

## The Politics of International Monetary and Financial Relations

(Generals Study Notes, Spring 2001, from Government 2720)

- What is *political economy*? (Alesina 1994) An approach that takes into account the “institutional constraints and rigidities in which policymaking occurs by emphasizing the role of distributive conflicts, ideological and opportunistic incentives of the politicians, and other factors.” By incorporating political variables into analysis, economic policy decisions that were seemingly irrational can be interpreted as the “rational outcome” of a “political-economic equilibrium.”

### I. Historical Overview: Middle Ages – 19<sup>th</sup> Century High Finance

- *Medieval banking*
  - Italian bankers in medieval England – were agents of transfer (loans, credit) in European-wide system of international trade and finance. The bankers played a key role in the economy by channeling royal funds into the most productive sector of the economy (took profits from loans and bought wool).
  - Repudiation and Confiscation by Medieval State: Why did lenders lend to kings, if confiscation and repudiation were likely?
    - Self-enforcing agreements: ensuring that benefits of the ongoing king-lender relationship were greater for the monarch than a one-time defection. Threat of lender boycott made this possible.
    - Also, self-enforcing agmts among the lenders to sustain a boycott → hierarchy of self-enforcing agreements, then, needed.
    - Collective confiscation only works when king has other sources of funding.
    - Individuals had no choice but to lend → refusal meant immediate confiscation, while lending meant only possible confiscation.
    - POINT: cooperation among individual citizens may be best protection against state’s ever-present incentive to renege on agreements and infringe property rights.
- *Property rights, credible commitments, and economic growth* – for economic growth to be achieved, the sovereign must make a credible commitment to property/investment rights, else no one will invest. The sovereign can do this in two ways: 1) responsible behavior (rare, see above); 2) constraining rules.
  - In 17<sup>th</sup> century England, the Glorious Revolution resulted in strengthening of Parliament and creation of an independent judiciary → these institutions/constraints on sovereign power were designed to prevent arbitrary/confiscatory behavior by the crown. So, reputation/iterated interaction insufficient to prevent sovereign renegeing → need political institutions.
  - Result of this greater protection of property rights → rise of private capital markets, investment, growth. Also, by increasing the credibility of its commitments, the Crown gained access to capital at lower interest rates.
- *19<sup>th</sup>-century high finance*
  - Why did capital markets work so well pre-1914, but break down in the interwar years?
    - In 1870-1914, UK was at center of financial system → focus on development finance deeply concerned with global financial stability for its trade and empire; by embracing free trade, the UK offered LDCs markets, thereby facilitating debt service.
    - During interwar era, US was at center of system → US protectionism led to debtors’ defaults and collapse of global financial markets.
  - Interest groups, political institutions, and financial integration pre-1914: Verdier argues that internationalization was a *political* choice by coalitions of domestic interests on which govts depended for support. Domestic institutions determined which coalitions were dominant.
    - Banks and savers in creditor states, large firms in debtor states favored openness.
    - Agriculture and smaller firms preferred capital controls.
    - More centralized states enabled pro-openness coalitions to win, while decentralized states enabled losers from capital market integration to more effectively oppose it. Thus, capital market centralization/openness was a function of political centralization.

- **Key point:** Surge in global finance was/is not inevitable/exogenous → rather, domestic political institutions determine whether or not governments can ignore anti-internationalization forces. Financial liberalization, then, is just as politicized as trade.
- *Gold Standard as ‘Good Housekeeping Seal of Approval’* – Bordo/Rockoff see adherence to GS as signal to financial markets that gained peripheral countries access to capital from the ‘core’ of Western Europe. Countries with poor records of adherence were charged more for capital → explains efforts to stay on gold by some capital-importing countries, even when it would have seemed economically in their interests to ‘defect’.
  - GS as ‘contingent rule’ with escape clauses (war, crisis, terms of trade shock) → certain reasons seen as valid for ‘temporary departure.’
  - Adherence to GS as signal overcoming *asymmetric information* problem → signaled to lenders that borrowers were willing to incur costs to avoid default.
  - Also, GS adherence overcame *time-inconsistency problem* → incentive to create surprise inflation and default.
  - Key question for today: is pegging/currency board an equivalent attempt by developing countries to get a ‘GH seal’? Is this as credible or durable?
- *Origins of the Federal Reserve* – Broz argues that it was a joint products model → banks overcame collective action problem of providing public good (monetary stability) because without it they could not reap the profits of the private good (profits from \$ as international currency). Internationalizing the dollar (bringing ‘denomination rents’ to large banks) required broader, more stable, more resilient, deeper US financial markets → this required the Federal Reserve system.
  - Extent of free-riding is inversely proportional to proportion of private benefits available.
  - So, three conditions for JP: 1) public good exists; 2) private good available as incentive to select members to participate in collective provision of the PG; 3) public and private goods cannot be disaggregated.
  - **Broader point:** ability to be a ‘world banker’ depends crucially on domestic institutions and policy choices.

## II. Historical Overview: Classical Gold Standard – Interwar Years

- *Globalizing Capital* (Eichengreen)
  - Four eras of global capital markets:
    - Pre-WWI: no capital controls → high capital flows
    - Interwar: collapse of the global financial system → capital controls and decreased flows
    - 1945-1971: relaxation of controls and recovery of flows
    - 1970s-present: high capital mobility
  - This U-shaped pattern undermines conventional explanation (rising capital mobility) for post-Bretton Woods shift from fixed to floating ERs. Rather, Eichengreen argues that, prior to WWI, policymakers were insulated from domestic pressures to tradeoff ER stability for other goals.
    - Several factors undermined this ‘classical liberalism’ (rise of unions, welfare state, extension of suffrage, labor parties) → result was ‘embedded liberalism’ during the BW era and willingness to sacrifice ER stability for other goals.
  - Bretton Woods era: capital controls substituted for pre-WWI limits on democracy → limited attacks on ER pegs and freed governments to pursue other goals.
  - Post-Bretton Woods: rising capital mobility AND no limits on democracy → pegs unsustainable (move either to floating or monetary integration → see Wyplosz below).
  - **Key point:** Path dependency and interdependence have played key roles in history of the IMS
- *Classical gold standard – mechanics*
  - Price-specie flow model (Hume): trade deficit → gold outflow → less money in circulation → prices fall domestically → more money abroad → prices rise abroad (specie flow produces change in relative prices)
    - This relative price shift made imports more expensive at home → imports fall/exports rise → deficit country’s BOP equilibrates.

- Limits of Hume: didn't account for international capital flows.
  - Adding capital markets to the model: adjustment took place not by relative price shifts, but by flows and interest rate differentials.
    - BOP deficit → raise interest rates → domestic securities prices rise → capital flows to (trade/gold) deficit country → interest rates and securities prices balance.
    - So, capital flows compensate for trade imbalances...no actual international transfers of gold.
  
- *The 'Rules of the game'* (Simmons) – accepted rules of national monetary policy under the GS
  - States had to give BOP priority over domestic economic conditions
  - States had to maintain reasonably open trade for GS adjustment mechanism to work
  - Exceptional finance had to be provided by central banks or private banking groups in surplus states if fixed ERs were to be maintained.
  
- *Interwar years* – Why did we see fluctuation during interwar years between cooperation (1925-31 gold exchange standard with US/UK/France; 1936-9 managed franc/pound devaluations) but competitive devaluations and bilateralism from 1931-6?
  - Oye – environmental factors (macroeconomic conditions, security concerns, changes in economic beliefs) changed the 'context' in which states made international monetary policy → changing context altered the prospects for cooperation ('under anarchy').
    - Ex: Great Depression led to view of short-term tradeoff between ER stability and domestic recovery → incentive to unilateral 'defection' → FDR saw departure from gold in 1933 as only way for US to recover domestically.
    - Bilateralism as response to inability of Great Powers to cooperate economically (sterling bloc, mark system)
    - Rise of Hitler led US and UK to desire rapid French recovery → willing to tolerate French devaluations in latter 1930s without retaliation.
  - Inherent problem of all systems (gold exchange, BW) that use payments deficits as a source of international liquidity: requires significant/intensive cooperation → if govts and private actors do not accept that reserve currency will maintain its par value, the 'currency holders' dilemma' threatens to lead to fluctuation/depreciation of the reserve currency.
  
- *Who Adjusts?* (Simmons)
  - Why did some countries adhere to the 'rules of the game' during the IW years, while others chose to adjust BOP deficits by devaluing and erecting trade barriers?
    - Simmons argument is that **differing domestic incentives/constraints** explain this variation → general argument for the role of domestic politics/interests in shaping international economy policy outcomes: "clear relationship between states' willingness to play by the international economy 'rules of the game' and patterns of domestic politics."
    - **Key point:** systemic (i.e., hegemonic) explanations are insufficient without also considering domestic-level factors.
  - Prior to WWI, political and social conditions limited domestic pressures on policymakers → made commitment to GS credible → rise of the 'politics of inclusion' (see Eichengreen above) rendered the unquestionable primacy of external balance/currency stability over domestic economic conditions unsustainable. Also, prewar era was characterized by expectations of cooperation to finance BOP deficits → this was gone during the interwar years (see Oye above).
  - So...during the interwar years:
    - Who abided? Countries with: small trade dependent economies, stable governments, quiescent labor movements, conservative parties in power (but chose trade protectionism), independent central banks.
    - Who adjusted? Countries with: large economies, unstable governments, strong labor unions and left parties in power, politicized central banks. These factors undermined the credibility of states commitment to the GS → both ability and willingness to maintain parity in the face of strong domestic pressure for adjustment led to capital flight and devaluation.

- *Domestic politics, the IMS, and specialization of tasks* – International monetary regimes (common sets of rules/conventions requiring a certain degree of macroeconomic policy coordination) have existed despite vast differences in the domestic constraints confronting policymakers. Thus, while most IPE theorists see the IMS as a ‘public good’ creating joint welfare gains for like-minded states, Broz argues that what really needs explaining is why IMS’s ever come about, given the diversity of state interests/domestic situations.
  - HST, functional regime theory, ‘dynamic effects’ arguments all treat states as like-minded.
  - Broz questions this assumption, arguing instead that participants in an IMS can have different/conflicting preferences, so long as the system allows a **specialization of tasks** among members of the system.
    - National governments pursue intl monetary policies for domestic political reasons, based on coalitions/interests ‘at home.’ → basically, joint products applied to the IMS (states willing to assume costs of ‘public good’ of intl monetary stability if it serves their ‘private good’ of domestic political advantage).
    - This effectively makes intl monetary stability a positive externality of self-interested state behavior.
  - Division of labor during the GS:
    - UK: stable international currency – to ensure trade, for strategic reasons (empire), and to satisfy domestic coalition (City, exporters, landowners).
    - France: LOLR and BOP financing – interest in macroeconomic stability → maintained large gold reserves to cushion against potential attacks on gold convertibility (aided other countries in crisis, so they would not adversely affect the French economy via spillover) → lack of landed aristocracy/exporters, strength of small farmers led policymakers to value domestic situation over ER stability.
    - Germany: Unlike UK, landed aristocracy had interests aligned with small farmers → focus on domestic stability → ‘conditional GS’ and joined France in LOLR role.
  - Upshot: homogeneous intl economic preferences not necessary for intl monetary stability → challenge to previous theories of the IMS that see it all as cooperation for mutual gains rooted in common interests.
    - Heterogeneous preferences may be negative (BW/EMS crises), but may be vital to intl monetary stability → need to specify further when good, when bad for the IMS.

### III. Historical Overview: The Post-War Era

*Managing the World Economy Under the Bretton Woods System: An Overview* (Eichengreen & Kenen)

Postwar institutional arrangements successful because they effectively combined rigidity (solving commitment/coordination problems, preventing opportunistic behavior and coordinating the transition to current-account convertibility and trade liberalization) and flexibility (coping with events and mistakes, adapting institutions to new problems)

- Four reasons why: 1) US willingness/ability to make side payments/sanctions; 2) small # of countries and economic/political similarity facilitated coordination; 3) closed nature of domestic economies freed govts to pursue domestic policy goals, e.g., full employment, but still comply with intl rules; 4) successful change mgmt by govts domestically (domestic settlements, e.g., welfare states and social democracy created domestic commits and side payments that locked in cooperative intl economic behavior)

Failure of BW instits to secure growth post-1970 as they had earlier? E&K argue that success of the postwar system gradually undermined the durability and adaptability of the system itself.

- As more countries joined, cleavages/negotiations became more difficult to manage
- Rising trade and capital mobility undermined 3) and 4) above → countries faced tradeoffs between domestic goals and international economic compliance

Why did US take steps to est intl economic order in 1940 but not in 1920s?

- Lessons of past
- More domestic economic interests with intl focus
- Geopolitical reasons

- Ideas: Keynesian stabilization policies and social welfare goals key (“embedded liberalism” → commitment to full employment facilitated domestic coalition building by muting capital/labor tension and enabling govts to pursue intl economic policies)

US vs. UK – differing agendas

- 1) US: sought to avoid problems of 1920s (ER instability, trade protectionism) → favored fixed ERs, trade nondiscrimination
- 2) UK: sought to avoid problems of 1930s (high unemployment, collapse of intl fin system) → favored adjustable ERs and trade controls to pursue full employment, tariff prefs to protect Commonwealth trade interests

Consensus reached on monetary system, but not on trade → hence, ITO failed, but BW did embed a common set of normative goals in the system (see above); Lack of developing world at the conference was key reason why BW failed to deal effectively with N/S issues

Early BW: EPU, Marshall Plan, etc. → adapting system to persistent problems, temporary bypassing of BW institutions

Late 1950s - 1970: US into persistent BOP deficit → ad hoc measures in 1960s to finance it (gold pool, etc.) → rising calls for protectionism in US, rising conflict between domestic economic goals and intl economic system → BW institutions (GATT, ER mechanism) ill-suited for adaptation to US declining economic hegemony, rise of Japan, rising trade and capital mobility)

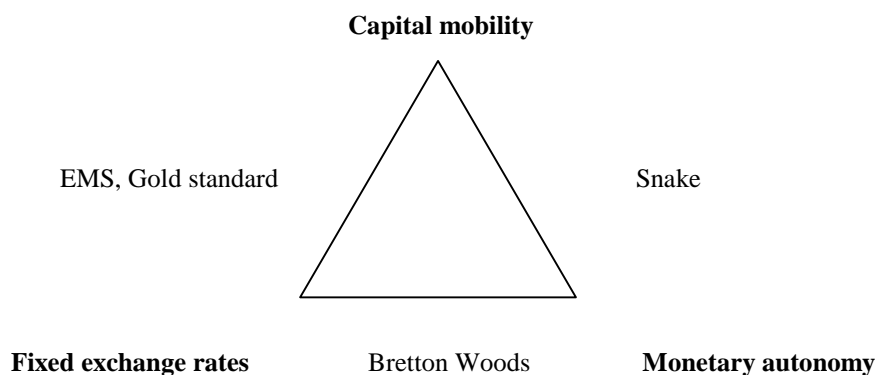
#### IV. International finance and interstate politics

- Kennedy: Interrelationship between economics and strategy – British economic dominance depended on peace to facilitate trade and international finance, but British hegemony required willingness and ability to go to war → contradiction. Appeasement strategically disastrous, but war economically disastrous in 1930s.
- Dual questions: 1) How do international economic interests affect security policy? 2) How do military capabilities/diplomacy affect the security of foreign lending?
  - Lipson: In general, UK did not intervene militarily/diplomatically to protect its private sector overseas investors. Strategic interests could impact upon, but not fundamentally change, basic relationships between investors and the government. Cold War played some role (BW, Marshall Plan, Turkey), but “de-linkage” of finance and security issues is the hallmark of the postwar era.
    - Bank lending today vs. bond lending earlier → main reason for more US intervention.
- Broz: joint products as model for emergence of CBs → need to finance wars as key factor leading to governments’ willingness to tie its hands on property rights/debt repayment. Probable reason for democracies’ edge in war is better access to finance due to credible commitment to repay (induces lenders to overcome free rider problem and fear of government renegeing).
  - Schultz and Weingast see this as the reason why democracies win wars more often: can outspend authoritarian states, since respect for property rights fuels economic growth and access to finance.

#### V. Contemporary International Banking

- Why multinational banking? One reason is defensive, fueled by FDI. Another is to cater to overseas nationals, or to provide foreign locals with specialized services. Or, MNBs may avoid domestic regulations (e.g., foreign banks not subject to Glass-Steagall) so have comparative advantage. But, this can cause externalities and inflation (increased liquidity).
- Capital mobility – Why the rapid increase? Political and economic consequences?

- Driven by globalization of production and finance → utility of national capital controls declined as ease of evasion by private sector actors rose. But, different pace of removal depended on whether increase was in inflows (earlier, Germany/Japan) or outflows (later, France/Italy).
  - Mundell-Fleming (cap mobility, monetary autonomy, fixed ERs) → with capital mobility, monetary policy (interest rates) doesn't affect aggregate demand, since capital mobility drives rates back to world level.
  - In early postwar period, governments used CCs to maximize policy autonomy while still benefiting from interdependence. But, rising mobility and evasion possibilities rendered this strategy unsustainable and increasingly costly.
- Causes of capital mobility?
    - Liberal model: technology/competition driven → limit is no room for politics.
    - Realist model: emphasizes role of government, particularly US hegemony → limit is seeming assertion that rollback is easy and unclear motivations for state behavior.
    - Pluralist model: domestic politics/lobbying.
    - Cognitive model: epistemic communities.
    - NEED SYNTHESIS OF THE FOUR, COHEN SAYS ("Dynamic Linkages")
- Consequences of capital mobility?
    - Macro level: what can states do? M-F again → integration has increased the costs of pursuing divergent monetary objectives. But, limited scope for govt policy does exist.
    - Micro level: who wins and loses? Investor interests (mobile) benefit, but not absolute. Need to move beyond categorical answers to understand how and under what conditions things matter.
- Why have developing countries, which could most benefit from CCs, liberalized since 1985? Haggard/Maxfield answer that, while governments/sectors favor controls to limit the effects of economic interdependence/BOP crises, need to maintain credibility with foreign investors to prevent massive capital flight leads to liberalization.
- Financial crises
    - Mishkin argues that asymmetric information leads to adverse selection/moral hazard. So, banking sector is vital to resolving informational asymmetries and preventing crises. Developing countries need to ensure a strong bank/regulatory system and government safety net to prevent crises. Financial liberalization without these prerequisites is recipe for disaster.
    - Chang argues against "bad macro policy" explanation for Asian crisis in favor of 'financial panic' view (maturity mismatch between assets and liabilities). Plays into debate on implications of crises for future policy. Bad policy supporters say LOLR is waste of good money after bad, but financial panic argument suggests LOLR could prevent financial crises. Bad policy arguers fail to specify why countries follow such policies and fails to specify when/where crises will occur empirically (since lots of countries have bad policy but not crisis).
- Kapstein: consensual knowledge, market forces, and state power interacted in formation of Basle Accords.
- International financial architecture: 2 key questions for any country: 1) how rapid should capital controls be removed? 2) how flexible should ERs be? Upshot for Frankel is that no single regime is right for all countries, and that certain inflow controls may be appropriate for some countries. Tradeoffs inherent in any side of the M-F "impossible trinity."



## VI. Sovereign lending in theory

- *Characteristics of international credit markets*
  - Two key imperfections in all credit markets: 1) imperfect information; 2) credible commitments problem → worse internationally than domestically. These are *microeconomic risks*.
  - But also, two additional risks that are unique to international lending: default risk and macroeconomic crisis risk ('monetary spillovers'). These are *macroeconomic risks*.
    - Asymmetric information worse internationally → international lenders charge higher interest rates → adverse selection problem (only those who can't get cheaper credit domestically seek capital on global markets).
    - Enforcement also harder – international banking policy less developed (but, fewer banking regulations may also be cost advantage to global lenders)
  - But, then, why is there international lending at all?
    - Risk diversification, differences in efficiency of domestic markets, rise of technology/info minimizing the above problems. Also, returns should be higher than comparable domestic investment options (risk premium).
  
- *Risk and international lending* – intl credit transactions subject to risks created by sovereign immunity of debtors (see medieval England, above). Lack of 3P enforcement mean that agreements must be self-enforcing → indirect mechanisms are only option (i.e., 'turning off the tap' to future flows). Key factors concerning risk and sovereign lending:
  - Ability of debtors to default on external obligations implies that credit transactions are constrained by willingness to repay, NOT ability. Sovereign's ability to default w/o direct penalty impedes intl capital flows → major problem with lending is getting sovereign to voluntarily fulfill contractual obligations. Imperfect information coupled with indirect enforcement → creates moral hazard.
    - Default by borrowers may actually hurt lenders more → further constraint on lenders' ability to sanction borrowers.
    - Suspension of future access to credit may undermine sovereign's ability to repay existing debt → again, constraint on lenders' sanctioning ability.
    - Lending boycotts against defaulters not always credible, due to new entrants in the lending market.
    - For these reasons, ST debt predominates and debt rescheduling is often in the interests of all parties.
  - But, given lack of enforcement, why doesn't everyone default?
    - Threat of expropriation, trade sanctions, 'reputation effect' are indirect instruments, but they can be very effective.
  - On the other hand, if reputation is so important, who do ever see default (i.e., why not just reschedule)?
    - Asymmetric information problem often makes creditors take 'extra-hard' stance against borrowers, leading to untimely default.

- Motives for international borrowing:
  - Smoothing consumption over time
  - Financing capital accumulation
  - Consumption/investment adjustment after shocks
  - Medium of exchange for international transactions
  
- Policies to strengthen financial sector → goal is to reduce risk, thereby encouraging efficient and widespread financial activity to benefit the economy.
  - Deposit insurance
  - Reserve/capital requirements
  - Restrictions on riskiness of assets held by financial firms
  - Direct supervision
  - Lender of last resort facilities
  
- *Debt renegotiation* – strategic interaction between lenders and borrowers
  - Increasing cost of default may be to borrowers advantage → profit-maximizing banks may end up hurting profits too much by enforcing loans → lead to beneficial rescheduling for the borrower.
  
- *Political economy of international lending*
  - Intl banking system is a ‘club’ of developed countries whose members face collective action problems in sharing benefits/costs. All benefit by ‘the club’, since it raises costs of default to borrowers, but it also creates incentives among the lender countries to free ride.
  - Three challenges facing ‘the club’: 1) moral hazard; 2) adverse selection; 3) free riding.
    - Cohesiveness of club stronger if hegemon exists → US reaps lion’s share of benefits, but must also bear cost of being the LOLR.
    - Moral hazard – larger the borrower, the greater its ability/incentive to renegotiate with impunity (‘too big to fail’ applies both to large lenders, as well as large borrowers).
  
- *The IMF and international lending* – role of international institutions
  - *Moral hazard of IMF lending* – Vaubel argues that IMF lending creates strong moral hazard incentives. Basic argument is that IMF bureaucracy seeks to maximize its budget and staff, demanding more money to spend and larger powers (conditionality).
    - Rescheduling begets demands for further rescheduling/threats of default → moral hazard → incentive to remain insolvent in order to retain access to IMF credit exists, Vaubel argues, and IMF bureaucracy’s incentives (above) only exacerbate this problem.
    - Rejects arguments in favor of IMF lending:
      - Conditionality: IMF lending induces borrowers to adopt required adjustment policies → but, why don’t they have incentives already to do this?
      - Enforcement: IMF in better position to enforce repayment/conditionality → but, then, why not just act to enforce private/national lending to LDCs, rather than lending itself.
      - Bogeyman: IMF is ideal ‘bogeyman’ to take the blame for unpopular policy changes (national leaders can use it as scapegoat) → but, still not a justification for why the IMF itself is giving money.
      - Coherence: Commercial banks not suited to negotiate necessary policy changes with sovereign governments (individually rational bank behavior may be collectively suboptimal). Need IMF as coordinating agent → again, still not a justification for why the IMF itself is actually lending (why not just be the coordinator?).
      - Superior information: IMF has better information on borrower creditworthiness than private sector → probably, but why not disclose this private info to markets by acting as agent of borrowers to secure good terms with private lenders? Again, no reason for IMF itself to lend.
      - Capital market imperfections: Some borrowers may not have access to credit privately → Schmidt’s argument: countries can always put up adequate



- collateral to gain access to capital by taxing/selling assets (this seems his weakest rebuttal).
  - So, Vaubel concludes that there are no economically valid arguments for the IMF to lend. Further, IMF lending may actually be harmful, causing moral hazard problems.
- *IMF and developing countries* (Edwards 1989)
  - IMF as 'seal of approval' ensuring LDCs access to private capital by reassuring markets that country in question is making serious effort to improve things.
  - Widespread criticism of IMF:
    - Left-wing critics – IMF programs are too harsh, inefficient, promote poverty.
    - Conservative critics – this is new in 1980s/90s → IMF behavior during Latin American debt crisis shows it is acting as development agency rather than as a financial institution requiring necessary macroeconomic reforms → postponing needed reforms in LDCs and endangering IMF's own financial stability.
  - Edwards critically evaluates IMF's role in developing countries' adjustment process to assess these claims. Key questions:
    - What model does IMF use to generate its advice?
    - Does IMF advice help countries?
    - Is IMF policy driven by technical knowledge or political views of largest members/
  - Conclusions:
    - IMF played key role in debt crisis and has shown adaptability over time in some areas. It has not blindly applied the same policy package to every country, as critics argue. But, its basic economic model for program design is basically the same one used in the 1950s (Polak model).
    - IMF programs have worked, in a narrow sense: on avg, external situation of countries has improved, inflation has been lowered, but growth targets less successfully achieved. In a deeper sense, 'proving' IMF policy effectiveness is difficult → need better counterfactual analysis.
    - Low rate of compliance with conditions during debt crisis suggests that IMF conditionality may not have been fully adequate to deal with the debt crisis.
    - Evidence that recent programs have been approved under political pressure of large members and over the objections of IMF staff.
    - Edwards provides initial evidence that, contrary to liberal critics of the IMF (who argue that its programs hurt income distribution/unemployment), no significant impact on labor's share of national income is evident.

## VII. Sovereign lending in practice

- *Spain under Philip II* – Genoese lenders linked specie deliveries from Spain to Low Countries to lending → use of indirect incentives to enforce their loans. King tried to renege, but penalties ultimately worked.
- *American state debts in 1840s* – Why did states repay foreign debts, even if they could not be sanctioned in courts and 'international tools' (trade/military sanctions) were not available because states were part of a larger economy/political entity? Reputational constraints.
- *Debt and default in the 1930s* – Why did states default in interwar era? Level of debt, magnitude of TOFT shocks during Great Depression, monetary and fiscal policies (budget deficits).
- *Privatization of debt financing and the debt crises* – bankers' dilemmas and international institutions
  - In 1970s, major shift from FDI to commercial loans as main LDC source of financing → linked to rise of Eurocurrency markets ('offshore banks').

- These debts were denominated in floating currencies (e.g., \$) → oil shocks rapidly depreciated currencies, increasing interest obligations relative to export earnings → debt crises.
- Role of IMF magnified → borrowers can't afford additional capital and lenders don't want to lend more → role for IMF as broker/conditionality.
- Lipson: need to focus on strategic interaction between borrowers, lenders, and IMF.
  - Private cooperation among commercial banks central to international debt management in 1980s.
  - But, bankers don't all have common interests, given different ties to borrowers → so, why do they cooperate?
    - Debt rescheduling: large banks negotiate terms, then seek to convince small banks to approve the deal.
      - Large bank cooperate because they know that sovereign default would be disastrous and they can't walk away (stakes + repeated game = resolution of the 'bankers' dilemma').
      - But, small banks have less at stake and fewer long-term ties to borrowers → incentive to 'defect' from agreements negotiated by large bank cartels → large banks threaten sanctions against small banks, because they fear a 'domino effect' of defection.
    - Problems of private cooperation: high transactions costs, difficult to mobilize responses quickly, incentives to defect.
      - National government pressure is not an effective substitute for private bank pressure (e.g., US Fed only has domestic jurisdiction, so it can't effectively put pressure on foreign small banks not to defect).
    - So...IMF has had an increasingly visible role in debt crises:
      - Overcoming coordination problems of private bankers
      - Gathering data necessary to resolving the 'bankers' dilemma'
      - 1982 – IMF forced private lending to increase chances of rescheduling being successful.
  - Upshot: despite problems, private cooperation has been remarkably effective.
- *Latin American debt crisis in 1980s*
  - Diaz-Alejandro: Policy incompetence alone can't explain the entire Latin American debt crisis.
    - In 1980-1, LA states faced need for adjustment (overvalued ERs, brittle financial systems, lax budgets), but conditions did not foreshadow a major crisis. 1979-1982 external shocks were the main reason for the crisis. This is clear, since countries with widely varying economic situations all found themselves in crisis (see Roberto Chang, below, on Asian crisis).
    - The real cause of the LA debt crisis was the confluence of domestic policies and external shocks (sharp decline in commodity export prices, collapse of LA and OPEC as export markets for LA countries) → 'not in Kansas anymore' (i.e., not the old story of bad policy causing crises).
  - Krugman: Assessing DA's argument leads to three questions about the debt crisis:
    - How did we get here? Was mismanagement by debtor countries the cause, or an adverse shift in their environment? K says 'what does it matter?'
      - What's really important is the *moral hazard* issue: if bad policy was the cause, bailouts create incentives for further irresponsible behavior; if 'act of G-d' was the cause, this is not a concern (again see Chang, below, on Asian crisis).
      - Also, treating sharp cutback of lending to LA debtors in 1982-3 as completely exogenous is problematic → domestic factors must have played a role.
      - But, upshot is that DA is right → irresponsible behavior alone did not bring on the crisis, so moral hazard concerns are unfounded.
    - How are we doing? Need to focus on move of LDC trade balances into large surplus. This is encouraging, but it's occurring at expense of investment, which will cripple future growth prospects.

- Where do we go from here? What should be debt strategy of lenders? K and DA largely say that, while continued lending during a debt crisis is unprofitable for individual lenders (risks of future nonpayment), it is in collective interest of creditors to avert immediate default...this can be used to justify both involuntary lending by existing creditors and official lending...basically, this is exactly what banks do with farmers in trouble...so, we're 'still in Kansas' after all.
  - Sachs: DA underestimates the domestic explanation, which plays a key role in explaining why the crisis occurred in LA but not elsewhere in the 1980s → policy adjustments (e.g., devaluation) to stem capital flight could have mitigated the crisis, i.e., it wasn't all exogenous 'acts of G-d.'

### VIII. International monetary systems in theory

- Madison: Value of money regulated by quantity → if quantities are fixed, prices will increase/decrease directly in proportion to changes in the money supply. Madison rejects this common view, arguing instead that the value of money depends on the credit of the state issuing it (or the specie/money ratio).
- WM Corden: the current intl monetary system is a "non-system" in that it emerged unplanned post-Bretton Woods. Still, it has a logic of intl laissez-faire in which govts are free to intervene (not really a system of freely floating ERs, since this would mean that monetary policy has no ER or current-account objectives, which is false).
  - Why do states intervene in forex markets?
    - Smoothing – short-med term fluctuations
    - ER protection – "leaning against the wind"
    - Maintaining quantitative targets – reserve levels or current accounts
- *HST and the intl monetary system* – Eichengreen. Intl monetary stability is a public good, with all the underproduction problems that entails, since it involves govts adhering to common rules that may diverge from their domestic preferences. The BW system is seen in this light, with the US assuming the costs of ensuring the monetary system's stability (similarly, UK pre-1914), while the interwar years are seen as the UK's inability to act as hegemon and the US' unwillingness.
  - Two variants: carrot (benevolent, side payments) and stick (coercive, sanctions).
  - PROBLEMS: 1) ambiguity about meaning of hegemony; 2) ambiguity about how hegemon asserts its influence (carrot or stick?); 3) ambiguity about the scope of HSTs of the IMS (creation, maintenance, decline?).
  - Eichengreen's question: was the market power possessed by the US/UK in the 3 periods 'causally connected' to the stability of the IMS?
    - Limitations of HST seen in failure to explain evolution over time of the IMS
    - Hegemon's willingness to act for stability tends to undermine its ability to continue to do so over time (see IPE summaries).
    - CREATION of IMS: Despite UK hegemony, Fr/Germ acted somewhat independently pre-1914; similarly, UK played key role in BW despite US hegemony.
    - OPERATION of IMS: With regard to adjustment, liquidity, and LOLR functions, HST is limited in explaining the 3 periods.
  - HST explains much of classical gold standard and early BW, but IMS has always been "after hegemony" in that more than hegemony was needed to ensure stability in the IMS.
- *International currencies* – 6 roles:

	<b>Private</b>	<b>Official</b>
<b>Medium of exchange</b>	Vehicle	Intervention (CBs)
<b>Unit of account</b>	Invoice	Peg (ER par values)
<b>Store of value</b>	Banking	Reserve

- *Evolution of ER Regimes* – how to explain? Eichengreen offers **6 hyps for SHIFT from fixed to flexible ERs**:

1. *HST* → but, are fixed ERs a public good? Also, see above for skepticism about HST's use here (stable IMS may not = fixed ERs).
2. *Cooperation/collective mgmt* → BW/EMS. But, unclear where line is between cooperation and leadership.
3. *Intellectual consensus* → among policymakers (lack of this key in interwar years between Fr/UK; agmt on models key for est. of BW).
4. *Stability of the macroeconomy* → larger shocks, harder to keep fixed rates. But, empirical data don't support this.
5. *Fiscal policy and monetary rules* → fixed rate regimes as anti-inflationary rule/commitment mechanism. Shifts from fixed to flexible reflect chgs in balance of costs/benefits of adhering to such a rule. But, why not directly commit to stable prices, rather than indirect mechanism of the ER?
6. *Distributional politics* → changing balance of political power between interest groups (Frieden). Brings in domestic politics, but is it possible to identify *effect* of IG pressure?

*Conclusion*: Goal is to gauge relative explanatory power of the hyps vs empirical evidence. Any one is insufficient, so need to blend approaches with goal of explaining how evolution of regime alters costs/benefits and leads to a shift to a new regime (*endogenizing* costs/benefits and choice).

- *Theories of monetary integration* (Tavlas) → SEE KRUGMAN BELOW FOR REALLY CLEAR ARTICLE ON COSTS/BENEFITS OF FIXED VS. FLEXIBLE ERs.
  - Early debate on fixed vs. flexible (Friedman, 1953): countries with price/wage rigidities should adopt flexible rates to maintain internal/external balance. From this, general perception in favor of flexible ERs arose.
  - Mundell, however, introduced OCA criteria: geographic domain most closely achieving internal (low inflation and unemp.) and external balance (BOP) under a single currency/fixed ERs is an OCA. Range of OCA criteria emerged in the lit:
    - Factor mobility key – less need to adjust ERs to correct BOP imbalances.
    - High degree of financial integration – cushioning imbalances.
    - Openness – ER changes bad since they can affect competitiveness.
    - Similar production structures – so TOT shocks affect symmetrically.
 Problems with OCA criteria: attributes don't all point in one direction, and can be inconclusive.
  - Alternative approach: costs and benefits of fixed vs. floating ERs. Focus on cost of sacrificing ER as adjustment tool.
  - Next-generation models now focus on effects of disturbances (related to OCA) and reputational considerations (tying hands).
- Determinants of choice of an ER regime (related to above): What are the implications of choosing fixed vs. floating?
  - Greater real exchange rate variability with floating (since nominal rates move, but prices are sticky).
  - Two key questions: 1) which system provides most efficient allocation of resources; 2) which system best protects the domestic economy from shocks?

*Economic Characteristics Associated with ER Regimes* (see Frieden for political)

<b>Peggers</b>	<b>Floater</b>
Small country	Large country
Open economy	Closed economy
Low capital mobility	High capital mobility
Low inflation differential	High inflation differential
Concentrated trade	Diversified trade
Product concentration	Product diversification
Large domestic monetary shocks	Small domestic monetary shocks
Small foreign price shocks	Large foreign price shocks

- Endogeneity of the OCA criteria (Frankel and Rose): Trade and business cycle correlation are OCA criteria, but they are endogenous (i.e., they themselves are affected by the ER regime choice). Thus, increased European trade liberalization is expected to lead toward a synchronization of business cycles across member-states.
  - This is an application of the Lucas Critique. The authors are arguing that using historical trade and business cycle data to judge the appropriateness of the EU as an OCA is endogenous, since the structure of the member-states economies are likely to change as a result of EMU.

## IX. International monetary systems in practice

- Bordo asks “Which IMS is best for economic performance?” Fixed, fixed-but-adjustable, or floating (i.e., gold standard, BW, or post-BW)? Why have some monetary systems been more successful than others? Key issues affecting choice/success:
  1. Welfare: Key advantage of fixed is reduced transaction costs of exchange. Key cost is that, in a world of wage/price stickiness, output and unemployment may be adversely affected by ER rigidity.
  2. Does ER provide monetary policy independence and insulation from shocks?
  3. Rules vs. discretion – fixed ER as commitment rule, but may be undesirable during wars or extreme shocks (see “contingent rule” of GS) → sees pattern of fixed/floating shifts since 1870 as adherence to a rule with an escape clause.
  4. International cooperation/policy coordination – need credible commitment mechanism.
  5. Case for international monetary reform – arise from perspective that fixed is preferable.
    - BW system saw worst economic performance, but fewest shocks.
    - GS rule of convertibility was credible commitment mechanism; lack of such during BW underlies its failure (confidence problem in US ability to maintain gold/dollar ratio, and lack of mechanism tying US to it led to collapse).
      - GS as “good housekeeping seal of approval” ensuring countries’ access to intl capital.
- Fratianni and Hauskrecht take on HST view of IMS, arguing that instead ER regimes are hierarchical (i.e., asymmetries exist, but top country still affected by behavior of others). They argue for move toward a bipolar dollar/euro IMS in which the two parties cooperate to achieve ER stability and a stable global financial system.
  - IMS as senior/junior hierarchical structure is historically more accurate than hegemonic view.
- BW: dollar shortage after WWII → US extended significant credit. Dollar shortage became dollar glut as European countries recovered and became net exporters to US → Triffin’s Dilemma/liquidity problem (rising stock of dollars relative to US supply gold) → led to confidence problem in US ability to maintain \$35 par value → led to call for new medium of intl liquidity (SDRs), but not enough → collapse in 1971.
- Krugman focuses on costs/benefits of substituting a common currency for an adjustable-peg system. Key point, as above with Tavlas, is that economic theory does not give us clear “rulings” on monetary union.
  - Benefit of fixed rates: decreased uncertainty about value of national monies. Cost: increased difficulty in adjusting relative prices during shocks.
  - *Monetary union as coordination mechanism* – Fixed rates eliminate need for cross-national CB coordination of monetary policies, but require someone to act as central banker. If not, then all countries print money for seignorage, leading to excess inflation. This is the *major difference* between fixed ERs and a common currency.
  - *Monetary union as credibility mechanism* – credible commitment to low inflation by pegging to Germany, for example. Krugman argues that a common currency might actually provide *less credibility* than an EMS-type fixed-but-adjustable peg. This is because, under the current EMS system, inflation-prone states can sacrifice autonomy implicitly and “hard currency” states can pursue their usual low-inflation policies. With a single currency and CB, however, K. argues that “the views of the inflationary nations would have to be reflected – whether they like it or not.” Thus, the anti-inflationary credibility of EMU, or any common currency system, would likely be LESS than a standard adjustable-peg system.



	1969	1985-9
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## X. International monetary policy: relative prices and interests

- *Exchange rate protection (sectoral impact of ER policies)* – when a country uses ER devaluation to protect its tradables sector relative to its nontradables sector (by allowing the ER to depreciate more than it would otherwise, or preventing an appreciation that would otherwise take place).
  - Goal is to maintain employment in tradables sector in response to some exogenous shock that would otherwise cause employment in the sector to fall (productivity improvements would lead to lower employment, unless output could be increased) → devaluation allows this, by making exports cheaper for foreigners to buy).
  - Richer explanation of ER protection: to protect *one sector* of tradables when there is a productivity improvement in another → i.e., oil discoveries in Norway benefit the “booming sector” but could harm the “lagging sectors” (other tradables). Effects of the productivity improvement:
    - Spending effect – Extra income increases demand for nontradables *and* creates a BOP surplus, i.e., excess domestic supply of tradables.
      - Without intervention, ER would appreciate, lowering output of lagging sector, employment in that sector, and income of lagging sector’s specific factors → equilibrium restored.
      - Part of extra income also spent in booming sector and as government revenue through greater tax revenue from booming sector.
    - Direct resource movement effect – Also, direct resource movement from lagging to booming sector, independent of ER (mobile factors move to high returns).
    - Indirect resource movement effect – Also, indirect resource movement from nontradables to booming tradables sector → results in excess demand for nontradables (less produced).
  - How ER protection works: devaluation prevents the appreciation that would have taken place. It offsets both the spending effect and the indirect resource movement effect. Some of the direct resource movement effect is unavoidable.
  - ER protection as not “first best” – results in aggregate welfare decrease. Direct subsidies would be better, avoiding excess increases in the size of the booming sector due to resource movement, and avoiding the excess lending abroad required to engineer a devaluation.
    - **Also, the *identification problem* – hard to tell if a government is *protecting the ER* or *just accumulating the optimal level of reserves*.**
      - Ex: was Britain accumulating foreign reserves as a way to absorb the temporary shock of discovering Barents Sea oil, or was it protecting its export sector?
  - ER protection uniformly raises domestic prices of tradables relative to nontradables → effects on output pattern and income distribution, as well as on BOP.
    - Most theories of protection (trade), however, focus only on shifts in output *within* the tradables sector (imports vs. exports). ER protection, then, is unique in that the “sides” are tradables/nontradables, not X/M.
  - Why ER protection?
    - Real income maintenance of specific factors in lagging tradables industries. Tariffs do the same thing, but ER protection may be preferable, as it 1) does not require legislation or violate intl commitments; 2) is less visible as a protectionist mechanism, therefore less likely to provoke competitive devaluations.
- Broader point of ER protection article and the article on decline of Spanish industry: in order to get the increased consumption benefits of a natural resource discovery, a country must convert the resource into goods and services normally consumed in the economy (i.e., it can’t consume all the new oil or export it all). Thus, to convert a resource increase into a desired consumption increase, the economy must undergo structural adjustment.
  - Real income increases will increase demand for both tradables and nontradables → in order to take full advantage, need both increased exports AND increased nontradables production → requires shift in production structure of the economy.

- Spain: increased bullion supply → increased demand of tradables and nontradables → production shifted to NT to satisfy demand, and excess tradables demand satisfied through new imports, financed by gold/silver inflows.
- *Interest groups, coalitions, and exchange rates* – General question: Do economic interests determine political actions, or does economic behavior adjust to politically-determined situations?
  - Hefeker: Yes. A combination of both necessary to understand fixed ER policies in 19<sup>th</sup> century.
    - Commercial free trade and hegemonic states overcame coalition of banks and small independent states to achieve monetary integration. Political expansion and trade integration drove national/supranational MI in 1800s.
      - Bimetallic system of 1800s was costly → economic rationale for MI. But, it was political economy – national gainers/losers interact with policymakers and institutional setting – that determined international economic policy.
      - Movement to MI determined by “implicit coalition” of economic and political interests. Trade and economic specialization generated rising private sector support for MI, while desire for political hegemony/integration (Italy, Germany) fueled MI.
    - Changing interests and asymmetric shocks undermined 19<sup>th</sup> century MI. Lack of MI commitment mechanisms was the ultimate reason for MI collapse.
      - States will engage in competitive monetary issuing (for seignorage – its importance as revenue source for small states and banks was key reason for their opposition to MI), undermining MI, unless a credible coordinating mechanism (single monetary authority) exists → lack of single CB in 19<sup>th</sup> century monetary unions was reason for failure, whereas establishment of CBs domestically was reason for rise of national currencies. Without centralized issuing rights, MI fails.
      - Rising trade competition led to more protectionism in 1870s Europe → MI collapsed for reasons outlined above.
    - Point: politically optimal currency areas are determined by financial power and political will, not economic efficiency as the OCA criteria would argue. Historical lessons for Maastricht and EMU. Politics shapes intl monetary policy.
- *Political choice of fixed exchange rates* – why do countries choose fixed ERs? (NB: see theory section above). Hefeker seeks to explain the strong recurrent tendency to adopt fixed ERs.
  - Commitment mechanism – for price stability → Hefeker finds this unconvincing: Why not directly commit to price stability? Also, assumes that govts choose aggregate welfare-maxing policy, rather than considering the distributional/political impact of their policies.
  - Endogenous policy perspective – political support-maximizing governments choose fixed rates to satisfy domestic interest groups.
    - Who wants fixed rates? Sectors exposed to intl trade, to minimize uncertainty and demand fluctuations.
      - Frieden: choice is between level and variability of ERs, when SIs are making fixed/floating choice → two may not point in the same direction for all private actors (e.g., exporters want stable, but depreciated currency). Hefeker argues that the stability matters more for intl traders, since it directly affects productive investment decisions and exporting firms directly bear the cost of ER fluctuations (must take world prices as given, so brunt of ER movement borne directly by firm).
    - Who wants monetary autonomy? Those for whom cross-border transactions are inconsequential: nontradables. Stable ERs don't matter, but ability to use monetary policy as adjustment mechanism does.
      - Why fixed ERs render monetary policy ineffectual: lowering interest rates to enhance output would lead to capital flight, undermining commitment to fixed ER.





- *Real exchange rate vs. nominal exchange rate*
  - *Nominal ER*: relative price of two currencies (\$/FF)
  - *Real ER*: relative price of two goods: price of tradable goods/price of nontradable goods → proxy for international competitiveness. Decline in the RER (known as an *appreciation*), reflects an *increase* in the domestic cost of producing tradable goods. This means that tradables now by fewer nontradables, indicating a decline in competitiveness.
- *Effect of common currency on trade* – Rose finds that two countries sharing a currency trade three times as much as they would with different currencies. There seems to be a dynamic effect of a common currency and trade, over and above (by an order of magnitude) that of eliminating ER volatility but retaining separate currencies (i.e., fixed ERs).
  - Implication: argument for monetary union in EU and elsewhere may be seriously undervalued.

## **XI. International monetary policies: parties and institutions**

- *Politics and business cycles* – How are inflation, unemployment, and economic growth influenced by political forces in industrial democracies? Alesina (1989) highlights four views of the relationship:
  - PBCs (opportunistic): (Nordhaus 1975) Politicians create desirable economic conditions in run-up to elections, even though such policies may require costly adjustments afterwards. Shortsighted voters “fall for it.” Pattern of sub-optimal/unnecessary economic cycles follows political cycles.
  - Partisan PBCs: Left/Right switches in government lead to excessive fluctuations in economic policy based on ideology. Depends on exploitable Phillips Curve and assumes constant policies for Left (low unemp, high infl) and Right (high unemp, low infl) through entire period of office.
  - Rational PBC theory (opportunistic): Rational expectations criticism of PBC theory: politicians can’t engineer them, voters won’t fall for them. Discrediting of the “exploitable Phillips Curve” by stagflation in the 1970s fueled these 1980s theories.
    - Voters not myopic, but imperfectly informed about policymakers’ objectives, candidates’ ability to manage the economy, or characteristics of the environment. Voters choose candidates expected to deliver highest utility given voters’ rational expectations about postelectoral outcomes. Politicians try to appear as competent as possible.
  - Rational partisan PBC theory (Alesina): combines ideology and rational voters → predicts expansion at beginning of Left govt and recession at beginning of Right govt. In latter part of terms, performance should be indistinguishable.
    - Partisanship DOES matter, but only in short-term after government switch. Systematic cycles are not evident. Different governments fight different economic problems at different times → so, what looks like partisan fluctuation may actually be economic situation. Also, both Left and Right governments will try to appear ‘moderate’ to win the support of voters; this may involve different policies depending on the party, however.
  - Alesina: More stable politico-institutional structures → better economic performance.
  - Limitations of PBC theory: (Clark, et al) PBC arguments flawed because they ignore the role of international and domestic institutions.
    - Fixed rate regimes (intl institution) or ICBs (domestic institution) during high capital mobility render opportunistic behavior by politicians in the manner of PBCs infeasible.
    - Also, endogenous electoral systems constrain PBC behavior → calling early elections sends a signal to the govt.
    - But, couldn’t politicians use fiscal policy instead? Clark, et al: Not if monetary and fiscal policy are closely linked (they are). Fiscally-induced PBCs are possible, but less likely [also, harder/slower to pass fiscal legislation at right times].
    - Implication is that institutional environment affects national policy autonomy, and that this autonomy varies significantly across states according to ER regimes, ICBs, and electoral systems.
- *Central bank independence*
  - Alesina and Summers: CBI promotes price stability, but has no measurable impact on real economic performance.

- CBI as commitment device to sustain lower inflation than desired by the median voter, who is “time inconsistent.” Alternatively, a commitment device to solve the policymakers’ own time inconsistency problem.
    - Prior arguments about CBI’s real effects: 1) predictability reduces risk premia built into interest rates; 2) CBI reduces partisan shocks to economy (see above) due to electoral cycles/govt switches; 3) CBI improves performance by solving high inflation problem, which breeds rent-seeking activity (same as 1).
    - Find near-perfect negative correlation between CBI and inflation, but no evidence of real impact of CBI (unemployment, growth, average real interest rates).
      - CBI only one of several factors affecting performance (also, ERs, etc.).
      - CBI may be endogenous if viewed from historical perspective (Germany).
  - GMT: two aspects of CBI:
    - Political independence: ability of CB to select its policy objectives independent of government influence (who’s on BOG, having price stability charter, etc.).
    - Economic independence: ability of CB to use monetary policy instruments without restrictions (degree to which CB must also finance govt deficit, etc.).
  - Lohmann: Two types of CBI to consider:
    - Formal independence: constitutional
    - Behavioral independence: ability to act
    - L. argues that monetary policy outcomes are driven by both types of CBI. Behavioral independence is influenced by the “types” of the central bankers (partisan or technocrat). CBI is influenced by the degree to which one or both types of CBI can be changed (i.e., formal changed through constitutional means; behavioral through appointing of new bankers).
      - So, CBI really a 2X2 with degree of independence on one axis, “type” of central bankers on the other.
      - Bundesbank’s formal independence unchanged in 1957-92, but behavioral independence fluctuated depending on partisan support for the federal govt in the Bundesrat. German central bankers are nonpartisan technocrats partially insulated from political pressures.
- *Electoral and representation systems*
  - GMT ask whether constitutional differences have any bearing on debt policy decisions?
    - In OECD, large public debts are correlated with highly PR systems and/or with short-lived coalition/minority govts. Is this due to political incentives created by such systems? GMT focus on two theories of public debt and politics:
      - Political stability – Two elements:
        - Instability – likelihood of being thrown out of office
        - Polarization – between different policymakers
        - These two features lead policymakers to behave more myopically, i.e., to discount the future further → this theory suggests that more unstable/polarized societies will have larger debts.
      - Government weakness – Greater conflict among political actors (ministers, CB vs. PM, etc.) makes changing SQ more difficult → unpopular decisions postponed, creating similar myopia.
    - PR systems fall prey to both greater instability (shorter governments) and more frequent occurrence of weak (fractured, minority) governments. Large public debts are correlated with countries having ‘representational democracies’ and fractionalized party systems.
  - Bernhard & Leblang: politicians’ incentives over ER regime reflect configurations of domestic political institutions (electoral and legislative). Three elements:
    - Decisiveness of electoral system: majoritarian vs. PR
    - Cost of opposition: legislative influence of the minority/non-govt parties

[These two factors combine to form three “types”: 1) majoritarian-low opposition influence; 2) proportional-low opposition; 3) proportional-high opposition (no cases of majoritarian-high opposition).]

- Timing of elections: exogenous vs. endogenous
  - Where cost of electoral defeat is high (majoritarian) and elections are exogenously timed, politicians will be less likely to forego monetary discretion by choosing fixed ERs (politicians unwilling to “take hands off the wheel” given high cost of defeat and possibility of using PBC as tool to maintain majority [but, what about Clark’s argument above...does EMU render B&L’s argument moot?]).
  - Where cost of electoral defeat is low (proportional) and elections are endogenously timed, politicians are more likely to adopt fixed ERs (since politicians here face coalitional partners and open policy process with opposition influence, fixed ERs can be a focal point among diverse parties for policy agreement; also political “cost” of adhering to fixed ERs is lower).
  
- *Links between international monetary system and regional monetary integration*
  - Most theories of European monetary integration explain EMU in terms of regional economic interdependence, political integration, issue linkage, and domestic politics. Henning, in contrast, emphasizes the link between disturbances in the international monetary system and EMU. He argues that disturbances in the IMS created incentives for European govts to cooperate on monetary issues at numerous key junctions over the last 40 years. He focuses on the destabilizing behavior of the hegemonic US as key impetus for smaller states to explore alternative, regional options.
  - Other approaches to explaining European monetary integration:
    - *Market integration* – two variants: 1) need for ER stability to maintain viability of CAP; 2) capital market integration rendered independent ERs infeasible (see Wyplosz earlier).
    - *German dominance* – Germany as anchor by which other states imported price stability.
    - *Domestic politics* – two variants: 1) stance of domestic interest groups and parties is critical to credibility of peg to DM; 2) domestic politics leads to convergence of national preferences among the EU MS on ER stabilization/price stability → drive to EMU.
    - *Linkage politics* – Grand bargain between France and Germany, trading political union for monetary union. Or, linkage between German unification and EMU facilitated by EC institutions.
    - *Beliefs* – emergence of intellectual consensus among policymakers on causal links among monetary policy, inflation, and growth → specifically, belief that expansionary monetary policy had limited scope for boosting growth and employment without also creating unacceptable inflation → served as impetus toward EMS/EMU.
  - Henning articulates his theory linking international systemic conflict and monetary regionalism, arguing that instability in the IMS creates several incentives for regional integration.
    - Basic point is that choice of ER regime and use of monetary/fiscal policy by large countries may have “transmission effects” changing economic conditions in smaller, receiving states, thereby altering payoffs for the smaller state when it chooses its own macroeconomic policies.
      - E.g., fiscal stimulus by large under fixed rates → capital mobility transmits increased output/wealth abroad, raising prices, employment, and income → small country was targeting certain levels of these, but now overshoots → pressure for small state to tighten macro policy.
      - Role of large country’s money as reserve currency exacerbates these effects.
    - Regional monetary cooperation as way to counter these “transmission effects” and create an “island of monetary stability.” Also counters asymmetric effects of large country policies on different members within a region. Finally, regional cooperation can transform a group of “small” countries into a “large” player in the IMS.
    - Institutional learning key → drive to monetary integration strengthened over time as policymakers learned patterns of US behavior and their impact on Europe.
    - Sees theory as complementary to earlier ones → C.P., drive to European monetary integration stronger during periods of transatlantic conflict (see Tables 566-7).