ONE

Introduction

The spectacular crash of Thailand's currency in the summer of 1997 constitutes one of the most memorable events of the Asian financial crisis. The Thai exchange rate had been overvalued for several years, and experts had been warning for some time that without adjustments in economic policies, the currency's peg would become unsustainable. Despite these warnings, the Thai government had been unwilling to implement the required policy changes. Rather than tighten fiscal and monetary policy, implement structural reforms, or introduce more flexibility into the exchange rate regime, they increasingly counteracted the mounting pressure on their currency through interventions on the foreign exchange market. In the process, they sold their entire foreign currency reserves until literally nothing was left. At that point, the authorities were no longer able to avoid adjustment and decided to let the exchange rate float. As a result, the currency crashed and lost half of its value, and the country experienced one of its worst economic crises to date.

From an economic efficiency perspective, this behavior of Thai policymakers is truly perplexing. However, it is far from unique: Policymakers in countries such as Argentina, Mexico, and, more recently, Belarus have also delayed needed macroeconomic adjustment, only to see their currencies crash later on. Typically, policymakers in these countries have delayed devaluations by spending billions of dollars in defense of a given exchange rate against speculative pressure, only to succumb to this pressure and to devalue their currencies later on, usually amid a full-blown currency crisis. This contrasts with the experience of other countries, where policymakers have been able to successfully address emerging balance-of-payments problems at a relatively early stage. For example, Britain's decision to abandon its exchange rate peg in 1992 came relatively quickly after serious speculation had started against the British pound sterling. Even though the central

bank lost a lot of money in its one-day attempt to stabilize the currency, the relatively speedy decision to let the currency depreciate led to a quick stabilization and a rapid recovery of the British economy.

Improving our understanding of this puzzling variation in policymakers' resolve to address emerging problems through an adjustment of their economic policies is an important task, because delayed adjustment often ends in a financial and economic crisis. Such crises have caused great disruptions around the globe, affecting developing countries, emerging markets, and advanced economies alike. They usually impose enormous costs, both in economic and political terms. A systemic banking crisis, for example, on average causes the gross domestic product (GDP) to shrink by about 9.3 percent, unemployment to rise by 7 percentage points, and real equity prices to fall by a whopping 55.9 percent (Reinhart and Rogoff 2010: 228–30). Similarly, currency crashes lead to an average output loss of 7.1 percent and significantly higher rates of inflation (Aziz, Caramazza, and Salgado 2000). In addition to these economic costs, macroeconomic crises and the policies implemented to resolve them often carry high political costs. The demonstrations and riots that accompanied the major economic and financial crises in countries as diverse as South Korea (1997–8), Argentina (2001), or Greece (2010–12), which left several people dead, make it evident that citizens are well aware of the pain these crises are causing. This is bad news for incumbents. Not surprisingly, financial crises are associated with higher rates of political turnover (Chwieroth and Walter 2010) and have at times even caused the fall of entire political regimes, as the fall of the Suharto regime in Indonesia demonstrates (Pepinsky 2009).

Much research has shown that the deterioration of certain macroeconomic indicators, such as a negative development of the current account, an increasingly overvalued real exchange rate, or a credit boom, is associated with an increased risk of currency, debt, and banking crises (e.g., Kaminsky, Lizondo, and Reinhart 1998; Berg, Borensztein, and Pattillo 2005; Mendoza and Terrones 2008; Jorda, Schularick, and Taylor 2010). Nonetheless, many episodes that exhibit such an increased risk of crisis pass by without major disruptions in the economy. Oftentimes, such noncrisis episodes are associated with early and decisive policy responses by the government, which reduce the risk of a deterioration turning into a full-blown crisis (Cardarelli, Elekdag, and Kose 2009). Obviously, some policymakers are able to implement corrective policy adjustments early on and to enjoy the benefit of the fact that such a prompt reaction to the initial problems is usually much less costly than the resolution of a crisis (Frankel and Wei 2004). Other policymakers, however, do not act until a full-blown crisis forces them to adjust, even though

the deterioration of the economic situation suggests that eventual adjustment will in all likelihood be inevitable. Given the costs associated with such crises, it therefore seems imperative to better understand which circumstances foster early adjustment and which circumstances facilitate delays.

The politics of macroeconomic adjustment is characterized by a second puzzle. Once balance-of-payments problems emerge, policymakers have a number of strategies at their disposal to stabilize the macroeconomic situation. The most important distinction here is between *internal adjustment strategies*, such as fiscal and monetary tightening and structural reforms, and *external adjustment strategies*, which involve an adjustment of the exchange rate, typically a depreciation or devaluation of the currency.[1] Both of these strategies are viable options to address macroeconomic problems, yet one can observe a lot of variation in the adjustment strategies chosen. For example, during the 2007–11 global financial and economic crisis, governments responded quite differently to the problems associated with the crisis. Countries such as Estonia or Latvia addressed the emerging problems by slashing government spending, while keeping the exchange rate firmly pegged to the euro. These measures induced a severe recession in which the Latvian GDP shrank by almost 20 percent and unemployment tripled. Other countries, such as Poland, let their exchange rates depreciate in response to the macroeconomic problems their countries faced, while leaving domestic economic and fiscal policies largely unchanged. Yet others, such as Hungary and Romania, opted for a mixed strategy in which domestic economic tightening was coupled with a moderate adjustment of the exchange rate. Apart from the question of whether necessary policy corrections are delayed or not, this variation raises the question of which type of adjustment strategy policymakers are likely to choose. To gain a better understanding of the politics of macroeconomic adjustment, we consequently also need to understand why some policymakers adjust internally, whereas others opt for external adjustment strategies.

To answer these questions, this book investigates when policymakers are willing to adjust their economic policies in response to macroeconomic problems, which types of adjustment strategies they choose, under what circumstances they delay reform, and when such delays are likely to result in crises. Using a political economy perspective and focusing on domestic politics in democratic countries, it examines how the distribution of voters' vulnerabilities to different types of adjustment strategies and electoral

[1] A loss in the currency's value relative to another currency is called a depreciation in flexible exchange rate regimes and a devaluation in fixed exchange rate regimes.

concerns influence policymakers' incentives to address macroeconomic imbalances. The book highlights how the internationalization of financial markets has altered the distributional effects of exchange-rate and monetary policy and has made the resulting vulnerabilities a salient determinant of macroeconomic policy outcomes. It particularly spells out how the liberalization of capital accounts has facilitated the emergence of such vulnerabilities by allowing firms and citizens to borrow abroad. The book shows that the resulting distributional concerns not only inform the type of adjustment strategy chosen by policymakers, but can also create strong incentives for policymakers to implement policies that are detrimental in the long run. Delay is particularly likely when sizeable parts of the electorate are vulnerable to both internal and external adjustment.

1.1 Why Macroeconomic Adjustment Becomes Necessary

Adjusting macroeconomic policies becomes necessary when fundamental balance-of-payments problems emerge. The balance of payments, which records all transactions between a country and the rest of the world, is in balance when inflows of goods, services, and capital approximately equal the outflow of goods, services, and capital.[2] In reality, however, one can often observe an imbalance in the balance of payments. Such imbalances can come in two forms: Surplus countries exhibit current account surpluses and capital account deficits, whereas deficit countries exhibit current account deficits and capital account surpluses. Overall, deficit countries are much more crisis prone than surplus countries and tend to face much stronger pressure to adjust when external financing dries up. A current account deficit typically implies that a country is importing more goods and services than it exports, for example, because foreign goods are cheaper than domestically produced goods. Moreover, domestic savings are smaller than domestic investments in deficit countries. Because exports do not generate enough revenue to finance all the purchases of imported goods and because the funds needed for investments are larger than those domestic citizens can provide in the form of savings, current account deficits are associated with capital inflows into a country.[3] Such inflows usually lead to an

[2] The balance of payments consists of the current and the capital account as well as balancing items such as reserve sales.

[3] The current and capital account as well as reserve sales and other balancing items balance each other by definition, so that a current account deficit is usually associated with a capital account surplus (more capital inflows than outflows) and vice versa. The causality between current account deficits and capital account surpluses can run both ways.

increase in foreign debt and foreign ownership of domestic assets, domestic credit expansions, and real exchange rate appreciations, which can fuel a further deterioration of the current account. When these capital inflows dry up – either because of a change in the global investment climate or because international investors become skeptical about the sustainability of the country's economic policies – policymakers need to act, because the current account deficit can no longer be financed with foreign capital. It is this type of balance-of-payments problems that lie at the heart of this book.

There are two ways to address such problems. The first is to use foreign currency reserves to finance the deficit; the second is to implement policies that lead to macroeconomic adjustment and a rebalancing of the current and capital accounts. Financing the deficit – for example, through sterilized foreign reserve sales – is an appropriate policy response to a current account deficit that has emerged in response to a temporary shock, such as a sudden and temporary change in the world market price of an important tradable good, a natural disaster that temporarily disrupts a country's productive capacity, or a temporary dip in international capital flows. In these situations characterized by a fundamentally stable macroeconomic environment, a significant adjustment of macroeconomic policies might do more harm than good by destabilizing economic activity. Consequently, a financing of the deficit is the economically sensible way to proceed. Sterilized intervention means that transactions in the foreign exchange market are conducted in such a way that they have no, or little, consequences for the domestic money supply and therefore do not affect domestic interest rates. Such sales allow the central bank to offset a drop in the demand for domestic currency, which puts downward pressure on the exchange rate, without changing its monetary policy stance. This enables policymakers to alleviate speculative pressure and stabilize the exchange rate, while simultaneously avoiding a serious adjustment of the macroeconomy. Of course, a prerequisite for a successful pursuit of this type of policy response is the sufficient availability of funds. Only countries that hold foreign currency reserves large enough to cover the deficit (or who can borrow such funds on international markets or from institutions such as the International Monetary Fund) can engage in this strategy.

Unfortunately, policymakers usually face a lot of uncertainty about whether the emerging economic problems are just temporary or whether they reflect deeper macroeconomic problems. A considerable debate exists about when current account deficits become unsustainable and under what circumstances they can be sustained for very long periods of time (Freund 2005; Freund and Warnock 2007). What is clear, however, is that sterilized

reserve sales can only satisfactorily resolve the problems caused by an economic shock when the economy is fundamentally sound. In contrast, when the underlying problems reflect more fundamental problems, such sales merely delay needed adjustment. This delay oftentimes aggravates existing problems and, hence, not only increases the amount of adjustment that is ultimately required to rebalance the economy, but also intensifies the risk that this adjustment will eventually take place in the context of a severe financial crisis.

This distinction between temporary and fundamental balance-of-payments problems is crucial, because oftentimes current account deficits result from deeper macroeconomic and structural problems, such as an unsustainably high level of consumer demand coupled with a weak industrial and services sector, high budget deficits, high growth rates of money and domestic credit, and/or overvalued exchange rates. In these situations, a more far-reaching policy response is needed. To achieve a rebalancing of the current account, foreign and domestic prices have to be realigned, and this can be achieved in two ways (as well as a combination of both). The first possible adjustment strategy is *external adjustment*, which means that the exchange rate depreciates. The goal of this adjustment strategy is to eliminate the trade deficit by using the exchange rate to make domestic products more competitive internationally and to raise the price of imports. As a result, expenditure is switched away from the consumption of internationally tradable goods and toward the production and export of such goods. A second possible adjustment strategy is *internal adjustment* in which monetary and fiscal policies are tightened and structural reforms are implemented to increase the economy's competitiveness. Here, the goal is to deflate domestic prices through a reduction in overall spending and productivity gains, which once more makes domestic products more competitive internationally and reduces the demand for imports. A tightening of monetary policies slows inflation and, hence, the rise of domestic prices, while also encouraging more savings and less investment. Moreover, higher interest rates can attract foreign capital or at least reduce capital outflows and, hence, reduce speculative pressures. This buys time for more far-reaching fiscal and structural reform measures, whose implementation is more time-intensive because they usually require parliamentary approval.

Both of these macroeconomic adjustment strategies are usually painful. Unfortunately for policymakers, however, avoiding adjustment and financing the deficit instead is not an option when the economy is experiencing fundamental problems. Even though adjustment can be avoided as long as the central bank commands or acquires enough foreign currency reserves

to finance the deficit, adjustment will have to occur eventually, either voluntarily by changing economic policies, or involuntarily in form of a crash. The latter often comes in the form of a so-called first-generation-type currency crisis (Krugman 1979).[4] Once a country's macroeconomic fundamentals have deteriorated significantly enough, adjustment becomes inevitable. Surprisingly, policymakers nonetheless frequently try to avoid macroeconomic adjustment. Past research has shown that on average, they wait between six and thirteen months after the beginning of serious balance-of-payments problems (especially a turnaround of capital flows) before genuine macroeconomic adjustment occurs (Frankel and Wei 2004).

1.2 How and When Do Policymakers Adjust? Existing Explanations

When serious balance-of-payments problems emerge, policymakers have to come to a decision on two sets of questions: First, which type of adjustment strategy should they choose to rebalance the economy, and second, when should these measures be implemented? These decisions about the type and timing of macroeconomic adjustment can have severe welfare implications. Both internal and external adjustment strategies tend to be costly in economic and political terms, and sterilized reserve sales carry the risk that they merely delay needed adjustment and let the situation deteriorate into a full-blown financial crisis. Given the high salience of addressing the situation in an appropriate manner, how do policymakers decide on these questions? The existing literature offers several answers.

1.2.1 Choosing between Internal and External Adjustment

Regarding the question of which type of adjustment strategy policymakers are likely to choose, existing research in economics has identified several factors that influence the relative cost of different adjustment strategies in different contexts. In particular, research on optimum currency areas (OCAs)

[4] Note that not all currency crises occur because of bad macroeconomic fundamentals, and not all speculative attacks on countries' currencies end with exchange-rate adjustments. Rather, exchange rates can come under pressure even when macroeconomic fundamentals are merely of a dubious quality. For example, in so-called second-generation-type currency crises, investors' skepticism regarding the government's determination to adjust to emerging macroeconomic imbalances internally and in a timely manner leads to speculative pressure on the exchange rate because investors anticipate that adjustment will eventually have to take place even though conditions have not (yet) deteriorated beyond policymakers' control (Obstfeld 1994, 1996).

has shown that certain country characteristics such as size, openness, or labor market flexibility influence the ease with which internal and external adjustment can be implemented (Mundell 1961; McKinnon 1963; for reviews, see Masson and Taylor 1993; Frankel 1999; Willett 2003). OCA theory suggests that in terms of aggregate economic efficiency, the costs of external adjustment are lower in larger, less trade-dependent economies, whereas internal adjustment is the less costly adjustment strategy for small open economies. In addition, more recent research has found that as financial globalization has progressed, the types of international capital inflows into an economy and their effects on the country's financial structure are playing an increasingly important role in determining the relative costs of external and internal adjustment (e.g., Frankel and Wei 2004; Eichengreen and Hausmann 2005). However, the effect of an economy's financial structure on the choice of adjustment strategies is not entirely clear. For example, while pervasive liability dollarization increases the costs of external adjustment, it also increases the economy's vulnerability to capital outflows and the likelihood of a drop in the value of the currency.

One of the main conclusions of this research in economics is that policymakers' macroeconomic policy choices are not predetermined solely by economic considerations. For example, looking at how policymakers deal with speculative pressure on countries' currencies, several studies find that the characteristics suggested by OCA analysis and other economic factors do not explain well the observed variation in the outcome of speculative attacks (Eichengreen, Rose, and Wyplosz 2003; Kraay 2003). As a result, political economists have argued that the aggregate economic efficiency effects stressed by traditional OCA analyses and other economic models are often not the only factor influencing exchange-rate and monetary policy choices in open economies (see, e.g., Cohen 2003; Willett 2006). Instead, political economy research suggests that policymakers' responses to speculative pressure depend on political factors as well (Leblang 2003; Sattler and Walter 2009; Walter 2009).

For one, international pressure and international considerations matter. For example, conditionality from the International Monetary Fund (IMF) has been found to increase the incidence of external adjustment (Dreher and Walter 2010). However, this is not always the case, as the recent examples of Latvia, Greece, and Ireland show, where the IMF has explicitly supported policies aimed at internal adjustment and a continuation of the countries' fixed exchange rate regimes.

Second, domestic political considerations are of great importance, which is not surprising if one considers that the decision to implement

macroeconomic adjustment can end political careers (see, e.g., Cooper 1971; Frankel 2005; Leblang 2005). The political economy literature on exchange-rate and monetary policymaking in open economies has demonstrated that domestic political factors shape country-specific choices about the relative importance of the two goals of exchange-rate stability and monetary policy autonomy, which are mutually exclusive when capital is fully mobile internationally.[5] With regard to macroeconomic adjustment, this literature has argued that in democracies, the costs of internal adjustment outweigh the costs of external adjustment (Eichengreen 1992, 1996; Simmons 1994). Yet, empirically there are also many cases in which democratic policymakers have chosen internal adjustment over external adjustment – the recent decisions by the Baltic states or Ireland to follow this strategy are such examples.[6] A possible explanation for this contradictory evidence is that existing research has typically assumed that voters have homogenous preferences regarding external and internal adjustment: With regard to internal adjustment, the majority of voters have been assumed to oppose internal adjustment and the increase in unemployment associated with it (Eichengreen 1992; Simmons 1994). Similarly, regarding external adjustment, voters have been assumed to uniformly oppose depreciation because it reduces their purchasing power (Frieden and Stein 2001b; Stein and Streb 2004; Blomberg, Frieden, and Stein 2005).

Empirical research, however, casts some doubt on these assumptions of preference homogeneity. Microlevel evidence suggests that voters' macroeconomic preferences and concerns are in fact quite heterogenous (e.g., Scheve 2004). To arrive at a better understanding of voters' policy preferences

[5] This research builds on the insights of the so-called unholy trinity or Mundell-Fleming-model, which implies that, when capital is mobile internationally, fixing the exchange rate means that interest rates cannot be manipulated in pursuit of domestic economic objectives (Mundell 1961; Fleming 1962; for a discussion and the labeling of this model as unholy trinity, see Cohen 1995). Likewise, the ability to gear monetary policy toward domestic objectives comes at the cost of giving up exchange-rate stability. This literature demonstrates that exchange-rate and monetary institutions evolve in the context of this trade-off (see, for example, Bernhard, Broz, and Clark 2003; Clark 2003; Bernhard and Leblang 2006) and that these institutional choices in turn are influenced by political factors, such as the political regime type (Leblang 1999; Broz 2002; Stierli 2006; Hall 2008; Guisinger and Singer 2010; Bearce and Hallerberg 2011), the type of electoral regime (Bernhard and Leblang 1999; Leblang 1999), the timing of elections (Frieden and Stein 2001a; Schamis and Way 2003), the government's partisanship (Garrett 1998; Oatley 1999; Bearce 2003, 2007), and interest group pressure (Frieden 1991b, 1996, 2002; Hefeker 1997; Hall 2005; Helleiner 2005).

[6] For Ireland during the ongoing euro crisis, external adjustment would mean the exit from the European Monetary Union and a reintroduction of the Irish pound at a devalued rate.

regarding external and internal adjustment, it therefore appears necessary to explore in more detail how this variation in policy preferences can be explained. In this context, an important question is how voters evaluate different policy options and which aspects they consider when forming their policy preferences (e.g., Kinder and Kiewit 1979; Mansfield and Mutz 2009; Leblang, Jupille, and Curtis 2011).

Existing research offers many clues as to the sources of such possible variation in voters' policy preferences. Although research on voters' preferences with regard to exchange-rate and other macroeconomic policy preferences has been relatively sparse,[7] the literature on the influence of special interests on exchange-rate and monetary policymaking provides insights into which aspects matter in these policy fields. It shows that different economic sectors favor different types of macroeconomic policies, and this variation in preferences depends on their exposure to international trade and their reliance on domestic economic conditions (e.g., Frieden 1991b; 1996; 2002; Hefeker 1997; Bearce 2003; Hall 2005; Helleiner 2005; Woodruff 2005; Kinderman 2008; Steinberg 2008, 2009; Walter 2008).[8] One implication of this research is that export-oriented industries should favor external over internal adjustment. The empirical evidence does not uniformly support this prediction, however. Quantitative studies have arrived at contradictory conclusions about how the size of the manufacturing or the tradables sector in a country influences exchange-rate policy (e.g., Frieden, Ghezzi, and Stein 2001; Hall 2008; Frieden, Leblang, and Valev 2010; Singer 2010a). For example, highly export-oriented economies, such as South Korea and Hong Kong, have fought unexpectedly hard in the past to avoid external adjustment, a behavior that is at odds with the prediction that export-oriented economies would benefit from a depreciated exchange rate.

A possible explanation for these inconsistent findings is that these studies only look at one half of the story. What they neglect to consider is that financial globalization has vastly transformed governments', firms', and consumers' access to international capital markets. This has had profound effects on their balance sheets, which now often contain not only assets and liabilities denominated in domestic currency but foreign-currency denominated positions as well. As a result, the effects of exchange rate and monetary policy decisions have become more complex. To properly understand the distributional

[7] An exception is the literature on individual preferences about the euro (e.g., Banducci, Karp, and Loedel 2003; Gabel and Hix 2005; Hobolt and Leblond 2009).

[8] The implementation of economic reforms more generally has been shown to be influenced by the coalitions of opponents and proponents of such reforms (e.g., Gourevitch 1986; Rogowski 1989; Frieden 1991a; Hiscox 2002; Häusermann 2010).