The University of Chicago

# Foreign Debt Becomes Foreign Influence

Trevor Faria
Convocation:
June 2025
A paper submitted in Partial Fulfillment of the requirements for the Master of Arts degree in the Master of Arts Program in the Committee on International Relations

Faculty Advisor:
Professor Robert Gulotty

Preceptor:
Professor Adam Parker

# External Debt Becomes External Influence

## Introduction

Many countries in Latin America have spent the last century pushing and pulling with the economies of the Global North in numerous attempts to achieve some economic sovereignty independent of their northern neighbors. These efforts have included export-led industrialization (Salvucci, 2006), Import Substitution Industrialization (ISI) I (Baer, 1972) and II (Bruton,1988), and finally, though intermittently throughout, trade liberalization (Bogliaccini, 2013). Throughout these periods, especially during ISI, Latin American countries engaged with global financial markets in search of loans. These loans would fund extensive spending on domestic manufacturing to create production capacity that rivaled that of international competitors. However, as domestic markets failed to generate the demand to feed these young producers, the emerging capacities in Latin America wilted. This cycle continued in Latin America from the 1950s into the 1980s, with the 1980s being commonly referred to as the "lost decade" (Federal Reserve, 2013).

North or South states have sought loans to finance projects of various magnitudes, going back to the Spanish Empire under Phillip II in the mid-16th century (Drelichman and Voth, 2008). For King Phillip II, loans served to fund armies and fleets and maintain imperial administrations abroad (ibid). Concomitant to this long history is the history of credit risk and lenders' influence in dictating terms for risky borrowers. Barry Eichengreen (1991) describes this historic relationship at length, noting that borrowing and defaulting have occurred cyclically throughout history, especially in Latin American countries. Essentially, states have borrowed against their future budgets by taking large loans from lenders, foreign or domestic. These loans are used to finance large projects such as infrastructure construction, building of factories, or

maintaining military forces in a time of war. However, conditional on these loans is a risk premium and interest rate the states must pay when paying back the loan. Therefore, as the cost of financing the loan is greater than the initial loan, states must ensure the projects they invest in are sufficient to pay back the value of the loan plus premium within the amortization period. The inability to meet this requirement initiates a default.

So, how do lenders determine whether a state will likely default on a loan? Lenders assess the borrowing states' ability to finance loans by measuring several factors, such as current debt-to-GDP ratios, default history, healthy prospects of future revenue, and more (Eichengreen and Hausmann, 1999). Another critical measure is the state's primary fiscal balance: *savings* minus *expenditures*. These factors tell lenders about the financial fitness of the state and the prospect of their loan being serviced before the amortization period closes. However, as loans and projects move across space and time, lenders and sovereigns encounter crossroads typically involving economic crises/shocks, political crises, or other local or international phenomena.

Suppose a state borrows from a foreign lender to construct oil pipelines, refineries, and ports to export that oil and import the technology required for oil extraction. Following this multi-year endeavor, the state can begin selling the oil and gas to domestic markets and exporting it abroad. Yet, at the same time, global oil prices drop due to a decrease in demand or increases in supply elsewhere. Stories like this affected Ecuador and Venezuela in 1986 when oil prices came down from the highs in the 1970s (Mora-Silva et al., 2023; Ristanovic, 2025; Gately et al., 1986). Lenders were left in the lurch as the states navigated decision matrices of default or imposed austerity.

Politically powerful groups act in their self-interest in such economic landscapes. The local population will be frustrated under austerity since its primary effect is cutting into social

welfare, whether it be jobs, tax hikes, or public spending. This can result in protests, breakdowns in coalition governments, or recall elections (de Bolle, 2022). External lenders, for their part, will push the government toward austerity (Kaplan and Thommson, 2017). This will force the politics of a given country into something of a seesaw motion, with lenders and the public fighting for influence over policy. Who, then, creates the winning coalition to decide the direction of domestic fiscal policy? Some examples should help contextualize this. Indeed, below, we see that the winning coalition for determining fiscal policy grows from solely domestic leaders to include foreign lenders as the size of foreign-held debt increases.

*Nicaragua 1991*

In 1979, Nicaragua emerged from a devastating civil war that unleashed deep economic turmoil across the country. The Sandinistas took power in 1979, though the country remained mired in civil conflict, with the Sandinistas facing off with Contras until 1990 (Ocampo, 1991). By the early 1990s, Nicaragua was attempting to get back on its economic feet, so it engaged with the IMF periodically to obtain loans to finance spending and stimulate economic growth. Public spending quickly became excessive, inducing inflation and other problems with exchange rates (ibid).

Beginning in 1989, the Nicaraguan government cut spending to a deficit of -5.6%, or roughly $57 million (ibid). Negotiations with the IMF required that Nicaragua begin some form of austerity to qualify for future lines of credit. Austere fiscal policy would help ensure foreign lenders that the government was serious about paying back its debts. Austerity was of paramount importance at this time because, up until this point, there was no reason to be confident in the Nicaraguan government. Nicaragua was already in massive debt by this point. The civil war had pushed the government deeper and deeper into debt by the time the 1990s rolled around.

Nicaragua's dependence on external lines of credit had left the government in a compromised financial position, with a reckoning coming about in the 1990s (CIA World Factbook). As the 1990s wore on, the nation's debt became so outsized that, by 1998, its debt amounted to more than 200% of GDP (International Monetary Fund, 2025). It was in a weak position to negotiate debt repayment plans and had no budget space to devalue the currency. However, instead of defaulting on payments or letting negotiations with the IMF stall, Managua decided in favor of austerity. Austerity was the tough choice, but the one that allowed Nicaragua access to capital markets in the future. Said differently, Managua prioritized its reputation as a disciplined borrower over becoming what Tomz called a *lemon* (Tomz, 2007).

*Mexico 1982*

In August 1982, following a decade of government mismanagement, Mexico defaulted on its debt to foreign lenders. The 1973 oil crisis precipitated this in some ways, along with tangential effects stemming from destabilizing confrontations between the US and the Soviet Union across Latin America. That notwithstanding, experts attribute much of the downturn in Mexico to the government's spending at that time (Gavin, 2010; Bazdresch and Levy, 1991). Regionally, import-oriented countries across Latin America were hit very hard by the oil crisis in 1973 as global supply fell and prices jumped. This same crisis would later help and hurt Mexico as the government-owned Pemex took advantage of the price hikes. Indeed, as oil prices rose, Pemex garnered big wages from oil sales abroad (Gavin, 2010). Although the government was initially hesitant about using the oil for exports, a change in administration brought about a big push for exports and oil windfalls (ibid). The estimated earnings from oil sales in the oil-starved market and the new oil findings in Mexico led to an estimated 8% leap in GDP by 1982 (ibid).

Prior to this boom, public spending was a strong feature of the Mexican government. Under President Luis Echeverria in 1971, Mexico accelerated public expenditures to increase employment as part of Echeverria's populist ploy (Bazdresch and Levy, 1991). During his first year in office, Echeverria increased public spending by 21% in real terms (ibid). Initially, this was accompanied by no reciprocal efforts in tax reform (ibid). Echeverria essentially sought to placate political turmoil with bigger government spending. This was due, in no small part, to Echeverria's widespread oppression. Spending would continue throughout his time in office, despite creeping inflation. This financial position was exacerbated by Mexico's increasingly outsized external debt position. Between 1974 and 1976, Mexico's foreign debt position doubled (ibid). The handoff to the new administration, led by Echeverria's finance minister, Jose Lopez Portillo (JLP), was imbued with hope of a turnaround as new oil fields would soon be discovered.

JLP tightened the screws on fiscal policy upon his assumption of office. His office worked on a fiscal policy generally approved by the IMF to rescue Mexico from economic hardship and malpractice (ibid., p 246, 1991). However, this fiscal discipline began to wane with the succeeding years as Mexico gained greater access to oil in the Cantarell oilfield in 1976. The Mexican president had already taken part in loosening fiscal policy as head of Mexico's Finance Ministry under his predecessor, Luis Echeverría (Doyle, 2025). With potential government revenue increases due to nationalized oil revenues, JLP dispatched with fiscal discipline and again sought public spending to fan the flames of oil investment and export (Bazdresch and Levy, p 248, 1991). Government expenditure under Portillo increased by 13.7% (ibid). As is germane to most natural resource exploitation, governments hope to spur investments by making public investments that will buoy the prospects of private investments. Nevertheless, the

Mexican government encountered a pacing problem, whereby government expenditures became excessive and unrequited by private investors.

Instead of the huge expected windfalls that would spur economic growth, oil revenues added a much smaller public-sector income, reaching 3.5% of GDP (Gavin, p 20, 2010). This shortfall came about due to poorly executed government spending. JLP's government emphasized spending on subsidies for energy prices in domestic markets (ibid). Instead of ushering in substantial growth, the government overspent, financing the oil industry's expansion and the demand for that oil. The government's eagerness to exploit new economic windfalls had, instead, pushed it further into debt. As revenues failed to meet expectations for the JLP government, fiscal space began to shrink.

In such circumstances, governments can often turn to lenders, foreign or domestic, as a means to rectify a debt position. However, the highly anticipated public sector earnings from oil had devolved into small profits and big debts (Bazdresch and Levy, p 249, 1991). Moreover, Mexico's problem was that it had already borrowed money abroad to finance the development of oil (Smith, 1996). Regionally, Smith points out that developing countries' debt grew from $68 billion to $2 trillion (ibid). So, when the oil development failed to produce a boom in Mexico as anticipated, the government was left staring down the barrel of another fit of austerity.

After defaulting in 1982, the Mexican government, led by President De la Madrid, forfeited the luxury of deficit spending. Foreign debt reached $92 billion, and the government turned to the IMF for stabilization (ibid., p 252, 1991). Mexico began cutting its public spending, although not quite what onlookers from the United States hoped for (CIA, 1986). Due to excessive inflation, some of Mexico's assumed debts had been underestimated in previous years (ibid). That notwithstanding, in 1983, President De la Madrid managed to cut roughly 25% of

government employees (ibid). Subsidies to public enterprises also dropped by a recorded 15% (ibid).

Despite some promise, however, the story of Mexico in the 1980s is one of checkered success in terms of rectifying outstanding debt obligations. Instead of running a perfect formula of cutting spending to the requisite amount, as dictated by the IMF, the data indicate that Mexico's government was hard pressed to meet these guidelines due to domestic pressures. Despite less than optimal outcomes for the government and the IMF, foreign lenders could not be pushed aside, so the government yielded to demands on multiple fronts.

In the above examples, Latin American governments are in weak financial positions. Their fiscal balances are negative, and they owe substantial amounts of money to foreign lenders. In both cases, the governments choose to tighten their budget and get on track to pay back their debts. However, nothing about this behavior is obvious or intuitive. Instead, one would expect rational actors to discount future profits and prioritize the present since their governing tenure is temporary compared to the borrowing prospects of the country. Said differently, why would today's administrations bother to help future ones, especially if they are to be political opponents? If the governments above behaved within this line, they would rebuff any obligation to finance their obligations, much like the Russians did in 1917.

Instead, these governments prioritize their foreign financial obligations over politically safer options like standing up to foreign lenders and increasing domestic expenditures. This paper seeks to answer this puzzle by adding an empirical perspective to Michael Tomz's reputational theory and Thomsson's and Kaplan's theory on foreign debt and fiscal policy. Both theories offer important explanations for the behaviors exhibited above. Namely, governments

will choose austerity over prosperity in the near term to keep lines of credit open in the long term.

## Literature Review

The literature of this field has covered much of Latin America's financial relationships with international markets, from international crises to impacts of austerity on local populations. Below, this paper breaks out these relevant contributions into distinct groups, categorizing them by theme, according to the linkages and variables the groups emphasize. It then visits existing literature, examining Latin America's natural resources and their effects on fiscal policy across different countries in the region. Then it moves to the literature's analysis of industrial policy and trade liberalization. Moving closer to the analysis of austerity, this paper examines the existing literature on fiscal policy and austerity. Finally, this review examines the literature on sovereign debt and debt crises.

Although natural resources are inarguably a boon for economies in some scale, some scholars have argued that these natural resources actually counteract growth in developing economies (Auty, 1993) (Sachs and Warner, 2001) (Mora-Silva, et al., 2023) (Gately et al., 1986) (Ristanovic, 2025). These authors all argue different relational points between natural resources and economic prosperity in Latin America and other developing parts of the world. These break out into two distinct directions. The first group, Auty, Sachs, and Warner, argues that resource-endowed countries can become beleaguered by their resources. This results in something called "Dutch disease," where the export of that resource crowds out the growth of other sectors in the economy.

This line of thinking contends that Latin American economies face resource management problems. This is undoubtedly true and is alluded to briefly in this paper. That aside, the authors principally focus on the effects of resource imports and exports on developing economies. Thus, their contributions are rounded out more so at trade and its effects on fiscal balances, though not necessarily foreign obligations and the effects thereof.

Not all Latin American industries faced the problems mentioned above. Indeed, some countries need not be resource-rich or poor but face challenges engaging the international market. Since its colonial history, many countries in Latin America have operated as exporters upstream of manufacturing in other economies, leaving them out of the higher value-added rungs in the productivity ladder. Many economists have studied the role this export history has had on economies in Latin America, finding different issues and solutions to those issues, like trade liberalization and industrial policy (Ocampo, 2013; Bulmer-Thomas, 2014); (Bruton, 1998) (Bogliaccini, 2013); (Salvucci, 2006). These contributions edge closer to discussing the relationship between foreign debt and domestic fiscal policy, though only tangentially. Some propose that Latin American states shed protective barriers to generate investment and growth, while others advocate an industrial policy underwritten by state spending. However, what remains unmentioned is whether or not states possess the fiscal agency to commit to such policies in the first place.

This review now pivots from literature covering resources and policy to literature on austerity and its effects on social welfare (Alesina et al., 2019) (Cohen, 2013; Bertola and Ocampo, 1996). These authors describe the different impacts austerity can have on social welfare, depending on the avenue governments take to achieve that austerity. Some governments may opt to increase taxes while others cut spending. Additionally, the authors analyze why

governments might choose some options over others. Throughout their analyses, the authors remain focused on the domestic aspects of fiscal policy and less on their relations or root causes. More specifically, they do not analyze potential causal relationships between different debt portfolios.

Other parts of the literature focus on the effects of politics on fiscal stability (De Bolle, 2022; Gonzalez-Garcia and Grigoli, 2013; Barta and Johnston, 2017). Some note that some regimes may face greater discrimination from capital markets than do others. Additionally, some of the authors maintain that domestic institutions determine favorable credit conditions. Interestingly, Barta and Johnston find that left-leaning governments face lower credit ratings from certain credit rating agencies, a finding that closely touches upon the findings in this paper.

This review now visits the literature most closely broaching the topic of my research–foreign lending and fiscal policy. The tectonic shift from ISI to trade liberalization ushered in new challenges for Latin America. Some of these most salient challenges manifest in financing government spending through debt. Authors have paid special attention to debt crises that punctuate Latin America's history (Williams, 2019; Ocampo, 2024) (Federal Reserve, 2025; Capraro and Perrotini, 2013) (Golub, 1991) (Altamura, 2020). Primarily, these articles focus on governments in times of crises, which, although important, do not offer much in the way of describing those same governments in regular operation.

Other authors focus more on the currency aspects, undergirding tensions in foreign lending (Eichengreen et al., 2023; Iacoviello and Minetti, 2006; Han, 2025). Eichengreen et al. (2023) describe what is called "original sin" in Latin American and other emerging economies. Namely, "original sin" describes the phenomenon whereby emerging economies cannot borrow abroad in their own currency (ibid). This is due to the (lack of) confidence foreign lenders have

in (local) global currencies, like the USD or Euro. Consequently, states borrow abroad in foreign currencies, exposing them to volatilities controlled in other financial centers like Brussels and Washington. Eichengreen et al. find that this phenomenon is persistent, despite efforts by emerging economies to the contrary. Conversely, Han finds that Latin American countries have successfully moved away from foreign-currency loans by borrowing domestically (2025). Iacoviello and Minetti (2006) do not dispute whether the composition is foreign or domestic; instead, they focus on the impact exchange rates have on local economies.

Finally, I devote special attention to a piece by Stephen Kaplan and Kaj Thomsson, as it resembles the work I set forth here. Kaplan and Thommson counter previous literature that asserts sovereign governments, like those in Latin America, will artificially engineer periods of growth to occur coincidentally with election cycles. They suggest that, instead, outside lenders constrain these governments in their behavior. The more funded these governments are through decentralized bond markets, the less agency those governments will have in creating artificial spending booms (ibid).

Although the thrust of their work is similar to what I set forth, it is different in several ways. Firstly, my research focuses exclusively on the power of external (foreign) lenders vis-à-vis local governments. Kaplan and Thommson focus their research on decentralized bond markets, which can include both foreign and domestic lenders. Secondly, they assess different outcomes. For their outcome variables, they measure fiscal balance, inflation, and GDP growth (p 609). Instead, my research will use fiscal balances, government spending, and tax percentage changes. For mechanisms, we share some inputs in controlling for election cycles and GDP. However, we differ in that the authors do not include a hard mechanism that represents the means by which outside lenders influence local policies. They only use an interaction term for

decentralized finance and elections. Here, I add the sovereign's credit rating, ranked from 1-21, as determined by the World Bank. This adds nuance, captures important nuance, and describes a potential mechanism for foreign actors to influence local fiscal policy.

**Theoretical Framework**

This paper proposes that domestic fiscal austerity, measured by primary account balances, government spending cuts, and tax increases, will increase as foreign lenders acquire greater shares of a sovereign's debt portfolio in Latin America. This follows two important theories developed in the last several decades in political economy. The first theory was developed by Kaplan and Thomsson, who contend that as sovereign governments become more dependent on decentralized bond markets, the less agency those governments have in fiscal policy. The second theory comes from Michael Tomz. Tomz theorizes that countries engender responsible fiscal policies in the face of foreign-held debt due to reputational concerns. Tomz argues that governments correctly calculate the value of future access to credit and therefore forfeit any interim *cheating*. He uses game theory to portray that fiscally responsible governments seek to avoid a *grim trigger*, whereby foreign lenders will cease working with debtor countries if they do not meet their debt obligations.

Why foreign lenders? Foreign lenders differ from domestic lenders for several reasons. Foreign lenders are likely not subject to the currency manipulations that domestic lenders may be. Regardless of the exchange rate, foreign lenders typically loan in stable currencies such as the USD or Euro, avoiding any would-be compromise by a devalued local currency. Foreign lenders invest less in the local economy than domestic lenders (ibid). Foreign lenders are primarily concerned with financing their loans, immaterial the long-term effects provoked by said financing. Domestic lenders enjoy no such agency since they fall within the legal

jurisdiction of the sovereign borrower and, potentially, under political influence or intimidation from that sovereign.

Foreign lenders operate outside domestic politics and exert external pressure on politicians to adopt austerity measures. However, not all lenders are created equal. Sovereigns with little debt owned by external actors do not demonstrate the same pliability as do their counterparts. Instead, foreign lenders influence austerity as their share of the sovereign's debt portfolio increases. At this point, foreign debt becomes something of a critical mass, controlled by the lenders.

Foreign lenders are especially troublesome for sovereign borrowers because the former control global checkbooks. Suppose sovereign borrowers wish to cheat on the borrowing terms of a given lender. In that case, the lender reports the default to larger institutions, such as multinational banks, funds, or even global institutions such as the IMF or the World Bank. Once a sovereign borrower earns a reputation as a cheater, future borrowing terms will be severely constrained by higher risk premiums and borrowing rates. Borrowers may be needy, but they are not foolish. Calculated correctly, future borrowing costs will always be higher if a country cheats than if a country does not. Thus, countries will choose austerity over default to maintain favorable borrowing terms.

What about domestic lenders? Domestic lenders are bound to the legal institutions within the sovereign debtor's purview. Because of this compromised relationship, domestic lenders cannot exercise the same influence over domestic fiscal policy as their foreign counterparts. Moreover, domestic lenders may not prefer measures of austerity, fearing that they might cause a government collapse, so their loans are never financed (Garcia and Grigoli, 2013). This does not

completely mute the influence of domestic banks. Indeed, they may exercise their wants. They simply will not be able to encourage austerity in the same fashion as foreign lenders.

As foreign lenders press on the dial of austerity, domestic forces strongly oppose this policy. Since the 1980s, Latin American constituents have responded to austerity measures differently, including protests or voting shifts (Kaplan and Thommson, p 1, 2016) (Alesina, 2019). This is because austerity represents a cut in their livelihood. Alesina (2019) documents the intricacies of this relationship by breaking out the different effects of taxes and spending cuts. He argues that spending cuts are likely to frustrate the public more than taxes since spending cuts affect more cohesive groups of individuals who value cuts higher than do taxpayers (ibid., p 143). Regardless of which cut affects them more, they both come as a consequence of the austerity measures imposed by governments. This puts the domestic population opposite foreign lenders.

Having documented the forces at work, foreign lenders, sovereigns, and domestic populations, this paper now sets forth an analysis of how and when foreign lenders overcome domestic opposition to such austerity. Significant in this paper is uncovering a relationship between excessive capacity via foreign lenders and spurring domestic austerity in Latin America. Although much is said of foreign lending and its effects on economies in Latin America, the relationship between foreign lenders and austerity has not been measured in this manner. Kaplan and Thommson (2016) most closely resemble this work by measuring fiscal balances, inflation, and GDP as the dependent variable. In my methodology section, I explain why I focus on other measures of austerity, though these are closely related. This paper contends that domestic political austerity, measured by primary and fiscal balances, government spending cuts, and increased taxes, is a function of increasing foreign-debt-to-GDP ratios.

**Methodology**

I run four regression analyses to assess the effects of external debt amounts on domestic austerity policies. My regression equation is as follows:

$$\Delta Policy^{k}_{(it)} = \beta_0 + \beta_1 \cdot Foreign_{(i,\, t-1)} + \beta_2 \cdot SovereignDebtRating_{(i,\, t-1)} + \beta_3 \cdot Election_{(it)} + \beta_4 \cdot Foreign_{(i,\, t-1)} \times Election_{(it)} + \beta_5 \cdot realGDPchange_{(it)} + \mu i + \lambda t + \epsilon(it)$$

$\Delta Policy^{k}_{(it)}$ represents policy, with superscript k indicating four variants of policy: (1) a change in gross tax revenues, (2) social spending, (3) primary balance, and (4) fiscal balance across four different regressions, where *i* is each individual country and *t* represents the given year. These four dependent variables are chosen as proxies for measuring policies of austerity in a given state in a given period. Tax revenues are chosen to reflect general tax policy within a given state. The intuition is that governments will raise taxes to meet foreign debt obligations, following periods of increasing externally held debt ($Foreign_{(i,\, t-1)}$) and the state's debt rating ($SovereignDebtRating_{(i,\, t-1)}$). I use tax revenue to proxy for austerity, in accordance with Alesina et al.'s work (2019), documenting the relationship between tax hikes and fiscal policy. Although there are several forms of taxes available in the data, including value-added taxes, trade taxes, and property taxes, I use gross tax revenue to account for any and all changes across the region, assuming states may use any combination of such methods to draw revenue.

$\Delta Policy_{(it)}$ also represents social spending. Intuitively, for governments to finance debt, they must increase revenues relative to expenditures. With tax hikes, governments attempt to increase revenues. With spending cuts, governments attempt to reduce expenditures. Both policies are forms of austerity, and governments must navigate their policy choices as some combination of the two (ibid). Though not the explicit focus of this paper, capturing the

differences between social spending cuts and tax hikes is a tradition that complements an important discussion in the literature (Kaplan and Thommson, 2017) (Andrews, 1994) (Cerny, 1995).

The primary balance is the difference between a government's revenues and its expenditures, including interest. The data in this study include the primary balance as a percentage of GDP. I use primary balance as a proxy for government austerity in a test to see if foreign debt holdings are sufficiently influential to move the needle on government balances. Since primary balances measure revenues and expenditures, my theory supposes that increases in foreign debt holdings will inspire increases in primary balances (greater revenues via austerity).

Fiscal balance differs slightly from primary balance in that the fiscal balance excludes interest payments. Fiscal balances tell us whether governments have the space to borrow again in the future, since they will also have to account for interest on current debt. I expect to see fiscal balances rise when lagged external debt increases, signifying a direction toward austerity as external debt increases. Alternatively, it is possible that fiscal balances will fall, with lagged external debt immaterial. This would be interest rates that outpace any increase in revenue, reflecting the interests accumulated on prior debt (Chien et al. 2022). Either way, testing fiscal balances in my regression follows the logic that governments will better address their fiscal positions when foreign debt increases.

$\beta_0$ represents my y-intercept, assuming no treatment from debt ratings, elections, etc. $\beta_1 \cdot \text{Foreign}_{(i,\, t-1)}$ is a lagged variable for foreign debt holdings as a percentage of GDP. This is the primary effect I test. It represents the main driver in my theory, that as foreign-held debt accumulates, local governments will be forced into greater levels of austerity (tax hikes, spending cuts). Importantly, foreign debt holdings differ from domestic holdings since the former

have greater autonomy from the borrowing government than do domestic ones (Iacoviello and Minetti, 2006). Testing this in my regression essentially asks *how much greater* is foreign debt holdings are as an influence than domestic holdings. I lag this variable to allow for reaction time in policy, assuming external debt holding increases will not immediately affect government behavior (Keele and Kelly, 2006; De Boef and Keele, 2008). The effect of this independent variable on austerity (specifically as measured by tax increases and spending cuts) has not been measured previously, insofar as the author is aware.

$\beta_2 \cdot \text{SovereignCreditRating}_{(i,\, t-1)}$ is foreign currency long-term sovereign credit ratings, indexed from 1-21, according to the World Bank (Kose et al., 2022). This ranking is the best available signal for cross-country analysis currently available for my disparate selection of countries. It must be stated that sovereign debt ratings are less granular than other measures, such as sovereign spreads, which more frequently respond to market signals. That notwithstanding, because this research examines debt holdings lagged by one year, it is reasonable to assume that government policies would respond to external held debt figures and sovereign credit ratings at the same pace. Thus, I use this figure to proxy for the signal or communication between foreign debt-holders and local sovereigns. My theory supposes that external debt holders communicate their sentiment to institutions such as the World Bank or the IMF, which is then communicated to local sovereigns via credit ratings reports.

$\beta_3 \cdot \text{Election}_{(it)}$ is a dummy variable (0, 1) whereby 1 indicates there is an election in that year and 0 indicates no election. This allows for control of election cycle influence on the dependent variable. Previous literature has documented the effects of (post) elections and their place within greater cycles of spending and austerity (Dovis et al., 2016; Brooks et al., 2022). Specifically, the research contends that newly elected officials will rise on a populist tide,

offering increased spending in one period, while challengers will move the opposite way, advocating for austerity and discipline later (ibid). Thus, it is important to control for this as a potentially omitted variable.

$\beta_4 \cdot \text{Foreign}_{(i,\, t-1)} \times \text{Election}_{(it)}$ is an interaction term, capturing the compounding effect of foreign holdings during election years. My theory supposes that governments will respond to foreign holdings more strongly in election years, causing greater tax hikes or spending cuts as foreign debt holdings increase. This is closely related to the interaction term used by Kaplan and Thommson (2017). However, they interact elections with decentralized bonds in an effort to assess the effects decentralized bonds have on government austerity. This is the same intuitive reasoning as that applied to election_year as a standalone variable, cited above (Dovis et al., 2016). The difference, here, is that the interaction term allows for insights into whether or not these independent variables have more power in conjunction with (conditional on) one another than alone (VanderWeele and Knol, 2014).

$\beta_5 \cdot \text{realGDPchange}_{(it)}$ indicates the gross domestic product in the national currency, at constant prices, and represented as a percent change. By controlling for GDP at constant prices, I avoid obfuscation via inflation or deflation. Moreover, controlling for GDP as a percentage change as opposed to a gross dollar amount ensures I am capturing the real health of the economy, year over year. Naturally, measuring economic metrics adjacent to government spending and debt should involve some sort of control for GDP.

Lastly, I use country and time fixed effects. Specific to my study of the Latin America region, I control for countries so as to avoid confounding effects from better or worse performing countries. The countries included in my study, by design, run a gamut of economic performance and debt profiles, and thus, it stands to reason that a regression that includes all of them needs to

control for their different economic performances. Secondly, time-fixed effects account for things like COVID, wars, changes in technology, or other global events that might shape all behaviors across time. If this study included the 1970s or earlier, time-fixed effects would account for things like ISI or regional wars.

**Data**

I use several datasets taken from the IMF, the World Bank, and the Inter-American Development Bank, tracing economic data from 1990-2024. I chose Latin America to assess the impact foreign lenders have had since Latin American economies have historically been in tougher positions vis-a-vis capital markets (Ocampo, 2013). Specifically, much of Latin America has undergone different export regimes that have been tied directly to debt financing (Geiger, 1990). Mexico, Argentina, and Brazil–to name several–have all defaulted or nearly defaulted, despite being considered more reliable borrowers today. This gives my theory a stronger test as it allows me to assess multiple countries in multiple financial contexts. Because of this historic position, I suppose that foreign lenders should have greater agency in influencing local sovereign governments. Again, this mirrors the motivations for Kaplan and Thommson's (2017) work.

I chose nine countries for my analysis: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Nicaragua, and Panama. These countries represent a wide spread of different foreign-debt profiles (World Bank(b), 2025), which allow me to assess the effects of different foreign debt amounts properly. This follows the statistical principle that a greater variance in the independent variable should allow a researcher to estimate its effects better. Mexico and Brazil, in particular, offer examples of countries with large GDPs. Mexico and Brazil are generally considered more reliable partners than countries like Argentina or Nicaragua. Inversely, smaller

countries like Bolivia and Nicaragua allow me to see if external debt holdings more significantly impact smaller GDPs.

There are 315 country-years, documenting the aforementioned country's economic statistics from 1990 to 2024. Because the data begins in 1990, it captures some of the hangover from ISI II in Latin America. Although this research would have benefited from access to debt finance data from the 1980s, specifically targeting years during and immediately after ISI, it was unavailable. Panama, for instance, does not indicate any data for the years 1980-2013, leaving only 2014-2024 to measure Panama's austerity against foreign-held debt. That notwithstanding, I can capture statistically significant relationships for some variables, which I document below in the results section.

## Results

This paper runs four regression analyses, comparing the effects of foreign-held debt and credit rankings on a vector of dependent variables. The tables below show four columns of regressions. The first table shows the vector of outcomes regressed on foreign-held debt. The second table shows the vector of outcomes regressed on credit rating. When running regressions on foreign-held debt and credit ratings as independent variables, foreign-held debt could crowd out the effect of credit ratings. Thus, the two are present in separate regressions provided below. Below the tables are several histograms accompanied by brief descriptions that illustrate the relationships in the data.

| | *Taxes on External Debt* | *Social Spending on External Debt* | *Fiscal Balance on External Debt* | *Primary Balance on GDP* |
|---|---|---|---|---|
| **Variable** | | | | |
| Externally Held | -0.004994 | -0.041875*** | 0.064499*** | 0.079882*** |

| | | | | |
|---|---|---|---|---|
| Debt (lagged) | (0.017496) | (.008) | (.017) | (0.017620) |
| Real Change in GDP | 0.215380***<br>(0.062093) | -0.034808<br>(.031) | 0.168020**<br>(0.064) | 0.134402**<br>(0.064314) |
| Sovereign Credit Rating (lagged) | -0.026562<br>(0.697937) | 0.04<br>(0.056) | -0.019909<br>(0.129) | 0.020502<br>(0.13045) |
| Election Year | -0.016948<br>(0.016044) | 0.129<br>(0.315) | -1.137763<br>(0.715809) | -1.059315<br>(0.724147) |
| Gross Debt | -0.006507<br>(0.011389) | 0.016 **<br>(0.0018) | 0.027730<br>(0.016378) | -0.035215**<br>(0.0166) |
| Extdebt_lag x election_year | -0.004264<br>(0.010934) | -0.0017<br>(0.005) | 0.004875<br>(0.011526) | 0.005012<br>(0.011660) |
| Sovereign credit rating x election_year | - | - | - | - |
| Observations<br>$R^2$ | 1.929 on 144 degrees of freedom | 0.8697 on 130 degrees of freedom | 2.119 on 159 degrees of freedom | 2.144 on 159 degrees of freedom |
| Adjusted R-squared | 0.8818 | 0.83 | 0.59 | .56 |
| Significance Codes | *** $p < 0.01$ | ** $p < 0.05$ | . $p <$ 0.1 | |

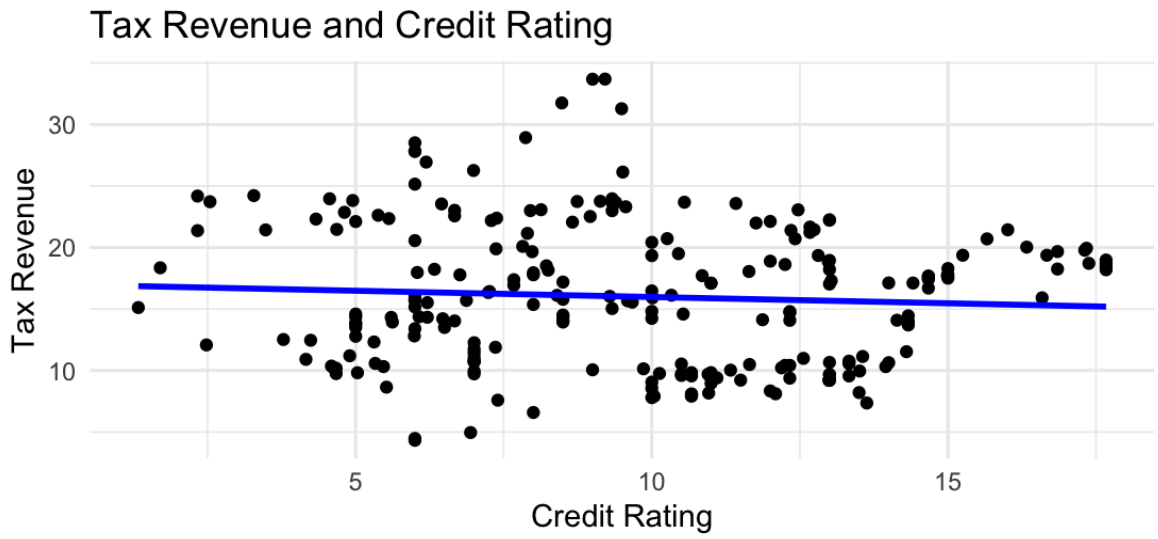
| | *Taxes on Credit Rating* | *Social Spending on External Debt* | *Fiscal Balance on External Debt* | *Primary Balance on GDP* |
|---|---|---|---|---|
| **Variable** | | | | |
| Externally Held Debt (lagged) | - | - | - | - |
| Real Change in GDP | 0.14834<br>(0.058) | -0.035940<br>(0.0314) | 0.14979**<br>(0.0589) | 0.12313**<br>(0.06) |
| Sovereign Credit Rating (lagged) | -0.66194***<br>(0.115) | -0.025616<br>(0.057) | 0.04632<br>(0.1194) | 0.06054<br>(0.123) |
| Election Year | 0.09570<br>(0.959) | -0.035940<br>(0.031) | 0.18571<br>(0.944) | 0.16371<br>(0.971) |

| | | | | |
|---|---|---|---|---|
| Gross Debt | -0.01372<br>(0.01) | -0.0142***<br>(.005) | 0.01689<br>(0.0109) | 0.02460**<br>(0.011) |
| Extdebt_lag x election_year | - | - | - | - |
| Sovereign Credit Rating x Election Year (lagged) | -0.03482<br>(0.091) | -0.0026<br>(0.044) | -0.09625<br>(0.089) | -0.08447<br>(0.092) |
| Observations<br>$R^2$ | 2.013 on 173 degrees of freedom | 0.0459 on 159 degrees of freedom | 2.112 on 189 degrees of freedom | 2.173 on 189 degrees of freedom |
| Adjusted R-squared | .873 | .793 | .57 | .52 |
| Significance Codes | *** $p < 0.01$ | ** $p < 0.05$ | . $p <$ 0.1 | |

---

Credit rating's negative coefficient supports my theory. My theory suggests that governments receiving negative reviews from the World Bank will respond by increasing tax revenues. As credit ratings increase, countries are less obliged and likely less in need of raising taxes to finance foreign debt requirements. However, tax revenue does not respond equally to a given foreign debt profile. Instead, foreign debt holdings have no statistically significant effect on tax revenue in a separate regression that excludes credit ratings.

The graph below captures the associative relationship between the two variables. As can be seen, the relationship is modest, though statistically significant.



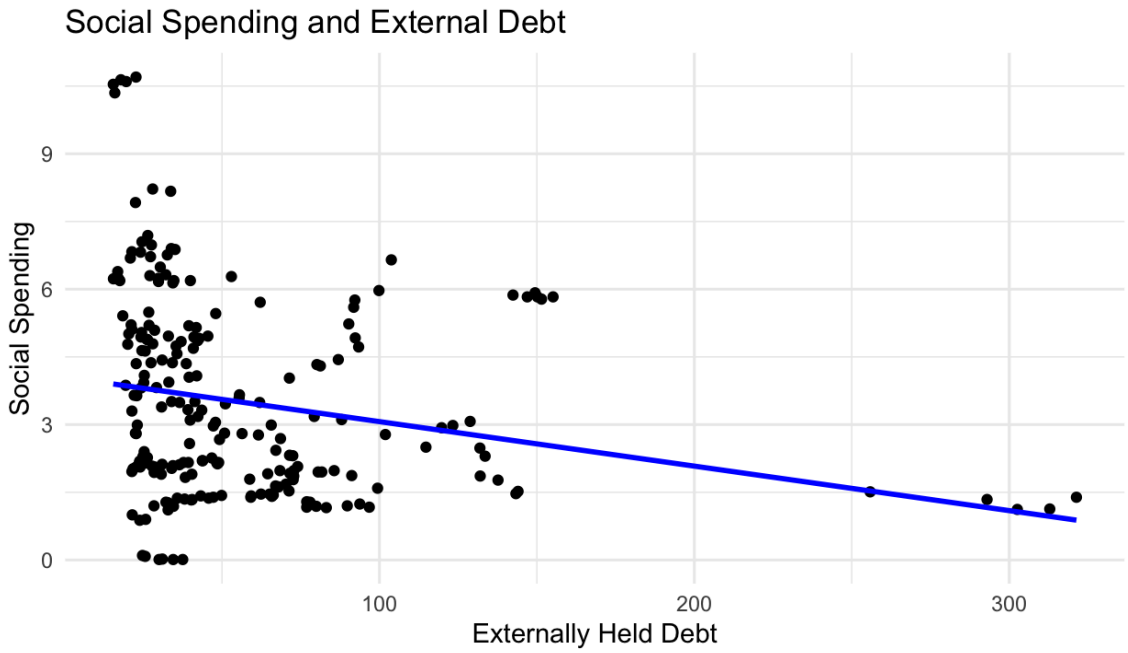

---

Therefore, although I demonstrate a statistically significant relationship between credit ratings and tax revenue and its movement in the predicted direction, this does not square neatly with the absence of a relationship between tax revenue and foreign-held debt.

This may suggest that credit ratings serve alternative purposes to those purported in this paper. Additionally, other factors may influence credit ratings besides foreign debt holdings. There may also be alternative pathways through which credit ratings work as a signal to different parts of the banking or finance sector. Private borrowers may find that credit ratings that affect their sovereign government carry residual perceptions on their borrowing ability. Nevertheless, such discoveries are neither found nor analyzed fully in the regressions of this paper.

My next regression assesses social spending against externally held debt and foreign credit ratings. Social spending shows a statistically significant inverse relationship with external debt holdings. This supports my theory that governments implement austerity as foreign debt holdings increase. The chart below illustrates that external debt can greatly influence social spending. External debt can also outpace GDP due to various factors, including the debt's

currency denomination. Outstanding debts held by countries like Nicaragua in the early 1990s exceeded 300% of GDP, as seen below. Because of such exceptional circumstances, as in Panama in 2014, Latin American countries draw down on social spending. I spend more time discussing this in the discussion and conclusion sections.




A third regression focuses on fiscal balance. Fiscal balance measures the country's revenues less its debt obligations (debt interest included). By including debt in this analysis (though I exclude it later in the next regression), I can differentiate the effects that debt interest may have on fiscal policies in a given country. A positive relationship here can also indicate confidence from lenders that the sovereign in question is better suited to finance more debt. This implies that fiscal balance is the independent variable, something that is not argued in this paper. For this reason, external debt is lagged as an attempt to capture fiscal balance *responses*. My theory supposes fiscal and primary balances should increase when regressed on lagged debt. The results of this regression indicated a statistically significant relationship between fiscal balance and external debt.

The finding is also economically significant. Because the data is measured in terms of percentages of GDP, .0645 is a movement of that percentage (from 2.00% to 2.065%). In a country like Brazil, with a GDP of $2 trillion, such a change would signify $1.29 billion. Said differently, when fiscal balances operate in ranges of -12% to 8%, with a mean of -2.36%, .0645 can be very impactful in real dollar amounts.

My last regression assesses the impact of foreign-held debt and credit ratings on the primary balance of a given sovereign. As stated above, the primary balance measures a country's revenue, less debt *and* debt interest. The primary purpose of including both balance figures is to determine if governments adjust their austerity policy between the figures of debt and debt interest. Essentially, is there any daylight between policies, potentially intensified austerity, when considering external debt? After running the regression, I find that lagged external debt is positively associated with primary balance and the relationship is statistically significant at the $p \leq .01$ level. The coefficient for lagged external debt in this regression is .079, indicating an increase of .079 percentage points for every one percentage point increase in external held debt.

As stated previously, this is of economic significance as it represents a percentage point movement in GDP. The comovement between primary balances and externally held debt supports my theory that governments tighten budgetary policy in light of increasing foreign debt obligations. It is also worth mentioning that the positive association in primary balances differs from that found with fiscal balances. A positive association between primary balances and external debt indicates that governments are controlling expenditures (social spending) and thereby increasing revenues. Although similar, the association with fiscal balance indicates that government efforts are substantial to the point of overcoming debt, and/or governments with larger foreign debt obligations can maintain such positions because they negotiate better interest

schedules, lowering fiscal obligations and increasing fiscal balances. Lastly, it is worth noting that the coefficient on fiscal balance (.0645) is smaller than that on primary balance (.079), indicating that fiscal balances are tougher to manage than primary balances.

## Discussion

This research set out to analyze relationships between foreign lenders and sovereign borrowers. My theory supposed that foreign lenders achieve outsized influence over sovereign governments in Latin America because their holdings in sovereign debt portfolios are so extensive that sovereign leaders must inevitably heed what the lenders say. I supposed that foreign lenders exert that influence via a credit rating mechanism. The World Bank credit rating rates sovereign borrowers on a scale of 1 to 21, using a buffet of indicators that measure a sovereign's ability to pay its debts on time. Finally, I theorized that these factors would demonstrate strong results during election years. My supposition for the influence of election years on financial markets and austerity is well-founded in the literature (Dinç, 2005; Kaplan and Thommson, 2017; Brooks et al., 2022). This paper now discusses the findings above, what they do to advance the literature, and potential policy implications.

There are two critical findings in this analysis. Firstly, tax revenue is inversely related to international credit rating. This is interesting as it moves in accordance with my theory. This suggests that states rated more poorly by the World Bank will increase tax revenues to reduce debt obligations. As the country's credit rating improves, tax revenues decrease as the need for austerity dissipates. However, it must be noted that tax revenues do not increase with greater holdings of external debt. This would help solidify my theory that foreign lenders move domestic policy through credit ratings. The data do not indicate that. In some ways, this leaves the finding only half-way supportive of my theory.

Nevertheless, if taxes are partly used to address international credit ratings, this says something about the austere policies used by sovereign governments. This is important for several reasons previously alluded to in the literature (Alesina et al., 2019). The Alesina work discusses different methods for imposing austerity, be it increasing taxation or cutting public spending. They find that governments would be better suited if they focused on cutting spending instead of increasing taxes, citing that tax increases generate greater economic contraction than decreases in spending.

This is worth diving into further, since the Alesina work primarily covers European economies, not Latin America. The research in this paper suggests the opposite occurs in Latin America–governments are more willing to cut spending in light of debt, external in this case. This raises a question of what separates Latin American governments from European ones. Many things do, of course, but this paper offers some possible avenues of explanation. Firstly, Latin American governments have endured extensive histories with debts and strenuous relations with the IMF. As a result, the countries of the region have innovated multiple ways to implement austerity, something not similarly experienced by European countries. Secondly, Latin American tax policies are not perfectly enforceable at the regional level (Shome, 1999). Although some governments may be more successful than others, there exists some difficulty in Latin America in enforcing things like individual income tax, forcing governments to get creative (ibid). Therefore, the data may indicate an enforcement problem more than a conscious policy choice.

Nevertheless, there are no doubt forces in any economy that lobby against increased taxation (ibid). The same must be said for countries in Latin America, where private interest groups can sometimes successfully lobby (Guzman et al., 2024). However, according to my study, those forces sometimes lose the fight, and international lenders have a more substantial

influence over fiscal policy, given their stake in debt. Indeed, private domestic lenders should likely encourage government spending cuts over tax hikes, seeing tax hikes as a danger to their incomes. Yet if credit ratings move the needle on tax reform, this paper offers some evidence that credit ratings inform government tax policy at the expense of these would-be domestic voices.

The second critical finding is that social spending as a percentage of GDP is inversely related to increasing foreign-held debt. This supports my theory that governments will respond to foreign-held debt by implementing austerity at home. Indeed, despite controlling for gross debt, including domestic debt, external debt holders have a significant influence over austerity. Sovereign governments are more bound to reputational forces and, more importantly, future borrowing capabilities (Tomz, 2007). Should governments default on debt repayment schedules, the fallout is significant for present and future governments (Hermann and Scholl, 2023). Instead, if governments can avoid defaults, they maintain credibility that confers on them lower interest rates, lower premiums, and other perquisites during negotiations (Eaton and Gersovitz, 1981).

However, as discussed in Alesina et al (2019) and Hermann and Scholl (2023), government austerity is situated somewhere between tax hikes and spending cuts. Therefore, although my theory supposes austerity, I was not clear about which form it would take. After running regressions, however, the data indicate that Latin American governments prefer to cut social spending instead of increasing taxes, at least when servicing foreign debt. Why governments choose spending cuts instead of tax increases is not the focus of this paper, though finding a difference between the two is sufficient for commentary. Thus, Latin American governments prefer spending cuts to tax increases to meet their foreign debt obligations. This confirms findings in previous works.

The last significant finding this paper addresses is the failure of credit ratings and elections to move the needle on austerity jointly. Previously, I supposed that foreign lenders would work through the credit rating mechanism to signal to sovereign borrowers. In this paradigm, lenders indicate either confidence (higher ratings) or lack of confidence (lower ratings) to sovereign borrowers, forcing a change in austerity behaviors. Instead, the credit rating, as determined by the World Bank, held questionable influence over austerity policies. Only one dependent variable (tax revenue) responded to credit ratings, but it did not do so in conjunction with any other supporting variable in the regression.

Additionally, as described by Brooks et al. (2022), I anticipated that elections, pre- or post-election, would significantly affect austerity. In Brooks et al.'s piece, they find that elections are not significant in austerity, except for left-leaning governments. Moreover, they argue that this effect comes only after elections. Regardless, my study indicates elections have no discernible effect on fiscal policy.

Aside from elections, sovereign credit ratings are one of many metrics by which lenders and borrowers may exchange information. However, it is unclear how governments read signals from international lenders. Indeed, governments do not want to give clear indicators to foreign lenders on how to influence them best, lest they lose sovereignty over domestic fiscal policy. Instead, sovereign governments choose to read a multitude of factors that give them insight into how foreign lenders perceive their creditworthiness. Governments can observe real-time market spreads, investor sentiment, or market fundamentals to ascertain their credit position in the eyes of foreign lenders (Cantor and Packer, 1996).

Secondly, the muted effects elections have on austerity are surprising. My theory supposed that elections would amplify the effects of outstanding foreign debt because

government challengers could use this to pressure incumbents and rally supporters. If governments maintained outstanding overseas debt positions, challengers should point to that as a fiscal policy mismanagement. Secondly, challengers could offer more fiscally stringent positions, inviting the goodwill and potential promotion of those foreign lenders and domestic groups interested in consolidating debt (Guzman et al., p 931, 2019). Yet, the data do not show such a relationship. Why?

The reason election years do not amplify the effects of external debt or credit ratings may be due to consistency across regimes. Governing differences between political factions appear immaterial. Instead, the ruling influence is external debt. Not finding a statistically significant relationship between these variables is not to say one does not exist somewhere, between different regimes or actors. Simply, these data do not show such a relationship. Instead, these data indicate that external debt consistently correlates with spending cuts across election cycles. This suggests that even governments or challengers that oppose spending cuts may be forced to do so once in office.

The point that both sides of any given political spectrum will or can pursue similar fiscal policies is alluded to in Brooks et al. (2022). In their work, the authors state that lenders in financial markets do not show a systematic response to election cycles, such as increasing borrowing costs for certain governments. This is demonstrated in my findings, where I use an interaction term to measure the impact that election years, lagged debt, and lagged credit rating have on fiscal policy.

At this point, I turn to several country case studies that exemplify the findings in this paper.

## Policy Recommendations and Conclusion

This paper has sought to outline an association between foreign-held debt and austerity as measured by fiscal balance, primary balance, tax revenues, and social spending on the domestic side. The most interesting association documented in this work is between foreign-held debt and social spending cuts. As demonstrated, sovereign governments will prefer to meet their foreign debt obligations by cutting social spending rather than increasing taxes.

This relationship holds in the Nicaragua and Mexico examples provided above. Alesina et al (2019) argue that cutting spending is less contractionary than tax increases, making the case that Latin American governments have the right approach. It might be argued that cuts to public spending will have some of the worst effects on social welfare. Indeed, excessive cuts to public spending may cut against growth and welfare (Izquierdo et al., 2018). Thus, there appears to be a disagreement between what to do and how to do it.

This author recommends a mixed approach. Some cuts to government spending are likely in order, especially spending in sectors that otherwise enjoy private investments as well. Such sectors include resource exploitation and the finance of state-owned enterprises. That is not to say these sectors do not merit investment. Instead, such sectors are better suited for venture capital. Yet, infrastructure investment is important as well for current and future welfare. Moreover, infrastructure investment may be essential for garnering private investment. As argued by Izuierdo et al. (2018), infrastructure investments are potentially more profitable and enticing for private capital investments. By mix, then, I mean investing in infrastructure that facilitates private ventures, but not investing in such ventures themselves to the point they become publicly backed ventures like Pemex in Mexico.

By stepping out of the tendency toward nationalization, sovereign governments would cut public spending in accordance with austerity policies without immediately forfeiting public welfare. Sovereign governments that do this could likewise negotiate with IMF lenders on terms of debt that allow for some taxation on trade (tariffs) that offset expenditures for public goods like healthcare and education. Although globally, austere outcomes such as liberal trade are witnessed after and treated as a matter of course for the economies on the negotiating end, it is possible that they can advocate for their constituents better than they do currently.

Additionally, IMF negotiators may need to include social welfare conditions when they negotiate borrowing terms, especially in developing economies. Developed economies spend significant portions of their budgets on social welfare projects such as healthcare, infrastructure, or education (ibid). Therefore, they are attuned to social requirements and the positions government officials find themselves in when negotiating. In an effort to help sovereigns clear foreign-held debt while maintaining their position and their society's welfare, IMF negotiators should begin with conditions on how government cuts should be implemented.

Once a country turns to the IMF, there is a degree of financial sovereignty that is at least tacitly surrendered to conditions provided by the institution. As the IMF brings large credit lines with it, so can it bring conditions on how to earn those credit lines. Typically, this takes the form of demanding commitments to austerity in a multitude of forms. This author proposes that the IMF impose additional terms that discourage dramatic cuts to social welfare spending.

Alternatively, sovereign governments may avoid such junctions in the future by stimulating capital markets domestically or regionally. Although understandable in theory, it is no doubt difficult to foster an economic environment in which financial markets flourish and issuing debt domestically is easy. This would be the natural course governments might pursue if

it were available to them. An alternative might be to "peg" their percentage of borrowing abroad to a percentage of borrowing domestically. By keeping their foreign borrowing below a threshold amount, governments would hedge against future currency or debt crises. Additionally, this hedges against international crises that might cause foreign borrowing rates to jump and hurt local economies.

To conclude, I briefly revisit my findings and recommend future avenues for research. In this analysis, I analyze a sampling of Latin American countries that make up a spread of debt profiles to help substantiate my findings. I find that Latin American governments with large external debt portfolios become susceptible to foreign pressures to create austere spending policies domestically. These same governments do not meaningfully increase their tax revenues as I expected, but instead collect fewer taxes. Primary balances and fiscal balances both move in the expected direction, indicating that governments tacitly agree with my theory that foreign debt obligations must be serviced through austerity at home.

This adds to the literature, as previous literature does not substantiate a role for foreign lenders in domestic austerity policies. Indeed, much of the literature discusses austerity in its own right or the various successes of austere policies. This analysis proves a strong association between foreign debt holdings and austerity. Although I am confident in this finding, several questions remain worth further research.

It remains unclear through what mechanisms sovereign governments receive the signal from foreign lenders to begin policies of austerity, be it their ledgers or signals from international institutions about the borrowing potential of the government in question. Turns to the IMF no doubt account for some of this signaling, yet they are not the main channel. I used a World Bank credit rating system (1-21) in this research to determine if governments reacted to this signal.

There was one statistically significant relationship between tax revenue and credit rating. Yet, this relationship did not move similarly with foreign-held debt. This raises some doubt about whether the international credit rating is a mechanism for foreign lenders or for someone else, perhaps domestic lenders or global institutions. Other metrics may be better suited to observing the relationship between foreign lenders and domestic fiscal policy. Metrics such as the Emerging Markets Bond Index (EMBI) provided by private banks are an option; using individual market spreads to index emerging economies according to creditworthiness is another. Alternatively, future research can assess if foreign lenders work through domestic political opposition to create the desired austere results.

Additionally, my research finds no significant relationship between election years, when interacted with external debt, and domestic austerity. My theory predicted that election years would magnify the impact of external debt as foreign lenders sought to tip the scales in favor of more austere future governments. Instead, governments change hands without significant changes in domestic fiscal policy. A study of political communications with foreign lenders might illuminate this phenomenon. Alternatively, research might assess the proposed fiscal policies compared to those enacted once in office, specifically as it concerns Latin American governments with extensive foreign debt profiles. Intuitively, it may be that challengers and incumbents alike move closer to a middle ground between appeasing domestic audiences and foreign lenders alike, yielding little difference between themselves.

Finally, future research may examine this relationship in other developing parts of the world, such as Southeast Asia, Eastern and Southern Europe, or Africa. Do these parts of the world show similar responses to foreign lenders, or do they respond to different indicators in the financial markets in their part of the world?

Wherever the research goes, the Latin American experience is instructive. It indicates that foreign lenders, knowingly or otherwise, can reach a point where they influence domestic fiscal policies in ways not intended by the borrowers. One might call it a cautionary tale. Although the mechanism remains unclear, sovereign leaders will be forced to accommodate foreign lenders' wants. Therefore, leaders in emerging economies are well advised to keep their foreign debt profiles small and their fiscal policies disciplined, lest their foreign debt becomes foreign influence.

# References

Alesina, Alberto, Carlo Favero, and Francesco Giavazzi. “What Do We Know About the Effects of Austerity?” *Journal of Economic Perspectives* 33, no. 2 (Spring 2019): 141–162. https://doi.org/10.1257/jep.33.2.141

Altamura, Carlo Edoardo, and Juan Flores Zendejas. “Politics, International Banking and the Debt Crisis of 1982.” *Business History Review* 94, no. 4 (Winter 2020): 753–778. Published online February 3, 2021. https://doi.org/10.1257/S0007680520000653

Amarante, Verónica, Nora Lustig, and Andrea Vigorito. "The challenge of income inequality in Latin America." *CEPAL Review* 2023, no. 141 (2023): 147-163.

Andrews, David. “Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations.” *International Studies Quarterly* 38, no. 2 (1994): 193–218.

Auty, Richard M. *Sustaining Development in Mineral Economies: The Resource Curse Thesis.* London: Routledge, 1993.

Barta, Zsófia, and Alison Johnston. 2018. "Rating Politics? Partisan Discrimination in Credit Ratings in Developed Economies." *Comparative Political Studies* 51 (5): 587–620. https://doi.org/10.1177/0010414017710263..

Bazdresch, Carlos, and Santiago Levy. “Populism and Economic Policy in Mexico, 1970–1982.” In *The Macroeconomics of Populism in Latin America*, edited by Rudiger Dornbusch and Sebastian Edwards, 223–262. Chicago: University of Chicago Press, January 1991. http://www.nber.org/chapters/c8302.

Bértola, Luis, and José Antonio Ocampo. “The Role of Fiscal Policy in Latin America.” *Inter-American Development Review* 31, no. 3 (1996): 69–90.

Bogliaccini, Juan Ariel. “Trade Liberalization, Deindustrialization, and Inequality: Evidence from Middle-Income Latin American Countries.” *Latin American Research Review* 48, no. 2 (2013): 79–105.

Brooks, Sarah M., Raphael Cunha, and Layna Mosley. “Sovereign Risk and Government Change: Elections, Ideology and Experience.” *Comparative Political Studies* 55, no. 9 (2022): 1501–1538. https://doi.org/10.1177/00104140211047407.

Bruton, Henry J. “A Reconsideration of Import Substitution.” *Journal of Economic Literature* 36, no. 2 (1998): 903–936.

Bulmer-Thomas, Victor. *The Economic History of Latin America since Independence.* Cambridge: Cambridge University Press, 2014.

Cantor, Richard, and Frank Packer. “Determinants and Impact of Sovereign Credit Ratings.” *FRBNY Economic Policy Review*, October 1996.

Capraro, Santiago, and Ignacio Perrotini. “Revisiting Latin America's Debt Crisis: Some Lessons for the Periphery of the Eurozone.” *Cambridge Journal of Economics* 37, no. 3, Special Issue (May 2013): 627–651.

Central Intelligence Agency. *Mexico: Debt and Political Stability.* December 1985. Accessed April 6, 2025. https://www.cia.gov/readingroom/docs/CIA-RDP88T00768R000300300001-0.pdf

Cerny, Philip. “Globalization and the Changing Logic of Collective Action.” *International Organization* 49, no. 4 (1995): 595–626.

Chien, F., K. Y. Chau, T. M. Aldeehani, et al. “Does External Debt as a New Determinant of Fiscal Policy Influence Sustainable Economic Growth: Implications After COVID-19.”

*Economic Change and Restructuring* 55 2022: 1717–1737. https://doi.org/10.1007/s10644-021-09365-1.

Cohen, Michael. "Austerity and the Global Crisis: Lessons from Latin America." *Social Research: An International Quarterly* 80, no. 3 (Fall 2013): 929–952. https://doi.org/10.1353/sor.2013.0073.

De Boef, Suzanna L., and Luke Keele. "Taking Time Seriously." *American Journal of Political Science* 51, no. 1 (2008): 184–200.

De Bolle, Monica. "Latin America's Unstable Politics Dim Hopes for Economic Growth." Peterson Institute for International Economics (PIIE), June 29, 2022. https://www.piie.com/blogs/realtime-economics/2022/latin-americas-unstable-politics-dim-hopes-economic-growth

Dinç, Serdar. "Politicians and Banks: Political Influences on Government-Owned Banks in Emerging Markets." *Journal of Financial Economics* 77 (2005): 453–79.

Dovis, Alessandro, Mikhail Golosov, and Ali Shourideh. *Political Economy of Sovereign Debt: A Theory of Cycles of Populism and Austerity.* NBER Working Paper No. 21948, January 2016. https://www.nber.org/papers/w21948.

Doyle, Kate, ed. "Prelude to Disaster: José López Portillo and the Crash of 1976." *National Security Archive Electronic Briefing Book No. 115.* Washington, D.C.: National Security Archive, March 14, 2004. Accessed April 6, 2025. https://nsarchive2.gwu.edu/NSAEBB/NSAEBB115/index2.htm.

Drelichman, Mauricio, and Hans-Joachim Voth. "Lending to the Borrower from Hell: Debt and Default in the Age of Philip II, 1556–1598." First draft, December 2007; revised December 2008.

Eaton, Jonathan, and Mark Gersovitz. “Debt with Potential Repudiation: Theoretical and Empirical Analysis.” *The Review of Economic Studies* 48, no. 2 (April 1981): 289–309. https://doi.org/10.2307/2296886.

Eichengreen, Barry. “Historical Research on International Lending and Debt.” *Journal of Economic Perspectives* 5, no. 2 (1991): 149–169.

Eichengreen, Barry, Ricardo Hausmann, and Ugo Panizza. “Yet It Endures: The Persistence of Original Sin.” *Open Economies Review* 34 (2023): 1–42. https://doi.org/10.1007/s11079-022-09704-3..\

Federal Reserve History. “Latin American Debt Crisis of the 1980s.” Accessed March 29, 2025. <https://www.federalreservehistory.org/essays/latin-american-debt-crisis>

Gavin, Michael. *The Mexican Oil Boom: 1977-1985*. Washington, D.C.: Inter-American Development Bank, 2010. https://doi.org/10.18235/0011582.

Gately, Dermot, Morris Adelman, and James Griffin. “Lessons from the 1986 Oil Price Collapse.” *Brookings Papers on Economic Activity*, no. 2 (1986): 237–284.

Geiger, Linwood T. “Debt and Economic Development in Latin America.” *The Journal of Developing Areas* 24, no. 2 (1990): 181–94.

Gonzalez-Garcia, Jesus R., and Francesco Grigoli. “State-Owned Banks and Fiscal Discipline.” *IMF Working Paper*No. 13/206 (October 2013). https://www.imf.org/external/pubs/ft/wp/2013/wp13206.pdf

Golub, Stephen S. "The Political Economy of the Latin American Debt Crisis." *Latin American Research Review* 26, no. 1 (1991): 175–215.

Guzman, Martin, Yanne Horas, Anahí Wiedenbrüg, and Maia Colodenco. “The Relationship between Sovereign Debt and Politics.” *Social Research: An International Quarterly* 91, no. 3 (Fall 2024): 913–938. https://doi.org/10.1353/sor.2024.a938582.

Han, Bada. “Original Sin Dissipation and Currency Exposures in Emerging Markets.” *Open Economies Review* 36 (2025): 281–327. Published April 19, 2024. https://doi.org/10.1007/s11079-024-09758-5.

Iacoviello, Matteo, and Raoul Minetti. “International Business Cycles with Domestic and Foreign Lenders.” *Journal of Monetary Economics* 53, no. 8 (2006): 2267–2282. doi:10.1016/j.jmoneco.2005.07.024

International Monetary Fund. “Nicaragua: Recent Economic Developments and Statistical Annex.” IMF Staff Country Report No. 1999/124, November 1999. Accessed April 27, 2025. https://www.imf.org/en/Publications/CR/Issues/2016/12/30/Nicaragua-Recent-Economic-Developments-and-Statistical-Annex-3271

Inter-American Development Bank. *December 2022 Latin America and the Caribbean Standardized Public Debt Database.* Accessed April 5, 2025. https://mydata.iadb.org/dataset/december-2022-latin-america-and-the-caribbean-standardized-public-debt-database.

Izquierdo, Alejandro, Carola Pessino, and Guillermo Vuletin, eds. *Better Spending for Better Lives: How Latin America and the Caribbean Can Do More with Less*. Development in the Americas. Washington, D.C.: Inter-American Development Bank, 2018.

Kaplan, Stephen B., and Kaj Thomsson. “The Political Economy of Sovereign Debt.” *The Journal of Politics* 79, no. 2 (April 2017): 605–623.

Keele, Luke, and Nathan J. Kelly. “Dynamic Models for Dynamic Theories: The Ins and Outs of Lagged Dependent Variables.” *Political Analysis* 14, no. 2 (2006): 186–205.

Kose, M. Ayhan, Sergio Kurlat, Franziska Ohnsorge, and Naotaka Sugawara. "A Cross-Country Database of Fiscal Space." *Journal of International Money and Finance* 128 (November 2022): 102682. https://www.sciencedirect.com/science/article/pii/S0261560622000857?via%3Dihub.

Mora-Silva, Demmy, María Belén Bravo, María José Sánchez, Renata Álvarez-Barba, and Carlos Mestanza Ramón. “The Oil Industry in Ecuador: History, Current Situation and Challenges.” *Green World Journal* 6, no. 3 (2023): 097. https://doi.org/10.53313/gwj63097

Ocampo, José Antonio. “Collapse and (Incomplete) Stabilization of the Nicaraguan Economy.” In *The Macroeconomics of Populism in Latin America*, edited by Rudiger Dornbusch and Sebastian Edwards, 331–368. Chicago: University of Chicago Press, January 1991. Accessed April 6, 2025. http://www.nber.org/chapters/c8304.

Ocampo, José Antonio. *The History and Challenges of Latin American Development.* Santiago: Economic Commission for Latin America and the Caribbean (ECLAC), 2013.

Ocampo, José Antonio. *The Latin American Debt Crisis in Historical Perspective.* New York: Initiative for Policy Dialogue, Columbia University, 2024.

Ristanovic, Anja. “Major Oil Market Crashes in History.” *Oil & Energy Online.* Accessed March 29, 2025. <https://oilandenergyonline.com/articles/all/major-oil-market-crashes-history/>

Sachs, Jeffrey D., and Andrew M. Warner. “The Curse of Natural Resources.” *European Economic Review* 45, no. 4 (2001): 827–838.

Salvucci, Richard. “Export-Led Industrialization.” In *The Cambridge Economic History of Latin America*, edited by Victor Bulmer-Thomas, John Coatsworth, and Roberto Cortes-Conde, 249–292. Cambridge: Cambridge University Press, 2006.

Shome, Parthasarathi. “Taxation in Latin America: Structural Trends and Impact of Administration.” International Monetary Fund Working Paper No. 99/19, February 1, 1999.

Smith, Stephen. *Case Studies in Economic Development.* 2nd ed. Upper Saddle River, NJ: Prentice Hall, 1996. ISBN 9780201421880.

Tomz, Michael. 2007. *Reputation and International Cooperation: Sovereign Debt Across Three Centuries*. Princeton, NJ: Princeton University Press.

VanderWeele, Tyler J., and Mirjam J. Knol. “A Tutorial on Interaction.” *Epidemiologic Methods* 3, no. 1 (2014): 33–72. https://doi.org/10.1515/em-2013-0005.

Williams, Philip. *Latin American Debt Crisis of the 1980s.* Accessed March 29, 2025. <https://philipwilliamsauthor.com/wp-content/uploads/2019/02/Latin-American-Debt-Crisis-of-the-1980s.pdf>

World Bank(a). *IMF World Dataset.* Prosperity Data 360. Accessed April 5, 2025. https://prosperitydata360.worldbank.org/en/dataset/IMF+WoRLD

World Bank(b). *Sovereign Rating Indicator.* Prosperity Data 360. Accessed April 5, 2025. https://prosperitydata360.worldbank.org/en/indicator/WB+CCDFS+sovrate.