share of the economy.

These interest groups’ alignment with the state shifted as Venezuela passed from dictatorship to a republic. The dictatorship of Marcos Pérez Jiménez during the 1950s aligned with foreign oil companies, investors, and magnates in the domestic construction
and service sectors, while excluding domestic industry leaders from industrial projects financed by state-owned corporations (Hellinger, 1991, p. 88). In contrast, the political parties Democratic Action (AD) and the Independent Electoral Political Organizing Committee (COPEI), which struggled to establish a republic, favored a populist political program that included at least a fifty percent share of oil profits for the state, import substitution in which domestic businesses played an active role, stricter enforcement of labor laws, agrarian reform, and investment in education and health (Hellinger, 1991, p. 54-58). As Collier and Collier (1991) point out, the inclusion of both industrial and rural labor in this populist pact distinguished Venezuela from Brazil, where corporatism was established under an authoritarian regime and rural labor was largely excluded. However, AD and COPEI were not all-inclusive: when pressured to choose between FEDECAMARAS and the Venezuelan Communist Party, both of which had fought the dictatorship, they aligned with the former and explicitly excluded the latter (Ellner, 2008, p. 61).

Exchange rates and the configuration of interest groups both were central to the consolidation and disastrous disintegration of Venezuela’s republic between 1958-1998. During the consolidation, marked by a political accord known as the Punto Fijo pact signed in 1958, policymakers struggled to balance the ever-expanding mix of interest groups. Their policy tools included taxes, which regulated the foreign and domestic business sectors’ share of the oil wealth; public spending, which regulated the lower classes’ share; and laws on labor and agrarian reform. The exchange rate policy complemented all of these other policies. It was kept fixed and appreciated, so it facilitated imports of both capital goods, which appealed to business, and consumer
goods, which increased the living standards of the general public (Rodríguez Araque, 2007, p. 14).

This exchange rate policy collapsed amidst the windfall oil profits created by the oil price shocks in the late 1970s. With the transfer of ownership of the oil industry to the national holding company PDVSA, the pressure to distribute the windfall rents led to a large fiscal expansion, which, when combined with a fixed exchange rate, caused real appreciation and contributed to the failure of state-financed industrialization projects that were intended to diversify the economy. The temptation to spend to satisfy interest groups motivated government officials to sidestep built-in policy controls, such as the Venezuelan Investment Fund, which was meant to sequester savings abroad to avoid over-expansion of the money supply and to prepare for the cyclical decline in oil revenues. Even though Venezuela ran trade surpluses during those years, it accumulated large and unsustainable foreign debts. The crisis culminated in 1983 with the public announcement of the end of the fixed exchange rate, the implementation of currency controls to protect foreign reserves, and devaluation of the currency. Venezuela had a crawling peg with multiple rates until 1989, when President Carlos Andrés Pérez announced the switch to floating rates along with structural adjustment reforms.

The crisis devolved into chaos after Pérez’s announcement. The urban poor, enraged by both economic hardship and the perception of corruption and betrayal by political leadership, swarmed the streets. Property was defaced and stores were thrashed and robbed. Pérez ordered the police to fire on the rioters to restore order, and by official figures, several hundred were massacred. The significance of this event for Chávez’s rise and policy decisions cannot be underestimated: it showed that the Punto Fijo leaders were
not on the side of the poor majority. Also, in the popular mindset it symbolically linked floating exchange rates and devaluation directly to the corruption and state failure that drove Venezuela’s oil boom to a bust.

The *Caracazo* symbolized a broader awakening of the popular sectors, leading to new forms of social protest and political engagement. People formed neighborhood associations that later came together into a broader Federation of Urban Community Associations. A leftist union movement began agitating for worker control of factories and workplaces, led by the Central United Venezuelan Workers Confederation, which was independent from the CTV. And at the municipal level, a new political party, *La Causa R*, won elections and represented an alternative to the Punto Fijo political establishment (Hellinger, 1991, p. 168; McCoy and Myers, 2004, p. 98-100).

To review, during the 20th century, Venezuela’s agricultural sector was replaced by a sovereign landlord state that drove the development process in collusion with the private business sector. The state used its control of the subsoil to increase its share of the oil wealth by taxing foreign companies. Oil-sector workers and rural laborers were incorporated into a populist pact called Punto Fijo. The leaders of this pact, however, mismanaged the windfall oil profits and nationalization of the oil industry, over-investing and over-spending to the point of utter collapse. In response, a variety of grassroots organizations and social movements increased political engagement.

**Venezuelan Interest Groups and Exchange Rate Policy 1993-2003**

In 1993, Venezuela’s GDP was roughly equal to its GDP in 1963 (Baptista, 1997).\(^{13}\) This massive retrogression led to deep shifts in the balance among interest

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\(^{13}\) Also see The Maddison Project, 2013 Version: http://www.ggdc.net/maddison/maddison-project/home.htm
groups during the 1990s. Most notably, the private business sector steadily declined, while the popular sectors increased their political engagement. Chávez at first tried to forge alliances with both groups, but the attempted coup d’état and political unrest in 2002-2003 showed these interests to be incompatible, leaving Chávez to realign himself with the urban poor, small business sector, and a portion of the unionized workforce.

Similar to Brazil, Venezuela had to balance the desire for stable trade, for which fixed rates are beneficial, with the reality of high inflation, which tends to make fixed rates unsustainable, and the need to remain competitive, for which a floating exchange rate is preferable. In contrast to Brazil, agriculture is not part of this equation. Agriculture dropped to just 3.8 percent of GDP in 2002 – the lowest in South America (ECLAC, 2016). Oil comprised between three quarters and 99 percent of exports over the prior four decades (World Bank, 2016). Because oil prices are highly volatile, trade as a portion of GDP is volatile. Natural resource rents bounced from 36.5 percent of GDP in 1990 to 21.9 percent in 1995, 33.4 percent in 1996, and 15.3 percent in 1998. During that same period, trade (exports plus imports) fluctuated between 40 percent and 60 percent of GDP. Meanwhile, inflation was high but never reached the point of hyperinflation: it rose from 40.7 percent in 1990 to a peak of 100 percent in 1996. It dropped to 23.6 percent when Chávez took office in 1999, but then rose to 38 percent amidst the unrest in 2003 (World Bank, 2016; ECLAC, 2016).

One counterintuitive feature of the 1990s in Venezuela is the rise of the secondary sector as a portion of both exports and GDP. The primary sector accounted for 98 percent of exports from the 1960s through the early 1980s, but then it dropped to 81.5 percent in 1998. Meanwhile, manufactures rose from 10.4 percent of exports in 1990 to 18.5 percent
in 1998, and then averaged 11.5 percent during Chávez’s first four years in office (ECLAC, 2016). As a portion of GDP, value added in manufacturing grew from 15 percent to 23.2 percent in 1997 and then hovered around 19 percent during Chávez’s first four years in office (World Bank, 2016). Although some of the growth in manufacturing as a portion of the economy may be attributed to the relative decline of oil prices, manufactures also grew in volume and in absolute market value during that time. The manufactured exports were mostly metals produced by SIDOR, the steel company created by the Pérez Jiménez dictatorship that was privatized in the mid-1990s; ALCASA, the state-owned aluminum company; and chemical products linked to the oil sector (Muñiz, 1998, p. 94). The secondary sector’s share of total employment dropped by five percentage points even as the sector grew, however, partially as a result of neoliberal reforms focused on efficiency. High-tech manufactures made up just 2.8 percent of manufactured exports on average between 1990-2013 (World Bank, 2016).

The rise of manufacturing should not be mistaken for a strengthening of the private business sector. According to Ortiz (2004), Venezuela’s family-based business empires dwindled after 1983, and by 2002, only one remained on the list of Latin America’s five hundred largest companies (p. 72). Business owners made fortunes acquiring assets abroad prior to the repeated devaluations of the bolivar, but these fortunes were not channeled toward investment in the country. President Pérez’s group of favored business insiders, known as the “12 Apostles”, provoked divisions within the business community, as emerging entrepreneurs from the country’s interior challenged the traditional elites who had controlled FEDECAMARAS since the 1940s. New rivalries manifested themselves in competition over ownership of the largest banks and media
companies as well as competition for political influence. With the neoliberal reforms in the 1990s, which dismantled much of the protectionist, state-led developmentalist framework, private business lost the influence that had been integral to its success during the Punto Fijo era.

The financial sector fared no better. Venezuela was in a banking crisis from 1994-1998. This was partly the result of over-leveraging amidst the heightened business confidence galvanized by the neoliberal reforms (Ortiz, 2004, p. 81). It was also the result of the accumulation of bad loans prior to the neoliberal reforms, when interest rates were low or negative, as well as poor banking oversight (Palma, 2011). The trigger was the political unrest caused by two coup attempts in 1992 – one of them led by Colonel Hugo Chávez, the future president. This reduced the availability of foreign capital. 19 of the nation’s most prominent banks collapsed, and seven were nationalized, while the total number of bank offices in the country was cut exactly in half (Muñiz et al., 1998). The banks had become partial owners of corporations, as well, so the financial crisis led to widespread business failure (Ortiz, 2004, p. 83-84). All in all, financial system deposits declined from 33.1 of GDP in 1991 to 14.2 percent in 2002 (World Bank, 2016).

With the decline of Venezuelan business and finance, foreign capital increased its share of the economy. The two highest-profile companies that were privatized, the telecommunications company CANTV in 1996 and the steel company SIDOR in 1997, were sold not to Venezuelan companies but to multi-nationals. Of the seven major banks nationalized during the financial crisis that were re-privatized in 1996 and 1997, four were acquired by Spanish, Chilean, and Colombian corporations. Foreign banks made up just ten percent of total banks in 1995, but this figure rose to 28 percent by 2002 (World
Bank, 2016). The volume of foreign debt remained steady at around $40 billion throughout the decade (ECLAC, 2016), but the volume of FDI stocks grew rapidly from $3.9 billion in 1990 to $45.6 billion in 2006 (UNCTAD, 2016). FDI stock as a portion of GDP rose from 8.2 percent in 1990 to 50 percent in 2003. FDI net inflows grew from less than one percent in the early 1990s to more than four percent in the year 2000. (World Bank, 2016).

The oil sector was also opened to foreign investment during the 1990s, weakening the state’s international bargaining power in its core area of strength. One key factor was that the management operated the state oil company, PDVSA, as a private, for-profit firm, using transfer pricing to keep profits abroad and switching accounting methods to reduce taxes paid to the government. But the main political issue at stake was the opening, known as la apertura, which included the contracting out of oil production and the negotiation of joint operations with foreign companies (Wilpert, 2007, p. 87-93). Opponents of this process, including new political parties like La Causa R, testified before the parliament that they supported la apertura as a means to develop the national productive apparatus, but they opposed clauses in the new joint operations contracts that implied a transfer of ownership to foreign companies, which encroached upon the state’s constitutional right to sovereignty over its subsoil (Rodríguez Araque, 2007, p. 65).

The standard of living of the lower classes declined during the 1990s.¹⁴ The unemployment rate grew from 6.6 percent in 1993 to 18 percent in 2003. Approximately half the population, and possibly more, was in poverty. ECLAC’s calculations show that the poverty rate was 37.3 percent in 1992 and 48.5 percent in 2002; Venezuela’s official

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¹⁴ This was also a broader trend in Latin America. See Portes and Hoffman (2003) for an explicit class-based analysis.
figures show an increase in poverty from 54.5 percent in 1997 to 62.1 percent in 2003 (ECLAC, 2016). The inflation of the 1990s also took its toll, reducing the purchasing power of wages to a twenty-year low (McCoy and Myers, 2004, p. 207). Income inequality increased, with the Gini coefficient rising from .486 in 1994 to .50 in 2002. The richest quintile of the population increased its share of the national income from 48 percent in 1992 to 54 percent in 2002. Each of the other four quintiles declined, but not equally: the poorest quintile’s portion decreased from 4.82 percent in 1992 to 2.59 percent in 2002 – a 2.23 percentage point drop – whereas the three middle quintiles declined by less than two percentage points each (ECLAC, 2016).

Worker enfranchisement also declined over the two decades prior to the 2003 decision. One way to confirm this is to infer that the shift of employment away from traditionally unionized sectors led to a reduction in unionization. Public-sector employment, which was always largely unionized, dropped from 18 percent to 13.8 percent of the workforce, and private-sector employment declined from 49 percent to 41 percent during the same period. Meanwhile, the informal sector grew from 44 percent of the workforce in 1994 to 58 percent in 2002, and the self-employed as a portion of the workforce grew from 25.2 percent in 1992 to 40 percent in 2002.

Employment in the primary and secondary sectors declined overall. Employment in manufacturing decreased from 16.2 percent of total employment in 1992 to 11.7 percent in 2002 (ECLAC, 2016), and Venezuela’s real manufacturing wage index decreased by almost 25 percentage points between 1990 and 2002 (ILO, 2003). Employment in agriculture declined from 11 percent in 1992 to ten percent in 2003 (ECLAC, 2016; World Bank, 2016). Consistent with this trend, the rural population
continued its downward historical trajectory, decreasing from 16 percent to 12 percent of the national population during the 1990s. The decline in the productive sectors was counterbalanced by the growth of the service sector from 62.4 percent of the workforce in 1993 to 69 percent in 2003 (World Bank, 2016). This growth was mostly in trade and other services; employment in financial services declined from six to five percent between 1992 and 2002 (ECLAC, 2016).

The clearest indication of the decline in worker enfranchisement is the drop in union density, although data are scarce. A patchwork of estimates show a decline in the rate of union membership from 33 percent in 1975 to 18 percent for the period 1980-1985, and finally to 13.5 percent in 1995 (Schütt, 2008; Blanchflower, 2006). Certain sectors were more highly unionized. According to estimates from the CTV and the Ministry of Labor, an estimated 55 percent of industrial workers and 75 percent of oil and mining sector workers were unionized in the late 1970s (Hellinger, 1991, p. 178). With the decline of both the public sector and the manufacturing sector in the wake of the 1983 fiscal crisis and the 1994 banking crisis, coupled with the increased informality of the workforce overall, unionization declined. Developments at SIDOR after its privatization in 1996 are indicative of this trend: SIDOR’s workforce of 12,000 full-time employees gradually transformed into a workforce of 4,000 employees and 9,648 non-unionized contract workers (Suggett, 2008).

Finally, Chávez’s exchange rate decision in 2003 was greatly influenced by the interest-group dynamics during his early years in office that led up to the attempted coup in April 2002 and the general strike in late 2002 and early 2003. As Wilpert (2007), Ellner (2008), and Eastwood (2011) point out, Chávez at first had some support from
wealthy business leaders, and his policies were relatively moderate during his first two years in office. However, he did challenge the traditionally dominant interest groups in several ways. First, he did not appoint business leaders to key ministerial posts that they were accustomed to controlling. Second, he passed a new Hydrocarbons Law that curtailed *la apertura* and a new Lands Law that permitted the state to forcibly purchase lands. Third, he initiated the re-writing of the national constitution by an elected constituent assembly, a project opposed by the Punto Fijo elites. And finally, he led an effort to replace the CTV, which opposed his government, through a national referendum. As a result of these actions, a tenuous alliance between FEDECAMARAS and the CTV formed, and these groups led the effort to overthrow Chávez in 2002 and to shutdown the economy in early 2003. These groups’ failure to oust Chávez demonstrated their weakness relative to the popular sectors (excluding the CTV), who backed Chávez. However, the coup and general strike did cause GDP to drop and unemployment to rise. And since Venezuela had a floating exchange rate at the time, the political instability led to large-scale capital flight. Stopping this capital flight was one of Chávez’s immediate objectives when he implemented capital controls along with the fixed exchange rate.

**Interpretation**

The evidence presented above indicates that the hypothesis is confirmed in the case of Venezuela, whether or not the popular sectors are taken into account.

Before considering the popular sectors, the net balance of interest groups in Venezuela in 2003 falls on the side of fixed exchange rates. The country’s reliance on trade in one volatile commodity placed structural pressure in favor of fixed exchange rates. In the productive sector, the sectors that favor floating rates, including agriculture
and most manufactured goods (apart from steel, aluminum, and chemicals), were small and weak; the sectors that favor fixed rates, including oil and the capital-intensive basic industries, were dominant. The financial sector had collapsed, taking many businesses with it, but the foreign-owned portion of the financial sector surged. The increased role of MNCs in the oil sector during the 1990s also would have increased pressure toward fixed rates. Therefore, the conclusion is that the net configuration of interest groups in Venezuela in the year 2003 showed a preference for fixed rates, and this matches the Chávez government’s exchange rate choice.

After taking into account the lower classes, the net balance of interest groups in Venezuela in 2003 still falls on the side of fixed exchange rates. The high rate of unemployment implies pressure for a floating exchange rate. However, this is more than counterbalanced by the decline in worker enfranchisement and the large increase in both poverty and inequality. Therefore, the net preference of the popular sectors was a fixed exchange rate.

One thing that is striking about this case study is that even the intense political instability in 2002-2003 did not alter the result. That is, the extreme weakness of FEDECAMARAS and the CTV after the coup and general strike was consistent with the steady decline in the private business sector and the unionized workforce during the 1990s. However, it would be inaccurate to try to explain Chávez’s policy choice without placing it squarely in the context of this political battle with the traditional power groups. This is because his policy stance was more moderate in the years before the coup. It is imaginable that if the coup and general strike had not happened – if the traditional power groups had been more conciliatory toward Chávez – then Venezuela would have
remained on a floating exchange rate or crawling peg and achieved a renewed expansion of domestic industry. Had this occurred, this study’s hypothesis would have been rejected in the case of Venezuela, casting serious doubt on existing theories of how interest groups influence exchange rate policy choice.
CHAPTER SIX: CONCLUSIONS

This study explored the impact of interest groups on the choice of exchange rate policy in Brazil and Venezuela. It hypothesized that the exchange rate policy choice in 2003 in both Brazil and Venezuela reflected the interest group configuration at the time of the decision. To define the exchange rate policy preferences of major business groups, it drew on seven postulates from existing research. It then proposed a theory of the exchange rate policy preference of the workers, with the intention of amending existing theories, which over-simplify and marginalize the role of the lower classes in general.

The study tested its hypothesis twice. The first test considered only the dominant interest groups. The second test considered the dominant interest groups as well as the popular sectors. The study used a cross-sectional case study method to define the net configuration of interest groups in early 2003, drawing on detailed data from the decade prior to the decision as well as broad data from the 20th century.

The hypothesis was rejected in the case of Brazil, and taking into account the popular sectors did not change this result. Growing trade and resurgent inflation put all those involved in the external sector on edge and increased concern about stability. A weak manufacturing sector, an agricultural sector more dependent on imported capital goods, and increasing trade in high-technology manufactures reduced the competitiveness incentive for floating rates. An enlarged, globalized financial sector augmented pressure for a fixed exchange rate. Meanwhile, the preference of the workers was ambiguous. Two indicators pointed toward a preference for floating exchange rates (higher unemployment and lower poverty), and two indicators suggested a preference for fixed exchange rates (inequality and informality). The potential balance-tipper was union density. Although
union density had increased slightly over the previous decade, it was still at a lower level than the past, and neoliberal legislation implied a weakening of unions in the 1990s. Therefore, the ambiguous preference of the general public combined with the strong leaning of the rest of the interest groups toward a fixed exchange rate tipped the net balance toward a fixed exchange rate.

The hypothesis was confirmed in the case of Venezuela, and taking into account the lower classes did not change this result. Volatile trade, high inflation, an utterly disintegrated private business sector, a dominant and capital-intensive oil and mining sector, and a surge in FDI and foreign takeovers of banks all pointed toward fixed exchange rates. Only one indicator of the popular sectors’ preference pointed toward floating rates (high unemployment), whereas declining enfranchisement and growing poverty and inequality indicated a greater preference for fixed exchange rates. Therefore, the net balance of interest groups pointed toward a preference for a fixed exchange rate.

**Broader Implications and Avenues for Future Research**

These results have four important implications for interest-group theories of exchange rate policy choice.

First, although incorporating workers’ policy preferences did not change the study’s results, it did make the explanation of the governments’ exchange rate policy choices more complete. It is possible that the popular sectors are simply irrelevant to exchange rate policy choice, but it is also possible that in other countries or in the same countries at different times they would be more relevant. Future case studies could help explore this further. Future research on this topic should consider the possibility that the theory of the workers’ exchange rate policy preferences proposed in this study is flawed,
and they should strive to find a nuanced, accurate assessment of what policy the popular sectors prefer.

Second, it is important to supplement large-N longitudinal analysis with cross-sectional case studies, because too much valuable information is lost when relying solely on inferential statistics. The discrepancy in findings between this study and Frieden (2015) with respect to the Brazilian manufacturing sector illustrates this point.

Third, the eight postulates listed above should not necessarily be taken for granted. For example, since there is convincing evidence that fixed rates can lead to exchange rate instability when combined with expansionary monetary and fiscal policy and speculative financial flows, it may be wrong to assume that fixed rates are associated with stability and low inflation. Likewise, since nuanced analysis shows that interest groups face complex tradeoffs that depend on multiple contextual factors, it may be wrong to assume that entire economic sectors prefer one policy over another. Manufacturers with tradable inputs and outputs, financiers with highly diversified portfolios, and unionized workers in volatile industries may conclude that the costs and benefits of fixed and flexible rates balance each other out. On a broader level, Latin American countries often depend on both capital imports and export revenue, so they stand to benefit to some degree from both fixed and floating rates. Furthermore, it is probable that the interest group’s size as a portion of GDP is a poor proxy for its influence over policymakers, so researchers should seek better measurements.

15 Hefeker (1996) hits this point precisely: “Why should a policy of pegging to a low-inflation currency be more reliable than a policy of maintaining a low growth rate for the domestic money stock under a regime of floating rates?” (p. 361). This also echoes the thesis that exchange rate policies are often a “mirage” in developing countries (see Calvo and Mishkin, 2003).
Finally, future studies should take into account institutions and government ideology. Lula took office in the midst of growing institutionalization and decentralization of power with the aid of an established political party, which constrained his individual ability to maneuver. Chávez, in contrast, took office amidst the institutional disintegration of the old regime, on the wings of an ad hoc electoral party in which he was the central figure. This allowed him to lead fast-paced, radical institutional change, and his exchange rate policy was a crucial lever of control over the oil earnings that financed that change. Institutional and ideological factors should complement interest-group politics as part of a comprehensive explanation of exchange rate policy choice.
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