AGENCY UNDER CAPITAL MOBILITY: DOMESTIC POLITICAL INSTITUTIONS AND THE POLICY AUTONOMY/EXCHANGE RATE STABILITY TRADEOFF

DISSERATATION

Presented in Partial Fulfillment of the Requirements for the Degree Doctor of Philosophy in the Graduate School of The Ohio State University

By

David H. Bearce, M.A.

*****

The Ohio State University 2001

Dissertation Committee:
Professor Edward Mansfield, Advisor
Professor Tim Frye
Professor Eric Fisher

Approved by

Advisor
Political Science Department
Under capital mobility, states must choose between an autonomous monetary policy with currency variability versus stabilizing exchange rates with the sacrifice of policy autonomy. The central research question asks what factors lead the advanced industrial democracies to choose stable exchange rates and what factors lead them instead towards an autonomous monetary policy in the post-Bretton Woods era characterized by international capital mobility.

I first show how a government's choice for/against monetary policy autonomy or exchange rate stability can be seen in its fiscal/monetary policy mix choice under capital mobility. To achieve economic growth and low inflation, government leaders require two independent policy instruments: fiscal policy and monetary policy. States can either direct fiscal policy towards economic growth and monetary policy towards inflation control, producing a loose fiscal/tight monetary policy mix. Or they can direct fiscal policy towards inflation control and monetary policy towards economic growth, yielding a tight fiscal/loose monetary policy mix.

Monetary autonomy means holding an interest rate different from the world interest rate. Since the world interest rate has been nominally lower than most national interest rates, a policy mix that raises (lowers) interest rates will likely increase (decrease) monetary autonomy. Consequently, governments with a loose
fiscal/tight monetary policy mix have effectively chosen greater monetary autonomy at the cost of exchange rate stability. Conversely, governments using a tight fiscal/loose monetary policy mix have opted for exchange rate stability with the associated costs of policy convergence.

I show next how domestic political institutions function as determinants of a state's fiscal/monetary policy mix and exchange rate variability in the post-Bretton Woods era. Leftist-led governments and multi-party governments in proportional representation electoral systems tend to choose policy autonomy with greater exchange rate variability. Conversely, rightist-led governments and single-party governments in majoritarian electoral systems opt for policy convergence to achieve exchange rate stability. These partisan and electoral factors function relatively unconstrained by other domestic institutions such as independent central banks and fixed exchange rate commitments. Likewise, the relative size of societal interest groups with differing preferences regarding the exchange rate stability/monetary autonomy tradeoff fails to explain the national government's policy choice.
Dedicated to my wife, Dana
ACKNOWLEDGMENTS

My biggest thanks go to the committee members, Edward Mansfield, Eric Fisher, Tim Frye, and David Rowe, who coach this project from beginning to end. Parts of this manuscript were presented at the 1999 and 2000 American Political Science Association’s Annual Meetings and at the 2000 Midwest Political Science Association’s Annual Meeting. The project benefited substantially from seminar presentations at Ohio State, Pittsburgh, Columbia, Northern Iowa, New Mexico and Missouri. Special thanks are also due to William Bernhard, Lawrence Broz, and Pat McDonald, who offered comments on various parts of the manuscript. Finally, the research was partially supported by a Presidential Fellowship from the Ohio State University.
VITA

April 13, 1967.................Born

1989.........................B.A. Political Science, Davidson College

1992.........................M.A. International Affairs, The American University

1995 – present ..............Graduate Teaching and Research Associate,
The Ohio State University

PUBLICATIONS


FIELDS OF STUDY

Major Field: Political Science

Minor Field: International Politics
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Introduction</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Agent/Structure Problem</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>International Regimes and Cooperation Theory</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>State/Society Debate</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>Policy Implications</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>Organization of Project</td>
<td>15</td>
</tr>
<tr>
<td>2.</td>
<td>The Policy Autonomy/ Exchange Rate Stability Tradeoff</td>
<td>21</td>
</tr>
<tr>
<td></td>
<td>Theoretical Foundation</td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>Mundell-Fleming Framework</td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>International Monetary Orientations</td>
<td>26</td>
</tr>
<tr>
<td></td>
<td>Monetary Autonomy under Capital Mobility</td>
<td>29</td>
</tr>
<tr>
<td></td>
<td>The Neoliberal Convergence Hypothesis</td>
<td>32</td>
</tr>
<tr>
<td></td>
<td>The Policy Mix Framework</td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>Policy Goals</td>
<td>36</td>
</tr>
<tr>
<td></td>
<td>Policy Instruments</td>
<td>38</td>
</tr>
<tr>
<td></td>
<td>Empirical Evidence</td>
<td>41</td>
</tr>
<tr>
<td></td>
<td>Interest Rate Differentials and Exchange Rate Stability</td>
<td>47</td>
</tr>
<tr>
<td></td>
<td>Interest Parity Condition</td>
<td>47</td>
</tr>
<tr>
<td></td>
<td>Empirical Estimates</td>
<td>50</td>
</tr>
<tr>
<td>Section</td>
<td>Page</td>
<td></td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>------</td>
<td></td>
</tr>
<tr>
<td>Monetary Autonomy in the post-Bretton Woods era</td>
<td>54</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>56</td>
<td></td>
</tr>
<tr>
<td>3 Domestic Political Institutions and the Policy Mix</td>
<td>66</td>
<td></td>
</tr>
<tr>
<td>Domestic Political Institutions</td>
<td>68</td>
<td></td>
</tr>
<tr>
<td>Political Parties</td>
<td>68</td>
<td></td>
</tr>
<tr>
<td>Electoral Systems</td>
<td>74</td>
<td></td>
</tr>
<tr>
<td>Independent Central Banks</td>
<td>78</td>
<td></td>
</tr>
<tr>
<td>Fixed Exchange Rate Commitments</td>
<td>83</td>
<td></td>
</tr>
<tr>
<td>Empirical Estimates for the Domestic Political Institutions</td>
<td>86</td>
<td></td>
</tr>
<tr>
<td>Political Variables</td>
<td>88</td>
<td></td>
</tr>
<tr>
<td>Statistical Results</td>
<td>89</td>
<td></td>
</tr>
<tr>
<td>Structures and Agents</td>
<td>94</td>
<td></td>
</tr>
<tr>
<td>Capital Mobility as a Structural Constraint</td>
<td>94</td>
<td></td>
</tr>
<tr>
<td>Partisan Agents under Capital Mobility</td>
<td>97</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>99</td>
<td></td>
</tr>
<tr>
<td>4 Societal Preferences and the Policy Mix</td>
<td>106</td>
<td></td>
</tr>
<tr>
<td>Societal Groups and their Preferences</td>
<td>110</td>
<td></td>
</tr>
<tr>
<td>Factors of Production</td>
<td>110</td>
<td></td>
</tr>
<tr>
<td>Economic Sectors</td>
<td>113</td>
<td></td>
</tr>
<tr>
<td>How do Societal Preferences Matter?</td>
<td>116</td>
<td></td>
</tr>
<tr>
<td>Economic Pluralism</td>
<td>116</td>
<td></td>
</tr>
<tr>
<td>Principal-Agent Framework</td>
<td>118</td>
<td></td>
</tr>
<tr>
<td>Empirical Results</td>
<td>123</td>
<td></td>
</tr>
<tr>
<td>Statistical Model</td>
<td>123</td>
<td></td>
</tr>
<tr>
<td>Statistical Estimates</td>
<td>128</td>
<td></td>
</tr>
<tr>
<td>The Principal-Agent Model and Societal Lobbying</td>
<td>131</td>
<td></td>
</tr>
<tr>
<td>The Emergence of Lobbying</td>
<td>132</td>
<td></td>
</tr>
<tr>
<td>Exchange Rate Lobbying in the United States</td>
<td>135</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>140</td>
<td></td>
</tr>
<tr>
<td>5 Policy Autonomy under Capital Mobility: France, Italy, and Sweden</td>
<td>146</td>
<td></td>
</tr>
<tr>
<td>Socialist Governments in France</td>
<td>147</td>
<td></td>
</tr>
<tr>
<td>Monetary Tightness</td>
<td>150</td>
<td></td>
</tr>
<tr>
<td>Fiscal Expansion</td>
<td>151</td>
<td></td>
</tr>
<tr>
<td>Exchange Rate Instability</td>
<td>154</td>
<td></td>
</tr>
<tr>
<td>Multiparty Governments in Italy</td>
<td>157</td>
<td></td>
</tr>
<tr>
<td>Fiscal Expansion</td>
<td>158</td>
<td></td>
</tr>
</tbody>
</table>
Appendices ........................................................................................................... 252
  Chapter 2 Appendix .................................................................................. 252
  Chapter 3 Appendix .................................................................................. 254

References ........................................................................................................... 260
# LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Four Fiscal/Monetary Policy Mixes</td>
<td>58</td>
</tr>
<tr>
<td>2.3</td>
<td>Estimates of Monetary Policy Orientation on Exchange Rate Variability, 1973-1997</td>
<td>60</td>
</tr>
<tr>
<td>3.1</td>
<td>Hypothesized Relationships between Domestic Political Institutions and Fiscal/Monetary Policy Choices and Exchange Rate Outcomes</td>
<td>101</td>
</tr>
<tr>
<td>3.2</td>
<td>Estimates of Domestic Political Institutions on Fiscal/Monetary Policy Choices and Exchange Rate Variability, 1973-1997</td>
<td>102</td>
</tr>
<tr>
<td>3.3</td>
<td>Three Theories of Partisan Economic Goals and Instruments</td>
<td>103</td>
</tr>
<tr>
<td>4.1</td>
<td>Hypothesized Relationships between Societal Group Size and Fiscal/Monetary Policy Choices and Exchange Rate Outcomes following Economic Pluralism</td>
<td>142</td>
</tr>
<tr>
<td>4.2</td>
<td>Estimates of Societal Preferences on Fiscal/Monetary Policy Choices and Exchange Rate Variability, 1973-1997</td>
<td>143</td>
</tr>
<tr>
<td>4.3</td>
<td>Principal-Agent Model and the Emergence of Societal Lobbying</td>
<td>144</td>
</tr>
<tr>
<td>4.4</td>
<td>Three US Governments, Exchange Rate Outcomes, and Societal Lobbying</td>
<td>145</td>
</tr>
</tbody>
</table>
## LIST OF FIGURES

<table>
<thead>
<tr>
<th>Figure</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>Average OECD Openness of Payments and Receipts of Capital, 1973-1997</td>
</tr>
<tr>
<td>2.2</td>
<td>International Monetary Orientations and the Mundell-Fleming Trilemma</td>
</tr>
<tr>
<td>2.3</td>
<td>Strategic Game between Governments and Central Banks</td>
</tr>
<tr>
<td>2.4</td>
<td>Average OECD Currency Variability versus SDR, 1973-1997</td>
</tr>
<tr>
<td>2.5</td>
<td>Average OECD Nominal Interest Rate Differential, 1973-1997</td>
</tr>
<tr>
<td>3.1</td>
<td>Policy Mix Strategic Game with Leftist and Rightist Governments</td>
</tr>
<tr>
<td>3.3</td>
<td>Policy Mix Strategic Game with Subordinate and Independent Central Banks</td>
</tr>
<tr>
<td>5.1</td>
<td>French Monetary Policy</td>
</tr>
<tr>
<td>5.2</td>
<td>French Fiscal Policy</td>
</tr>
<tr>
<td>5.3</td>
<td>Italian Fiscal Policy</td>
</tr>
<tr>
<td>5.4</td>
<td>Italian Monetary Policy</td>
</tr>
<tr>
<td>5.5</td>
<td>Swedish Fiscal Policy</td>
</tr>
<tr>
<td>5.6</td>
<td>Swedish Monetary Policy</td>
</tr>
<tr>
<td>6.1</td>
<td>Japanese Fiscal Policy</td>
</tr>
<tr>
<td>6.2</td>
<td>Japanese Monetary Policy</td>
</tr>
<tr>
<td>6.3</td>
<td>British Monetary Policy</td>
</tr>
<tr>
<td>6.4</td>
<td>British Exchange Rate Variability</td>
</tr>
<tr>
<td>6.5</td>
<td>US Fiscal Policy</td>
</tr>
<tr>
<td>6.6</td>
<td>US Monetary Policy</td>
</tr>
<tr>
<td>6.7</td>
<td>US Exchange Rate Variability</td>
</tr>
<tr>
<td>A.1</td>
<td>Loose Fiscal/ Tight Monetary Policy Mix</td>
</tr>
<tr>
<td>A.2</td>
<td>Tight Fiscal/ Loose Monetary Policy Mix</td>
</tr>
<tr>
<td>A.3</td>
<td>Monetary Expansion under Fixed Rates</td>
</tr>
<tr>
<td>A.4</td>
<td>Fiscal Expansion under Fixed Rates</td>
</tr>
</tbody>
</table>
CHAPTER 1

INTRODUCTION

Scholars now recognize capital mobility, or global financial integration, as the leading feature of the international monetary system in the post-Bretton Woods era. After seeking to explain the resurgence of global capital in the last thirty years, political economists now grapple with understanding its consequences. Does capital mobility mean that states must necessarily sacrifice an autonomous monetary policy in order to achieve domestic price stability and external currency stability? Or does the pursuit of domestic price stability using monetary policy sometimes hinder the external goal of exchange rate stability? If states are not forced by capital mobility to constrain their monetary policies and, thus, remain able to hold an autonomous monetary policy in the post-Bretton Woods era, how can we explain a state’s monetary policy choice and its exchange rate stability? This research project addresses all these important questions.

Political economists have long debated whether statist or societal approaches are more helpful in explaining how governments formulate their domestic and foreign economic policies. Most of the attention has been directed toward trade and
commercial policy; much less work has examined the determinants of monetary and exchange rate policies. Are monetary and exchange rate policies determined by the relative size and political influence of societal interest groups: for example, international investors who prefer stable exchange rates or import-competing manufacturers who prefer an autonomous monetary policy? Or is monetary policy insulated from societal influence due to independent central banks and fixed exchange rate commitments? If societal preferences do matter, then can we construct a model to explain how preferences regarding monetary/exchange rate policy affect actual policy outcomes?

While scholars have posed some of these questions before, we have few answers and even less empirical evidence bolstering our preliminary conclusions. Until recently, political scientists neglected the topic of monetary and exchange rate politics, perhaps because our discipline lacked a strong theoretical framework for understanding the interaction among financial integration, monetary policy choices, and exchange rate outcomes. This neglect is unfortunate since such a framework has long been available in the economics discipline.

The Mundell-Fleming framework from open-economy macroeconomics (Mundell 1960, 1963; Fleming 1962), introduced to political scientists as the “Unholy Trinity” (Cohen 1993), demonstrates that governments can obtain, at most, only two of the following three conditions at one time: capital mobility, monetary policy autonomy, and exchange rate stability. In the post-Bretton Woods era where capital mobility has arguably re-emerged as a “structural” condition of the international
political economy (Andrews 1994a, Webb 1995, Cohen 1996), this trilemma reduces to an interesting political dilemma: choosing an autonomous monetary policy with currency instability or stabilizing exchange rates with the sacrifice of policy autonomy. The central question underlying this research project asks what factors lead national governments to choose stable exchange rates and what factors lead national governments to choose instead an autonomous monetary policy under the condition of capital mobility. This choice has profound implications for which groups in society win and lose with global financial integration (Frieden 1991).

My answer to this research question identifies domestic political institutions\(^1\) as primary determinants of the exchange rate stability or monetary autonomy choice in the post-Bretton Woods era. Leftist-led governments and multi-party governments in proportional representation electoral systems tend to choose monetary policy autonomy. Conversely, rightist-led governments and single-party governments in majoritarian electoral systems opt for monetary constraints in order to achieve exchange rate stability. These partisan and electoral factors function relatively unconstrained by other domestic institutions such as independent central banks and fixed exchange rate commitments. Likewise, the relative size of societal interest groups with differing preferences regarding the exchange rate stability/monetary autonomy tradeoff (e.g. international investors, import-competting manufacturers) fails to explain the national government’s policy choice.

---

\(^1\) I define domestic institutions broadly to include practices and organizations that structure political activity at the unit level, including political parties, electoral systems, bureaucratic divisions, and internal commitments made to external regimes.
While the research question does follow from an economic model – the Mundell-Fleming framework\(^2\) - its answer bears on some of the most important theoretical questions in political science, including the agent/structure debate, theories of international regimes and cooperation, and the state/society debate. As the title of the project indicates, my answer to the research question focuses on the concept of “agency.” Agency holds two important definitions in political theory. It refers both to the ability of actors to make meaningful choices\(^3\) despite external constraints (as in the agent/structure debate) and also to the authority to act on behalf of another’s interests (as in the principal-agent model). I will show that even under capital mobility, governments have a meaningful choice (i.e. agency) about whether to hold an autonomous monetary policy or stabilize exchange rates. The choice, in turn, reflects the government’s interest and obligation (as an agent) to act on behalf of certain groups/electoral constituencies within its society.

Agent/Structure Problem

The agent/structure problem in international relations was brought to the fore by scholars in the constructivist tradition (Wendt 1987, Dessler 1989, Carlsnaes 1992), who wanted to highlight the difficulty in building theories which acknowledge

\(^{2}\) Robert Mundell received the 1999 Nobel Prize in Economic Sciences for this work regarding exchange rates and monetary policy in financially-open economies. J. Marcus Fleming might also have been eligible for a share of this prize had he not died in 1976.

\(^{3}\) At the limit, actors always have choices. For example, someone being robbed at gunpoint faces the choice to resist or submit. But if resistance means certain death, then this choice is not particularly meaningful.
both the choices/power of agents and the causal influence of structural factors on these agents. The agent/structure dichotomy accords with Waltz’s (1979) neorealist framework decomposing a system into interacting units (agents) and structure. In international relations, states (or national governments) function as the primary agents, individuals units which make choices to satisfy particular goals. Structure, in the agent/structure framework, refers broadly to ordering principles, such as anarchy, and systemic processes, such as international trade and cross-border capital flows (i.e. capital mobility).

How can we account for the importance of capital mobility without denying that states/governments still make choices consistent with their own domestic and even partisan interests? In identifying the resurgence of capital mobility as the “most significant change in the political economy of the industrialized countries over the past three decades” (Simmons 1999, 36), scholars (e.g. Andrews 1994a, Webb 1995) tend to emphasize the constraints imposed on states by international financial integration. In terms of the agent/structure dichotomy, the conventional wisdom concerning capital mobility is structure-heavy and agency-thin.

According to the conventional wisdom, capital mobility exerts powerful pressures on the advanced industrial democracies, leading to the convergence of their monetary, and even fiscal, policies. Many international political economists believe that state agency, in terms of economic policymaking, is severely circumscribed, if not completely eliminated. Agents who flout the structural constraint will be severely punished and even eliminated, explaining the demise of leftist governments whose
economic policies are supposedly hostile to capital interests (Kurzer 1993). This academic view accords with the conventional wisdom outside of academia concerning the end of the nation-state (Ohmae 1995) and the loss of national economic sovereignty (Wriston 1992).

To be fair, it is not hard to fathom why the conventional wisdom assigns so much importance to the constraints imposed on governments by internationally-mobile capital interests. It is now estimated that the turnover in foreign exchange markets exceeds $1 trillion per day. A growing number of Americans, for example, now own stocks and bonds, held perhaps in a mutual fund, and hold the capacity, through advances in telecommunications, to move these financial assets on a global basis in response to mere rumors of changes in economic conditions. Shortly after the 1992 elections, President-elect Clinton lamented to his economic advisors the powerful role that he expected the bond market to play in shaping US economic policies: “You mean to tell me that the success of the [deficit reduction] program and my reelection depends on the Federal Reserve and a bunch of f---ing bond traders?” (Woodward 1994, 84).

Yet, political scientists should be skeptical of any story that makes politics, i.e. the interests, power, and institutions of agents, completely subordinate to economic forces. Indeed, a few scholars have already launched a limited counterattack to this wave of capitalist economic determinism, focusing mainly on divergent fiscal policy outcomes under economic globalization. Garrett (1995, 1998), in particular, showed that capital mobility may not be so constraining in terms of
fiscal policy choices: government spending, budget deficits, and capital taxation policies. In many ways, however, his critique of the capital mobility constraint on national economic policies remains incomplete both empirically and theoretically. There is little empirical evidence concerning the effect of capital mobility on national monetary policy choices and exchange rate outcomes. Perhaps more importantly, we lack a theory about how national leaders coordinate their fiscal and monetary policies (the policy mix) to achieve competing domestic economic goals under capital mobility.

In identifying partisan politics as an important determinant of a state’s choice for/against monetary autonomy and exchange rate stability, I wish to inject agency back into the study of global financial integration. The theory and evidence will reveal that capital mobility does not force states to constrain their monetary policies, nor does it promote stable exchange rates. States do face a tradeoff between monetary autonomy and exchange rate stability under capital mobility as the Mundell-Fleming framework suggests, but states resolve this tradeoff in different ways. Domestic political factors help explain this economic choice.

International Regimes and Cooperation Theory

Neorealists and neoliberal institutionalists continue to debate whether international regimes foster cooperation among states or whether these the presence of these regimes simply reflect a pre-existing harmony of national interests. One
important task for institutionalist scholars in this debate is to demonstrate how
international regimes impact national policymaking (Martin and Simmons 1998). In
the context of Western Europe, for example, did membership in the exchange rate
mechanism of the European Monetary System ((EMS) promote exchange rate
stability by constraining national monetary policies?

My answer is “not necessarily.” While the EMS may have promoted
exchange rate stability on a very narrow basis (relative to the German DM), broader
measures of exchange rate stability (relative to the Special Drawing Right – an IMF
reserve currency using the a weighted average of the US dollar, Japanese yen,
German DM, French franc, and British pound as its benchmark) reveal surprisingly
little effect on the part of this regime. Upon reflection, this result should not be
surprising. Even when states make monetary adjustments to reduce variability versus
a single currency (such as the German DM in Europe) such adjustments may have the
effect of increasing variability versus other major currencies (such as the US dollar
and Japanese yen) following the interest parity condition. Yet if one wants to
measure accurately the amount of currency instability faced by international traders
and investors who operate on a global – and not just regional - basis, it is important to
look at measures that capture more than narrow bilateral relationships.

This finding also means that scholars cannot accept the “easy” answer to the
research question posed here; that governments with fixed exchange rate
commitments have chosen stable exchange rates, while governments without such
commitments have chosen monetary policy autonomy. Exchange rate regime membership in the post-Bretton Woods era has been remarkably easy to reconcile with monetary policy autonomy. Regimes such as the “Snake” and later the EMS were constructed to allow substantial national flexibility, permitting member-states to realign their currencies within the regime when domestic macroeconomic conditions required external adjustments.

Regarding the monetary autonomy/exchange rate stability tradeoff, scholars (e.g. Gilpin 1987, Simmons 1996) regularly identify periods of exchange rate stability as cooperative and episodes of policy autonomy as non-cooperative, even defections from international cooperation. The research presented here will suggest that such a categorization may be misleading and even theoretically incorrect. Political scientists have long employed Keohane’s (1984, 51) definition of cooperation, borrowed from Lindblom (1965, 227): “Cooperation occurs when actors adjust their behavior to the actual or anticipated preferences of others, through a process of policy coordination.” In order for exchange rate stability to be cooperative, rather than simply harmonious, some actors need to have adjusted their behavior to pursue policies that they would not otherwise have pursued in the absence of policy coordination.

As Oye (1986, 7) cautioned cooperation theorists: “When you observe cooperation, think Harmony....” What I will demonstrate in this project is that governments, especially rightist ones, pursuing economic policies consistent with exchange rate stability may be acting in their own ideological and electoral interests.

---

4 The interest parity condition argues that exchange rates move according to interest rate differentials.
While some adjustments may have taken place, these adjustments correspond to domestic economic preferences in many cases, suggesting a harmony of interests. For example, scholars have lauded the 1985 Plaza Accord, which led the United States, Japan and West Germany to act jointly for currency stability, as a prime example of international cooperation. Yet it is notable that rightist governments, with strong domestic reasons to achieve exchange rate stability, led each of these G-3 states at the time of the Plaza Accord.

State/Society Debate

At the unit level of analysis, comparative political economists continue to debate the relative importance of societal preferences versus statist institutions to explain economic policy choices. Societal approaches to the study of a government’s domestic and foreign economic policies view the government as a simple referee in a game where interest groups compete to achieve their preferred policy outcomes. Societal theorists often assume that larger, richer, and more influential interests groups will prevail in such a competition. Conversely, statist approaches do not view the government as a neutral referee. Instead, the government plays an independent role in determining economic policies, often following the so-called “national interest” and ignoring the preferences of even large societal interest groups.

Higher interest rates attract capital, leading to currency appreciation, while lower interest rates prompt capital to exit the economy in search of higher returns elsewhere, leading to currency depreciation.
Concerning societal preferences under capital mobility, Frieden (1991) argued that internationally-oriented sectors of the economy tend to benefit from exchange rate stability, while domestically-oriented sectors prefer an autonomous monetary policy directed toward internal goals. Other scholars (McNamara 1998, Garrett and Lange 1995, Gowa 1988, Odell 1982, Krasner 1978) deny that such societal preferences explain much in terms of actual monetary policymaking. Instead, central banks, often as independent state institutions, set monetary policy and help determine exchange rate outcomes consistent with their own narrow interests or particular conceptions of the national interest.

One problem with the state/society framework is that it often treats statist and societal approaches as competitors, rather than as potential complements. The framework also has difficulty handling factors that do not fit neatly into the state/society, or public/private, dichotomy. One such factor is partisan politics. Parties, when they win an election, comprise the “state.” And parties, especially after losing an election or being excluded from the governing coalition, function within society to organize interest groups. While this point may be obvious, partisan factors have been sorely neglected in the long-running state/society debate and the discipline may have missed a parsimonious way to integrate the two approaches.

The theory and evidence to be presented in this research project will demonstrate a central role for political parties in determining a state’s choice regarding the monetary autonomy/exchange rate stability tradeoff. Leftist-led governments tend to choose monetary policy autonomy, while rightist-led
governments opt for exchange rate stability. A state’s electoral system also plays an important role: multiparty governments in proportional representation electoral systems tend more towards monetary autonomy than single-party governments in majoritarian electoral systems. Independent central banks and fixed exchange rate commitments play a lesser role, but do have an influence regarding a state’s fiscal policy choice, which in turn impacts monetary policy and exchange rate outcomes. Societal preferences following the “economic pluralist” logic, which posits that larger groups in society are more likely to obtain their preferred policy outcomes, play little role.

In this sense, my research would appear to offer clear support for statist approaches over societal alternatives. This facile conclusion, however, may be somewhat misleading. In employing an economic pluralistic framework to explain how societal preferences get translated into government policy outcomes, societal theorists tend to “black box” the political process. Societal group size may be telling us nothing at all about economic policy outcomes because it is not the relevant political variable.

Instead, societal preferences appear to matter (i.e. get translated into policy outcomes) through the partisan character of the government, consistent with the principal-agent model. Political parties act as agents for particular groups in society, who function as principals. When a societal group’s agent holds power, its preferences are likely to become government policy, regardless of the group’s relative size. For example, labor-intensive import-competing manufacturers obtain their
preference for policy autonomy when leftist parties hold power, just as capital-intensive international investors obtain their preference for exchange rate stability when rightist governments decide economic policy. These societal groups, as principals, will find their preferences frustrated when their respective agents do not hold power. Thus, the partisan character of the state makes certain societal interests more likely to be heard and transformed into state policy than others.

Policy Implications

The policy implications of this research project are numerous. First, the tradeoff between monetary autonomy and exchange rate stability under the condition of capital mobility is real. While we have long had strong theoretical reasons to believe that this relationship would be empirically valid, very little empirical evidence has been brought to bear in support of the Mundell-Fleming framework (Rose 1994). OECD governments holding a national interest rate that differs from the prevailing "world" interest rate will pay a penalty in terms of exchange rate variability. It is not necessarily the case that a national interest rate above the world interest rate always leads to currency appreciation; sometime a high national interest rate precedes depreciation. But regardless of the direction of currency movements, national interest rates diverging from the world interest rate have been associated with greater exchange rate variability in the post-Bretton Woods era.
Second, governments under capital mobility are not so restricted in policy terms as they may believe. While governments must maintain both economic growth and low inflation in order to retain and attract mobile capital, they have some latitude in how to achieve these policy goals. Governments have two main policy instruments (fiscal and monetary policy) and must direct one towards economic growth and the other towards inflation control. In policy terms, governments can move towards a “convergent” tight fiscal/loose monetary policy mix or an “autonomous” loose fiscal/tight monetary policy mix. The first policy mix remains a popular option as exemplified by the EMU convergence criteria. But the other policy mix can be capital-friendly, especially when fiscal expansion pays for the provision of public goods (infrastructure, worker training, research and development projects) and monetary contraction keeps inflation in check. This latter policy mix does come with associated costs in terms of exchange rate instability (just as the convergent policy mix comes with the potential cost of under-supplied public goods). To the extent that governments are willing to live with some exchange rate variability, they have policy options beyond what neoliberal advocates would suggest.

Finally, this research provides some important insights into the potential viability of the European Monetary Union (EMU), launched in 1999. While I argue that EMS membership should not be treated as evidence that a state has sacrificed monetary autonomy to achieve exchange rate stability, EMU membership, with its common currency and European central bank, stands as an unambiguous choice for
monetary (and even fiscal) convergence. This new institutional arrangement certainly ties the hands of national policymakers in Europe.

In assessing the future prospects of EMU, most observers focus on whether the participating European states fit the criteria for an optimal currency area. But these economic criteria may be only necessary, but not sufficient conditions. Even if these European economies are structured in such a way that they feel exogenous shocks in a similar manner (when a recession hits Ireland, it also hits Italy and Finland, for example), political leaders may wish to respond to the economic shock in different ways. Facing an economic recession, for example, leftist governments seem to prefer fiscal expansion, while rightist governments prefer monetary growth. It is perhaps notable that the four European Union states (Britain, Denmark, Sweden, and Greece) who remained outside EMU upon its launching in 1999 were all led by leftist governments. One important political criteria for EMU success may be the longevity of rightist governments in Europe who genuinely believe in neoliberal policy convergence. It remains to be seen how the new leftist governments in both Germany and France can accommodates both the monetary and fiscal strictures of EMU membership.

Organization of Project

In the chapters that follow, I tell a story of economic agency and monetary divergence among the advanced industrial democracies in the post-Bretton Woods
era. Under capital mobility, some governments have chosen to sacrifice monetary autonomy and stabilize exchange rates, while others have sacrificed currency stability in order to maintain monetary autonomy. The next chapter introduces the economic model underlying the research question. This model, which is based on the Mundell-Fleming framework, argues that states confront a tradeoff between exchange rate stability and monetary policy autonomy under capital mobility. I thus pose the central research question: what factors lead national governments to choose stable exchange rates and what other factors lead these actors to opt instead for an autonomous monetary policy?

Many scholars believe that this question has already been answered. A body of research, which I identify as the “neoliberal convergence hypothesis”, argues that the OECD states, albeit with different degrees of enthusiasm, have embraced exchange rate stability over monetary policy autonomy in the post-Bretton Woods era. I show how this convergence hypothesis offers an incomplete prediction regarding the monetary behavior of OECD states since 1973. The empirical evidence shows divergent, not convergent, monetary behavior of the part of many OECD governments under capital mobility. Thus, we need a theory to explain divergent policy choices.

My alternative to the neoliberal convergence hypothesis is labeled the “policy mix framework.” It begins with the understanding that, since mobile capital can be expected to move in order to maximize real returns, all governments face two primary domestic macroeconomic policy goals: sustainable economic growth (to maximize
nominal returns on capital) and price stability (to minimize inflation losses). To achieve these two different domestic economic goals, government leaders require two independent policy instruments: fiscal policy and monetary policy. States can either direct fiscal policy towards economic growth and monetary policy towards inflation control, leading to a loose fiscal/tight monetary policy mix. Or they can direct fiscal policy towards inflation control and monetary policy towards economic growth, leading to a tight fiscal/loose monetary policy mix.

Monetary autonomy means holding an interest rate different from the world interest rate, which is determined by the largest capital-producing states in the international system (effectively the G-5 economies). Since the world interest rate has been lower, on a nominal basis, than most national interest rates, a policy mix that raises (lowers) interest rates will likely increase (decrease) monetary autonomy. Consequently, governments with a loose fiscal/tight monetary policy mix have effectively chosen greater monetary autonomy at the cost of exchange rate stability. Conversely, governments using a tight fiscal/loose monetary policy mix have opted for exchange rate stability with the associated costs of policy convergence.

Chapter three examines how domestic political institutions affect a state’s policy mix. Contrary to the neoliberal convergence hypothesis, not all OECD governments have chosen the tight fiscal/loose monetary mix associated with monetary convergence and currency stability. Leftist governments and proportional representation electoral systems lead states towards the “autonomous” loose fiscal/tight monetary policy mix. Rightist governments and majoritarian electoral
systems pull states towards monetary convergence. Scholars often posit independent central banks and fixed exchange rate commitments to act as constraints on monetary policy, perhaps stabilizing exchange rates. Yet both these monetary commitment technologies force governments to rely more on fiscal policy expansion to achieve economic growth objectives, sometimes leading monetary authorities to raise interest rates to restrain inflation, which may negate any expected benefits in terms of exchange rate stability.

In chapter four, I consider the question of societal preferences regarding the monetary autonomy/exchange rate stability tradeoff under capital mobility. In certain ways, the sectoral and factorial models which predict divergent monetary policy and exchange rate outcomes based on different societal preferences and interest group size ("economic pluralism") compete with my own explanation based on domestic institutions. The empirical evidence, however, will show that interest group size offers little explanatory power in models of a state’s policy mix and exchange rate outcomes. Domestic institutional factors offer a more consistent and compelling story.

This does not mean, however, that societal preferences do not matter in terms of the monetary autonomy/exchange rate stability tradeoff. Political parties effectively act as agents for different interest groups in society. The partisan character of the government makes certain societal preferences more likely to be heard and transformed into "state" policy, regardless of the relative size of the
particular interest group. I then develop a principal-agent model to account for the pattern of societal lobbying on exchange rate policy.

Chapter five presents three cases of monetary autonomy under capital mobility. Despite the numerous accounts of the French Socialists adopting neoliberal policy strategies in response to capital mobility, the Mitterrand government consistently held a looser fiscal policy, coupled with a tighter monetary policy, than its EMS partners, resulting in relative exchange rate instability and frequent realignments within the regime. To illustrate how proportional representation electoral systems lead states toward policy autonomy, I examine Italy’s policy mix and exchange rate outcomes under a series of coalition governments. Italy’s expansionary fiscal policy, accompanied by monetary tightening to restrain inflation, resulted in substantial monetary autonomy and relative exchange rate instability even inside the EMS. Finally, I examine how the Swedish Social Democrats have maintained policy autonomy within the European Union, choosing not to participate in European Monetary Union.

In chapter six, I examine three cases of policy convergence to achieve exchange rate stability. Japan, under a succession of conservative LDP governments, has consistently used a tight fiscal/loose monetary policy mix to maintain a stable and competitive currency, despite eschewing any external commitments to “fix” the value of the yen. Great Britain, in the Thatcher years, remained outside the European Monetary System, yet it nonetheless followed a tight fiscal/loose monetary policy mix consistent with exchange rate stability and monetary convergence. Finally, I
investigate a so-called “anomalous” case: the first Reagan Administration in the United States, where a rightist government apparently opted for monetary autonomy and exchange rate instability with a loose fiscal/tight monetary policy mix more often associated with leftist governments. The case analysis shows that Reagan administration’s policy mix was much less autonomous than is commonly understood.

In the final chapter, I conclude by considering the broader political theory questions implicated in this research project. I focus also on what the findings presented here imply for the future of the EMU project in Western Europe and how this research project could be extended to include states in the developing world.
CHAPTER 2

THE POLICY AUTONOMY/EXCHANGE RATE STABILITY TRADEOFF

In an environment of formally or informally pegged rates and effective integration of financial markets, any attempt to pursue independent monetary objectives is almost certain, sooner or later, to result in significant balance-of-payment disequilibrium, and hence provoke potentially destabilising flows of speculative capital. To preserve exchange rate stability, governments will then be compelled to limit either the movement of capital or their own policy autonomy. If they are unwilling to unable to sacrifice either one, then the objective of exchange rate stability itself may eventually have to be compromised. Over time, except by chance, the three goals [capital mobility, exchange rate stability, and monetary policy autonomy] cannot be attained simultaneously. (Cohen 1993, 147)

In 1992, German monetary authorities raised nominal discount rates to address internal inflation concerns in the wake of reunification. Capital flowed into the German economy to take advantage of the higher rates of return for holding Deutschmarks (DM). The DM appreciated, while the British pound and Italian lira depreciated under attack by currency speculators. Unable to stabilise the value of their currencies within the European Monetary System’s Exchange Rate Mechanism, Britain and Italy exited the regime, allowing their currencies to float freely in international currency markets.

This much-discussed episode in European monetary relations helps illustrate that, in the post-Bretton Woods era where capital moves across international borders, states must choose between exchange rate stability and monetary policy autonomy. This tradeoff means that if states desire to use their monetary policy for certain internal
objectives, such as inflation control, the external goal of exchange rate stability may be sacrificed and exchange rate regimes may even be undermined. The central question underlying this research project asks when do state leaders choose to stabilize exchange rates and when will these actors opt instead for an autonomous monetary policy?

Many scholars believe that this question has already been answered. A recent wave of research proposes that advanced industrial democracies, especially in Western Europe, have sacrificed autonomous policymaking in favor of exchange rate stability—the "neoliberal convergence hypothesis." This answer to the research question has an obvious appeal. OECD governments, even those of the political left, appear to have embraced the policy goal of inflation control. (Kurzer 1993, Notermans 1993) Likewise, several states participated in, with varying degrees of success, the European Monetary System (EMS), a managed floating exchange rate regime with the German currency as the system anchor. (McNamara 1998, Andrews 1994b, Walsh 1994)

Yet, there is also prima facie evidence for skepticism concerning the neoliberal convergence hypothesis. The policy goal of inflation control may, in fact, lead some states to assert monetary autonomy, raising interest rates in an effort to stabilize domestic prices. Furthermore, exchange rate regime membership in the post-Bretton Woods era has been remarkably easy to reconcile with monetary policy autonomy. Regimes such as the "Snake" and the Exchange Rate Mechanism of the European Monetary System (EMS) were constructed to allow substantial national flexibility, permitting member-states to realign their currencies within the regime when domestic macroeconomic conditions required external adjustments. McNamara (1998: 98-121) described the high
degree of monetary policy autonomy associated with the Snake from 1973 to 1978. Gros and Thygesen (1992: 68) documented 12 EMS realignments from 1979 to 1990, involving some 40 individual national currency adjustments. After the 1992 European exchange rate crisis, EMS bands were widened to 15%, turning the arrangement into an effective free float.

Thus, our understanding of how the advanced industrial democracies resolve the Mundell-Fleming tradeoff under capital mobility remains very incomplete. As Pauly (1995, 386) asked: “Under what conditions do powerful and potentially dominant states voluntarily relinquish policy autonomy? This remains a key question for future research in this area.” Cohen (1996, 285) concurred: “The number of conditions that might influence the preferred trade-off between policy autonomy and exchange rate stability is quite large. What is needed is more careful applied investigation of how each works in today’s financially integrated world.”

This chapter sets the foundation for such an applied investigation. The chapter is divided into four parts. The first part describes the macroeconomic model positing a tradeoff between policy autonomy and exchange rate stability. The second section examines the conventional wisdom concerning the research question: the neoliberal convergence hypothesis. Section three develops my alternative model of macroeconomic policymaking under capital mobility: the policy mix framework. And in the fourth part, I show how a state’s fiscal/monetary policy mix indicates its choice regarding the policy autonomy/exchange rate stability tradeoff under capital mobility.
Theoretical Foundation

The Mundell-Fleming Framework

In the early 1960s, open-economy macroeconomists such as Robert Mundell (1960, 1963) and Marcus Fleming (1962) argued that while states may prize three fundamental economic conditions – exchange rate stability, monetary policy autonomy and capital mobility – they can, at most, achieve only two of the three conditions simultaneously. States prize exchange rate stability because fluctuations in currency values are thought to impose significant transaction costs on international trade and cross-border investment. The relationship between stable currencies and expanding trade is regularly cited as a justification for monetary coordination in Europe, for example, although the evidence is, at best, mixed in this regard. As one IMF review reported: “The large majority of empirical studies on the impact of exchange rate variability on the volume of international trade are unable to establish a systematically significant link between measured exchange rate variability and the volume of international trade, whether on an aggregated or on a bilateral basis” (cited from Edison and Melvin 1990, 21).

States desire an autonomous monetary policy to fight economic recessions and control inflation. Faced with an economic decline, policymakers might like to loosen monetary policy to stimulate economic activity. In an economy with rising prices, state leaders might like to tighten monetary policy to reduce inflationary pressures. Scholars often refer more broadly to “policy autonomy.” In many cases, this is not conceptual sloppiness, but instead suggests important links between monetary and fiscal policies.
Sometimes monetary policy becomes autonomous because of certain fiscal policy choices; this is a point that I develop at length in the third section of this chapter.

Finally, states desire capital mobility (currency convertibility) for the efficiency gains of integrated financial markets. As Krugman (1999, 61) argues, governments “would like to assure business that money can be freely moved in or out of the country, if only to avoid the bureaucracy, paperwork, and opportunities for corruption inevitably associated with any attempt to limit capital movements.” Nonetheless, of the three economic conditions, capital mobility may be the least prized. Cohen (1993, 147) observed that “if polled ‘off the record’ for their private preferences, however, most [governments] would probably admit to prizing exchange-rate stability and policy autonomy even more [than capital mobility].”

Yet, for better or for worse, capital mobility has become a fact of life for OECD governments in the post-Bretton Woods era. Scholars now regularly identify capital market integration as a structural feature of the international monetary system (Andrews 1994a, Webb 1995). As measured in terms of the OECD’s average openness on the payments and receipts of capital (see Figure 2.1), capital market integration seems nearly complete. Quinn’s (1997) data on the restrictions on payments and receipts of capital, which uses a 0-4 openness scale, shows that capital accounts were already fairly open when the Bretton Woods regime ended in the early 1970s. Capital mobility has increased steadily through the post-Bretton Woods era with no reversal of this general trend.
Indeed, scholars identify capital mobility as a structural feature precisely because states will likely find the trend extremely difficult to reverse due to changes in information/communications technology, national regulatory environments, and market practices (Bryant 1987, Cerny 1993, Goodman and Pauly 1993).¹ As Andrews (1994a, 214) concluded: “The difficulties in reversing the trend toward financial integration derive in part from this diversity of sources and in part from their collective interaction. The costs of reversing the technological advances that underlie capital mobility are difficult to contemplate in any straightforward counterfactual sense.” Thus, in the post-Bretton Woods era, the so-called Mundell-Fleming “trilemma,” known also as the “Unholy Trinity” (Cohen 1993), can be reduced to a simple dilemma – the tradeoff between stabilizing exchange rates and holding an autonomous monetary policy.

*International Monetary Orientations*

According to the Mundell-Fleming framework, three different international monetary orientations are feasible, as illustrated in Figure 2.2. Political scientists have tended to identify particular orientations with historical periods, although such characterizations do not necessarily mean that some states did not deviate from the

---

¹ This does not mean that governments do not occasionally consider the re-imposition of capital controls. In the wake of the Asian financial crisis, some government leaders in Asia and even some Western economists advocated such an approach to dampen the flows of speculative capital. It is interesting to note that, at the time this project was completed, no OECD governments have re-imposed capital restrictions.
prevailing orientation during the period in question. For example, even during the classical gold standard, supposedly the Golden Age of exchange rate stability under capital mobility, "monetary authorities developed a variety of techniques for evading the rules of the game.... Monetary policies in this period were never really either fully passive or simply automatic (Cohen 1995, 212)."

Political scientists have also sometimes talked as if capital mobility was a relatively new feature of the international monetary system. But international capital mobility marked the years before WWI, as well as the interwar era (Verdier 1998, Nurkse 1944). To deal with currency variability, the major powers constructed "fixed" exchange rate regimes, the successful operation of which would require the subordination of monetary policy to the external objective of maintaining a stable currency. The classic gold standard, which operated between 1870 until the outbreak of WWI, is generally considered a success (Gilpin 1987, 123-7), in large part because governments had not yet developed the interventionist practices that would later come to characterize the Keynesian welfare state (Ruggie 1983). Scholars often treat the gold exchange standard of the interwar years as a less successful attempt to stabilize the international monetary order (Simmons 1996). After WWI, governments faced better-organized domestic constituencies and new political ideologies demanding that economic policy instruments be directed toward internal objectives such as economic growth, employment, and

---

2 Indeed, one conclusion emerging from this project is that the post-Bretton Woods era cannot be easily characterized by a single monetary orientation. Capital mobility has led some states to retain policy autonomy just as other states have embraced currency stability.

3 Gilpin (1987, 126-7) also attributes the success of the classic gold standard to British hegemony. Likewise, he attributes the failure of the gold-exchange standard to the lack of a hegemon during the interwar years.
inflation. The gold exchange standard broke down in the early 1930s as governments subordinated the external goal of exchange rate stability to satisfy such internal objectives.

The Bretton Woods regime, created in 1944 and ending in the early 1970s, sacrificed capital mobility in favor of exchange rate stability and monetary policy autonomy. Ruggie (1983) labeled this new international monetary orientation as “embedded liberalism” since the regime was economically liberal, seeking to foster international trade with fixed exchange rates. The dollar standard pegged the value of the US dollar to gold and pegged other national currencies to the dollar. The international liberal orientation was embedded in a larger framework which permitted, and even encouraged, governments to intervene in their domestic economies to affect national (and partisan) objectives concerning economic growth, employment and inflation. In order to achieve these differing objectives, state leaders required policy autonomy.

Thus, capital mobility had to be sacrificed. Indeed, the Bretton Woods agreement acknowledged the right of states to impose capital controls and financial restrictions designed to discourage speculative flows, those capital movements not linked to trade flows. Quoting John Maynard Keynes (from Gold 1977, 11): “As a permanent arrangement, the plan accords to every member government the explicit right to control all capital movements. What used to be heresy is now endorsed as orthodox.... It follows that our right to control the domestic capital market is secured on firmer foundations than ever before, and is formally accepted as a proper part of agreed international agreements.”
As money became more internationally mobile evading national capital controls and convertibility restrictions, states moved to floating exchange rates in the early 1970s in an effort to preserve their policy autonomy. The Bretton Woods era was over. Currency values - now under pressure from the real economy and financial flows - fluctuated dramatically, prompting some state leaders to make new commitments to multilateral exchange rate institutions (in Europe, the “snake” 1973-78 and later EMS 1979-1998) or peg the value of their currencies unilaterally to major international currencies. But honoring a commitment to a stable currency (which was not always the primary purpose of joining such institutions) would require states to sacrifice policy autonomy, implying a return to the international monetary orientation exemplified by the classic gold standard. McNamara (1998) identified this apparent shift in the post-Bretton Woods era to stabilizing exchange rates under capital mobility with the sacrifice of policy autonomy as “competitive neo-liberalism,” arguing that this international monetary orientation has been adopted not only by rightist governments in Europe, but leftist governments as well.

Monetary Autonomy under Capital Mobility

With the current focus on explaining the apparent neoliberal shift to currency stability and the accompanying loss of policy autonomy, the third international monetary orientation under the Mundell-Fleming framework has largely been ignored. And when scholars have investigated instances of monetary autonomy under capital mobility (e.g. the interwar years and the breakdown of the gold exchange standard), they have tended to
treat the orientation as pathological (e.g. Simmons 1996). Episodes involving exchange rate instability are often seen as systemic breakdowns, failures to maintain international exchange rate cooperation (e.g. Gilpin 1987, 130). This view identifies exchange rate stability as an international "public good." While one can accept the idea of exchange rate/monetary policy as "public" in character (Gowa 1988), scholars should be careful characterizing exchange rate stability as an unambiguous "good." Frieden’s (1991) model of sectoral preferences under capital mobility suggests that domestically-oriented sectors of the economy (the non-tradable service sector, import-competitng producers) benefit little from currency stability. To the extent that achieving the external goal of currency stability requires governments to neglect certain internal macroeconomic objectives, stable exchange rates under capital mobility may instead function as a public "bad" for a large segment of society.

To satisfy internal macroeconomic goals, traditional Keynesian demand-side economic policies necessitated some measure of monetary autonomy — either “loose” money to stimulate the economy in the trough of the business cycle or “tight” money to fight inflation at the crest. To the extent that elected governments lacked control of monetary policy due to the independent status of central banks, government leaders often employed expansionary fiscal policies to boost aggregate demand, leading independent central bankers to assert monetary autonomy in order to restore domestic price stability.

Even as capital owners may view traditional demand-side Keynesian policies as unfriendly to their international interests, there is growing evidence that some governments have shifted toward more capital-friendly, supply-side interventionist
policies (Boix 1998, Garrett and Lange 1991). Policies to make public goods investments in infrastructure (physical capital), education and worker training (human capital), and research and development (technological capital) with an eye to expanding the supply-side of the economy are typical examples of this “new growth” fiscal orientation (Aschauer 1990, Barro 1990, and Romer 1990). Scholars have not fully explored the monetary implications of these supply-side fiscal policies. However, fiscal expansion directed at the supply-side of the economy could lead to greater monetary autonomy if states concomitantly raise interest rates in order minimize any inflation pressures coming from fiscal expansion; even supply-side policies may have some demand-side effects. And governments asserting such policy autonomy might be expected to weaken their commitments to fixed exchange rate regimes, even if they do not actually exit the multilateral arrangement or formally abandon a unilateral peg.

This discussion of possible international monetary orientations given the Mundell-Fleming framework suggests that, at least in theory, substantial monetary agency for national governments should remain even under capital mobility. Some governments may prefer to accept the loss of policy autonomy in order to maintain external stability. Other governments may prefer to pay the price of exchange rate instability in order to obtain policy autonomy. As Oatley (1997, 15-16) notes, “even if we treat a high level of capital mobility as exogenously given, we are still left with the need to explain which of remaining two [exchange rate stability or monetary policy autonomy] will be chosen.”
The Neoliberal Convergence Hypothesis

In response to the research question asking when governments choose monetary autonomy versus exchange rate stability, the neoliberal convergence hypothesis\(^4\) argues that all OECD governments – albeit at different rates (Walsh 1994) and with differing degrees of enthusiasm - have generally accepted the sacrifice of policy autonomy for inflation control and exchange rate stability. McNamara (1998, 3) sought to explain this “historic economic policy convergence that occurred across the majority of the European governments beginning in the mid-1970s and solidifying in the 1980s.” Notermans (1993, 133) observed a broader convergence, explaining a “general consensus amongst policy authorities in the OECD area that macroeconomic policies should have but one goal – the fight against inflation.” Consistent with these trends, Andrews (1994b, 428) noted a “predisposition towards exchange rate stability,” especially in Western Europe.

The neoliberal convergence hypothesis links the structural feature of capital mobility (Andrews 1994a) to the macroeconomic goal of inflation control and the policy outcome of exchange rate stability. Neoliberal convergence scholars argue that the economic policies pursued by different political parties once in power have become effectively indistinguishable. Leftist parties, much like rightist ones, have made low inflation their overriding macroeconomic goal in order to retain and attract mobile capital. As Kurzer (1993, 3) claimed, while “social democratic parties are again or still in

\(^4\) What I term the “neoliberal convergence hypothesis” is sometimes called the “capital mobility hypothesis” (Oatley 1997, 1999) or simple the “convergence thesis” (Garrett 1995, 1998). I prefer the first term since the second is theoretically inaccurate as Oatley correctly notes. Capital mobility does not logically imply that governments must accept monetary constraints or embrace currency stability. The
power... they simply follow the cues and programs of right-wing or conservative parties and have no alternatives to proposals to shrink the public sector, privatize social services, and deregulate labor markets.”

These neoliberal convergence scholars also argue that the convergence process tends to accelerate when national governments, such as those in Western Europe, make formal “fixed” exchange rate commitments, constraining the autonomous use of their monetary policies by joining multilateral exchange rate regimes. As McNamara (1998, 2) argued, “political actors from socialist to conservative [have] supported an exchange rate regime that in effect gives away economic policy tools and limits their ability to use macroeconomic policy to distinguish themselves” to groups in society.

In terms of policy instruments, the neoliberal convergence hypothesis argues that states use a tight fiscal policy to restrain inflation, freeing monetary policy for the pursuit of exchange rate stability (Moses 1994). Convergence theorists do not always clarify what this means for the direction of monetary policy (I will return to this point later). Nonetheless, it is often claimed that capital mobility implies that “in anything but the short run, the fiscal and monetary policies of governments of the left and the right should converge” (Garrett and Lange 1991, 543). It is important to understand that such a logic can be sustained only if states face a single internal macroeconomic objective that can be

---

third term used by Garrett does not immediately indicate on what economic policies national governments must converge when capital is internationally mobile.
5 As noted above, Garrett has modified his position since his 1991 article with Peter Lange. In 1991, they argued that in terms of demand-side policies — fiscal and monetary policies — the left and right behave similarly, in terms of supply-side policies, the left and right differ. I agree with this latter contention, but not the former, since fiscal and monetary policies have supply-side, as well as demand-side, implications. Take, for example, a government funded infrastructure project; it will have supply effects in terms of adding physical capital and demand effects in terms of creating jobs. To the extent that supply-side
achieved through fiscal instruments so that monetary instruments can be directed toward external stability.

Garrett (1995, 1998) began the critique of the neoliberal convergence hypothesis, showing that capital mobility leads some governments to expand, not contract, their fiscal policies. Rodrik (1997) and Boix (1998) presented additional evidence of fiscal expansion in response to global financial integration. I extend their critique of neoliberal convergence, focusing here on monetary and exchange rate policies, and building on their story of fiscal divergence under capital mobility.

Garrett does briefly investigate the effect of capital mobility on short-term real interest rates. While he tells a story of fiscal divergence, his discussion of interest rates actually suggests monetary convergence, consistent with the neoliberal hypothesis. He reports that “capital mobility was significantly associated with a lowering of rates” (1995, 675), a result implying that OECD governments’ interest rates have fallen more in line with the low-inflation, low-nominal interest rate international price-setting states (the United States, Japan and Germany) which largely determine the “world” interest rate. As I will demonstrate later, real interest rates tell us little about monetary autonomy and market interest rates tell us little about monetary choices made by governments and their monetary authorities under capital mobility.

Thus far, the critique of the neoliberal convergence hypothesis is incomplete – limited to the fiscal side – and potentially misleading – on the monetary/exchange rate side. Until we further develop theories about how governments use their fiscal and

policies differ in terms of a government’s partisan orientation, it should be expected to show up in the
monetary policies in combination (the policy mix), we can do little more than test competing arguments about whether financial openness leads to greater “efficiency” within an economy or additional “compensation” for negatively affected groups. Of course, capital mobility may have both efficiency and compensation effects; indeed, this seems to be the conclusion offered by Garrett’s research. Yet without a priori theorizing about the fiscal/monetary mix under capital mobility, it will be hard to predict how OECD governments in the post-Bretton Woods era use available policy instruments to reconcile competing economic objectives.

The Policy Mix Framework

The rigid focus on the single policy goal of inflation control under capital mobility tells an incomplete story. Certainly, capital mobility does lead governments to pay close attention to domestic price stability (i.e. low inflation) when money can freely exit the economy in search of higher real returns elsewhere. Yet the economic definition of real returns, which is roughly expressed as nominal returns minus inflation, reveals that inflation (or expected inflation) is only half the story. Just as real returns decrease with expected inflation, real returns increase with nominal returns. If nominal returns on capital are small, or even negative, then low expected inflation alone may not be sufficient to prevent capital flight or attract outside capital into the domestic economy. Consider, for example, the Japanese economy in the late 1990s. Despite experiencing government’s use of fiscal and monetary instruments.
negative rates of inflation (falling prices, which should boost real returns for investors),
capital fled the country in search of higher nominal returns in Europe and the United
States as Japan fell into an economic recession.

Policy Goals

The political implications of such an economic story are simple. Governments
under capital mobility must pursue at least two internal macroeconomic policy goals:
inflation control and economic growth. Consider the interests of foreign direct investors
(FDI) – long-term capital holders. To the extent that FDI can be considered a substitute
for international trade (Frieden 1991, 430), economic growth and national income may be
important positive considerations. The basic gravity model of bilateral trade indicates
that cross-border exchange increases with national income and decreases with distance
(Anderson 1979, Linnemann 1966). Thus, international investors are likely to be
attracted to markets where income is high and economic activity is expanding. Short-
term capital, in the form of portfolio investment, has similar interests in economic
expansion. Growth today may be seen as a signal of greater business profits in the future,
attracting equity investors into the domestic economy. Bond investors can likewise be
attracted and retained with increased yields (higher nominal returns) on corporate and
government debt, even as inflation pressures mount due to economic expansion.

If political leaders have two primary domestic macroeconomic objectives, then
they will need at least two independent policy instruments directed internally to satisfy
these goals. Much as a system of equations is “underdetermined” if it contains more
variables than equations, economic policymaking usually requires at least as many
instruments as goals (Tinbergen 1966). As Mundell (1968, 201) concisely explained, “to
achieve a given target [goal] there must be an effective instrument, and to achieve various
independent targets there must be at least an equal number of effective instruments. If a
program includes more targets than instruments, at least one target cannot be fully
attained....”

Yet this relationship between the number of policy goals and the number of policy
instruments is not true simply by definition. Some policy goals, such as economic
growth (the expansion of production) and employment, tend to be achievable using a
single policy instrument, provided that it is properly directed. As national production
expands, so does the employment rate. Other policy goals, such as economic growth and
low inflation, are much harder to achieve simultaneously using a single policy
instrument.

Policymakers have sometimes expressed “growth and employment with low
inflation” as a single policy goal (Mundell 1968, 204). Implicitly, such an expression
makes reference to the Phillips curve, which describes the empirical relationship between
employment and inflation in Great Britain from 1861-1957 (Phillips 1958). Phillips’s
analysis showed that wage inflation increased (decreased) with the employment
(unemployment) rate. To the extent that the relationship between employment and
inflation is one-dimensional (a curve or line has only one dimension), then policymakers
would in principle need only a single policy instrument to achieve their desired
combination of employment/economic growth and inflation.
The problem for policymakers is that employment/economic growth and inflation outcomes do not fall along the so-called “Phillips curve” in the post-Bretton Woods era. The stagflation (high unemployment coupled with high inflation) experienced by many OECD states in the mid-1970s and again in the early 1980s cast considerable empirical doubt on the simple Phillips curve relationship, while the monetarist revolution in economics (Friedman 1968, Phelps 1967) pronounced strong theoretical skepticism. If economic growth and inflation outcomes are better understood in two-dimensional space, then policymakers in the post-Bretton Woods era need two independent policy instruments to achieve the often competing goals of sustainable economic growth and low inflation. One policy instrument must be directed at production in order to expand the economy and the other policy instrument must be directed at price stability in order to keep inflation in check.

Policy Instruments

States possess two main instruments for economic policymaking: fiscal and monetary policy. Economists define the policy mix as the combination of monetary and fiscal policies (Dornbusch and Fischer 1990, 149). Fiscal and monetary policy can be treated as “loose” or “tight”, although these terms are best understood on a continuum rather than dichotomous categories. A loose (tight) fiscal policy means more (less)

---

6 While political leaders do possess other instruments, the independence and effectiveness of these instruments may be very limited. Take, for example, the instrument of commercial policy: export subsidies and import restrictions. At some level, export subsidies—government spending targeted on the exporting sector—can be understood as an extension of fiscal policy; hence commercial policy may be non-independent from fiscal policy. States’ ability to effectively employ import restrictions may be very limited since many tariffs and quotas run contrary to GATT rules concerning free trade.
government expenditures, perhaps with larger (smaller) budget deficits. Due to the global integration of financial markets, monetary looseness/tightness must be understood in terms of an international standard. National interest rates below (above) the “world” interest rate can be considered loose (tight).

Using the familiar tight/loose dichotomy for fiscal and monetary policy, Table 2.1 illustrates four possible policy mixes. The fiscal/monetary combinations in cells 1 and 4 may be relics of the Bretton Woods era when capital flows were restricted. In the post-Bretton Woods era, using both policy instruments to achieve a single policy goal and neglecting other domestic macroeconomic obligations can be viewed as non-competitive from the perspective of mobile capital. Tightening both fiscal and monetary instruments (cell 1), except during periods of high inflation, portends an economic contraction, inducing capital to exit the domestic economy in search of higher nominal returns elsewhere. Loosening both fiscal and monetary instruments (cells 4), except during a deep recession, may also provoke capital flight as economic expansion leads to unchecked rising prices with inflation eroding the real returns for capital within the national economy.

Faced with the possibility of capital flight, governments pursuing the twin goals of economic growth and low inflation may prefer the more competitive, and capital-friendly, policy mixes in either cells 2 or 3. These fiscal/monetary combinations assign one policy instrument to each of the two internal economic goals. If government leaders use a tight fiscal policy to restrain inflation, then monetary authorities can employ a

---

7 I will provide an operational definition for the world interest rate (i*) later in this chapter.
looser monetary policy to promote economic growth. Following McNamara (1998) and Moses (1994), the tight fiscal/loose monetary policy mix in cell 2 can be identified as “neoliberal.” Conversely, if government leaders use a loose fiscal policy to expand the economy, monetary authorities may need to tighten interest rates to keep inflation in check. To the extent that the fiscal expansion is directed toward the supply-side of the economy, the loose fiscal/tight monetary policy mix in cell 3 can identified as “new growth” (Aschauer 1990, Barro 1990, and Romer 1990).

This policy mix framework can be more formally modeled as a strategic game between governments, controlling the fiscal instruments, and central banks, possessing the monetary instruments, as shown in Figure 2.3. Both players, the government and the central bank, have two strategy options: to expand or contract its policy instrument. With regard to player preferences, I argue here that central banks function as agents of the government. Hence, both players have relatively harmonious preferences for achieving moderate economic growth with low inflation.8 Thus, the outcome of “moderate economic growth with low inflation” is preferred to either the outcome of “high growth with high inflation” or the outcome of “no inflation with no economic growth.”9 I make no particular distinction at this point between independent and subordinate central banks; nor do I differentiate here between the preferences of rightist and leftist governments.

---

8 I will relax this assumption in the next chapter.
9 With regard to the choice between “high growth with high inflation” and “no growth with no inflation,” governments are likely to prefer the former for electoral reasons, while central banks are likely to prefer the latter given their mission to guarantee domestic price stability.
Facing fiscal expansion by the government to boost economic growth, central banks raise discount rates (monetary contraction) to restrain inflation, resulting in a loose fiscal/tight monetary policy mix. In the wake of fiscal contraction by the government to maintain low inflation, central banks may lower discount rates (monetary expansion) to boost economic growth, yielding a tight fiscal/loose monetary policy mix. The likely outcome in this strategic interaction is either the loose fiscal/tight monetary policy mix or the tight fiscal/loose monetary policy mix. Given the relatively harmonious preference ordering identified here, the government is indifferent between these two policy mixes inasmuch as they are both expected to produce moderate growth with low inflation.10

Empirical Evidence

Certainly, this game represents a highly stylized version of domestic economic policymaking under capital mobility. But it does posit a simple and testable hypothesis: in the post-Bretton Woods era characterized by international capital mobility, OECD monetary authorities will tighten (loosen) discount rates when governments expand (contract) fiscally. To test empirically the strength of this association between fiscal and monetary policies, I estimate the simple model in equation 2.1 for 23 OECD countries11 over the 1973-1997 period.

10 Of course, over time if one or both policy mixes consistently fail to achieve the desired economic outcomes, the governments may not be so indifferent.
11 The OECD sample includes: the United States, Japan, Germany, Britain, France, Italy, Netherlands, Belgium, Luxembourg, Denmark, Ireland, Greece, Spain, Portugal, Austria, Sweden, Finland, Norway, Switzerland, Iceland, Canada, Australia, New Zealand, and Turkey. I restrict my analysis in this project to the advanced developed democracies for both theoretical and empirical reasons. The argument that I
\[
\text{INTRATE}_{it} = \beta_0 + \beta_1 \cdot \text{FISCAL}_{it} + \beta_2 \cdot \text{KAPMOB}_{it} + \\
\Sigma(\alpha_j \cdot \text{COUNTRY}_{jit}) + \Sigma(\alpha_j \cdot \text{YEAR}_{jit}) + e_{it} \quad (2.1)
\]

The dependent variable INTRATE, measures a state’s nominal central bank rate in year \( t \).\(^{12}\) For reasons that I will develop more fully later, it is *nominal* interest rates that matter in a study of monetary policy autonomy. Real interest rates (more accurately, real interest rate differentials) indicate the extent to which capital moves to equalize real returns (i.e. capital mobility, which is a different menu item in the Mundell-Fleming framework). I focus on a state’s central bank rate, which is a policy choice rather than a market outcome, to best capture how a state chooses to vary its monetary policy.

FISCAL indicates the level of government consumption as a percent of state \( i \)’s GDP in year \( t \).\(^{13}\) Higher (lower) values indicate a more expansionary (contractionary) fiscal policy orientation in constant terms.\(^{14}\) I use a measure of government spending, rather than budget deficits, to best capture a state’s fiscal policy *choice*. Budget deficits

---

12 The central bank rate comes from the International Monetary Fund, *International Financial Statistics*, line 60 ("discount rate"). When line 60 is empty, I use values from line 60b, followed by 60c, both of which are other central bank interest rates. For the United States, 60b is the "Federal funds rate" and 60c is the "Treasury bill rate."

13 These data are provided by the OECD, *Annual National Accounts* (various years).

14 I use a spending measure in constant terms to be consistent with the IS-LM models presented in the appendix. The IS-LM framework assumes fixed prices.
(measured as tax revenues minus government expenditures) can vary for reasons unrelated to a government’s fiscal policy orientation. For example, tax revenues tend to decrease in an economic recession; hence, a budget deficit may reflect poor economic conditions as much as it reflects an expansionary fiscal orientation. Furthermore, to the extent that deficits do reflect a fiscal policy choice, they reflect choices made by past governments, rather than the current government.

I start with a control variable for a state’s capital account openness. To the extent that a state’s capital account is not fully open, it may not be forced to pursue the twin domestic policy goals of economic growth and low inflation to forestall capital flight. Finally, to control for a host of omitted country-specific domestic factors and year-specific systemic factors (Green, Kim and Yoon 1999), I add dummy variables for all countries in the sample, except the United States, and all years, except 1973.

The reader should understand that I do not intend equation 2.1 to serve as a complete model of a state’s monetary policy orientation. Indeed, I will offer a fully specified model in the next chapter. My goal here is to examine the empirical association between OECD fiscal and monetary policies in the post-Bretton Woods era. My argument suggests that $\beta_1$, the coefficient on FISCAL, should be positively signed and statistically significant: when states expand their fiscal policy for economic growth purposes, they will raise interest rates (monetary contraction) for inflation control. To the extent that states simply focus on a single domestic policy goal using both monetary and fiscal policies, $\beta_1$ should be negatively signed and statistically significant: when states...

---

15 These data come from Dennis Quinn (1997).
expand their fiscal policy for economic growth purposes, they will instead lower interest rates (monetary expansion) also for economic growth purposes. To the extent that states do not coordinate their fiscal and monetary policies in any consistent fashion, $\beta_I$ will be statistically insignificant.

As the error structure in time-series cross-sectional models is likely to be non-spherical, i.e. plagued by autocorrelation, heteroskedasticity or both, I use an econometric technique to estimate this model, and all models elsewhere in this project, that corrects for both panel heteroskedasticity and spatial (contemporaneous) autocorrelation (Beck and Katz 1995). I also correct for potential serial autocorrelation within each panel by estimating and adjusting for a panel-specific AR(1) process. This technique for pooled time-series provides Prais-Winsten coefficients with Panel Corrected Standard Errors (PCSE).

The initial results are reported as model 1 in Table 2.2. Consistent with my policy mix hypothesis, the coefficient on FISCAL is positive and statistically significant. A one percent increase (decrease) in government consumption relative to GDP is associated with an increase (decrease) in the central bank rate of almost 23 basis points. Fiscal expansion to with an eye to economic growth appears to be met with monetary contraction to keep inflation in check. Fiscal contraction to restrain inflation permits

---

16 There are several ways to deal with serially correlated errors in a time-series cross-sectional model: including a lagged dependent variable, using first differences, or correcting for a first order autoregressive AR(1) process. Achen (2000) strongly advises against the first technique. I use the third technique in order to preserve observations that would otherwise be lost using a lagged term or first differences. All techniques produce similar substantive results. The AR(1) correction estimates $\rho$, a measure of first-order autocorrelation via Prais-Winsten, preserving the first observation in the estimation routine. This measure is then used to transform the data: $y_i^{\text{new}} = y_i - (\rho \cdot y_{i-1})$. This transformation is effectively a form of differencing, conditioned on $\rho$. 

44
monetary expansion for economic growth. And since I measured interest rates in terms of the central bank rate (a policy choice) rather than market interest rates (an economic outcome), this relationship cannot simply be dismissed as “crowd out,” which may occur when an expansionary fiscal policy increases the demand for money causing market interest rates to rise.

When I add another control variable for the state’s inflation rate in year $t$ (INFLAT), the estimated coefficient for the FISCAL term gains both substantive and statistical strength (model 2). This result further illustrates that states make monetary policy choices in response to more than just inflation. Inflation control is important when facing the possibility of capital flight (as the statistically significant INFLAT term indicates), but it does not appear to be the only economic consideration.

I argued earlier that membership in monetary/exchange rate regimes would be only weakly associated with monetary convergence due in part to the flexible construction and operation of these regimes. Monetary convergence means bringing national interest rates more in line with the low prevailing world interest rate. Consequently, to achieve monetary convergence, states need conditions allowing them to lower nominal interest rates. To test this proposition, I also estimate equation 2.1 with the additional of three dummy variables indicating membership in various fixed exchange rate regimes (model 3). EMS is coded as 1 if country $i$ was a member of the exchange rate mechanism of the European Monetary System in year $t$; otherwise 0. SNAKE is coded as 1 if country $i$ was a member of the European multilateral currency arrangement
known as the “snake” in year $t$; otherwise 0. PEG is coded as 1 if country $i$ pegged its exchange rate unilaterally in year $t$, otherwise 0.\textsuperscript{18}

If regime membership did promote monetary convergence, then the coefficient for each (or some) of these monetary/exchange rate regime indicators should be negative and statistically significant. While EMS, SNAKE and PEG are all negatively signed, the results do not attain statistical significance at even the .10 level. As a robustness check and to verify that the regime variables are not statistically insignificant due simply to collinearity with the fiscal policy measure (i.e. governments who join monetary regimes contract their fiscal policies to facilitate monetary convergence) or the inflation term, I also estimate the models without these terms (models 4 and 5). These results still suggest that membership in a monetary/exchange rate regime is not a statistically significant predictor of monetary convergence toward the low world interest rate. In short, if we want to understand when states opt for monetary autonomy or exchange rate stability under capital mobility, we must look beyond membership in “fixed” exchange rate regimes.

\textsuperscript{17} This logic can be seen in the EMU interest rate convergence criteria requiring prospective EMU member-states to hold long-term interest rates not exceeding that of the three lowest inflation member-states by more than two percentage points.

\textsuperscript{18} Data on exchange rate regime membership come from the International Monetary Fund, Exchange Arrangements and Exchange Restrictions Annual Report (various years).
Interest Rate Differentials and Exchange Rate Stability

**Interest Parity Condition**

In this policy mix framework, the *external* goal of exchange rate stability does not have an independent policy instrument.\(^1\) However, if political leaders desire exchange rate stability vis-à-vis the large trading and capital-producing states (the G-5 economies), then the neoliberal (tight fiscal/loose monetary) policy mix can help stabilize currency values, just as the new growth (loose fiscal/tight monetary) policy mix tends to increase currency variability due to the interest parity condition.

Indeed, macroeconomists express the exchange rate stability/monetary policy autonomy tradeoff under full capital mobility in terms of the interest parity condition.

\[
\Delta e = i - i^* \quad (2.2)
\]

Equation (2.2) is known as the uncovered interest parity condition\(^2\), stating that the expected change in the exchange rate \(e\) is given by a *nominal* interest rate differential (the

---

\(^1\) It should be recognized that it is sometimes difficult to distinguish policy goals from policy instruments. Exchange rates are a case in point. The exchange rate is often understood as a policy instrument to be manipulated by policymakers, although its effective manipulation in an era of floating exchange rates usually requires another policy instrument, that of monetary policy. Exchange rate *stability* should be understood as a policy goal inasmuch as external currency stability is thought to increase cross-border trade and investment, which in turn leads to rising incomes and wealth.

\(^2\) There is also a covered version of the interest parity condition, which adds a forward premium term to the right-hand side of equation (1): \((i - i^* f_p)\) where \(f_p\) measures the forward premium to cover expectations of future currency movements. However, the data demands for calculating the forward premium are quite high, making the measure very difficult and expensive to obtain for anything but a very small sample of states (see Simmons 1999: 58-9 for a discussion of the problems). Since I want to look at a full sample of OECD states in the post-Bretton Woods era, I focus here on the uncovered interest parity
national interest rate \( i \) minus the world interest rate \( i^* \). If the government wishes to keep the exchange rate stable (\( \Delta e \to 0 \)), then they must move the national interest rate in line with the prevailing world interest rate in order to minimize their nominal interest rate differential.

Monetary policy autonomy becomes a story of nominal interest rate differentials not because inflation does not matter, but because the nominal interest rate differential reflects fully any expected inflation differential when capital is fully mobile.\(^{21}\) It is important to understand that real interest rate differentials signify the extent to which money can move across national borders to equalize real returns (i.e. capital mobility). Thus, the real interest rate differential does not capture the concept of national monetary autonomy as understood in macroeconomics; rather it measures the extent of capital mobility – a different menu item in the Mundell-Fleming framework.

The interest parity condition thus provides a tractable definition of "monetary policy autonomy" under the condition of capital mobility: the extent to which a country's nominal interest rate differs from the prevailing world interest rate. However, uncovered interest parity has been widely criticized by some economists for its poor predictions regarding the direction of exchange rate movements (Fama 1984, Frankel and Froot

---

\(^{21}\) The nominal interest rate differential can be rewritten in terms of real interest rates (\( r \)) and expected inflation rates (\( \Pi \)): \( [r + \Pi] - (r^* + \Pi^*) \). With full capital mobility, the real interest rate differential is assumed to be zero; hence \( r - r^* = 0 \). If the real interest rate differential is not zero, then capital can be expected to flow until such differential real returns are equalized, underscoring the important point that the real interest rate differential simply measures the extent of capital mobility, not the extent to which national monetary policies are autonomous. With full capital mobility, the \( r \) terms cancel and the nominal interest rate differential fully reflects any differential rates of expected inflation. To the extent that capital is not fully mobile, I add a control variable for capital account openness in the statistical models that follow.
1989, Rose 1994). In other words, high nominal interest rate differentials are not always associated with currency appreciation (positive $\Delta e$), sometimes a rise in national interest rates precedes a currency depreciation (negative $\Delta e$). Economists continue to debate the underlying micro-foundations for such exchange rate movements; many explanations center on the fact that foreign and domestic assets function as complements (rather than as substitutes) and that investors have different risk profiles and inflation expectations.\(^{22}\)

The fact that a rise in national interest rates could be associated with appreciation, depreciation, or both over a particular period of time does not mean that a tradeoff between monetary autonomy and exchange rate stability under capital mobility does not exist. But it does suggest the need to consider an alternative measure of exchange rate variability, one that captures currency movements in all directions. I thus define exchange rate variability in terms of a coefficient of variation ($Ve$) to replace the $\Delta e$ term on the left-hand side of equation (2.2). The coefficient of variation captures the relative variability of the national currency (measured against an external benchmark), and is calculated by dividing the standard deviation by the mean.\(^{23}\)

The time-series description data for this measure have obvious face validity. Figure 2.4 plots the average coefficient of currency variation for the 23 OECD states over

\(^{22}\) Frankel (1993) reviews many of these arguments. To understand how these factors contribute to currency variability, consider a rise in national interest rates. Risk-averse investors may see higher rates as a signal of future inflation and greater risk, thus selling assets denominated in that currency and producing depreciation pressures. More risk-acceptant investors may view higher interest rates as a sign of "extra" return and buy more assets denominated in the currency, producing appreciation pressures. Thus, the direction of currency movements will be difficult to predict, but the currency value may be highly variable as investors increase their transactions in that currency to balance and adjust their portfolios in response to the interest rate change.
the 1973-1997 period. This broad measure of exchange rate variability shows a spike in 1985 (the instability leading to the Plaza Accord), a period of relative stability from 1987 to 1990 (the Louvre target zone era), and a final spike corresponding to German reunification and the associated exchange rate crisis in Europe. Contrary to the neoliberal convergence hypothesis, these data show little or no trend towards exchange rate stability among the OECD states in the post-Bretton Woods era.

**Empirical Estimates**

To test whether this alternative measure of exchange rate variability is positively associated with greater nominal interest rate differentials, I estimate the model in equation (2.3) for the same panel of 23 OECD countries over the 1973-97 period.\(^{24}\)

\[
\begin{align*}
\text{EXRCV}_{it} = & \beta_0 + \beta_1 \cdot \text{MONAULT}_{it} + \beta_2 \cdot \text{KAPMOB}_{it} + \\
& \Sigma(\alpha_j \cdot \text{COUNTRY}_{jit}) + \Sigma(\alpha_i \cdot \text{YEAR}_{jit}) + e_{it} \quad (2.3)
\end{align*}
\]

The dependent variable, EXRCV, indicates the coefficient of nominal variation for country \(i\)'s currency versus the SDR in year \(t\).\(^{25}\) MONAULT measures the monetary

---

\(^{23}\) In the pooled time-series models that follow, it would be incorrect to use the standard deviation, which is an absolute measure of variability and affected by the unit of measurement (i.e. national currency unit) since this unit of measurement differs for each country in the sample.

\(^{24}\) This exercise has a very important empirical purpose. As Rose (1994, 26) cautioned, “economists should be more reluctant to believe strongly in the holy Trinity since the latter is nothing but an unproven (though theoretically reasonable) proposition of approximately the same status as monetary models of the exchange rate.” McNamara (1998, 53) likewise recently warned political scientists: while the “framework is generally accepted in economic thinking, it has not been subjected to systematic empirical analysis.” To the extent that no such tradeoff exists in the real world, the economic theory underlying this research project poses a false political choice.

\(^{25}\) Exchange rate data come from the International Monetary Fund, *International Financial Statistics* (CD-ROM). For exchange rates, I use the IMF’s SDR benchmark (.....ac.zf...) because it is a weighted average
autonomy of country $i$ in year $t$, taking the absolute value of the term on the right-hand side of equation (2.2) since nominal interest rates either below or above the world interest rate may produce currency movements: $|i - i^*|$. To capture the policy "choice" of national governments, I calculate monetary autonomy using the state's central bank rate ($i$) relative to the weighted (by GDP) average of G-5 central bank rates, which operationalizes the prevailing "world" interest rate ($i^*$).

KAPMOB controls for the country's openness on the payments and receipts of capital (Quinn 1997), to the extent that capital is not completely mobile across state $i$'s border in year $t$, the government may not fully face the expected tradeoff between monetary autonomy and exchange rate stability. Finally, to control for country-specific domestic factors and year-specific systemic factors that affect investment risk, I add dummy variables for all countries in the sample, except the United States, and all years, except 1973.

I expect $\beta_1$ to be positively signed and statistically significant: larger absolute interest rate differentials lead to greater exchange rate variability. I make no prediction of the G-5 currencies and I measure monetary policy autonomy relative to the weighted (by GDP) G-5 average central bank rate. I obtain a yearly coefficient of variation using monthly exchange rate values. Using the SDR as the benchmark currency offers an important advantage in that it represents a broader measure of currency variability than do single currency benchmarks such as the US$ or German DM. It is important to understand that monetary adjustments to stabilize exchange rate movements vis-a-vis a single currency can produce greater currency variability versus other major currencies. Using a narrow measure of exchange rate instability may thus substantially misrepresent the level of currency variability experienced by actors engaged in cross-border trade and investment. In theory, one might create a trade and capital-weighted measure of national currency variability. In practice, such a measure is difficult to construct for at least two reasons. First, the data on bilateral capital flows are extremely poor. Second, to the extent that currency variability helps determine trade levels, trade-weighted measures of currency variability tend to suffer from serious endogeneity problems. I thus prefer to use the simple SDR benchmark.

26 For each G-5 state in the sample, I make an important adjustment. The interest rate differential for the United States, Japan, Germany, Britain, and France is measured relative to the other G-4 states.
concerning the sign of $\beta_2$ as capital mobility does not necessarily imply either more or less exchange rate variability. This project begins with the understanding that states face a political choice between stabilizing exchange rates or holding an autonomous monetary policy. However, the neoliberal convergence hypothesis argues that $\beta_2$ should be negatively signed; capital mobility has led the advanced industrial democracies towards currency stability through monetary convergence. To the extent that $\beta_2$ is not negatively signed and statistically significant, we have additional evidence that the neoliberal convergence hypothesis overstates the extent to which OECD states have embraced the external policy goal of exchange rate stability.

Table 2.3 reports the results, showing strong empirical support for a monetary policy autonomy/exchange rate stability tradeoff in the post-Bretton Woods era. Among the OECD states, a one-point change in the monetary autonomy indicator associates with a 0.19 unit increase in the coefficient of variation of the national currency unit versus the SDR. The capital mobility term is positively signed and gains statistical significance as additional control terms are added to the model. I will develop this result more fully in the next chapter, but this finding suggests that the neoliberal convergence hypothesis about capital mobility leading OECD states towards exchange rate stability in the post-Bretton Woods era is broadly incorrect.

To further test my argument that membership in a fixed exchange rate regime should not be regarded as a proxy for exchange rate stability, I add the three dummy variables for membership in various fixed exchange rate institutions (EMS, SNAKE and

---

27 The logic here is that the G-5 states have the world’s largest capital-producing economies and, thus, set
PEG) in model 7. Neoliberal convergence theorists would expect that the signs for all three variables would be negative (i.e. less currency variability when states make commitments to fix their exchange rates) and statistically significant. However, only the SNAKE and EMS terms are negatively signed and both fall well short of statistical significance. This set of results provides further support for my contention that fixed exchange rate commitments should not be taken as evidence that a government has necessarily embraced currency stability or voluntarily sacrificed monetary policy autonomy under capital mobility.

As a robustness check and to deal with any concerns about multicollinearity among the monetary autonomy indicator and the fixed exchange rate regimes variables (i.e. states making fixed exchange rate commitments defend their commitments with monetary adjustments), I estimate the equation again dropping the MONAUT term in model 8. My results, showing a weak relationship between fixed exchange rate commitments and this broad measure of exchange rate variability, appear quite robust. None of the fixed exchange rate regime variables are a statistically significant predictor of exchange rate stability relative to the IMF's benchmark currency. Only the EMS term has the expected negative sign and this variable fails to attain statistical significance.

One might argue that the results would have been different had I used a narrower measure of exchange rate variability. For example, Frieden (1998) found a statistically significant negative relationship between “Snake” and EMS membership and currency variability vis-a-vis the German DM. But these different sets of results underscore an

the prevailing world interest rate.
important point: a state adjusting its monetary policy to stabilize its currency in terms of a single external currency (e.g. the German DM) may find that variability versus other major currencies, especially those outside of the European regimes (e.g. US $, Japanese yen, British pound) has increased. McNamara (1998: 22-3) presented some evidence that this has indeed been the case for European states. Thus, to truly assess the extent of currency variability faced by international traders and investors, we need a measure of exchange rate variability relative to a broad external benchmark.

*Monetary Autonomy in the post-Bretton Woods era*

Using the nominal interest rate differential measure for monetary autonomy, it is important to note that national interest rates could be above or below the world interest rate: either condition would be expected to generate exchange rate variability. But, as Figure 2.5 shows, most developed states in the post-Bretton Woods era have held nominal interest rates above the world interest rate (i.e. positive nominal interest rate differentials). This fact means that in order to achieve monetary convergence and exchange rate stability, governments need macroeconomic conditions allowing them to lower nominal interest rates, bringing them more in line with the low world interest rate. While one must be careful about drawing any strong conclusions from simple descriptive data, this time-series suggests that any trend toward monetary convergence (nominal interest rate differentials \(\rightarrow 0\)) is quite weak. OECD governments appear to be retaining
substantially more policy autonomy than the conventional wisdom about monetary convergence predicts.

Since monetary policy autonomy in the post-Bretton Woods era has been characterized largely in terms of national interest rates that are tighter on a nominal basis than the world interest rate, we need a model of macroeconomic policymaking to explain why states seek monetary policy autonomy in the form of high nominal interest rates under capital mobility. Neoliberal convergence theory has no answer for this, but the fiscal/monetary policy mix framework introduced above accounts well for this behavior. States seek monetary autonomy in the form of high nominal interest rates for inflation control because they engage in fiscal expansion for economic growth under capital mobility. Fiscal and monetary policy choices become linked under capital mobility.

Thus, a state's choice regarding the monetary autonomy/exchange rate stability tradeoff under capital mobility can be seen in its policy mix choice. When a state chooses to expand using fiscal instruments, perhaps to provide greater public goods, it must contract its monetary policy to counter any inflationary expectations. This loose fiscal/tight monetary policy mix has the effect of moving national interest rates away from the low prevailing world interest rate (greater monetary autonomy) and, thereby, increasing exchange rate variability.

Conversely, when a state chooses to tighten its fiscal policy for inflation control, it can expand its economy with a looser monetary policy. With this tight fiscal/loose monetary policy mix, national interest rates move closer to the prevailing world interest rate (i.e. monetary convergence) helping to stabilize the national currency. But currency
stability comes with the cost of fiscal contraction, which may leave public goods under-supplied. I illustrate more formally, using the IS-LM models from macroeconomics, the effect of these two policy mixes on the measure of monetary autonomy \((i - i^*)\) in the appendix to this chapter.

Conclusion

This chapter has set the foundation for the rest of the project, which examines how political factors affect the monetary policy autonomy/exchange rate stability tradeoff under capital mobility. I created operational measures of both monetary policy autonomy and exchange rate stability when capital is internationally mobile. A state’s monetary policy becomes more autonomous as its nominal central bank rate diverges from the prevailing world interest rate. Exchange rate stability is measured as the coefficient of nominal variation of the national currency unit relative to a broad external benchmark: the IMF’s Special Drawing Right.

I showed how these operational measures have the relationship expected by the Mundell-Fleming framework: states with greater nominal interest rate differentials experience greater exchange rate variability. This result is important because it helps demonstrate that the tradeoff between monetary autonomy and exchange rate stability is real. While scholars have long expected that such a tradeoff should exist, very little empirical evidence has been offered in support of such a relationship.

I also showed that when the advanced industrial democracies have sought monetary autonomy in the post-Bretton Woods era, it has been in the form of high
nominal interest rates. Governments opt for such monetary policy autonomy because of their fiscal policy choices. I explained this logic in terms of the policy mix framework. Facing the possibility of capital flight, governments must pursue both economic growth and low inflation to attract and retain mobile capital. To achieve these two different economic policy goals, states will need two independent policy instruments: fiscal and monetary policy. If states use fiscal policy for economic growth (fiscal expansion) then they must use monetary policy for inflation control, leading to high nominal interest rates and greater monetary autonomy.

The most important conclusion is that a state's choice with regards to the monetary policy autonomy/exchange rate stability tradeoff under capital mobility can be seen in its fiscal/monetary policy mix. I show that OECD states in the post-Bretton Woods era have gravitated towards either a loose fiscal/tight monetary policy mix or a tight fiscal/loose monetary alternative. The former policy mix is effectively a choice for policy autonomy under capital mobility with associated costs in terms of exchange rate stability. The latter mix is a choice for policy convergence to achieve exchange rate stability, with associated costs coming from fiscal contraction (e.g. less public goods spending).
<table>
<thead>
<tr>
<th>Tight Fiscal</th>
<th>Loose Fiscal</th>
</tr>
</thead>
<tbody>
<tr>
<td>1: Both instruments on inflation control. No inflation with no economic growth</td>
<td></td>
</tr>
<tr>
<td>2: Fiscal instrument on inflation control and monetary instrument on economic growth. Low inflation with moderate economic growth</td>
<td></td>
</tr>
<tr>
<td>3: Fiscal instrument on economic growth and monetary instrument on inflation control. Moderate economic growth with low inflation</td>
<td></td>
</tr>
<tr>
<td>4: Both instruments on economic growth. High economic growth with high inflation.</td>
<td></td>
</tr>
</tbody>
</table>

Table 2.1: Four Fiscal/Monetary Policy Mixes
<table>
<thead>
<tr>
<th>Model #</th>
<th>1 INTRATE</th>
<th>2 INTRATE</th>
<th>3 INTRATE</th>
<th>4 INTRATE</th>
<th>5 INTRATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-1.47</td>
<td>-5.23*</td>
<td>-5.11*</td>
<td>-1.00</td>
<td>2.53</td>
</tr>
<tr>
<td></td>
<td>(2.96)</td>
<td>(3.23)</td>
<td>(3.12)</td>
<td>(1.67)</td>
<td>(1.78)</td>
</tr>
<tr>
<td>FISCAL</td>
<td>0.23*</td>
<td>0.30**</td>
<td>0.30**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.14)</td>
<td>(0.15)</td>
<td>(0.15)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>KAPMOB</td>
<td>0.84**</td>
<td>1.23***</td>
<td>1.18***</td>
<td>1.48***</td>
<td>0.80*</td>
</tr>
<tr>
<td></td>
<td>(0.40)</td>
<td>(0.42)</td>
<td>(0.42)</td>
<td>(0.40)</td>
<td>(0.43)</td>
</tr>
<tr>
<td>INFLAT</td>
<td>0.17***</td>
<td>0.17***</td>
<td>0.17***</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.05)</td>
<td>(0.05)</td>
<td>(0.05)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EMS</td>
<td></td>
<td></td>
<td></td>
<td>-0.69</td>
<td>-0.69</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.63)</td>
<td>(0.69)</td>
</tr>
<tr>
<td>SNAKE</td>
<td></td>
<td></td>
<td></td>
<td>-0.97</td>
<td>-0.75</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.73)</td>
<td>(0.69)</td>
</tr>
<tr>
<td>PEG</td>
<td></td>
<td></td>
<td></td>
<td>-0.60</td>
<td>-0.36</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(0.52)</td>
<td>(0.56)</td>
</tr>
</tbody>
</table>

Observations | 575     | 575     | 575     | 575     | 575     |
Chi2         | 1338.90 | 3922.42 | 4668.03 | 3100.61 | 1581.34 |
Pr > Chi2    | 0.000   | 0.000   | 0.000   | 0.000   | 0.000   |

Estimates are Prais-Winsten coefficients with Panel Corrected Standard Errors in parentheses. Each model is estimated with country and year-specific fixed effects, which are not reported here. Statistical significance is indicated as follows: *** p < .01, ** p < .05, and * p < .10. Two-tailed tests reported for each estimate.

<table>
<thead>
<tr>
<th>Model #</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EXRCV</td>
<td>EXRCV</td>
<td>EXRCV</td>
</tr>
<tr>
<td>Constant</td>
<td>2.42***</td>
<td>2.33***</td>
<td>0.63</td>
</tr>
<tr>
<td></td>
<td>(0.87)</td>
<td>(0.91)</td>
<td>(0.98)</td>
</tr>
<tr>
<td>MONAUT</td>
<td>0.19***</td>
<td>0.19***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.05)</td>
<td>(0.05)</td>
<td></td>
</tr>
<tr>
<td>KAPMOB</td>
<td>0.21</td>
<td>0.22</td>
<td>0.70**</td>
</tr>
<tr>
<td></td>
<td>(0.24)</td>
<td>(0.26)</td>
<td>(0.29)</td>
</tr>
<tr>
<td>EMS</td>
<td>-0.03</td>
<td>-0.06</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.38)</td>
<td>(0.40)</td>
<td></td>
</tr>
<tr>
<td>SNAKE</td>
<td>-0.32</td>
<td>0.16</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.47)</td>
<td>(0.51)</td>
<td></td>
</tr>
<tr>
<td>PEG</td>
<td>0.17</td>
<td>0.21</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.34)</td>
<td>(0.37)</td>
<td></td>
</tr>
</tbody>
</table>

Observations | 575 | 575 | 575
Chi2         | 2579.62 | 2942.44 | 1677.57
Pr > Chi2    | 0.000 | 0.000 | 0.000

Estimates are Prais-Winsten coefficients with Panel Corrected Standard Errors in parentheses. Each model is estimated with country and year-specific fixed effects, which are not reported here. Statistical significance is indicated as follows: *** p < .01, ** p < .05, and * p < .10. Two-tailed tests reported for each estimate.

Figure 2.1: Average OECD Openness on Payments and Receipts of Capital, 1973-1997.
Figure 2.2: International Monetary Orientations and the Mundell-Fleming Trilemma
Figure 2.3: Strategic Game between Governments and Central Banks

Figure 2.4: Average OECD Currency Variability versus SDR, 1973-1997.
Figure 2.5: Average OECD Nominal Interest Rate Differential, 1973-1997.
CHAPTER 3:

DOMESTIC POLITICAL INSTITUTIONS AND THE POLICY MIX

The previous chapter demonstrated that in the post-Bretton Woods era, a loose fiscal/tight monetary policy mix is effectively a choice for monetary policy autonomy, defined as holding a national interest rate that diverges from the low world interest rate. Such high nominal interest rate differentials, often associated with expansionary fiscal policies, lead to greater exchange rate variability following the interest parity condition. Conversely, a tight fiscal/loose monetary “neoliberal” policy mix functions as a choice for relative exchange rate stability and monetary convergence, as the national interest rate moves down toward the low world interest rate. This policy mix, however, imposes certain costs associated with fiscal contraction.

How then can we explain a state’s choice to follow a tight fiscal/loose monetary policy mix associated with monetary convergence and exchange rate stability or a loose fiscal/tight monetary policy mix associated with monetary autonomy and exchange rate instability? My answer, which will be presented and tested in this chapter, focuses on unit-level political factors, i.e. domestic politics, to explain this choice. Leftist-led governments and proportional representation electoral systems lead states to opt for the
loose fiscal/tight monetary policy mix associated with monetary autonomy and exchange rate instability. Rightist governments and majoritarian electoral systems lead states in the opposite direction, toward monetary convergence and exchange rate stability.

In addition to partisan politics and electoral systems, I also examine two other domestic political institutions: independent central banks and fixed exchange rate commitments. Scholars often posit that independent central banks and fixed exchange rate commitments act as strong constraints on monetary policy, helping to reduce monetary autonomy and stabilize exchange rates. Yet I will show how both these monetary commitment technologies force governments to rely more on fiscal policy expansion to achieve their economic growth objectives, sometimes leading monetary authorities to raise interest rates (i.e. asset monetary autonomy) to counter inflationary expectations. As a result, these two political institutions play a lesser role in explaining the monetary policy autonomy/exchange rate stability tradeoff.

Chapter three proceeds in three sections. Section one will present my theoretical framework linking domestic political institutions to the policy mix choice and exchange rate outcomes. I will make a series of hypotheses regarding the relationship between each political factor and a state’s fiscal policy orientation, monetary policy orientation, and exchange rate variability. Section two will test these hypotheses on a panel of OECD countries in the post-Bretton Woods era. Finally, section three will discuss the results and their implications for theories about capital mobility and state economic agency in the post-Bretton Woods era.
Domestic Political Institutions

Political Parties

The policy mix choice, as presented in the previous chapter, was motivated solely by the twin domestic macroeconomic goals of economic growth and low inflation designed to retain and attract mobile capital. But certainly, states do have other policy goals, including the provision of public/collective goods, income redistribution, and, of course, exchange rate stability. The strategic game between governments holding the fiscal instruments and central banks holding the monetary instruments, shown in Figure 2.3, suggested that governments would be indifferent between the loose fiscal/tight monetary and the tight fiscal/loose monetary policy mixes. In practice, governments are not so indifferent, in large part because they value other policy goals, which must be achieved with a limited number of effective policy instruments.

In general, I expect that governments led by leftist parties are more likely to choose the loose fiscal/tight monetary policy mix, while governments led by rightist parties prefer the tight fiscal/loose monetary alternative.¹ To understand this partisan choice under capital mobility, I consider other policy goals, motivated largely by

¹ There are important exceptions to this general statement; one apparent anomaly is the Reagan years in the United States where a rightist-led government was associated with fiscal expansion and monetary tightening. Below I will discuss in some detail other domestic political factors leading rightist governments to behave as leftists in terms of the policy mix. Two factors help in explaining the apparent Reagan anomaly. First, divided governments, often associated with proportional representation electoral systems but sometimes occurring within majoritarian systems, tend to use fiscal instruments for expansion and monetary tightening for inflation control. Second, independent central banks lead all governments to rely more on fiscal instruments to achieve domestic growth objectives since monetary instruments are effectively unavailable to the government. The Reagan administrations faced both a divided government (Democratic majorities in Congress) and a very independent Federal Reserve Board.
ideological concerns, beyond simple economic growth and low inflation, which in principle could be achieved using either competitive policy mix.

Scholars have long identified leftist parties with two "dominant" ideological economic policy objectives: income redistribution and the provision of public goods, other than national defense (Kirschen and others 1964, Boix 1998, Garrett 1998). Given two policy instruments (fiscal and monetary), how can these ideological objectives be realized without compromising growth and inflation goals? Monetary adjustments tend to affect the economy as a whole (Gowa 1988); consequently, targeting specific groups in society, especially lower-income groups who are traditionally core leftist supporters, may be difficult to achieve with monetary expansion. While a lower interest rate may eventually produce more jobs and raising wages for the labor class, the initial impact of a monetary expansion is likely to be felt by the owner class, those borrowing to start businesses or make investments to expand existing business ventures. In the short-run, monetary expansion may even increase income inequality between the owner and labor classes before the effects "trickle-down" to the lower-income groups.

Fiscal policy, on the other hand, is relatively easy to target on specific groups. Government spending can be directed at lagging sectors of the economy to benefit particular interest groups. In the post-Bretton Woods era, leftist parties have focused more government spending on supply-side public investment projects, notably those involving infrastructure, education/worker training, and research & development (Boix 1998, Garrett and Lange 1991). To the extent that infrastructure projects increase blue-collar employment and education/worker training helps the labor class to find better jobs
even when full employment cannot be achieved, income redistribution objectives can better satisfy the use of an expansionary fiscal policy. Government expenditures in research and development also allow the left to appeal to better-educated professional classes, potentially extending its electoral base beyond core labor supporters.

However, if fiscal policy is used to expand the economy, then monetary policy must become the instrument for inflation control (i.e. monetary contraction). Higher nominal interest rates effectively mean greater monetary autonomy from the low world interest rate and, consequently, greater exchange rate variability. It is interesting to note, however, that external stability has long been a relatively “minor” policy goal for leftist parties (Kirschen and others 1964, 227) as the political left draws much of its electoral support from labor. As a factor of production confined largely to the domestic economy, labor arguably receives few direct benefits from exchange rate stability and, thus, faces little incentive to stabilize the national currency in order to promote international capital flows. To the extent that currency volatility adds to the cost of moving capital – through uncertainty and the expense of purchasing forward exchange contracts – exchange rate instability tends to act as a sort of de facto capital control. As such, it may help to keep financial capital in the domestic economy from exiting for potentially higher returns elsewhere in the absence of currency volatility. Scholars have already demonstrated that

---

2 The idea here is that labor is a relatively immobile factor of production, certainly relative to financial capital. In practice, it may not be much less mobile than physical capital, especially in the short-run.

3 As Frieden (1991) pointed out, a specific-factors model focusing on different sectors of the economy may be a better framework for understanding the distributional effects of capital mobility. I take up this issue in the next chapter. For now, I note that the two sectors of developed economies most interested in monetary policy autonomy – import competing manufacturing and nontradable services – are generally more labor-intensive than the sectors preferring exchange rate stability.
leftist parties embrace *de jure* capital controls more willingly than rightist parties (Quinn and Inclan 1997, Quinn 1997, Grilli and Milesi-Ferretti 1995).

Rightist parties have different economic ideological objectives, leading them towards the tight fiscal/loose monetary (neoliberal) policy mix. To the extent that rightist parties desire to get the central government “out” of the economy, one might expect rightist governments to use fiscal contraction (less government spending) as their instrument for inflation control. Fiscal contraction, of course, means less public goods and reduced opportunities for redistribution. However, rightist parties have long treated the provision of public goods, other than national defense, and income redistribution as relatively unimportant, even “negligible,” priorities (Kirschen and others 1964, 227).4

Since rightist parties do have ideological preferences for private - rather than public - investment, they may prize monetary expansion as the instrument for economic growth, thus leading them towards the neoliberal policy mix associated with monetary convergence and exchange rate stability. The external goal of exchange rate stability stands as an important neoliberal policy objective (McNamara 1998). Since the political right receives much of its electoral support from capital interests, groups intensely involved in international business, rightist governments may face pressure from their capital-intensive electoral base for currency stability to facilitate cross-border trade and investment.

---

4 Concerning so-called “public” goods, the neoliberal market logic argues that if society desires a good, such as quality education, then the private sector can be expected to provide that good, albeit in a private form, provided that interest rates remain low enough to encourage private investment. Rightist governments can better maintain attractive interest rates when government expenditures are kept to a minimum, avoiding any “crowd-out” effect of public sector spending.
To illustrate more formally this argument about partisan ideological goals and the policy mix, I flesh out the generic policy mix strategic game presented in the last chapter, now distinguishing between leftist and rightist governments in Figure 3.1. As in the earlier policy mix game, I assume that all governments prefer moderate economic growth with low inflation. But now these governments become sensitive to the actual policy mix employed in order to achieve other ideological policy goals. With regards to the central bank actor, I again assume that these monetary authorities act as agents of the government, hence sharing the government's preference for a policy mix that achieves economic growth with low inflation. Thus, at this point in the chapter, I make no distinction between independent and subordinate central banks and retain the same central bank preference ordering from the generic game in Figure 2.3.

Diagrammed as a 2 x 2 normal form game, partisan governments face what appears to be a coordination problem. However, because the government moves first with its fiscal policy decision (expansion or contraction), coordination with the central bank to reach the government's most preferred outcome is relatively easy to achieve. Leftist governments move toward fiscal expansion for economic growth with redistribution and public goods, knowing that the central bank then has preferences to contract for low inflation. This allows the left to achieve its most preferred loose fiscal/tight monetary policy mix. Rightist governments move first towards fiscal contraction to facilitate exchange rate stability, knowing that the central bank will accommodate with monetary expansion, allowing the right to achieve its most preferred tight fiscal/loose monetary policy mix.
Thus, holding central bank preferences constant, I begin with three hypotheses regarding the effect of partisan politics on the fiscal/monetary policy mix and exchange rate outcomes:

\(H1:\) Governments led by leftist parties will have more expansionary fiscal policies.

\(H2:\) Governments led by leftist parties will have more contractionary monetary policies, resulting in greater monetary autonomy from the low world interest rate.

\(H3:\) Exchange rate variability will increase under governments led by leftist parties.

The state’s electoral system helps determine the partisan character of the government in power. While majoritarian systems lead to single-party governments where the partisan policy mix choice described above may be relatively clear, proportional representation (PR) electoral systems tend to produce multi-party coalition governments. How do multi-party governments choose their fiscal/monetary policy mix? One might simply assume that a multi-party government, reflecting a broad set of societal interests, should be relatively centrist in character, holding a policy mix that is neither particularly tight or loose on both the fiscal and monetary sides.\(^5\) Alternatively, many scholars see PR states, especially in Western Europe, as relatively convergent in

---

\(^5\) Consider, for example, the commonly used data set constructed by Woldendorp, Keman and Budge (1993), which uses a five-point scale to measure the proportional share of the left, center and right parties to account for the relative strength of parties in industrialized parliamentary countries. To the extent that the left and right share power in a balanced situation, the government is coded using the middle category [= 3 on a 5-point integer scale]. Implicitly, this coding makes the assumption that multiparty governments in PR systems would act more **centrist** in terms of economy policy choices.
character. I will show below that such reasoning may be very misleading when considering the policy mix used in PR states to address a diverse range of societal interests and demands.

Electoral Systems

A recent wave of political economy research focuses on the relationship between electoral systems in democratic countries and exchange rate outcomes' institutions. Examining how currency markets react to political information, some scholars posit that PR electoral systems, due to their consensual multi-party character, produce less surprise for economic actors. One extension of this logic is that PR systems are associated with less currency variability than majoritarian electoral systems where changes in government are likely to produce wide changes in economic policies (Freeman, Hayes and Stix 2000).

Other scholars have shown that governments in PR electoral systems prefer to make formal "fixed" exchange rate commitments, perhaps as focal points for economic policy coordination (Bernhard and Leblang 1999). If one assumes that a fixed exchange rate commitment is evidence of a choice for exchange rate stability, then one might assume that PR states have sacrificed policy autonomy. Taken together, these arguments clearly imply that multi-party governments, more than single-party governments, opt for exchange rate stability and monetary policy convergence. But much of this research program fails to account directly for the monetary and fiscal policy choices of multi-party
governments in PR states and how this policy mix choice, in turn, affects external currency stability.

The main theoretical distinction that I wish to make here concerns proportional representation electoral systems, often producing multi-party governments, and majoritarian electoral systems, more likely to produce single-party governments. Multi-party coalition governments, more so than single-party majoritarian governments, may need to engage in income redistribution towards coalition members as a strategy to maintain a diverse political coalition. Consequently, I expect that PR governments - rather than being either “centrist” or “convergent” in their policy mix choice - may opt instead for the “autonomous” loose fiscal/tight monetary policy mix.

I begin by considering the fiscal policy choice of multi-party governments in PR systems. The party at the head of the governing coalition must satisfy the differing demands of its governing partners to maintain its coalition. As stated above, fiscal and monetary expansion do not function as perfect substitutes. Fiscal expansion is better suited for income redistribution and targeted economic growth. Conversely, monetary adjustments are “public” in character, rendering this instrument difficult to target on a diverse set of electoral constituencies. Thus, PR governments may prefer fiscal instruments to expand the economy with redistribution in order to satisfy coalition demands for targeted growth.

My argument about a PR governments’ use of an expansionary fiscal policy certainly accords with Roubini and Sachs’s (1989, 102) finding that weak and divided governments “have been less effective in reducing the budget deficit than have stable and
majority-party governments.” The reader should understand, however, that I am advancing a different argument to explain this fiscal policy choice: PR governments expand fiscally, not necessarily because they are too weak or divided to agree on fiscal contraction, but because the alternative growth strategy - monetary expansion – is insufficient for targeting key supporters and achieving redistributive policy goals. As Clark and Hallerberg (2000, 342) recently concluded: “although an increase in the money supply [monetary expansion] may help certain groups...more than others, it is a blunt instrument for cultivating specific clienteles. Fiscal policy, in contrast, is more suited to targeted use, whether through greater spending, tax cuts, or both. The implication is that these different strategies have markedly different macroeconomic consequences.”

According to the policy mix framework presented in the previous section, if governments use fiscal instruments to pursue targeted economic growth, then they must reserve monetary policy as their instrument for inflation control under capital mobility. Such monetary contraction means higher nominal interest rates, greater monetary autonomy from the low world interest rate, and the possibility of greater exchange rate variability despite membership in “fixed” exchange rate regimes. Italy stands as a notable example in this regard. Coupled with their expansionary fiscal stance, multi-party Italian governments have permitted the Bank d’Italia to hold one of the tightest monetary policies in Europe since the mid-1970s (Fratianni and Spinelli 1997). Italian governments realigned their currency within the EMS nine times from 1979 to 1990, suggesting substantial monetary autonomy within this regime (Oatley 1997, 139).
Thus, to summarize the expected relationships between a state’s electoral system, its fiscal/monetary policy mix and exchange rate outcomes, I hypothesize the following:

**H4:** Governments with PR electoral systems will have more expansionary fiscal policies.

**H5:** Governments with PR electoral systems will have more contractionary monetary policies, resulting in greater monetary autonomy from the low world interest rate.

**H6:** Exchange rate variability will increase under governments with PR electoral systems.

In emphasizing the central role of political parties and electoral systems to explain a state’s policy mix and its choice regarding the monetary autonomy/exchange rate stability tradeoff under capital mobility, one might respond that these political factors are simply trumped by domestic monetary institutions, such as an independent central bank and a fixed exchange rate commitment.\(^6\) Indeed, much of the recent literature on monetary politics identifies these two monetary commitment technologies as the most important determinants of a state’s monetary policy in the post-Bretton Woods era (e.g. Clark and Reichert 1998). As such, some scholars argue that independent central banks and fixed exchange rate commitments - if states have them - tend to facilitate both monetary convergence and exchange rate stability.\(^7\) However, I will show below that,

---

\(^6\) While the exchange rate regime itself should be treated as an *international* factor, the commitment to join and participate in the regime occurs at the unit-level. Hence, I identify an exchange rate commitment as a domestic political institution.

\(^7\) If states do not have such institutions, neoliberal policy advocates often advise governments to create them (i.e. make their central bank more independent and make formal fixed exchange rate commitments, often to a multilateral institution) in an effort to facilitate the monetary convergence process.
using the policy mix framework, such a conclusion may be very misleading, leading to incorrect predictions concerning the effect of these institutions on monetary policies and exchange rate outcomes.

*Independent Central Banks*

Political science scholarship on central banks identifies one clear policy preference for these conservative monetary authorities: central bankers are inflation hawks with an overriding priority in keeping domestic prices stable (Simmons 1996, Woolley 1984). Whether or not these inflation-averse central bankers possess the power to achieve this objective depends on their status – independent or subordinate - relative to the government in power. Scholarship in the economics discipline clearly establishes the link between an independent status for central banks and low inflation outcomes in the OECD economies. (Alesina and Summers 1993, Cukierman, Webb and Neyapti 1992, Grilli, Masciandaro, and Tabellini 1991)

This latter finding might suggest that states with independent central banks would be strongly associated with both monetary convergence and exchange rate stability. Since independent central banks hold anti-inflation credibility, they may be able to hold lower nominal interest rates (reduced monetary autonomy vis-à-vis the low world interest rate) when domestic prices are relatively stable. In other words, lower inflation outcomes may allow lower nominal interest rate differentials and, if monetary policy autonomy can be reduced under independent central banks, then exchange rates should stabilize. Subordinate central banks, possessing less anti-inflation credibility, may need to hold
higher nominal discount rates than their independent counterparts, leading to greater monetary autonomy and exchange rate instability.

While plausible, this simple economic story overstates the link between central bank independence and monetary convergence/exchange rate stability because it fails to consider how central bank independence affects a government’s fiscal policy choice. In short, we need to add some politics to this economic story. As argued above, governments must be very concerned about promoting economic growth when capital is internationally mobile. To this end, governments have two possible policy instruments: monetary or fiscal expansion. However, if governments see the monetary expansion option as potentially foreclosed by an independent central bank, then all governments (including those who generally prefer monetary expansion) may face incentives to rely on greater fiscal expansion to achieve their economic growth objectives under capital mobility. For example, Italian fiscal policy expanded markedly in 1981 when the Italian central bank became more independent, as I will document in chapter 5.

Thus far, in presenting the policy mix strategic game, I have argued that central banks function largely as monetary agents for the government; hence they have similar preferences for achieving moderate economic growth with low inflation. Distinguishing between subordinate and independent central banks forces a reconsideration of that assumption, suggesting that the latter actor may be unwilling to act in accord with the growth preferences of the government. A central bank’s independent status allows it to
act more in accord with its presumed preferences for low (or no) inflation outcomes\(^8\), making it harder for governments to achieve a tight fiscal/loose monetary policy mix if so desired.

This problem is formally illustrated in Figure 3.2, where I diagram the policy mix strategic game distinguishing between the presumed preferences of a subordinate and an independent central bank. For simplicity, I do not differentiate here between leftist and rightist governments; I assume the generic government actor modeled in Figure 2.3. Since a subordinate central bank is more likely to share the preferences of the government for achieving both moderate economic growth and low inflation, a government desiring to achieve these policy goals with exchange rate stability can expect that fiscal contraction will be met with monetary expansion by the central bank. The resulting tight fiscal/loose monetary policy mix leads to monetary convergence and exchange rate stability. With a subordinate central bank, either the loose fiscal/tight monetary or the tight fiscal/loose monetary policy mix can be equilibrium outcomes.

But with an independent central bank, the tight fiscal/loose monetary policy mix, may be unattainable. An independent central bank, not legally required to act as an agent of the government, has the opportunity to act on behalf of its own preferences for achieving domestic price stability, regardless of the economic growth considerations. To the extent that independent central banks have a dominant preference for inflation control (no inflation > low inflation > high inflation), governments cannot be certain that fiscal

\(^8\) It should be noted that the independence of the central bank does not measure its policy preferences. Simmons (1996) and Woolley (1984) argue that the price stability preferences of central bankers derive from their institutional mission and background in the financial service community. Central bank
contraction will be met by monetary expansion. Indeed, this preference ordering for independent central banks shows that these conservative monetary authorities have a dominant strategy to contract and can be expected to raise interest rates in response to any hint of inflation. Hence, governments having the objective of achieving at least moderate economic growth (i.e. all governments facing the possibility of capital flight) face an incentive to rely more on fiscal expansion when facing an independent central bank.

To the extent that this fiscal expansion leads to the expectation of rising prices, independent central banks with an overriding interest in inflation control may raise nominal discount rates, effectively asserting monetary autonomy and even exacerbating currency variability. The independent German Bundesbank asserted this sort of monetary autonomy in response to inflation concerns associated with German reunification, helping to ignite the European exchange rate crisis in 1992. Thus, despite being able to hold lower nominal interest rates when domestic prices are stable due to their credibility with market actors, an independent central bank may have little effect in promoting either monetary convergence or exchange rate stability because the institution leads the government to rely more on fiscal expansion.

The first Reagan Administration’s experience with the independent Federal Reserve Board helps illustrate this relationship. The Reagan economic team arguably wanted to pursue a strategy of fiscal contraction (Stockman 1986), but saw the Fed as

---

independence merely measures the ability of these conservative monetary authorities to act on behalf of their own interests, as opposed to the interests of the government.

9 This conclusion accords with Simmons’s (1996) account of central bank behavior from 1925 to 1938, the interwar years marked by the collapse of the Gold Exchange Standard.
unwilling to accommodate with lower interest rates. The Reagan administration instead pursued fiscal expansion in the economic recession, which, in turn, created new pressures for the Fed to raise interest rates. The Fed’s tight money policy contributed to a highly variable (appreciating) US dollar in the early 1980s.

To summarize my expectations concerning independent central banks, the fiscal/monetary policy mix and exchange rate outcomes, I make three additional hypotheses:

*H7*: States with independent central banks will have more expansionary fiscal policies.

*H8*: Independent central banks will have no significant effect in reducing monetary autonomy from the low world interest rate.

*H9*: Independent central banks will have no significant effect in reducing exchange rate variability.

These hypotheses also suggest the need to reconsider the traditional expectation that leftist governments have their policy objectives frustrated by independent central banks (Way 2000, Simmons 1996). While this may have been the case before capital mobility, the policy mix framework reveals that rightist governments may instead be more frustrated by independent monetary authorities in their quest to achieve a tight fiscal/loose monetary policy mix. Leftist governments tend to let subordinate central banks behave much like their independent counterparts, raising interest rates for inflation control while fiscal policy expands for economic growth. Such logic explains why leftist governments have not revoked central bank independence. On the contrary, leftist parties have generally supported moves to increase central bank independence in France, Italy,
Spain, Switzerland and New Zealand. More conservative governments, such as the Reagan Administration (Johnson 1998, 186), have considered steps to reduce central bank independence when monetary authorities blocked their preferences for a looser monetary policy consistent with rightist ideological objectives. Indeed, when rightist governments have achieved their preferred tight fiscal/loose monetary policy mix, they have often done so with relatively subordinate central banks as will be detailed more fully in chapter 6.

**Fixed Exchange Rate Commitments**

Governments may also attempt to stabilize exchange rates by making a visible commitment to fix the value of their currencies – either by declaring a unilateral peg or joining a multilateral currency arrangement. In the previous chapter, I presented empirical evidence that such commitments were poor predictors of both monetary convergence (lower nominal interest rates in table 2.2) and exchange rate stability (table 2.3). The logic offered at the time argued that fixed exchange rate commitments in the post-Bretton Woods era were either weak (e.g. the “snake”), flexible (e.g. the EMS), or both (e.g. unilateral pegs). There is, however, a more-sophisticated story that helps explain why such commitments would only be weakly associated with monetary convergence and exchange rate stability. This story begins by examining the effect of fixed exchange rates on the expected fiscal policy behavior of governments with economic growth objectives.
The Mundell-Fleming framework establishes that if exchange rates are truly fixed, then monetary expansion is an ineffective growth strategy but fiscal expansion remains a highly effective alternative. I formally illustrate this logic in the appendix to chapter three using IS-LM models with the assumption of fixed rates. To the extent that this logic is correct (i.e. fiscal expansion is a highly effective growth strategy with fixed exchange rates) or even if governments simply believe that it is correct, then governments may face increased incentives to rely on fiscal policy, rather than monetary policy, to achieve their economic growth objectives when fixed exchange rate commitments exist.\textsuperscript{10}

This fiscal expansion, however, can put monetary authorities into a potential political bind. As the IS-LM framework posits, they must either lower nominal interest rates to maintain fixed exchange rates or perhaps raise rates to counter any associated inflationary pressures. And since I have argued that all governments under capital mobility must maintain inflation control, I expect that often the monetary adjustment in response to fiscal expansion will run contrary to exchange rate stabilization.

\textsuperscript{10} Looking at a sample of 13 OECD states over the period 1968-1994, Oatley (1999) finds some evidence that governments, especially leftist ones, do rely more on fiscal expansion under fixed rates and more on monetary expansion under floating rates.
With regard to the fixed exchange rate commitment, it is worth remembering that the government, not the central bank\textsuperscript{11}, offers the commitment. Indeed, monetary authorities, especially independent central banks, may have little interest in maintaining fixed exchange rates in the wake of fiscal expansion. As Simmons (1996, 409) argued, "domestic price stability is more salient for central bankers than international exchange-rate cooperation when these two values come into conflict."

The policy mix framework helps explain when these two policy goals (inflation control and exchange rate stability) are likely to come into conflict: under the condition of fiscal expansion, which is encouraged by the existence of fixed exchange rate commitments. It is notable here EMS member-states had greater levels of discretionary government spending relative to GDP than non-EMS states\textsuperscript{12}, reflecting perhaps the perceived effectiveness of fiscal expansion under "fixed" exchange rates. Monetary authorities, however, often counter this fiscal expansion with monetary contraction to ease inflationary expectations. Such monetary adjustments may put significant pressure on exchange rates. Indeed, there were twelve major EMS realignments between 1979 and 1990, resulting in almost 40 individual national currency adjustments (Gros and Thygesen 1992, 68).

Thus, fixed exchange rate commitments may not have the expected convergence effect on monetary policy or the expected stabilizing effect on exchange rates, not just

\textsuperscript{11} Oatley (1997) argued that leftist governments may even make such fixed exchange rate commitments in order to tie the hands of an independent central bank.

\textsuperscript{12} This data comes from the OECD, National Accounts (various years) and will be used in a statistical model later in the chapter.
because the commitments are weak and/or flexible, but also because they tend to induce fiscal expansion. To conclude this section, I make three final hypotheses:

**H10:** States with fixed exchange rate commitments will have more expansionary fiscal policies.

**H11:** Fixed exchange rate commitments will have no significant effect in reducing monetary autonomy from the low world interest rate.

**H12:** Fixed exchange rate commitments will have no significant effect in reducing exchange rate variability.

---

**Empirical Estimates for the Domestic Political Institutions**

The twelve hypotheses enumerated in the previous section are summarized above in Table 3.1. I test these hypotheses on the same panel of 23 OECD countries\(^{13}\) as examined in the previous chapter over the 1973-1997 period (the post-Bretton Woods era). With three different dependent variables (government spending, nominal interest rate differential, and exchange rate variability), I estimate three models, each of which takes the following general form:

\[
DV_{it} = \beta_0 + \beta_1 * GDPGROW_{it} + \beta_2 * INFLAT_{it} + \beta_3 * KAPMOB_{it} + \]

\(^{13}\) The OECD panel includes: the United States, Japan, Germany, Britain, France, Italy, Netherlands, Belgium, Luxembourg, Denmark, Ireland, Greece, Spain, Portugal, Austria, Sweden, Finland, Norway, Switzerland, Canada, Australia, New Zealand, and Turkey.
\[
\beta_4 \cdot \text{LEFTIST}_{it} + \beta_5 \cdot \text{PR}_{it} + \beta_6 \cdot \text{CBI}_{it} + \beta_7 \cdot \text{FIXCOMMIT}_{it} + \\
\Sigma(\alpha_j \cdot \text{COUNTRY}_{jit}) + \Sigma(\alpha_j \cdot \text{YEAR}_{jit}) + \epsilon_{it} \quad (3.1)
\]

In equation (3.1), DV is one of three dependent variables. Indicating a state’s chosen fiscal policy orientation, GOVEXP measures the level of discretionary government expenditures as a percent of country \(i\)'s GDP in year \(t\). Higher (lower) values indicate a more expansionary (contractionary) fiscal policy.\(^{14}\) MONAUT measures country \(i\)'s nominal interest rate differential in year \(t\) relative to the weighted G-5 average \((i - i^*)\). I use the state’s central bank to capture its monetary policy “choice” rather than some imposed market rate. Finally, EXRCV indicates the coefficient of nominal variation for country \(i\)'s currency versus the SDR in year \(t\).\(^{15}\)

The first three independent variables serve largely as control terms. Considering that all governments can be expected to make some adjustments to monetary and fiscal policy in response to economic growth and inflation, I include these variables in the model. GDPGROW measures the growth rate of state \(i\)'s GDP in year \(t\), while INFLAT indicates the inflation rate.\(^{16}\) KAPMOB controls for the country’s openness on the payments and receipts of capital (Quinn 1997).

---

\(^{14}\) These data are provided by the OECD, *Annual National Accounts* (various years).

\(^{15}\) The source and construction of these two variables were described in the previous chapter.

\(^{16}\) These data come from the International Monetary Fund’s *International Financial Statistics* (CD-ROM).
Political Variables

The next four independent variables serve to test the hypotheses in Table 3.1. LEFTIST measures the partisan character of the head of government for state \( i \) in year \( t \), using data from Lane, McKay and Newion (1997) and Banks and Mueller (1998). LEFTIST employs a three-point scale where 0 indicates a rightist party (Conservative and Christian Democrat), 1 for a centrist party (Agrarian and Liberal parties), and 2 for a leftist party (Social Democrat and Socialist).\(^{17}\) PR is a dummy variable coded as 1 if state \( i \)'s electoral system was proportional representation in year \( t \); other systems are coded as 0.\(^{18}\)

CBI measures the independence of state \( i \)'s central bank in year \( t \), using data from Cukierman, Webb and Neyapti (1993).\(^{19}\) Their aggregate central bank independence score is continuous between 0 and 1, with larger values indicating greater legal independence from the government. FIXCOMMIT indicates whether state \( i \) had a fixed exchange rate commitment in year \( t \). I use my own simple index for exchange rate

---

\(^{17}\) I treat the Japanese Liberal Democratic Party as rightist and the US Democratic Party as leftist. I obtain very similar results if I code the party heading the Economic/Finance Ministry/Department. Other work has been done to code the ideological complexion of governments in the developed world; the most often cited data set comes from Woldendorp, Keman and Budge (1993). The construction of this data set renders it less than desirable to test the different expectations presented here since these authors code multiparty governments as relatively centrist in character. This is an assumption that bears further empirical examination by looking at the party heading government and whether or not they share power in separate variables. It may be the case that shared power - due to a country's electoral institution, for example - consistently moves economic policy to the left or right, rather than to the center.

\(^{18}\) Austria, Belgium, Denmark, Finland, Germany, Ireland, Italy, Luxembourg, Netherlands, Norway, Sweden, and Switzerland operate with PR parliamentary systems. Australia, Britain, Canada, France, Japan, New Zealand, Turkey, and the United States operate with more majoritarian electoral systems. Greece, Portugal, and Spain shift to a PR electoral system in the 1970s; hence, there is some temporal variation, as well as cross-sectional, variation in these data.

\(^{19}\) I update these data for the post-1990 years and make adjustments to account for changes in central bank status in France, Belgium, Italy, Spain, and New Zealand. Hence, the CBI variable includes temporal, as well as cross-sectional, variation.
commitments\footnote{These data come from the International Monetary Fund Exchange Rate Arrangements and Exchange Restrictions Annual Report (various years).}: states that float their exchange rates are coded as 0, a unilateral peg is coded as 1, and membership in a multilateral currency arrangement is coded as 2. The idea here is that states committing to a multilateral currency arrangement face greater pressures to maintain their commitment in some form.\footnote{Since I have argued that these multilateral arrangements (the snake and the EMS) are flexible, maintaining a commitment can take several forms. For example, states may stay within the arrangement but realign their currency.} While states with only a unilateral commitment are likely to pay internal audience costs for abandoning the fix, states with a multilateral commitment may also face external audience costs. Hence, membership in a multilateral regime implies a greater commitment to fix exchange rates than does a unilateral peg.

Finally, COUNTRY is a set of dummy variables for each country in the sample, with the United States as the reference category, to control for any country-specific effects that may otherwise be omitted from the model. YEAR is a set of dummy variables for each year in the sample, with 1973 as the reference category, to control for any year-specific systemic effects.\footnote{Since there is temporal variation in all the institutional measures, I can include the country-specific fixed effects to reduce concerns about omitted variable bias. See Green, Kim, and Yoon (1999) for a strong argument about why fixed effects should be included in pooled time-series models whenever possible.}

\textit{Statistical Results}

The estimates for the three models are reported together in Table 3.2. For the eight hypotheses where I predict a positive relationship between the domestic political institution and the dependent variable (see Table 3.1), I obtain the expected sign in all
eight cases and achieve statistical significance in seven. With regards to the four hypotheses where I predict no significant relationship, the estimated results fail to achieve statistical significance at even the .10 level of confidence in all four cases.\textsuperscript{23} I now turn to a discussion of these results in terms of each domestic political factor.

\textit{Political Parties}. It is perhaps not surprising that leftist-led governments are associated with statistically significant higher levels of government expenditures in the post-Bretton Woods era, indicating a more expansionary fiscal policy than rightist-led governments. But how do leftist governments run monetary policy in this era of global financial integration? When leftist governments use fiscal instruments to achieve their economic growth objectives under capital mobility, the policy mix framework posits that monetary authorities will contract monetary policy.\textsuperscript{24} The results in the second model of Table 3.2 appear to confirm this hypothesis; leftist governments are associated with interest rate differentials that are more than 60 basis points higher than rightist governments.\textsuperscript{25} Given the inflation rate control variable in the model, this result cannot be explained simply by higher inflation outcomes associated with leftist governments. Instead, it appears to reflect a policy choice by leftist governments and their monetary

\textsuperscript{23} It is important to acknowledge that the failure to reject the null hypothesis (that the estimated coefficient is zero) does mean that the estimated coefficient is necessarily zero.

\textsuperscript{24} Garrett (1998, 102) rejected the idea that leftist governments counterbalance fiscal expansion with monetary contraction. However, his model used market interest rates to reach this conclusion. Here, I look at the interest rate set by the central bank, a policy choice more directly indicating the state’s chosen monetary policy orientation.

\textsuperscript{25} The estimated coefficient of 0.31 measures a one-unit increase in LEFTIST. As rightist-led governments are coded as 0, centrist-led governments as 1 and leftist-led governments as 2, the difference between right and left parties represents a two-unit change. This result can be confirmed using a dummy variable for leftist parties in place of the trichotomous LEFTIST variable.
authorities to keep monetary instruments relatively tight as compared to rightist governments.

As these high nominal interest rate differentials are equivalent to greater monetary autonomy from the low world interest rate, we should expect to see a statistically significant positive sign for LEFTIST in the model for exchange rate variability. Indeed, leftist governments are associated with a 0.40 (2 x 0.20) increase in the coefficient of variation of the national currency unit versus the SDR compared to rightist governments. In short, leftist governments tend to sacrifice some exchange rate stability in choosing an autonomous loose fiscal/tight monetary policy mix under capital mobility that better satisfies their ideological objectives.

Electoral Systems. As measured by the level of discretionary government expenditures relative to GDP, states with proportional representation electoral systems are also associated with a more expansionary fiscal policy than states with more majoritarian systems. Given the results in Roubini and Sachs (1989), this should not be a surprising result, but what does it imply for monetary policy? The policy mix framework predicts that when PR governments rely on targeted fiscal expansion to achieve economic growth with redistribution under capital mobility, they can be expected to rely on monetary contraction to achieve their inflation control objectives. The results in the second model of Table 3.2 tend to confirm this expectation as PR states have higher nominal interest rate differentials than states with more majoritarian electoral systems.
Greater monetary autonomy for the PR states does not, however, appear to be accompanied by greater exchange rate variability. While the PR term in positively associated with exchange rate variability in the third model of Table 3, it fails to achieve statistical significance. It is interesting to consider why this might be the case. One possible answer is that these PR states, holding greater foreign exchange reserves as compared to states with majoritarian electoral systems, intervene regularly in international currency markets, leaning against the wind to dampen exchange rate variability even as they hold an autonomous monetary policy.

**Monetary Commitment Technologies.** Scholars looking at the effect of political institutions on monetary policies tend to emphasize the dominance of two monetary commitments technologies: independent central banks and fixed exchange rate commitments. Both institutions are conventionally expected to act as monetary constraints, promoting monetary convergence (smaller interest rate differentials vis-à-vis the world interest rate) and exchange rate stability. Yet the results in the second and third models of Table 3.2 suggest that such effects are relatively weak. In the model for monetary autonomy, the estimated coefficients for CBI and FIXCOMM/T are negative (suggesting some convergence effect) but not statistically significant at even the .10 level. In the model for currency variability, these terms again fail to achieve statistical significance.

To determine if these weak results are simply an artifact of coding decisions in the CBI and FIXCOMM/T indicators, I operationalized the underlying concepts using
slightly different measures. For central bank independence, I also created an index, following Bernhard (1998), which uses the mean independence score from three different sources (Alesina and Summers 1993, Cukierman, Webb and Neyapti 1992, Grilli, Masciandaro, and Tabellini 1991). For fixed exchange rate commitments, I utilized two other indicators. The first was a single dummy variable, which combined the effects of a unilateral peg and membership in a multilateral currency arrangement. States that floated their currencies were coded as 0, states that attempted to fix their currencies with either a unilateral peg or membership in a multilateral regime (the snake or EMS) were coded as 1. The second was a series of dummy variables, PEG, SNAKE and EMS, as employed in the previous chapter. None of these alternate indicators for monetary commitment technologies achieved statistical significance with a negative sign (which would indicate monetary convergence and exchange rate stability), revealing that the hypothesized weakness of these monetary institutions is robust across a variety of specifications.

Insignificant results are certainly not uncommon, but the policy mix framework provides an interesting story to explain why these two terms should not be strongly associated with either monetary convergence or exchange rate stability. It argues that independent central banks may lead governments to rely more on fiscal expansion to achieve their economic growth objectives, a statistically significant result in the first model of Table 3.2. Furthermore, independent central banks, despite being able to hold lower nominal interest rates when domestic prices are stable, may tend to tighten more than their subordinate counterparts in response to inflationary expectations associated
with fiscal expansion. Such a monetary stance can, in turn, put pressure on currency values, helping to negate any expected effect in promoting exchange rate stability.

Likewise, fixed exchange rate commitments also lead governments to rely more on fiscal expansion to achieve growth objectives (also a statistically significant result in the first model of Table 3.2). Monetary authorities (independent or otherwise) valuing inflation control more than currency stability, may abandon (or simply weaken) the government’s fixed exchange rate commitment with a monetary contraction in order to counter any inflationary expectations associated with fiscal expansion. Such moves toward monetary autonomy would negate much of the institution’s expected effect in terms of promoting monetary convergence and exchange rate stability.

Structures and Agents

*Capital Mobility as a Structural Condition*

The neoliberal convergence hypothesis argues that capital mobility produces powerful pressures leading to monetary convergence among the OECD states. This research program identifies capital mobility as a structural feature of international politics, “a constraining condition which rewards certain behavior and punishes others (Andrews 1994a, 202).” In terms of the monetary autonomy/exchange rate stability tradeoff, this conventional wisdom argues that monetary autonomy has been eroded with capital mobility (Cohen 1996, Peterson 1995, Freeman 1992). Governments face strong pressures to adopt neoliberal policies (a tight fiscal/loose monetary policy mix associated

Why capital mobility should punish monetary autonomy and reward exchange rate stability is not entirely clear. Indeed, the Mundell-Fleming framework, which underlies much of the political science scholarship seeking to establish capital mobility as a structural condition in the international political economy, suggests no such convergence effect. When capital can move freely across national borders, states face a political choice: they can hold a monetary policy close to the world interest rate in order to facilitate exchange rate stability or they can hold an autonomous monetary policy consistent with other internal objectives, sacrificing some exchange rate stability.

I have shown that the partisan character of the government in power, in particular, helps explain this political choice. Partisan agency in the area of monetary and exchange rate policymaking appears to be alive and well in the post-Bretton Woods era. However, it would be wrong to argue that capital mobility exerts no independent effect on the economic policy choices of national governments. However, rather than punishing monetary autonomy and rewarding exchange rate stability, governments may behave as if capital mobility does the reverse. In other words, capital mobility may reward certain types of monetary autonomy, especially when interest rates are raised to counter inflationary expectations. Likewise, capital mobility could make it harder for governments to achieve stable exchange rates.

The models estimated in Table 3.2 all included a term measuring the openness of the OECD states' capital accounts (KAPMOB). This variable, achieving statistical
significance in all three models, allows one to assess the independent effect of capital mobility, after controlling for other economic conditions and domestic political factors. In the fiscal policy model, capital mobility is associated with greater discretionary government expenditures relative to GDP. Rather than promoting fiscal contraction, governments appear to behave as if capital mobility rewards fiscal expansion. Such a result should not be surprising when this government spending goes toward the provision of public goods attractive to capital interests. Thus, it is worth remembering that capital flows in the post-Bretton Woods era have tended to run north-north (Simmons 1999), rather than north-south, suggesting that the public goods available in the developed economies may well compensate capital interests for potentially higher tax levies necessary to pay for them.

In terms of monetary policy, capital mobility has not been associated with smaller nominal interest rates differentials (i.e. monetary convergence). Rather, the opposite trend is evident as the KAPMOB term in the second model of Table 3.2 attains statistical significance with a positive sign, indicating greater nominal interest rate differentials. Monetary policy autonomy remains possible, and even rewarded, in the post-Bretton Woods era as many of the advanced industrial economies raised interest rates in order to

---

26 Garrett's (1995, 1998) use of interaction terms including capital mobility make it difficult to discern its independent effect. Friedrich (1982) reminds us that the inclusion of an interaction term makes the interaction term and its non-interacted components into conditional terms with conditional standard errors. Thus, in Garrett's setup, the interaction term of left/labor power with capital mobility measures the effect of capital mobility conditioned on left/labor power. The non-interacted capital mobility term also measures a conditional effect, that of capital mobility when left/labor power is equal to zero (hence, capital mobility under right dominance); it does not measure the effect of capital mobility independent of the partisan context.

27 This result also accords with a different argument made by Garrett (1995, 1998) and Rodrik (1997), who suggest that government spending is not necessarily rewarded by capital mobility, but that governments may need to spend more to compensate certain societal groups negatively affected by globalization.
counter the inflationary expectations associated with fiscal expansion, helping to retain and even attract mobile capital.

The third model in Table 3.2 presents some final evidence that the conventional wisdom misidentifies the capital mobility constraint on monetary policy. Rather than leading governments toward exchange rate stability, the KAPMOB term is positively signed and statistically significant, indicating that as capital has become more mobile across national borders, national exchange rates have become increasingly variable. Thus, rather than “rewarding” exchange rate stability, capital mobility appears to make this external policy goal harder, and more costly, to achieve.

*Partisan Agents Under Capital Mobility*

This analysis reveals that capital mobility does matter systematically in terms of a state’s fiscal/monetary policy mix and exchange rate stability in that it appears to punish certain behaviors and reward others, although the conventional wisdom appears to have misidentified the relevant pressures. In this sense, it may be appropriate to think of global financial integration as a structural feature of international politics. That being said, however, this feature leaves substantial room for partisan government agency, the ability of a democratic government to choose its preferred fiscal/monetary policy mix in support of its ideological economic objectives.

The policy mix analysis detailed here, and introduced in the previous chapter, provides a new framework to explain divergent economic policymaking in the post-Bretton Woods era. To conclude this discussion, the partisan policy mix framework can
be compared to the two other theories of economic policymaking, summarized below in Table 3.3.

The partisan ideological thesis (Lipset 1963, Kirschen 1964, Hibbs 1977) also suggests divergent behavior both in terms of dominant policy goals and the policy instruments used to achieve these goals. Leftist governments were expected to intervene in the domestic economy, using all available fiscal and monetary instruments, to reduce dips in the business cycle and redistribute wealth to core labor supporters; inflation control was only a "minor" priority. Conversely, rightist parties had inflation control as their top priority, assigning relatively little importance to full employment and achieving high rates of economic growth since a rapidly expanding economy could lead to rising prices, undermining a low inflation agenda. Rightist parties were expected to avoid intervening in the domestic economy, holding a tight fiscal policy and also tightening monetary policy when expectations of inflation arise.

But such patterns of behavior became hard to defend with the new structural constraint of capital mobility in the post-Bretton Woods era. Such "old left" behavior meant inflation rates unacceptable to mobile capital. Such "old right" behavior led to slower rates of economic growth and less public goods than mobile capital preferred. Consequently, some new theorizing about partisan economic behavior was required.

The neoliberal convergence hypothesis countered that, due to the possibility of capital flight, all governments had to make low inflation and exchange rate stability their dominant policy goals using a tight fiscal/loose monetary policy mix. The political left would effectively converge on both the goals and policy instruments of the political right,
using a tight fiscal/loose monetary policy to achieve inflation control and exchange rate stability. Such monetary *convergence*, however, appears largely inconsistent with the observed patterns of OECD economic behavior in the post-Bretton Wood era (see Figures 2.4 and 2.5). Certainly, some states are pursuing convergent monetary policies, but many other are not. We thus need a theory to explain divergent policy choices under capital mobility.

The partisan policy mix framework argues that partisan agency and divergent economic behavior remain possible, at least in terms of policy instruments, even with global financial integration. Capital mobility does lead all governments to make low inflation and moderate economic growth their dominant policy goals. In this sense, capital mobility does exert pressure for convergence. But to achieve these dominant policy goals, governments can pursue one of two different policy mixes consistent with other ideological policy goals, such as exchange rate stability, income redistribution and the provision of public goods. Divergent economic behavior is not only possible under capital mobility, we should expect it to occur.

**Conclusion**

This chapter examined how certain domestic political institutions affected a state’s fiscal and monetary policy mix, as well as its exchange rate variability. I focused here on four institutions: political parties, electoral systems (proportional representation or majoritarian), central bank status (independent or subordinate) and formal commitments made by the government to fix the value of the national currency. Scholars
studying capital mobility have recently tended to diminish the importance of the first two factors (partisan and electoral), while elevating the importance of the last two factors. Yet I show that this relative emphasis is misplaced.

The partisan character of the government in power helps explain not only its fiscal/monetary policy choice, but also the variability of the national currency. Electoral systems also play an important explanatory role. States with proportional representation electoral systems, leading to multi-party coalition governments, tend to engage in greater fiscal expansion for redistribution purposes. Such an expansionary fiscal stance leads them towards greater monetary autonomy with somewhat greater exchange rate instability.

A state’s central bank status and the presence of a fixed exchange rate commitment play a surprisingly small explanatory role. Scholars often posit that these two monetary commitment technologies should both promote monetary convergence and help stabilize exchange rates. The empirical results, however, show that they have little effect in this regard. Indeed, the policy mix framework explains why: both of these domestic monetary institutions lead governments toward greater fiscal expansion. As governments expand fiscally, they create pressure for monetary autonomy in the form of high nominal interest rates. Thus, the fiscal expansion induced by independent central banks and fixed exchange rate commitments tend to negate much of these institutions’ expected effect with regards to reducing monetary autonomy and exchange rate variability.
<table>
<thead>
<tr>
<th></th>
<th>Government Spending (Fiscal Expansion)</th>
<th>Interest Rate Differential (Monetary Autonomy)</th>
<th>Exchange Rate Variability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Leftist-led Governments</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>PR Electoral Systems</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Independent Central Banks</td>
<td>+</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Fixed Exchange Rate Commitments</td>
<td>+</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Plus (+) signs indicate a positive expected relationship. Zeros (0) indicate no expected significant relationship.

Table 3.1: Hypothesized Relationships between Domestic Political Institutions and Fiscal/Monetary Policy Choices and Exchange Rate Outcomes.
<table>
<thead>
<tr>
<th></th>
<th>GOVEXP</th>
<th>MONAUT</th>
<th>EXRCV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>13.51***</td>
<td>-5.39</td>
<td>2.17</td>
</tr>
<tr>
<td>GDPGROW</td>
<td>-0.08***</td>
<td>-0.01</td>
<td>0.01</td>
</tr>
<tr>
<td>INFLAT</td>
<td>-0.04***</td>
<td>0.18***</td>
<td>0.16***</td>
</tr>
<tr>
<td>KAPMOB</td>
<td>0.26**</td>
<td>1.34***</td>
<td>0.61**</td>
</tr>
<tr>
<td>LEFT/ST</td>
<td>0.10**</td>
<td>0.31*</td>
<td>0.20**</td>
</tr>
<tr>
<td>PR</td>
<td>0.56*</td>
<td>3.77***</td>
<td>0.87</td>
</tr>
<tr>
<td>CBI</td>
<td>2.73*</td>
<td>-4.11</td>
<td>-4.64</td>
</tr>
<tr>
<td>FIXCOMMIT</td>
<td>0.16**</td>
<td>-0.34</td>
<td>0.05</td>
</tr>
</tbody>
</table>

Observations 575 575 575
Chi2 12648.62 2547.94 2470.44
Pr > Chi2 0.000 0.000 0.000

Estimates are Prais-Winsten coefficients with Panel Corrected Standard Errors in parentheses. Each model is estimated with country and year-specific fixed effects, which are not reported here. Statistical significance is indicated as follows: *** p < .01, ** p < .05, and * p < .10. Two-tailed tests reported for each estimate.

Table 3.2: Estimates of Domestic Political Institutions and Fiscal/Monetary Policy Choices and Exchange Rate Outcomes.
<table>
<thead>
<tr>
<th>Theory</th>
<th>Goals</th>
<th>Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partisan Ideological</td>
<td><em>Divergent</em>: Left- economic growth and employment Right- low inflation</td>
<td><em>Divergent</em>: Left - loose fiscal and/or loose monetary Right - tight fiscal and/or tight monetary</td>
</tr>
<tr>
<td>(domain: before capital mobility)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Neoliberal Convergence</td>
<td><em>Convergent</em>: All parties have the same goals - low inflation, exchange rate stability</td>
<td><em>Convergent</em>: All parties use tight fiscal for low inflation, monetary instrument for exchange rate stability</td>
</tr>
<tr>
<td>(domain: under capital mobility)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Partisan Policy Mix</td>
<td><em>Convergent</em>: All parties have low inflation and economic growth as dominant goals</td>
<td><em>Divergent</em>: Left - loose fiscal and tight monetary Right - tight fiscal and loose monetary</td>
</tr>
<tr>
<td>(domain: under capital mobility)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 3.3: Three Theories of Partisan Economic Goals and Instruments.
(1.0) High economic growth with high inflation. Loose fiscal/loose monetary policy mix.


(0,1) No inflation with no economic growth. Tight fiscal/tight monetary policy mix.

(1,0) High economic growth with high inflation. Loose fiscal/loose monetary policy mix.


(0,1) No inflation with no economic growth. Tight fiscal/tight monetary policy mix.

Players:
- Government
- Central Bank

Strategies:
- Expand
- Contract

Outcomes:
- 3 - Most preferred
- 0 - Least preferred

Figure 3.1: Policy Mix Strategic Game with Leftist and Rightist Governments.
(1,0) High economic growth with high inflation.
Loose fiscal/loose monetary policy mix.

(2,2) Moderate economic growth with low inflation.
Monetary autonomy and exchange rate instability.
Loose fiscal/tight monetary policy mix.

(2,2) Low inflation with moderate economic growth.
Monetary convergence and exchange rate stability.
Tight fiscal/loose monetary policy mix.

(0,1) No inflation with no economic growth.
Tight fiscal/tight monetary policy mix.

(1,0) High economic growth with high inflation.
Loose fiscal/loose monetary policy mix.

(2,1) Moderate economic growth with low inflation.
Monetary autonomy and exchange rate instability.
Loose fiscal/tight monetary policy mix.

(2,1) Low inflation with moderate economic growth.
Monetary convergence and exchange rate stability.
Tight fiscal/loose monetary policy mix.

(0,2) No inflation with no economic growth.
Tight fiscal/tight monetary policy mix.

Players:
- Government
- Central Bank

Strategies:
- Expand
- Contract

Outcomes:
- 2 - Most preferred
- 0 - Least preferred

Figure 3.2: Policy Mix Strategic Game with Subordinate and Independent Central Banks.
CHAPTER 4

SOCIETAL PREFERENCES AND THE POLICY MIX

In the previous chapter, I showed how certain domestic institutions - political parties and electoral systems - function as crucial determinants of a state's fiscal/monetary policy mix and, therefore, its choice regarding the monetary autonomy/exchange rate stability tradeoff under capital mobility. Leftist-led governments and proportional representation electoral systems lead states toward a loose fiscal/tight monetary policy mix associated with autonomous policymaking and exchange rate variability. Rightist-led governments and majoritarian electoral systems lead states toward a tight fiscal/loose monetary policy mix associated with policy convergence and exchange rate stability. Two other institutions - independent central banks and fixed exchange rate commitments - play a lesser role.

In response, one might argue that, in focusing on institutional variables, I neglected another set of important unit-level factors: that of societal preferences for/against monetary autonomy and exchange rate stability. Societal groups benefiting from exchange rate stability might be expected to lobby the government for policy convergence to achieve the goal of a more stable national currency. Conversely, other
societal groups benefit little from exchange rate stability since their economic interests are largely domestic; these groups might be expected to lobby the government on behalf of policies, including expansionary fiscal policies, requiring monetary autonomy under capital mobility following the policy mix framework.

This response feeds into a long-running debate among comparative political economists concerning the relative importance of statist institutions versus societal preferences in determining domestic (and foreign) economic policy. This debate, which has been conducted over the last two decades without reaching any conclusive resolution, especially with regards to monetary/exchange rate policy, typically presents statist (institutional) approaches and societal (pluralist) approaches as competitors, rather than as potential complements. The statist view emphasizes the independent role of government actors in formulating economic policy consistent with the “national interest.” The societal view treats the government, especially in the advanced industrial democracies, as the arbiter among competing groups, following an economic pluralist logic where larger societal groups, by virtue of their size and resources, are more likely than smaller groups to obtain their preferred policy outcome.

Despite the long-running debate, several important questions about the role of societal preferences and the formulation of monetary/exchange rate policy need to be answered. Most broadly, do societal preferences with regards to the monetary autonomy/exchange rate stability tradeoff under capital mobility “matter” for economic policymaking? If societal preferences do matter, then do they matter following a factorial or sectoral framework? Finally, how do societal preferences get translated into
policy outputs – following economic pluralism (larger groups win) or an agent/principal logic (groups obtain their preferred outcomes when their agents hold power regardless of group size)?

In answering these questions, we must be able to tell a story that accords with one very important empirical observation: episodes of societal groups visibly lobbying the government for particular exchange rate policies are relatively rare (Krasner 1978, Gowa 1988, McNamara 1998). As Odell (1982, 126) reported about monetary policymaking in the United States (often identified as a weak state permeated by interest group influence): “Despite the supposed interests of various economic groups with respect to international monetary questions, the 1960s and 1970s saw virtually no campaigning by organized groups on these issues. This is one of the most striking findings of this study. Unknown private contacts between officials and close associates might have taken place, but not a single interviewee from the executive branch was able or willing to cite an instance of lobbying on international monetary issues.”

Societal groups benefiting from exchange rate stability generally failed to lobby the Carter Administration when exchange rates became unstable in the late 1970s (Cohen and

---

1 Scholars sometimes argue that lobbying does not occur because societal groups do not understand their monetary preferences. As Krasner (1978, 65) once stated: “Private actors rarely saw how monetary decisions related to their specific interests and therefore did not press for greater access to the decision-making machinery.” The problem with the societal ignorance thesis, which draws almost exclusively from the American experience, is that there has been occasional lobbying suggesting that groups do understand their own monetary interests. Furthermore, political scientists should be very skeptical of any claim that interests cannot be understood since “interests” remains a central disciplinary concept.

2 McNamara (1998) advanced a more updated, but similar, claim regarding the influence of societal groups on European monetary/exchange rate policy. Relying on Giovannini’s (1992) conclusion that there are no stable constituencies for or against fixed versus flexible exchange rates, McNamara argued that “policymaking on European monetary integration issues is a highly insulated process, occurring at the level of national government elites and their counterparts in the European Commission in Brussels (41).”
Meltzer 1982). In the mid-1980s, US exchange rate lobbying did explode, before subsiding substantially in the late 1980s (Destler and Henning 1989).

In this chapter, I will examine theories of societal monetary preferences based on both production factors and economic sectors. Using an economic pluralist logic, the statistical results suggest that while the sectoral model may offer a better framework for understanding societal preferences, it does a relatively poor job explaining policy outcomes, as does the factorial model. This does not mean, however, that societal preferences are unimportant for policy outcomes, but rather that political institutions function in such a way as to render societal group size a relatively poor predictor of its preferred policy outcomes.

Other scholars have already pointed out that economic pluralism offers a poor political model for understanding how societal preferences get translated into state policy outcomes (e.g. Garrett and Lange 1995, Milner 1997). Yet, in the absence of any simple and viable alternative, economic pluralism remains the conventional foundation. As an alternative to economic pluralism, I develop and test a principal-agent framework for understanding the importance of societal preferences in monetary/exchange rate policymaking. Political parties function as agents for societal principals. Rightist parties tend to represent internationally-oriented business groups with preferences for exchange rate stability, while leftist parties do the same for domestically-oriented societal groups preferring policy autonomy under capital mobility. Only when these partisan agents fail to carry out the preferred policies of their societal principals (i.e. shirk) will costly lobbying emerge. Conversely, when the partisan agents successfully
work on behalf of the preferred policies of their societal principals, no lobbying is necessary. And, since lobbying is a costly activity, societal principals will not lobby the agents of other principals since those agents are not beholden to their preferences.

**Societal Groups and their Preferences**

To answer the question about whether or not societal preferences matter with regards to monetary/exchange rate policy, we must first understand which groups in society are likely to have strong preferences in this issue area and know what policy outcomes they prefer. Two frameworks for understanding societal preferences on economic policy issues predominate: factors and sectors. I will look first societal cleavages along production factors, then at cleavages along economic sectors.

**Factors of Production**

As the policy autonomy/exchange rate stability tradeoff follows analytically from the condition of capital mobility, it is natural to think about societal preferences organized along factors of production. Here I focus on a simple two-factor model with capital (K) and labor (L), applying a Heckscher-Ohlin framework. There are strong empirical and theoretical reasons to use such an undifferentiated two-factor model. On the empirical side, Heckscher-Ohlin tends to perform best when analyzing only two factors (Frieden 1991, 436). On the theoretical side, Heckscher-Ohlin is a long run
framework. And over a long period of time, it often makes little sense to differentiate within factors. For example, the differences between physical and financial capital disappear over time: factories can be converted (i.e. sold) for money, just as money can buy factories and physical equipment. On the labor side, differences between skilled and unskilled labor also tend to disappear over time as unskilled workers obtain training and education to advance to more skilled positions.

Heckscher-Ohlin assumes that factors of production can move without cost from one sector of the economy to another. As such, factor returns become equalized across sectors of the economy. In other words, the returns on capital are assumed to be identical regardless of whether the capital is being invested in steel or electronics. Likewise, the returns on labor (i.e. wages) are assumed to be the same for workers in steel and electronics. However, the returns for each factor vary according to their relative endowment within the domestic economy. International openness (trade and financial integration) tends to raise the returns of the abundant factor, benefiting owners of the abundant factor to the disadvantage of scarce factor owners.

Especially relative to the developing world, capital can be treated as an abundant factor in the advanced industrial democracies. Hence, global financial integration (capital openness) can be expected to benefit capital owners in the developed world as they gain a greater range of international investment options. To the extent that labor is scarce in the developed world relative to the developing world, then capital openness

---

7 Because I ultimately conclude that factorial cleavages explain societal preferences less well than sectoral cleavages, it is important that I develop the factorial model in its most favorable terms to avoid simply creating a straw man.
may tend to disadvantage OECD labor as capital moves toward cheaper labor in other parts of the globe (the so-called “race to the bottom” account of globalization).

What might be the preferences of capital and labor in OECD states regarding the monetary autonomy/exchange rate stability tradeoff under capital mobility? Since capital has the freedom to exit, its returns are not tied to the condition of the local economy and capital may be less interested in domestic policy autonomy. While mobile capital can relocate in search of higher investment returns, exchange rate instability adds to this investment risk. Of course, capital holders may purchase forward-exchange contracts to reduce currency risk, but such contracts are costly (when available), also eroding investment returns. Consequently, one might hypothesize that capital holders would favor the convergent (tight fiscal/loose monetary) policy mix associated with exchange rate stability. Indeed, the assumption of powerful capital interests pushing states toward policy convergence and exchange rate stability is a common (and untested) one (e.g. Gill and Law 1989, Underhill 1991).

More tied to the domestic economy than mobile capital, OECD labor could be expected to have stronger preferences for policy autonomy, often in the form of a loose fiscal/tight monetary policy mix. Labor stands to benefit not only from redistribution, but also from the public goods provided through fiscal expansion. However, since labor will lose jobs and income if inflationary expectations due to fiscal expansion drive

---

4 It remains an open question, however, whether this risk actually reduces international trade and investment. Edison and Melvin (1990) point out that the evidence is mixed in this regard.
5 Forward exchange contracts lock in a given exchange rate for a set period of time.
6 Even in the Europe Union where the movement of labor across national borders is permitted, labor mobility tends to be quite low due especially to European cultural and linguistic differences. Most non-
capital out of the domestic economy, labor may be willing to accept tighter monetary conditions for inflation control. The obvious cost of this policy mix is exchange rate instability as national interest rates “diverge” from the low world interest rate. However, currency instability may provide some unexpected benefits to labor. If currency volatility raises the cost of moving capital out of the home economy due to increased investment risk and the expense of purchasing forward-exchange contracts, then capital may be more likely to remain in the home economy, helping to provide jobs and income for labor.

This application of the Heckscher-Ohlin framework to the issue area of international money comes with substantial criticism. Frieden (1991, 436) mounted the most vigorous objection, noting its difficulties in explaining cleavages and outcomes in “the short and medium run, which is the time frame more relevant to political analysis.” He observed that political cleavages on monetary/exchange rate issues appear to lie less along factoral lines and more around sectoral divisions. Hence, Frieden offered a different cut at explaining societal preferences under capital mobility using the Ricardo-Viner framework.7

Economic Sectors

Ricardo-Viner assumes that factors of production remain fixed in different sectors of the economy at least in the short-term. A steel factory cannot be effortlessly

---

European states maintain controls on labor mobility, as do European Union states with regards to non-EU
converted into an electronics factory, just as a steel worker cannot be expected perform work in electronics without substantial time and retraining. Consequently, capital and labor interests within a given sector can be expected to converge. However, different sectors of the economy may have different monetary/exchange rate preferences depending largely on whether their business activities are domestically or internationally-oriented. Frieden identified four important economic sectors (exporters, international investors, nontradable services, and import-competing producers), specifying their interests concerning the monetary autonomy/exchange rate stability tradeoff under capital mobility.

The internationally-oriented sectors, notably exporters and international investors, can be expected to favor stable exchange rates since the currency risk associated with moving goods and money across international borders can be reduced if exchange rates remain fixed. Since their business activities are not confined to the local economy, domestic monetary autonomy would not be a high priority, especially since high interest rate differentials raise currency instability. Thus, one might expect exporters and international investors to favor a “convergent” tight fiscal/loose monetary policy mix associated with exchange rate stability.

The domestically-oriented sectors (nontradable services and import-competing producers) may prefer a more “autonomous” policy mix due to their interest in public labor.

7 Alt and others (1996) present a useful overview of the Heckscher-Ohlin and Ricardo-Viner frameworks. 8 Although exporters and international investors both have preferences in favor of stable exchange rates, they differ with regards to the preferred currency value. Exporter might prefer a stable depreciated and “competitive” currency, while international investors might prefer a stable but appreciated currency.
goods provision through fiscal expansion. Monetary expansion, as the alternative “growth” strategy, may leave such public goods either under-supplied or supplied in a private form inaccessible to many firms confined to the domestic economy. Since rising prices do hurt the domestically-oriented sectors, they may prefer inflation control through monetary policy, accepting monetary contraction with fiscal expansion.

Higher nominal interest rate differentials associated with this autonomous policy mix can be expected to generate additional exchange rate variability, but since the nontradable service sector does no (or little) business involving foreign currencies, a loose fiscal/tight monetary policy mix associated with exchange rate instability arguably imposes few costs on the sector. Furthermore, some exchange rate instability may even advantage the import-competing sector as currency fluctuations tend to increase business risk for import competition and raise the price of imported goods, helping to make domestically-produced goods appear less expensive in the home market.

It is important to note that Frieden’s model using the Ricardo-Viner framework is not the only story of sectoral preferences regarding monetary/exchange rate policies. Both Henning (1994) and Hefeker (1997) identify banking/financial services, a segment of the service economy with international interests, as a key sector in this issue area.¹⁰ Henning and Hefeker both posit that financial services will prefer exchange rate

---

¹⁰ Some scholars identify Frieden’s “international investors” as banking/financial services. However, Frieden (1996) operationalized this sector in terms of foreign direct investors. Hence, I treat financial services as a potentially different group, although with the same expected preferences for exchange rate stability as foreign direct investors.
stability under capital mobility, although they identify different underlying reasons. Despite banks’ ability to hedge their foreign currency exposure, Henning (1994, 25) argued that “exchange rate volatility has inflicted large losses on banks and exposed weaknesses in management control. In a couple of instances [Bankhaus I. D. Herstatt and Franklin National Bank of New York in the 1970s], volatility has rendered banks completely insolvent and threatened associated creditor banks.”

Scholars (e.g. McNamara 1998, 37-8) sometimes argue that banks often profit from currency instability due to their sales of forward-exchange contracts and other hedging instruments. However, Hefeker (1997) showed that banks, especially large ones, possess special reasons to favor currency stability, and eventual monetary union, because total banking transactions can be expected to grow with financial integration. Thus, any profits lost in the foreign exchange divisions of large banks will be more than offset by profits earned elsewhere. Hence, large banks may be expected to act as enthusiastic supporters of policies promoting monetary convergence, including fiscal contraction, and eventually monetary union.

How do Societal Preferences Matter?

Economic Pluralism

These various models of monetary/exchange rate policy preferences, either along factorial or sectoral lines can be extended into simple models of political outcomes following an economic pluralist logic. Despite claims that their models are only intended to explain political cleavages, and not political outcomes, the scholars
introducing these models to the political science discipline have taken this second step. Rogowski (1987) borrowed Becker’s (1983) simple model where pressure groups compete for political influence based on their wealth and income. Likewise, Frieden (1996, 1998) implicitly employed the economic pluralist logic in positing that governments will make greater efforts to stabilize exchange rates as international trade and investment grow, reflecting the growing political clout of exporters and international investors.

Economic pluralism argues that policy outcomes can be treated as a function of political competition among groups with different preferences and varying political/economic clout (Garrett and Lange 1995, 628). In short, we need to know something about the various group preferences (described in the sub-section above) and relative group size (i.e. how much power do they possess relative to the other groups). Group size is usually measured relative to another group (such as a capital/labor ratio) or relative to the total economy (such as exports/GDP). Larger, and presumably wealthier, groups can be expected to win the political competition, achieving their desired policy outcome. Economic pluralism certainly has virtues in terms of its simplicity, but does it accurately describe policy outcomes?

Garrett and Lange (1995, 633) answered that “in many instances, the course of policy change will differ markedly from that anticipated by economic pluralism. Existing institutions generate powerful pressures for governments to persist with policies that are favored by the constellation of interests that initially supported their ascent to power, even if the power of these interests has declined, and even if this has
deleterious consequences for macroeconomic performance." For the advanced industrial democracies under study here, Garrett and Lange identified the state’s electoral system, central bank status, and union organization as important institutional factors that influence how (and which) societal groups can affect the monetary/exchange rate policy process. Without offering a substitute model, their focus on political institutions seemed to suggest that economic pluralism might be operative as a political model if one included the proper controls for domestic institutions.

Even controlling for these political institutions, economic pluralism runs contrary to standard collective action logic. As Olson (1971) described, while every member of an interest group may benefit from lobbying for a collective good, they will benefit even if they do not contribute to the lobbying cost. Rational societal actors will thus “free ride,” not paying their share of the lobbying cost and costly lobbying activities may disappear. Gowa (1988) showed how monetary/exchange rate policies can be treated as collective goods, which are non-excludable and inexhaustible. Effectively, the central bank sets one discount rate for the entire society and the prevailing exchange rate applies to all segments of an economy.\textsuperscript{11}

These objections to economic pluralism do not mean that societal preferences are unimportant, but rather that we need to take a greater account of the political institutions and collective action problems. Aldrich (1995, 23) argued that the “political party has long been the [institutional] solution” to collective action problems. Likewise,

\textsuperscript{11} At the limit, monetary/exchange rate policies do become exhaustible. For example, more borrowing at a low interest rate shrinks the supply of money that banks have to lend, raising the interest rate. As more international investors make overseas purchases to take advantage of an appreciate exchange rate, the supply of domestic money rises relative to foreign currencies, leading to a currency depreciation.
North (1981, 45-58) described how ideology, a key organizing principle for political parties in the advanced industrial democracies, can overcome the free rider problem.

*Principal-Agent Framework*

As an alternative to economic pluralism, I develop a principal-agent model to show how societal preferences get translated into policy outcomes through the partisan character of the government in power. Societal groups function as *principals*, economic actors with specific policy goals, delineated above in terms of the monetary autonomy/exchange rate stability tradeoff. To achieve their goals and surmount collective action problems, these societal groups employ *agents*, other actors who are entrusted to achieve their goals and desired policy outcomes. In liberal Western democracies, these agents are often political parties.

If political parties effectively act as agents for specific economic groups in society, then we need to examine affiliations between societal economic groups and organized political parties. In many contexts, such affiliations are posited without explicit reference to principal-agent model. For example, scholars studying partisan politics in the advanced industrial economies have long been comfortable in identifying leftist parties as agents for labor interests in society, while rightist parties function as agents for capital interests, following cleavages along factors of production (or classes). As I will discuss below, it is not the case that all laborers or labor unions look to leftist parties to advance their interests, for example, but it does describe well-accepted general trends.
Looking also at cleavages along economic sectors, it is not hard to identify general sectoral-partisan affiliations. Rightist parties in the developed world tend to have relatively tight links to banks ("financial services") and the large multinational corporations engaging in foreign direct investment ("international investors"). Likewise, leftist parties can be linked historically to blue-collar manufacturing ("import-competing producers"), low-skilled and labor-intensive domestic industries such as construction, transportation, storage, social, and government services (all major components of "nontradable services").

It is, of course, harder to identify the broad export sector with either leftist or rightist parties. In general, one might expect that rightist parties would tend to act as agents for more capital-intensive exporters, likely to be the very same multinational firms identified above as "international investors." Likewise, leftist parties may tend to represent more labor-intensive exporters, firms who export some of their production, but also suffer from import competition at home. Indeed, it is notable that such firms experience import competition because their production is relatively labor-intensive and, thus, subject to competition from lower-cost labor-intensive producers in the developing world. Such an understanding begins to blend, of course, factorial and sectoral considerations, which may be appropriate in the medium term.

In saying that rightist and leftist political parties tend to function as agents for particular sectors of the economy, I am not arguing that all individuals within the sector

---

12 Frieden (1994, 31) argued against strong affiliations, noting that "many of the economic sectors in question cut across traditional party lines." I admit that that the overlap is far from perfect and, indeed, there are often major divisions within a political party. Nonetheless, I believe there is enough of a
vote exclusively for either rightist or leftist parties or that all firms within the sector contribute financially to only rightist or leftist parties. Nor am I arguing that leftist parties work only on behalf of domestically-oriented groups, with rightist parties helping exclusively internationally-oriented groups. Indeed, political incentives exist in democratic systems for both leftist and rightist parties to broaden their electoral base. Parties often seek to broaden their base by pursuing policies attractive to economic sectors more affiliated with opposing parties, but this comes with the cost of alienating one’s own electoral base (Przeworski and Sprague 1986). In the language of the principal-agent model, the neglected core supporters may view the party’s attempts to broaden its electoral base by appealing to new groups as “shirking.” When principals detect shirking, they will apply pressure on their partisan agents to return to their traditional policy positions; I will return to this point in greater detail below.

These caveats aside, I believe that one can plausibly argue that different party types (left versus right) draw their primary electoral support from different sectors of the economy and that these sectors tend to rely on a particular party type to advance their economic interests. This principal-agent logic suggests that the societal economic groups identified will obtain their preferred policy outcomes not necessarily when they are relatively large (i.e. economic pluralism), but rather when their respective agents hold the reins of government power. Leftist governments, representing their domestically-oriented sectoral principals, could be expected to choose an “autonomous” policy mix associated with greater exchange rate variability. Likewise, rightist

sectoral-partisan overlap to make the principal-agent model potentially operative using economic sectors
governments could be expected to opt for a “convergent” policy mix to achieve exchange rate stability, consistent with the interests of their more internationally-oriented societal principals.

In short, despite the long-running state-society debate on monetary/exchange rate policy formation, we have no conclusive answers to the research questions posed in the introduction to the chapter. Our lack of answers stems in part from the dearth of empirical research on the subject. I know of no attempts to test empirically a factorial model of fiscal/monetary/exchange rate policy outcomes, although Quinn and Inclan (1997) used a factorial model to explain financial openness. On the sectoral side, Frieden (1996, 1998) performed some preliminary tests of his model, for example, but these tests were limited to a small number of European states, include only two different sectoral measures (exporters and institutional investors), and examine only exchange rate outcomes (ignoring monetary and fiscal policy choices). As McNamara (1998, 40) recently stated, “a more systematic empirical test of the sectoral interest group approach is necessary....” I will offer a more systematic test in the next section of the paper.

---

as well as factors (classes) of production.
Empirical Results

Statistical Model

In order to test how (and whether) societal preferences matters for economic policy outcomes, I add seven new independent variables to the three models used in the previous chapter explaining the fiscal policy choice, monetary policy choice, and exchange rate variability of the advanced industrial democracies in the post-Bretton Woods era. Due to data limitations, which will be discussed below, these models are estimated for a panel of 22 OECD states (Luxembourg drops from the sample) over the 1973-92 period (and I lose the years 1993-96). The new models take the following general form:

\[
DV_{it} = B_{0} + B_{1} \cdot GDPGROW_{it} + \frac{B_{2} \cdot INFLAT_{it} + B_{3} \cdot KAPMOB_{it} + B_{4} \cdot LEFTIST_{it} + B_{5} \cdot PR_{it} + B_{6} \cdot CBI_{it} + B_{7} \cdot FIXCOMMIT_{it} + B_{8} \cdot UNION_{it} + B_{9} \cdot KLRATIO_{it} + B_{10} \cdot EXPORT_{it} + B_{11} \cdot FDI_{it} + B_{12} \cdot IMPORT_{it} + B_{13} \cdot NONTRADE_{it} + B_{14} \cdot FINSERV_{it} + \Sigma(\alpha_{j} \cdot COUNTRY_{jit}) + \Sigma(\alpha_{j} \cdot YEAR_{jit})}{.}
\]

As in the previous chapter, DV is one of three dependent variables. GOVEXP measures the level of discretionary government spending as a percent of GDP for country \(i\) in year \(t\).\(^{13}\) MONAUT measures the monetary tightness of state \(i\)'s central

\(^{13}\) Data from the OECD’s Annual National Accounts, Volume II: Detailed Tables (various years).
bank rate in year $t$ relative to the G-5 average.\textsuperscript{14} EXRCV indicates the nominal coefficient of variation of state $i$'s currency versus the SDR in year $t$.\textsuperscript{15}

The first three independent variables act as economic controls. I include these variables in the model because all governments can be expected to make some policy adjustments in response to economic growth and inflation. $\text{GDPGROW}$ measures the growth rate of state $i$'s GDP in year $t$, while $\text{INFLAT}$ indicates the inflation rate.\textsuperscript{16} $\text{KAPMOB}$ controls for capital account openness.\textsuperscript{17}

The next five independent terms model the domestic political institutions. Certainly, the interaction between societal preferences and statist institutions can be complex, but here I follow the advice of Garrett and Lange (1995, 655), who argue that “it is first necessary to isolate [the institutions’] independent effects.” $\text{PARTY}$ measures the partisan character of the \textit{head of government} in state $i$ in year $t$, employing a three-point scale where 0 indicates a rightist party (Conservative and Christian Democrat), 1 indicates a centrist party (Agrarian and Liberal parties), and 2 indicates a leftist party (Social Democrat and Socialist).\textsuperscript{18} $\text{PR}$ is a dummy variable coded as 1 if state $i$'s electoral system was proportional representation in year $t$; majoritarian systems are coded as 0.\textsuperscript{19} $\text{CBI}$ measures the independence of state $i$'s central bank in year $t$.\textsuperscript{20}

\textsuperscript{14} Given its construction, MONAUT $(i,t)$ is both a measure of monetary autonomy and monetary tightness. Positive values indicate nominal interest rates above (tighter than) the weighted G-5 average while negative values indicate interest rates below (looser than) the weighted G-5 average, which operationalizes the prevailing world interest rate.

\textsuperscript{15} The monetary policy and exchange rate data come from the International Monetary Fund’s \textit{International Financial Statistics} (CD-ROM).

\textsuperscript{16} GDP and inflation data also come from the International Monetary Fund’s \textit{International Financial Statistics} (CD-ROM).

\textsuperscript{17} Capital mobility data from Quinn (1997).

\textsuperscript{18} These data come from Lane, McKay and Newton (1997) and Banks (1998).

\textsuperscript{19} These data provided by Rogowski (1987).
FIXCOMMIT indicates whether state $i$ had a fixed exchange rate commitment in year $t$. I use a simple index for exchange rate commitments: states that float their exchange rates are coded as 0, a unilateral peg is coded as 1, and membership in a multilateral currency arrangement is coded as 2.\textsuperscript{21}

The new institutional control variable is UNION, which measures the percent of the workforce that is unionized for country $i$ in year $t$.\textsuperscript{22} Since unions are organized across different sectors of the economy, including financial services (Visser 1991), they may have differing preferences with regards to the policy mix and monetary autonomy/exchange rate stability tradeoff depending in their position within the economy.\textsuperscript{23} Consequently, I have no strong expectations about concerning the sign of the UNION coefficient. This diverse set of preferences, however, does suggest that it would be wise to isolate the effects of unionization from partisan politics since union interests may depart in some cases from those of leftist parties.\textsuperscript{24} In this regard, it is important to note that some unions affiliate themselves with rightist (especially Christian Democratic) parties in Europe.

The next set of independent variables indicates the relative size (as a measure of the economic power) of the societal groups discussed earlier. KLRATIO measures the

\textsuperscript{20} Cukierman, Webb and Neyapti (1993).
\textsuperscript{21} These data come from the International Monetary Fund Exchange Rate Arrangements and Exchange Restrictions Annual Report (various years). The idea here is that states committing to a multilateral currency arrangement face greater pressures to maintain their commitment in some form. While states with only a unilateral commitment are likely to pay internal audience costs for abandoning the fix, states with a multilateral commitment may also face external audience costs.
\textsuperscript{22} This data comes from the Trade Union Membership Data Base, created by Jelle Visser in the Department of Sociology at the University of Amsterdam.
\textsuperscript{23} Data breaking down unionization rates by economic sector is only available for a very limited number of years, so I am forced to use the more aggregated UNION measure.
capital/labor ratio of country $i$ in year $t$ (in constant $\$US$) to operationalize the relative strength of capital versus labor interests.\textsuperscript{25} EXPORT operationalizes the potential strength of the export sector, looking at exports as a percent of country $i$'s total GDP in year $t$.\textsuperscript{26} FDI indicates the relative size of international investors, measuring outward foreign direct investment as a percent of country $i$'s total GDP in year $t$.\textsuperscript{27} IMPORT measures the imports of country $i$ in year $t$ as a percent of its GDP.\textsuperscript{28} NONTRADE indicates the size of the nontradable service sector net of financial services as a percent of total GDP for country $i$ in year $t$. FINSERV measures the size of the banking/financial service sector as a percent of total GDP for country $i$ in year $t$.

To complete the model, COUNTRY is a set of dummy variables for each country in the sample, with the United States as the reference category, to control for any country-specific factors that may otherwise be omitted from the model. YEAR is a set of dummy variables for each year in the sample, with 1973 as the reference

\textsuperscript{24} Garrett's (1995, 1998) work uses an index to measure the combined power of leftist parties and labor unions, presumably because their interests are identical.

\textsuperscript{25} These data come from the Penn World Tables, Mark 5.6a, and are available only through 1992; hence, the reduced temporal domain for the OECD sample in this chapter.

\textsuperscript{26} Export, import, service sector, and financial service sector data all come from the OECD’s Annual National Accounts, Volume II: Detailed Tables (various years). Sectoral data for Luxembourg was unavailable so it was dropped from the OECD sample.

\textsuperscript{27} Investment data are provided in the World Bank’s World Development Indicators (CD-ROM). Ideally, one would also include short-term international investments (portfolio investment) in the calculation, but this data is not available for many observations in the sample and is often unreliable even when available. I chose outward foreign direct investment since firms headquartered in the domestic economy are likely to hold the greatest political influence. The results do not change substantially if I use an inward FDI measure or inward plus outward FDI.

\textsuperscript{28} A careful reader will recognize that this variable does not measure the potential political strength of the import-competing sector, rather it indicates the threat faced by the import-competing sector. Another way to more directly indicate the relative size of this sector would be to subtract exports from total manufactures; the remainder might indicate the amount of manufactured goods that remain in the domestic market subject to import competition. However, because export data includes re-exports and intra-firm trade, exports often exceed total manufactures, especially for the small open European states. Hence, this alternate indicator sometimes yields implausible negative numbers. I thus use imports relative...
category, to control for any year-specific systemic effects. As done previously, these models are estimated with an AR1 correction to eliminate any first-order serial autocorrelation and panel-corrected standard errors to deal with contemporaneous autocorrelation and panel heteroskedasticity.

Economic pluralism posits that states with higher capital/labor ratios, greater exports, foreign direct investment, and financial services should be associated with a more convergent policy mix (i.e. less government spending permitting lower nominal interest rates) to reduce exchange rate variability. States with greater import competition and nontradable service sectors should be associated with a more autonomous policy mix (greater government spending and higher nominal interest rates) leading to greater exchange rate variability. The expected signs for the economic pluralist model are summarized below in Table 4.1.

The principal-agent logic, however, suggests that these societal group size terms (KLRATIO, EXPORT, FDI, IMPORT, NONTRADE, and FINSERV) should be statistically insignificant; relative group size should not be an important consideration since partisan agents have incentives to follow the preferences of their societal principals even when those principals are relatively small. Explanatory power comes instead from the LEFTIST term, which should be positively signed in all three models. Leftist-led governments should be associated with greater governments spending, leading to greater monetary autonomy and exchange rate variability, consistent with the interests of their domestically-oriented principals. To the extent that neither LEFTIST

\[ \text{to GDP as the preferred indicator, while acknowledging its potential weakness in an economist pluralist} \]
nor the six societal size terms achieve statistical significance with the expected signs, then both the principal-agent model and economic pluralism can be seen as theoretically inadequate to explain economic policy outcomes. The estimates for the three models are reported together in Table 4.2.

*Statistical Estimates*

Considering first societal preferences based on factors of production, the KLRATIO term fails even to achieve the expected negative sign in two of the three models (fiscal policy choice and exchange rate variability). Not only does the factorial model poorly explain policy outcomes, I would argue that its failure to obtain the expected signs reveals also its limitations in accounting for societal preferences under capital mobility. Indeed, the positive sign in the fiscal policy choice model seems to suggest that some capital owners prefer fiscal expansion, especially when government spending is directed towards public goods such as education, infrastructure, and research and development. As such, one cannot say that capital owners with global financial integration consistently prefer fiscal contraction to achieve monetary convergence with exchange rate stability. Indeed, some capital owners may be willing

---

29 It does achieve statistical significance with the expected negative sign in the model for monetary policy autonomy, but one should be very careful about pronouncing victory for economic pluralism based on this isolated result. If the greater relative share of capital in the economy relative to labor mattered systematically for economic policy outcomes following the economic pluralist logic, then we should observe this result beyond just the monetary policy model. Instead, the statistically significant negative sign for KLRATIO in the MONAUT model may simply reflect the fact that capital is cheaper (i.e. lower interest rates) in economies where it is plentiful, reflecting a supply/demand logic rather than economic pluralism.
to accept greater exchange rate variability as the price for greater public goods through fiscal expansion.

Looking next at the sectoral measures, the results are slightly more promising. In the three models, the five sectoral terms (EXPORT, FDI, IMPORT, NONTRADE, and FINSERV) achieve the correct sign in 12 of 15 (80%) places. However, the results attain statistical significance in only 3 of 15 (20%) places, all with the correct sign. The only real support for economic pluralism comes from the EXPORT term. This result is interesting, and not unexpected, since exporters are the economic sector least affiliated with any particular party type (left or right).\textsuperscript{30}

I draw two conclusions from this set of results. First, given the fact that the sectoral terms do return the expected sign 80 percent of the time, the underlying sectoral models appear to offer a more reasonable account of societal preferences for/against policy autonomy/exchange rate stability under capital mobility than does the factorial model.\textsuperscript{31} In this sense, Frieden (1991, 436) appears correct that sectoral cleavages identify a better breakdown of societal preferences under capital mobility in the short to medium term. However, I also conclude that sectoral group size is, at best, only a marginal consideration in economic policy outcomes.\textsuperscript{32} Even if multinational firms prefer a convergent policy mix to reduce exchange rate variability and even if non-

\textsuperscript{30} It may well be the case that with leftist and rightist parties both competing for political influence in the broad export sector, group size matters more for exporters than any other economic sector.

\textsuperscript{31} There is only a 1.4% chance of obtaining 12 out of 15 “correct” signs due to chance alone.

\textsuperscript{32} Sectoral size may matter indirectly in that more voters in a given sector provides an advantage to a particular party type. However, the number of employees as voters in each relevant sector can be hard to count. For example, it is easier to identify the number of employees in the financial service sector, but harder to identify the number of employees in the import-competing sector for reasons discussed in a footnote above. Even if countable, the fact that countries with large import-competing sectors do not
tradable services can accept greater currency variability to achieve an autonomous policy mix, their relative economic size does not explain the actual policy outcomes. Thus, if societal preferences do matter systematically for policy outcomes, we need some alternative to simple economic pluralism.

Consistent with the principal-agent logic, societal interest groups obtain their preferred policy outcomes not when they are large (since FDI, IMPORT, NONTRADE, and FINSERV are generally statistically insignificant), but when their respective partisan agents take government power. The LEFTIST term achieves statistical significance with the expected positive sign in all three models.\textsuperscript{33} Leftist-led governments, acting as agents for domestically-oriented economic groups, accept greater exchange rate variability to achieve policy autonomy (a loose fiscal/tight monetary policy mix). Conversely, rightist-led governments, acting as agents for internationally-oriented economic groups, adopt a convergent policy mix (tight fiscal/loose monetary) to reduce exchange rate variability.

The new institutional variable, UNION, appears to confirm the importance of political agents in the policy process, although one of the results may appear counter-intuitive. If parties act as the primary agents for societal economic groups since they hold the actual reins of state power once elected, unions can be seen as intermediate

\textsuperscript{33} These results also serve as a robustness check on the statistical findings in the previous chapter. Despite the efficiency loss in including seven new independent variables and dropping more than 100 observations (due to missing data on the societal variables), the institutional factors emphasized earlier – especially the partisan character of the government (LEFTIST) and the state’s electoral systems (PR) – maintain their explanatory power.
agents, linking workers in different sectors of the economy to various political parties, usually - but not always - leftist in partisan character.

The results show that high unionization is associated with significantly more fiscal expansion. High unionization also associates with higher nominal interest rate differentials, although this result does not achieve statistical significance. The surprising result for the UNION term occurs in the exchange rate model, where greater unionization associates with significantly less exchange rate variability. The fact that unions are organized in different sectors of the economy, with many unions in the export sector, may account for this result. Countries with high aggregate unionization rates are also more likely to have unions in the financial service sector, another sector with expected preferences for exchange rate stability. Finally, this result underscores the need to separate unionization measures from indicators of government partisanship. When unions exist in the internationally-oriented sectors of the economy and ally themselves with rightist parties, the monetary interests of unions and leftist parties may diverge.

The Principal-Agent Model and Societal Lobbying

Additional evidence can be brought to bear in support of principal-agent model of economic policymaking. An important test for any model of societal preferences in

---

34 It is tempting to conclude that this result reveals only that since the European states have high unionization rates, they also have greater exchange rate stability. Since the model, shown in equation (4.1), also includes country-specific fixed effects and a control for fixed exchange rate commitments, I think the result says more about unionization in sectors with preferences for exchange rate stability.
the monetary/exchange rate issue area is whether or not it can account for the empirical observation that episodes of societal groups visibly lobbying the government for particular exchange rate policies are relatively rare. The agent/principal framework sets forth some very restricted conditions under which such societal lobbying activity should emerge.

The Emergence of Lobbying

First, one should understand that lobbying the government represents a very costly activity in terms of political capital, time and financial resources. Societal groups will thus tend to conduct less lobbying when such activity is either 1) unnecessary or 2) likely to be ineffective. To understand when lobbying will be necessary and potentially effective, we need to know if the principal’s agent holds government power and if the agent who does hold power is working on behalf of the principal’s interests. (see Table 4.3).

Lobbying is unlikely to occur when the principal’s agent does not hold power and yet the agent in power is unexpectedly working to satisfy the principal’s preferences. For multinational corporations (MNC) normally allied with rightist parties, there is no need to lobby a leftist government not beholden to MNC interests when exchange rates remain relatively stable. Expensive lobbying becomes unnecessary when the societal principal is receiving unexpected benefits from some other group’s agent in power.
Lobbying the government will also be unnecessary for societal principals interested in exchange rate stability when their own agents (rightist governments) have already stabilized exchange rates. In other words, international investors, bankers, and capital-intensive exporters need not engage in costly lobbying when rightist governments adopt a “convergent” policy mix consistent with exchange rate stability. Costly lobbying is simply unnecessary in cases where beholden agents are “working” on behalf of their principals’ preferences.\(^{35}\) Since stable exchange rate can be readily observed, agent monitoring can be accomplished without extensive lobbying by the principals.\(^{36}\)

Finally, we should also not expect to see much evidence of societal lobbying by principals whose partisan agent does not hold power even when the government works against their interests. This case describes the situation for groups preferring exchange rate stability when leftist governments hold power since lobbying activity may be ineffective. Leftist agents appear generally more beholden to societal principals with domestically-oriented business interests (import-competing manufacturers and nontradable services including sheltered government services) and preferences for a “autonomous” policy mix associated with exchange rate instability. The lack of lobbying certainly does not mean that societal groups favoring a more stable currency will be happy with leftist exchange rate outcomes (in fact, just the opposite), but rather

\(^{35}\) Odell (1982, 127) made a similar point in his study of US monetary policy: “Groups may not need to bother with lobbying if they can place their own members directly in government offices. It is certainly true that international banking and business have been successful in this respect...”

\(^{36}\) Austen-Smith and Wright’s (1994) theory of counteractive lobbying argues that groups will lobby their own agents, even when those agents are working, in an effort to counteract the lobbying activity of
that the leftist agents holding the reins of power are not beholden to these internationallly-oriented business interests. Rather than engage in costly and potentially ineffective lobbying of leftist governments, societal principals interested in exchange rate stability may do better purchasing forward exchange contracts as a hedge against unexpected currency movements. While such hedging instruments are costly, their effects will be more immediate than lobbying than someone else’s agent.

Under what conditions are we most likely to observe costly lobbying on behalf of exchange rate stability? The principal-agent logic suggests that lobbying will emerge when the principal’s agent does hold power, yet does not work on behalf of principal interests. For exchange rate policy, this situation occurs when rightist governments fail to achieve the policy outcome of exchange rate stability demanded by its societal principals. Such rightist governments are more beholden than leftist ones to protect the interests of internationally-oriented sectors favoring currency stability. If rightist governments “shirk” this duty to their principals, then lobbying becomes both necessary and potentially effective as principals signal publicly to their agent that “shirking” has been detected and that the agent can expect the loss of electoral support if policy changes do not occur.

Shirking can occur for several reasons. First, rightist governments may misinterpret how much currency volatility their societal principals can tolerate with floating exchange rates. Second, rightist parties may attempt to broaden their electoral base before an election, engaging in greater government spending to court traditionally opposing groups. Their theory is tested on judicial nominations and they conclude that their theory may
leftist societal groups. Such fiscal expansion can put pressure on monetary policy and exchange rates in ways that alienate core rightist business constituencies, leading them to lobby on monetary/exchange rate issues.

These expectations about societal lobbying fit accord well with the US experience in the post-Bretton Woods era. Due to space considerations, I focus on three American governments: the Carter Administration, the first Reagan Administration, and the second Reagan Administration. These three cases offer interesting variation in terms of partisan agency, exchange rate outcomes, and the extent of societal lobbying as summarized in Table 4.4. During the Carter years, exchange rates were relatively unstable, especially in 1977-78, yet there is little evidence of societal lobbying for greater currency stability. Exchange rate instability grew during the first Reagan Administration and Republican business groups became quite active in lobbying the government for a more stable and competitive US dollar. Finally, exchange rates became more stable during the second Reagan term in the wake of Plaza and Louvre Accords; correspondingly, societal lobbying on exchange rate policy subsided.

*Exchange Rate Lobbying in the United States*

*Carter Administration:* As this left-of-center government’s societal principals were not particularly interested in exchange rate stability, the Carter government “perceived no need to expend significant time or energy on exchange rate policy” (Cohen and Meltzer 1982, 17). And since the economic interests of the Democratic
Party’s electoral base were more domestically-oriented, the Carter economic team favored policy autonomy under capital mobility. Cohen and Meltzer (1982, 31) explicitly noted the “priority extended by the Carter administration and the Federal Reserve Board to the pursuit of domestic economic considerations over purely balance of payment factors....”

A growing US trade deficit put downward pressure on the dollar’s value and the dollar began to fall rapidly in late 1977. Exchange rate instability grew in 1978, yet there was no significant lobbying on the part of societal groups with international business interests disrupted by US currency instability. As Cohen and Meltzer (1978, 33) stated, “domestic pressures and constraints were not a factor in the formulation or conduct of U.S. exchange rate policy in the 1977-78 period.” They continued (34): “While it is difficult to prove that something does not exist, extensive research and interviews failed to find evidence of any major or sustained domestic criticism of official exchange rate policy in the public domain.”

It appears not to be the case that societal groups failed to lobby because either their interests were unharmed or they were not organized for lobbying activity. US banks and MNCs did express their concerns about the dollar’s volatility, although not directly to Carter Administration officials. Likewise, these business groups did possess an infrastructure for lobbying in Washington, an infrastructure that would later be put to use during the first Reagan Administration. Rather, these groups refrained from costly lobbying because the Carter government made it clear that exchange rate stability would be a low priority as the economic team focused on domestic growth and inflation.
control. Treasury Secretary Michael Blumenthal even publicly stated his administration’s willingness to accept unstable exchange rates in a controversial 1977 Washington Post interview (Cohen and Meltzer 1982, 20).

_1st Reagan Administration_: Destler and Henning (1989), in their account of US monetary politics during the 1980s, term the 1981-84 period as one of “exchange rate neglect” in the United States. Scholars sometimes argue that the Reagan Administration was never interested in exchange rate stability, but this is a conclusion reached about economic outcomes ex post rather than political objectives ex ante. It is worth remembering that many members of the Reagan economic team did believe that a stable US dollar should be a top priority and some even advocated a return to a gold-standard fixed exchange rate regime (Stockman 1986, 63).

Certainly, Republican principals, especially banks and MNCs, favored exchange rate stability and convergent fiscal and monetary policies to promote international trade and investment. Dissatisfied with the Carter Administration’s loose fiscal/tight monetary policy mix, they anticipated that the new Reagan government would pursue a tighter fiscal stance permitting lower interest rates, more consistent with stable exchange rates. But the Reagan Administration’s atypical rightist policy mix – looser on the fiscal side and tighter on the monetary side than their principals desired – meant

---

37 Carter Administration perhaps worked indirectly for exchange rate stability in pressuring foreign governments, notably Japan and Germany, to expand fiscally: the so-called “locomotive” strategy pursued in the wake of the 1978 Bonn Summit. Fiscal expansion abroad would permit US fiscal expansion to proceed with a smaller trade deficit and less depreciation of the dollar. It is notable, however, that “exchange rates were largely neglected as a topic of conversation at the summit itself” (Henning 1994, 268).
that exchange rate stability objectives would be difficult to achieve. As the US budget
deficit swelled, US interest rates stayed high, attracting international capital and putting
strong upward pressure on the dollar. When the Treasury Department, led by Donald
Regan and Beryl Sprinkel, announced in 1981 that it would no longer intervene in
international currency markets for dollar stabilization, Republican societal principals
began to see the Reagan Administration as “shirking” its duties to achieve a stable and
competitive US dollar. \(^{38}\)

Thus, internationally-oriented businesses began to lobby the Reagan
Administration on behalf of policies to help stabilize the dollar (cuts in government
spending and lower interest rates) beginning in late 1982. Caterpillar Inc. and the
Business Roundtable’s Task Force on International Trade and Investment took the early
lead. A long list of other international firms and organizations, reluctant at first to
criticize the administration due to their “affiliation with the Republican Party and
interest in Reagan’s reelection” (Destler and Henning 1989, 36), soon followed.

Consistent with the principal–partisan agent logic, firms within the more labor-
intensive import-competitive sector of the US economy - also hurt by a strong dollar but
not necessarily by currency instability per se - lobbied their Democratic agents in
Congress for trade relief and the closing of American markets to foreign competition.
As Destler and Henning (1989, 123) noted, the AFL-CIO’s “lobbying energy went
toward trade and industrial policy rather than exchange rate remedies....” Furthermore,
these Democratic societal principals tended to lobby Congress because these groups

\(^{38}\) It is important to note that some members of the Reagan cabinet, including Secretary of State George
“saw the White House as generally hostile, and lobbying the administration as a waste
of political resources” (ibid 124).

2nd Reagan Administration: The years 1984-85 arguably marked the peak of societal lobbying on exchange rate policy in the United States during the post-Bretton
Woods era. This lobbying activity eventually produced its desired effect as the Republican government worried about the “movement of core Reagan supporters in the large multinational companies to the [Democratic] trade-activist camp” (ibid, 41).
James Baker replaced Regan as Treasury Secretary in 1981 and immediately ended the non-intervention policy in international currency markets. More significantly for Republican societal principals interested in exchange rate stability and curtailing protectionist impulses in Congress, Baker orchestrated the September 1985 Plaza Accord, an event which led to coordinated G-5 currency intervention to stabilize the dollar at a more competitive level and strength the Japanese yen.

As Destler and Henning (1989, 46) concluded:

“In policy terms, the Plaza strategy was a clear success. Economists will forever debate whether the dollar would have come down anyway at about the same rate, and properly so. For Baker as a domestic and international politician, however, it sufficed that clear action had been followed by desired marker movement.

When the dollar declined sharply, traded-goods producers and the Congress voiced their relief and their approbation. For the first time, the Reagan administration had shown receptive and positive leadership in the broad international economic policy sphere. One close advisor to the President even described Plaza as ‘the most successful public relations operation of the decade.’”

Schultz, opposed Regan and Sprinkel non-intervention policy (Destler and Henning 1989, 40-1).
The second Reagan administration remained active on behalf of its societal principals favoring stable exchange rates. Notable in this regard was US participation in the 1987 Louvre Accord, establishing a de facto target zone for the G-5 currencies. The US dollar remained relatively stable for the rest of the 1980s. Since the second Reagan Administration had "redressed the main grievances of Congress and private groups regarding exchange rate policy, the interest of outside [societal] actors tended to wane" and lobbying activity "virtually evaporated" (ibid 74, 131).

Conclusion

This chapter has shown that societal preferences do matter with regards to the formation of fiscal, monetary and exchange rate policy. Consistent with the interest group theories of Frieden (1991), Heming (1994) and Hefeker (1997), societal cleavages along sectoral lines appear to offer a better story of societal preferences than cleavages along factorial lines, although factorial endowments do play a role. For example, international investors have "international" business interests because of their deep capital positions, just as import-competitng firms in the advanced industrial economies "compete" with imports from the developing world due to their labor-intensive production.

However, the statistical results show that economic pluralism poorly translates societal preferences into state policy outcomes. Different societal groups tend to look towards particular party types to advance their economic interests. Thus, societal interest groups obtain their preferences regarding the policy autonomy/exchange rate
<table>
<thead>
<tr>
<th></th>
<th>Government Spending (Fiscal Expansion)</th>
<th>Interest Rate Differential (Monetary Autonomy)</th>
<th>Exchange Rate Variability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital/Labor Ratio</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Exports</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Foreign Direct Investment</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Import Competition</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Nontradable Services</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Financial Services</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Plus signs (+) indicate a positive expected relationship. Minus signs (-) indicate a negative expected relationship.

Table 4.1: Hypothesized Relationships between Societal Group Size on Fiscal/Monetary Policy Choices and Exchange Rate Outcomes following Economic Pluralism.
<table>
<thead>
<tr>
<th>DV</th>
<th>GOEXP</th>
<th>MONAUT</th>
<th>EXRCV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>7.90***</td>
<td>0.03</td>
<td>4.17</td>
</tr>
<tr>
<td></td>
<td>(2.14)</td>
<td>(7.72)</td>
<td>(5.25)</td>
</tr>
<tr>
<td>GDGPROW</td>
<td>-0.09***</td>
<td>-0.07</td>
<td>0.02</td>
</tr>
<tr>
<td></td>
<td>(0.01)</td>
<td>(0.07)</td>
<td>(0.05)</td>
</tr>
<tr>
<td>INFLAT</td>
<td>-0.04</td>
<td>0.14***</td>
<td>0.11***</td>
</tr>
<tr>
<td></td>
<td>(0.01)</td>
<td>(0.05)</td>
<td>(0.03)</td>
</tr>
<tr>
<td>KAPMOB</td>
<td>0.35***</td>
<td>1.48***</td>
<td>0.49*</td>
</tr>
<tr>
<td></td>
<td>(0.14)</td>
<td>(0.46)</td>
<td>(0.29)</td>
</tr>
<tr>
<td>LEFTIST</td>
<td>0.11**</td>
<td>0.33*</td>
<td>0.19**</td>
</tr>
<tr>
<td></td>
<td>(0.05)</td>
<td>(0.18)</td>
<td>(0.10)</td>
</tr>
<tr>
<td>PR</td>
<td>0.77***</td>
<td>3.19**</td>
<td>0.49</td>
</tr>
<tr>
<td></td>
<td>(0.30)</td>
<td>(1.35)</td>
<td>(0.98)</td>
</tr>
<tr>
<td>CBI</td>
<td>4.80**</td>
<td>-1.10</td>
<td>-4.54</td>
</tr>
<tr>
<td></td>
<td>(1.93)</td>
<td>(8.25)</td>
<td>(6.43)</td>
</tr>
<tr>
<td>FIXCOMMIT</td>
<td>0.16**</td>
<td>-0.39</td>
<td>0.05</td>
</tr>
<tr>
<td></td>
<td>(0.08)</td>
<td>(0.36)</td>
<td>(0.20)</td>
</tr>
<tr>
<td>UNION</td>
<td>0.11***</td>
<td>0.08</td>
<td>-0.08**</td>
</tr>
<tr>
<td></td>
<td>(0.02)</td>
<td>(0.05)</td>
<td>(0.04)</td>
</tr>
<tr>
<td>KLRATIO</td>
<td>0.00004</td>
<td>-0.00038***</td>
<td>0.00004</td>
</tr>
<tr>
<td></td>
<td>(0.00003)</td>
<td>(0.00009)</td>
<td>(0.00007)</td>
</tr>
<tr>
<td>EXPORT</td>
<td>-0.09***</td>
<td>-0.10</td>
<td>-0.09**</td>
</tr>
<tr>
<td></td>
<td>(0.03)</td>
<td>(0.07)</td>
<td>(0.04)</td>
</tr>
<tr>
<td>FDI</td>
<td>-0.06</td>
<td>0.09</td>
<td>-0.07</td>
</tr>
<tr>
<td></td>
<td>(0.04)</td>
<td>(0.11)</td>
<td>(0.09)</td>
</tr>
<tr>
<td>IMPORT</td>
<td>0.007</td>
<td>0.10**</td>
<td>-0.02</td>
</tr>
<tr>
<td></td>
<td>(0.012)</td>
<td>(0.04)</td>
<td>(0.03)</td>
</tr>
<tr>
<td>NONTRADE</td>
<td>0.03</td>
<td>0.18</td>
<td>0.12</td>
</tr>
<tr>
<td></td>
<td>(0.04)</td>
<td>(0.14)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>FINSERV</td>
<td>0.02</td>
<td>-0.38</td>
<td>-0.24</td>
</tr>
<tr>
<td></td>
<td>(0.06)</td>
<td>(0.28)</td>
<td>(0.16)</td>
</tr>
</tbody>
</table>

Observations 440 440 440
Chi2 110819.34 5690.20 4907.55
Pr > Chi2 0.000 0.000 0.000

Estimates are Prais-Winsten coefficients with Panel Corrected Standard Errors in parentheses. Each model is estimated with country and year-specific fixed effects, which are not reported here. Statistical significance is indicated as follows: *** p < .01, ** p < .05, and * p < .10. Two-tailed tests reported for each estimate.

<table>
<thead>
<tr>
<th></th>
<th>YES</th>
<th>NO</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Is the agent in power working to satisfy the principal’s preferences?</strong></td>
<td><strong>YES</strong></td>
<td><strong>NO</strong></td>
</tr>
<tr>
<td></td>
<td>No lobbying</td>
<td>Lobbying ineffective</td>
</tr>
<tr>
<td></td>
<td>Unexpected benefits to societal principals</td>
<td>Agent not beholden to societal principals</td>
</tr>
<tr>
<td><strong>Is the principal’s agent in power?</strong></td>
<td><strong>YES</strong></td>
<td><strong>NO</strong></td>
</tr>
<tr>
<td></td>
<td>Lobbying unnecessary</td>
<td>Lobbying both necessary and potentially effective</td>
</tr>
<tr>
<td></td>
<td>Societal principals already obtaining preferences</td>
<td>Agents are shirking and beholden to societal principals</td>
</tr>
</tbody>
</table>

Table 4.3: Principal-Agent Model and the Emergence of Societal Lobbying.
<table>
<thead>
<tr>
<th>Government</th>
<th>Exchange Rates</th>
<th>Lobbying Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carter 1977-80</td>
<td>Dollar relatively unstable, especially 1977-78</td>
<td>Low - agent in power not beholden to principals preferring exchange rate stability</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st Reagan 1981-84</td>
<td>Dollar relatively unstable, especially 1984-85</td>
<td>High - agent in power shirking preferences of its societal principals</td>
</tr>
<tr>
<td>Rightist agent expected to favor exchange rate stability</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd Reagan 1985-88</td>
<td>Dollar relatively stable, especially 1986-88</td>
<td>Low - agent in power working for its societal preferences</td>
</tr>
<tr>
<td>Rightist agent expected to favor exchange rate stability</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Table 4.4: Three US Governments, Exchange Rate Outcomes, and Societal Lobbying.
CHAPTER 5

POLICY AUTONOMY UNDER CAPITAL MOBILITY:
FRANCE, ITALY, AND SWEDEN

In the previous chapters, I presented a deductive model to explain how governments, depending on their partisan orientation and electoral system, choose a different fiscal/monetary policy mix in order to achieve economic growth with low inflation under the condition of capital mobility. Leftist-led governments and multi-party governments in proportional representation electoral systems tend to choose an "autonomous" loose fiscal/tight monetary policy mix associated with currency instability, but offering greater possibilities for redistribution and public goods provision. Conversely, rightist-led governments and single-party governments in majoritarian electoral systems opt for a "convergent" tight fiscal/loose monetary policy mix associated with less public goods, but greater exchange rate stability. The large-N statistical results offer broad support for this partisan policy mix framework.

In this chapter, I will investigate how particular OECD governments in the post-Bretton Woods era have chosen an "autonomous" policy mix to accord with their ideological objectives and the preferences of core societal constituencies. This case
analysis covers multiple observations in the pooled time-series data set, offering a
deep illustration of the general arguments presented earlier in this project.

This chapter is divided into three main sections, each focusing on a different
country. The first section looks at Mitterrand’s Socialist governments in France. The
second case examines the economic policy choices made by a series of proportional
representation multiparty governments in Italy. These two cases represent interesting
effects to illustrate policy autonomy under capital mobility since both governments
maintained fixed exchange rate commitments to the European Monetary System (EMS).
Consequently, observers often treat these cases, especially France after 1983, as
potential examples of neoliberal policy convergence. The third case considers the
autonomous policy choices made by the Swedish Social Democrats (SAP) since
returning to power in late 1994 and the SAP’s decision to remain outside Economic and
Monetary Union (EMU). This case further helps to dispel the myth that leftist
governments run national economic policy in the same manner as rightist governments,
with a particular focus on exchange rate stability under capital mobility.

**Socialist Governments in France**

To scholars seeking support for the neoliberal convergence hypothesis, Socialist
governments in France are often cited as an example of the political left adopting
rightist strategies for managing the economy. While Mitterrand did embrace the policy
goal of low inflation, his governments achieved their lower inflation outcomes primarily
through monetary, not fiscal, contraction. Government spending was reduced relative to planned expenditures, but French government consumption remained higher than the OECD average throughout the Mitterrand era. Thus, French Socialists did not follow the neoliberal tight fiscal/loose monetary policy mix associated with monetary convergence and exchange rate stability, although France retained its membership in the European Monetary System (EMS). Instead, the Socialists followed primarily a “new left” loose fiscal/tight monetary policy mix, which allowed the Socialists to achieve their policy goals of redistribution and public goods provision at some cost of exchange rate instability.

François Mitterrand won the presidency of France in 1981, dissolved the National Assembly, called for new elections, and won a leftist majority in national legislative elections. He chose Pierre Mauroy as his prime minister to head a coalition government of socialists and communists. This government was the first French leftist regime in the post-Bretton Woods era; consequently, they had little experience with economic governance under the condition of global capital mobility. Inheriting a situation of rising unemployment and slow domestic growth, Mitterrand began with a reflation policy, described as “redistributive Keynesianism” (Hall 1986, 194), using relatively loose fiscal and monetary policies.

Mitterrand’s reflation program had three main components: increase the minimum wage to boost private consumption, increase welfare benefits, and boost economic growth with greater government spending, including worker training and funding for research and development (Muet and Fonteneau 1990, 75). As Goodman
(1992, 127) wrote: “In the Socialists’ macroeconomic strategy, fiscal policy became the principal motor of economic growth. In fact, little attention was paid to monetary policy, which was expected to accommodate [remain loose to facilitate] the planned increase in government spending.”

The previous government led by right-of-center Valery Giscard d’Estaing had helped construct the EMS and committed France to this multilateral exchange rate regime. Although the Socialists did not repudiate EMS membership, they expressed little genuine interest in exchange rate stability. Goodman (1992, 127) continued: “Most Socialist party leaders agreed on these points [fiscal expansion with redistribution], but far less accord existed on the question of exchange rate policy. Although Mitterrand’s electoral policy promised to defend the franc, it was never clear how this goal would be reconciled with the government’s commitment to domestic growth. One leading Socialist economist admitted: ‘We were thinking more about growth, protecting employment, and structural reforms.... Defending the franc was a secondary consideration.’”

This “old left” policy mix (loose fiscal and loose monetary) quickly became unsustainable with capital mobility. The French economic situation worsened as inflation rose, the twin deficits (budget and trade) grew, capital exited, and the franc lost value. The franc’s weakness within the EMS left Mitterrand with two major policy options. One option was to stay within the EMS and devalue the franc; the other was to exit the EMS and float the franc.
Mitterrand’s advisors were divided on the value of the EMS. On one side stood the CERES group (Centre d’Etudes de Recherche et d’Education Socialistes), led by Jean-Pierre Chevennement, who wanted to pursue full economic expansion regardless of the inflationary consequences, withdraw from the EMS, and institute trade/capital controls to buffer against external pressures. The so-called “second left” (deuxième gauche) opposed the CERES group. Michel Rocard and Jacques Delors, who served as the Socialist finance minister, argued for some contraction to restore domestic price stability, while remaining open to the world economy. The second left also argued that EMS membership could provide some anti-inflation credibility even if exchange rate stability was not a top economic priority (see Oatley 1997, 111-20).

Monetary Tightness

The second left won this policy struggle over several years as France undertook a series of austerity programs and realignments inside the EMS. In 1981, the Mitterrand government raised nominal interest rates to the highest level seen in France in the post-Bretton Woods era. This tight monetary policy reflected a deliberate choice on the part of the Socialist-led government since the French central bank, the Banque de France, was quite subordinate to the Delors Finance Ministry with regards to monetary policy. As shown in Figure 5.1, French nominal interest rate differentials remained positive - above the “world” interest rate - throughout the 14 years of the Mitterrand presidencies, reflecting relative monetary tightness in an international context. The figure also shows that during the “cohabitation” years (1986-87 and 1993-95), when Gaullist ministers ran
French economic policy under a Mitterrand presidency, French monetary autonomy tended to decline, consistent with rightist monetary preferences.

The tight money policy instituted in 1981 took its time to reduce inflation. Predictably, French monetary autonomy led to exchange rate instability. France realigned within the EMS first in October 1981, then again in June 1982, and a third time in March 1983. In 1983, Finance Minister Delors instituted an even tighter monetary policy measured in terms of money growth. “An implicit target for the growth of domestic credit was set at 12 percent, a significant drop from the previous year. But Delors reportedly rejected the central bank’s proposal and set a 10 percent target, apparently anticipating that the government would have to tighten monetary policy even further in 1983” (Goodman 1992, 135).

Monetary tightness eventually produced the desired effect in stabilizing domestic prices. As Loriaux (1991, 220) argued: “The Socialist party outperformed its conservative predecessor in its efforts to impose price stability and to contain the growth of wages. By 1985, the Socialists had brought inflation to under 6 percent, compared with an average in excess of 10 percent under the government of Raymond Barre [Giscard’s prime minister].”

Fiscal Expansion

At the same time French Socialists directed monetary instruments at inflation control, they needed another policy instrument to help maintain economic growth and promote employment, traditional leftist macroeconomic priorities. The chosen policy
instrument was fiscal expansion. As Figure 5.2 illustrates, French government consumption relative to GDP outpaced the OECD average in every year from 1981 to 1995. Contrary to conventional expectations, French fiscal policy was relatively expansionary even during the austerity years (1982-83). And as the partisan policy mix framework predicts, French fiscal policy tended to contract when the French right controlled fiscal policy instruments during cohabitation (1986-87 and 1993-95).

Mitterrand certainly began his tenure in 1981 with an eye toward fiscal expansion. It is often argued, however, that the two austerity programs, the first coming in June 1982 and the second in March 1983, led to drastic cuts in French government spending. Perhaps the Socialists fiscal policy was less expansive than it would have been absent the austerity programs, but France maintained its focus on redistribution and public goods provision through fiscal growth, with contraction and inflation control coming primarily on the monetary side (see figure 5.1).

The 1982 austerity package came as part of the franc realignment within the EMS. The package consisted of three primary components. First, France would seek to hold its budget deficit to 3% of GNP, which could be attained through tax increases rather than drastic spending cuts (Oatley 1997, 119). Second, France would contract monetarily, slowing money growth from 12% in 1982 to 10% in 1983. Third, France instituted a series of wages and price controls to aid in inflation control.

When this package failed to deliver the desired effect, France accepted a second austerity program in conjunction with the 1983 franc realignment with the EMS. The second program had four main parts (ibid 124-5): 1) increase taxes to reduce the budget
deficit, 2) some cuts in government spending, especially grants to nationalized sectors and reduced welfare payments, 3) measures to increase the national saving rate, and 4) additional capital controls (for example, a 2000 franc limit on foreign exchange transactions for foreign travel).

Often interpreted as a "U-turn" in Socialist economic policymaking, Goodman (1992, 138) identified Mitterrand’s acceptance of austerity as “a true watershed in Socialist economic thought.” As Prime Minister Mauroy stated at the time: “A real left-wing policy can be applied in France only if the other European countries also follow of the left…. If the French resign themselves to living with an inflation [rate] of 12 percent, then they should know that, because of our economic interdependence with Germany, we will be led into a situation of imbalance. France must rid herself of this inflationary disease” (cited in ibid).

Certainly, the so-called U-turn does represent the Socialists ultimate acceptance of inflation control as a top macroeconomic priority under capital mobility, along with economic growth. Yet does it also represent a long-term trend of neoliberal policy convergence in France – tight fiscal condition permitting lower nominal interest rates to converge with the low world interest rate? The evidence clearly shows that French fiscal policy, as measured by government consumption relative to GDP, remained loose on an international basis even during the austerity years. Perhaps spending was cut relative to planned levels and, certainly, French budget deficits fell as tax revenues grew. But contraction occurred primarily on the monetary side as French nominal discount rates rose well above the world interest rate. As Loriaux (1991, 214)
concluded, Socialist policy employed “monetary rigor beside which the policies of Raymond Barre paled.”

Further evidence for the Socialists’ embrace of the “new growth” policy mix (loose fiscal/ tight monetary) came in 1984 after austerity when Mitterrand increased government expenditures by six percent with a focus on the provision of public goods. “Of particular interest in the 1984 budget was the government’s efforts to stimulate investment by raising industrial assistance grants by 11 billion francs, the funds for which were generated by cutting other programs. Moreover, efforts were made to increase state financial aid to research, to education, and to programs that fought unemployment. In the same vein, the government created an income tax exemption for investors in mutual risk venture funds, modified the capital gains tax in a manner that benefited investors, and created a new savings instrument, the corporate passbook account” (Loriaux 1991, 219).

*Exchange Rate Instability*

As long as the world interest rate remained low on a nominal basis, this “new growth” policy mix (loose fiscal/tight monetary) was generally incompatible with the external goal of exchange rate stability under capital mobility. Arguably, Mitterrand’s loose fiscal/tight monetary policy mix offered greater currency stability than the “old left’s” loose fiscal/loose monetary alternative, but the former does not represent neoliberal policy convergence to achieve exchange rate stability with the loss of monetary policy autonomy. Indeed, even after the two austerity programs, France
continued to face pressures within the EMS: a fourth realignment occurred in April 1986 and a fifth in January 1987.¹

Consequently, Mitterrand’s decision to remain inside the EMS should not be interpreted as a choice for exchange rate stability over monetary policy autonomy. The decision instead illustrates the Socialist’s foreign policy goal to maintain a firm commitment to European institutions, perhaps to contain Germany and also to balance the United States.² As Jean Peyrelevade, an economic advisor to President Mitterrand, stated, “Allowing the franc to float [i.e. exiting the EMS] would have caused our international partners, who were already suspicious, to doubt the new government’s attachment to Europe” (cited in Goodman and Pauly 1993, 71).

However, as the EMS evolved into an effective Deutschmark-zone, often forcing weaker currency countries (including France) to adjust to Germany’s chosen monetary policy stance, Mitterrand became the vocal leader in searching for a new European monetary regime to replace the EMS. His alternative was European Monetary Union (EMU) with a European central bank, which Mitterrand surprisingly reasoned might be more responsive to French Socialist policy preferences than the

¹ France did attain some exchange rate stability with active foreign exchange market intervention (Goodman 1992, 128, 141).
² France was also interested in the EMS because of its apparent flexibility, allowing France to potentially shift the costs of adjustment to its EMS partners: “some scholars have argued that France’s true interest in the EMS was to re-create a more tolerant international environment for its inflationary industrial policies. Far from applauding the creation of the EMS, advocates of radical monetary integration expressed keen disappointment. The ECU was not the common currency they were calling for, but merely a refurbished EUA [European Unit of Account used for the Common Agricultural Policy] bolstered by the vague commitment that it would be used for currency market interventions. The EMS, moreover, established neither a European central bank with some say over national policies, nor an independent bank endowed with the right to issue a parallel money. On the contrary, it established a lender of last resort that had even less say over national policy than the International Monetary Fund” (Loriaux 258).
German Bundesbank. Indeed, the French fought hard for an agreement with prospective EMU partners to make Jean-Claude Trichet, the French central bank governor, the second president of the European Central Bank after the shortened-term of Wim Duisenberg.

With regards to French societal pressure for exchange rate stability rather than monetary policy autonomy, it is interesting to note that French international investors and the financial service sector remained relatively quiet in the early 1980s – a period of high international exchange rate instability – as compared to their counterparts in Japan, Great Britain, and the United States (which were all governed by rightist parties). Consequently, the Socialist government played only a minor role at the 1985 Plaza Accord, when G-5 finance ministers agreed to multilateral currency intervention to help stabilize international currency markets (Funabashi 1989, 173). The logic here is that societal interest groups whose agents do not hold power – i.e. international investors and financial services when the left governs – tend not to engage in expensive lobbying activities. These principals do not lobby - not because their interests are not being hurt - but because they have little expectation that leftist political agents not beholden to their interests would respond favorably to their preferences for exchange rate stability. When cohabitation began in 1986, with the Gaullists taking over French economic policy, French interests in exchange rate stability grew. The Gaullists took a move active interest in exchange rate stability, hosting the G-5 Louvre meeting in 1987, which established a de facto exchange rate target zone.
Conversely, when leftist agents hold power, the principal-partisan agent framework for economic policymaking introduced in the previous chapter predicts real lobbying on the part of domestically-oriented societal groups when leftist governments fail to work for policy autonomy under capital mobility. It is thus interesting to note that Mitterrand faced not only intense lobbying, but also social revolt, principally by those in the sheltered service sector when he announced the austerity packages in the early 1980s. “A long and bitter strike occurred in health services; large demonstrations brought together artisans, small shopkeepers, and patrons of small businesses; a dockers’ strike paralyzed foreign trade; and student unrest awakened fears of a “mai ’68 à l’envers” – a “May ‘68” turned around and directed at a government of the Left” (Loriaux 1991, 218). The French experience helps illustrate that leftist governments, not usually subject to lobbying for exchange rate stability, will face lobbying for fiscal expansion (part of an autonomous policy mix) when they shirk core electoral constituencies.

Multiparty Governments in Italy

The modern political history of Italy is one of short and divided governments. Italy’s proportional representation (PR) electoral system has helped produce over 25 different governments in the post-Bretton Woods era, although the conservative Christian Democrats have consistently held the largest share of political power. Consequently, the partisan character of Italian governments has often been
characterized as relatively rightist (Woldendorp, Keman and Budge 1993, 70), perhaps leading one to the conclusion that Italy has followed a neoliberal policy mix consistent with monetary convergence and exchange rate stability under capital mobility. Indeed, Italy’s choice to participate in the EMS from 1979 to 1992 would appear to confirm this conclusion.

Yet, like the French case discussed above, multiparty governments in Italy have chosen policy autonomy over exchange rate stability in the post-Bretton Woods era, despite nominal participation in a multilateral currency regime. Italian monetary autonomy has been led by fiscal expansion, resulting in the loose fiscal/tight monetary policy mix associated with greater currency variability. As Goodman (1992, 181) noted, Italy appears to be an unusual case for the traditional ideological-partisan thesis: “no simple connection can be drawn between socialist governments and inflation, on the one hand, and conservative governments and price stability, on the other.” It is not, however, a perplexing case for the policy mix framework, which argues that PR multiparty governments, more than their majoritarian counterparts, will use fiscal expansion for targeted economic growth with redistribution. With fiscal expansion under capital mobility, monetary contraction becomes the instrument for inflation control, making exchange rate stability very hard to achieve given the high nominal interest rate differentials (vis-à-vis the low world interest rate).
Fiscal Expansion

Italian fiscal policy has long been expansionary in character. Di Palma (1980) identified the Italian government as the "available state" because its multiparty governments stood ready to satisfy a wide variety of societal demands. Indeed, Italy is marked by wide regional and social divisions, organized across (and sometimes within) political parties. Given this diverse set of electoral expectations and the need to target a multitude of different interest groups to maintain multiparty governing coalitions, fiscal policy became the instrument directed towards economic growth with redistribution towards coalition members. Monetary policy, given its public character, is poorly suited for targeted use. As Fratianni and Spinelli (1997, 212) concluded about Italy, fiscal policy became "profligate," noting the "supremacy of fiscal policy over monetary policy."

As Figure 5.3 demonstrates, Italy turned up the fiscal tap in the early 1970s. Fratianni and Spinelli (1997, 214) wrote that the 1970s were an era of "fiscal dominance," witnessing "an explosion of expenditures and budget deficits." Although Italian governments do take steps to reduce their budget deficits, the share of government expenditures relative to GDP grew slowly but steadily (except for the period 1993-95) in the post-Bretton Woods era. Thus, even in the 1990s, these neoliberal economists concluded that "fiscal policy... remains the Achilles' heel of the country" (ibid 254).
Other scholars (e.g. Roubini and Sachs 1989) argued that Italy expanded fiscally because its multiparty governments were simply too weak to agree on fiscal contraction. Yet this assumes that Italian governments generally wanted fiscal contraction. Instead it appears to be the case that fiscal expansion reflected a deliberate policy choice, even by rightist Christian Democrats, for targeted economic growth with redistribution in order to maintain governing coalitions. And, as I will show below, this deliberate policy choice included monetary tightness for inflation control since the Italian central bank was (and remains) relatively subordinate to the government in power. As Goodman (1992, 147) wrote about the Andreotti government (1972-73), which led Italy into the post-Bretton Woods era, "given its more conservative slant, this government might have been expected to favor price stability strongly.... But Prime Minister Giulio Andreotti, who had succeeded to leadership in the Christian Democratic [DC] party in part by refusing to tie himself to any rigid economic doctrine, now recognized that his government's existence depended on support from the left wing of his party; the power of the DC left, in turn, rested on the support of the CISL, the union confederation loosely affiliated with the DC.\(^3\) Thus, when the DC left wing 'refused to support any measures, such as deflation, that threatened the newfound position of the unions,' Andreotti came down on the side of expansion."

Italian governments became even more reliant on fiscal expansion to achieve economic growth objectives under capital mobility when the Bank d'Italia gained

---

\(^3\) The fact that some unions, especially those in capital-intensive export sector of the economy, ally themselves with rightist parties helps explain the result in the previous chapter that greater union density is associated with less exchange rate variability.
greater independence from the government in 1981, an event known as the “divorce.” The policy mix framework predicts that when governments could be denied the use of monetary policy for economic growth purposes by a (more) independent central bank, these governments face greater incentives to expand fiscally, leaving monetary policy as the default instrument for inflation control. As Goodman (1992, 143) has already noted, central bank reform in Italy “did not force the government to reform its spending habits....” Just the opposite: greater independence for the Bank d’Italia arguably led the government to rely more on fiscal expansion since the monetary option to obtain economic growth became more uncertain. It is notable in this regard that Italian fiscal policy expanded markedly the year of the divorce (1981), making its largest jump during the post-Bretton Woods era (see Figure 5.3).

It is also interesting to note that the Italian Communists supported the divorce, accepting greater independence for Bank d’Italia (Goodman 1992, 171). While some scholars argue that leftist parties will find their economic goals frustrated by independent central banks (Way 2000), the policy mix framework suggests that leftist parties can accept monetary tightness for inflation control provided that higher interest rates are accompanied by fiscal expansion to achieve economic growth and employment. As such, independent central banks may be very compatible with the leftist policy mix under capital mobility. Hence leftist parties should not be expected to

---

4 In 1981, Treasury Minister Nino Andreotti announced that the Italian central bank would no longer be required to purchase leftover Treasury securities, thus freeing the Banca d’Italia from financing government deficits.
oppose, and may even promote in certain cases, greater independence for monetary authorities.

**Monetary Tightness**

In terms of monetary policy, Italy began the post-Bretton Woods era with a slightly negative interest rate differential (comparing the Italian central bank rate to the average G-5 central bank rate), reflecting a relatively loose monetary policy to begin the 1970s. But the situation changed dramatically in 1976 as the Italian government, with a pre-divorce subordinate central bank, chose to raise interest rates, tightening monetary policy (see Figure 5.4). This tight monetary policy continued throughout the 1980s and 1990s as Italy consistently held nominal central bank rates not only above the world interest rate (as measured by the G-5 average), but also above the average OECD central bank rates.

The rise in interest rate came as a response to the inflation and current account deficit experienced by Italy in the early 1970s. The Italian government went to the International Monetary Fund (IMF) for balance of payment financing and the IMF, in turn, asked for monetary contraction. It is tempting, therefore, to argue that Italian monetary tightness was simply imposed by external actors and not a deliberate policy choice. Yet as Goodman (1992, 151-2) argued, the Italian government raised interest rates well above the IMF requirements. “Once the Italian government had approved the IMF program, the Banea d’Italia moved quickly to tighten monetary policy...
adopt[ing] an economic program which was more restrictive than that suggested by the [IMF’s] letter of intent."

The policy mix framework argues that leftist parties and multiparty governments accept monetary tightness for inflation control as the due price for fiscal expansion under capital mobility. It is thus notable that even leftist parties in the Italian multiparty governments accepted high interest rates. "While conventional wisdom [the partisan-ideological thesis] suggests that leftist parties – when in power – favor expansionary [monetary] policies, the Italian Communists did not. In fact, their role in the governing majority led to exactly the opposite result." Goodman (1992, 159, 161) continued: “in September 1976, the Communists wholeheartedly endorsed the government’s decision to impose a series of restrictive monetary measures. Even more important, the Communists proved willing to accept and sell the new IMF program to the unions.”

Italian monetary policy tightened again in 1981 as the Bank d’Italia gained greater independence in its so-called “divorce” from the government. Even with the divorce, the Italian central bank remained relatively subordinate to the government, notably the Finance Ministry, in terms of economic policymaking. Yet, the government permitted interest rates during the 1980s that were extremely tight to control inflation and forestall capital flight. As Fratianni and Spinelli (1997, 247) noted: “Real interest rates, that is, the difference between short-term rates of interest and the one-year inflation rate, rose sharply over the 1980s.... From 1983 onward,

---

5 All three major rankings of central bank independence (Grilli, Masciandaro, and Tabellini 1991, Alesina and Summers 1993, and Cukierman, Webb and Neyapti 1993) code the Italian central bank below average among the OECD states in terms of its political independence even after the divorce.
Italian real rates of interest were significantly above those of the other six EMS countries.”

Italy joined the EMS in 1979, not so much to achieve exchange rate stability, but rather to help assure inflation control. Indeed, Italy joined the EMS with wider bands than the other member-states. EMS membership with the goal of inflation control provided an external excuse for high nominal interest rates that certain societal interest groups might resist. As Oatley (1997, 136) argued, “defending the exchange rate provided strong justification for interest rate levels that the government would otherwise have resisted and perhaps vetoed. In 1980-81 the Banca d’Italia pushed the discount rate up to almost 20 percent, justifying the move as necessary to defend the lira’s value in the EMS. Without the exchange rate commitment the bank would probably not have pushed rates up so high.”

*Exchange Rate Instability*

Despite such formal exchange rate commitments to the EMS, Italy has not experienced much currency stability, as the policy mix framework predicts for an economy following a loose fiscal/tight monetary policy mix leading to substantial policy autonomy from the world’s largest capital-producing states. To deal with its currency variability, the Italian government followed two main strategies: capital controls and realignments within the EMS. What success Italy did achieve in stabilizing the lira’s value came through the aggressive use of foreign exchange
reserves, borrowing from the IMF in the 1970s and making use of EMS stabilization funds in the 1980s.

Capital controls were imposed on an occasional basis when the lira came under sustained pressure in international currency markets. Goodman and Pauly (1993, 77) wrote that “with an economic [fiscal] policy more expansionary than that of its neighbors, exchange markets would not long find credible the country’s commitment to maintain a fixed exchange rate. Here, too, capital controls were seen as a way of avoiding hard choices. Controls were eased and then reimposed each time the lira came under attack in exchange markets.”

Within the EMS, Italy had wider bands than the other member-states (6.0% versus 2.25%). Even with the wider bands, Italy realigned frequently. Gros and Thygesen (1992, 68) documented 12 EMS realignments from 1979 through 1990. Italy participated in nine, devaluing the lira each time. The cumulative devaluation during this period was greater for Italy than any other EMS member-state. Such frequent realignments led one observer to conclude that the Italian government used “the EMS more as a crawling peg than as a fixed exchange rate system” (Oatley 1997, 134).

Italy moved to the narrower bands (2.25%) within the EMS in 1990. This experience was short-lived, however, as Italy – like Great Britain – dropped its formal exchange rate commitment in September 1992 during the ERM crisis. In effect, Italian membership in the EMS was quite meaningless in terms of the exchange rate stability/monetary autonomy tradeoff under capital mobility. As Oatley (1997, 139)
noted, “EMS flexibility granted the Italians a devaluation of about 7.5 percent approximately every six months and, thus, a fairly high degree of monetary autonomy.”

Indeed, it is not clear how much Italian governments even valued currency stability despite their interest in the EMS. As Nino Andreatta, the Christian Democratic Finance Minister, stated in 1980, “competitiveness should be frustrated by the exchange rate, so that production is pushed toward greater innovation, efficiency, and quality” (quoted in Goodman 1992, 165). Furthermore, despite difficulties in obtaining a more stable currency, Italian exports relative to GDP doubled from 1973 to 1997, the period under study in this project. At least in the Italian case, currency stability has not been a pre-requisite to export growth.

**Swedish Social Democrats after 1994**

This final case in this policy autonomy chapter focuses on Sweden post-1994 after the Social Democrats (SAP - Sveriges Socialdemokratiska Arbetareparti) returned to power. Governed by a leftist party in a proportional representation electoral system, the policy mix framework predicts that Sweden would follow a loose fiscal/tight monetary policy mix associated with policy autonomy and exchange rate flexibility.

This is a prediction that runs contrary to the conventional wisdom interpreting the SAP’s earlier electoral defeat in 1991, being replaced by a center-right “bourgeois” coalition government, as the end of social democratic practices and policies in Sweden. Certainly, the center-right government (1991-94) did shift towards a more neoliberal
policy agenda, including less government spending, lower nominal interest rates to facilitate private investment, and a renewed interest in exchange rate stability. The question to be answered here is did the SAP, upon returning to power, continue the neoliberal policy convergence agenda or did they instead move towards greater policy autonomy under capital mobility?

Sweden post-1994 represents an interesting case to examine in detail since the country joined the European Union (EU) in 1995, after the SAP returned to power. On its face, this decision would appear to be consistent with European policy convergence. As Kurzer (1993: 3) predicted, while “social democratic parties are again or still in power... they simply follow the cues and programs of right-wing or conservative parties and have no alternatives....” Yet the SAP joined the EU on its own distinct terms, electing to remain outside of Economic and Monetary Union (EMU) to help ensure Swedish policy autonomy. In this case analysis, I will first show that the SAP, upon returning to power in late 1994, more closely followed a “new growth” policy mix, rather than the neoliberal alternative. Next, I will examine the SAP’s decision to stay outside of EMU as a choice for monetary autonomy.

An Autonomous Policy Mix

The center-right coalition government elected in September 1991 had attempted to reform the Swedish economy following a neoliberal playbook, including widespread cuts in government spending. As the economy recovered, however, these reforms
became increasingly unpopular among certain groups in Swedish society. Only three years later, the SAP returned to power after the September 1994 general elections. As Moses (1998: 214) wrote: “Carl Bildt’s Moderate (read: Conservative) government prescribed neoclassical medicine for Sweden’s economic woes. His government introduced a series of measures, including limits on interest-rate deductions, new pension-saving measures, less regulation of stockholders, and weaker social-insurance programs. But eventually this government was removed from office in large part because of its ambitious restructuring and deficit-cutting goals.”

With much of Swedish electorate, especially in the labor-intensive service sector opposed to widespread fiscal contraction, the SAP slowed and even reversed government spending cuts. Sweden has long held one of the highest rates of discretionary government spending among the OECD economies. Figure 5.5 plots Sweden’s government consumption expenditures relative to GDP along with the average OECD government consumption measure for comparison. Certainly, spending did fall from 1993 to 1995, the last year reflecting the outgoing center-right government’s spending decisions. In fact, Swedish government spending fell more than the OECD average over this period under center-right economic governance.

Yet, when the left returned to power, spending cuts were slowed and even reversed. Measured by government consumption expenditures relative to GDP, Sweden retains a very loose fiscal policy compared to the average OECD economy. As Weiss (1998; 87) concluded after the era of spending cuts: “in spite of the conditions highly favorable to a radical restructuring of social policy – the extraordinary pressures on the
public purse, the emergence of a fiscal crisis, and the advent of a rightward-leaning bourgeois coalition – most changes have occurred at the margins, thus preserving the structure of existing programmes.”

Sweden under the SAP continues to use fiscal policy as its instrument for economic growth and employment. Before Persson, the SAP’s choice as prime minister to replace Carlsson in 1996, took over the position, “he promised [as finance minister] to restore unemployment benefits to 80 per cent of the previous earnings and to halve the number of jobless by 2000, an objective to which he pledged SKr50 billion in June 1996. In April 1997, the government announced a four-year programme against unemployment, with SKr66 billion – what became known as the ‘Persson money’ – devoted to preserving public-sector services, creating 70,000 extra higher-education places and providing early retirement incentives. A further SKr8 billion was promised the following September” (Aylott 1999; 174).

This fiscal expansion was not a temporary measure. As Miles (2000, 235) reported, “Persson announced that spending on welfare services is to be raised by SEK 8 billion ($1.1 billion) in 1999 and 2000 in order to reverse some of the harsh effects arising from the country’s high unemployment and governmental austerity cuts of previous years. The new allowances (targeted at health care, social services and education) were widely regarded as victories for the traditional wing of the party at the 1997 party congress at Sundsvall.” With regards to other public goods, Sweden continues to have one of the highest rates of R&D spending in the world (Weiss 1998; 104).
To the extent that fiscal policy remains the Swedish instrument for economic growth with a focus on public goods provision, monetary policy must serve as the instrument for inflation control under capital mobility. Indeed, the Riksbank, the relatively subordinate Swedish central bank, began to operate their inflation-targeting approach to monetary policy in 1995, seeking to “limit the annual increase in the consumer price index from 1995 onwards to 2%, with a tolerance up or down of 1 percentage point” (Bernanke 1999; 174).\(^6\) An important point here is that leftist parties often grant subordinate central banks much de facto independence in setting interest rates for inflation control, provided that economic growth objectives can be satisfied through fiscal expansion.

This explicit inflation-targeting approach must be seen as a choice for monetary autonomy as it replaced the Swedish exchange rate peg as the anchor for monetary policy. As Bernanke concluded, Sweden replaced “an exchange-rate-based policy that was in direct conflict with domestic economic goals [i.e. potentially sacrificed monetary policy autonomy] with a more flexible inflation-targeting regime....”

Since the SAP, more than the preceding center-right government, used monetary policy for inflation control\(^7\), it would be expected that nominal interest rates would rise when the SAP began to implement their preferred policy mix in 1995. Berg and

---

\(^6\) Formal inflation-targeting simply institutionalized an existing practice as, under SAP governments, monetary policy had long been instrument of inflation control. Aylott (1999, 112) wrote “monetary policy had been given a significantly changed role since the middle of the previous decade [1980s]. Rather than being mainly a tool of counter-cyclical macroeconomic policy, its primary aim became to keep inflation down, as the Social Democratic government implicitly gave up relying on labour market parties to co-operate in keeping inflation in check.”

\(^7\) This does not mean that Bildt’s center-right government was not interested in inflation control, but rather that it was achieved through fiscal, more than monetary, contraction.
Grotthaim (1997; 150), in their study of Swedish monetary policy for the Bank of International Settlements, showed that the Swedish central bank rate generally rose in 1995 after the SAP regained power. It is interesting to note that the Riksbank’s rate generally fell under the Bildt government, especially in 1993 and early 1994, despite the rise in the Swedish consumer prices that occurred in 1993.

As would be expected with a prevailing low world interest rate, Swedish monetary policy became more convergent (lower interest rate differentials) under the center-right government and more autonomous (higher interest rate differentials) in 1994-95 as the SAP returned to power (see Figure 5.6). Indeed, Berg and Grotthaim noted that “by the end of 1995, the Riksbank’s monetary policy stance was being criticised [by societal groups with a more neoliberal orientation] as being too tight and lagging behind, in view of the inflation outlook and the decline in European interest rates.”

Figure 5.6 also shows that Sweden was able to lower nominal interest rates in 1996 and 1997. This fall in nominal interest rates became possible under inflation-targeting when inflation fell at a very dramatic rate. As Bernanke (1999; 194) wrote, “inflation continued to fall during the second and third quarters of 1996, at a rate considerably faster than expected. In April headline inflation stood at 1.3%. In its Inflation Report published at the beginning of June, the Riksbank attributed the lower-than-expected inflation figure mostly to lower import prices and lower mortgage rates.” But despite the possibility of a more “convergent” monetary policy, the SAP maintained
a strong interest in maintaining domestic monetary autonomy under capital mobility, even at the cost of exchange rate stability.

Policy Autonomy within the European Union

The SAP had a long tradition of opposing Swedish membership in the European Union (then the European Community). Somewhat abruptly in October 1990, however, Carlsson’s SAP government reversed this position, announcing that it would be willing to accept EU membership as a solution to Sweden’s economic woes at the time. Several months earlier in May 1990, opposition party leaders, Bengt Westerberg of the Liberal Party and Carl Bildt of the Moderate Party, had come forth with their support for full Swedish membership in the EU.

The Carlsson government was also under pressure from the Landsorganisationen (LO), the Swedish trade union confederation. With many of its unions in the export sector of the Swedish economy, the “LO leadership was convinced that the Swedish welfare model would be endangered unless the country’s export industries possessed adequate foreign outlets for their products....” (Miles 1997, 182). Exporting firms allied with the political left also directly lobbied the SAP government. Aylott (1999, 109) noted that “the country’s big export firms were very keen on EC membership, and... they exerted pressure on the government to pursue the option. Their

---

8 In 1961, SAP Prime Minister Erlander publicly voiced his “doubts about the effects of accession on the government’s ability to follow an active labour market policy and develop its generous welfare state provision (Miles 2000, 220). In 1971, SAP Prime Minister Palme again rejected EC membership when Denmark, a major Swedish trading partner, applied to enter the Community along with Britain and Ireland.
concentration, organisation and traditionally close ties to the Social Democratic elite gave them the means to do this.”

Due to competition from opposition parties and political pressure from export-oriented unions/firms in their own camp, the Carlsson government’s decision to join the EU in late 1990 should not be read as an eager embrace on the part of Social Democratic elites of European policy convergence with the voluntary sacrifice of Swedish policy autonomy. Indeed, the decision is more often read “as either a hasty decision made on faulty economic grounds or as a desperate populist move to reverse Carlsson’s poor personal ratings in public opinion polls taken earlier in the year” (Miles 1997, 225).⁹ Sweden then formally applied for EU membership in July 1991, just two months before the general elections. Despite (and maybe because of) Carlsson’s move to the right, the SAP lost the elections and the center-right government, more genuinely interested in exchange rate stability, assumed power.

In May 1991, after the decision to join the EU (but before the formal Swedish application), the Carlsson government switched their exchange rate peg from a trade-weighted basket of currencies to the ECU (European Currency Union). On its face, the very fact that Sweden unilaterally pegged the krona’s value in the post-Bretton Woods era would seem to suggest that the Social Democratic governments had long been interested in exchange rate stability with the sacrifice of monetary policy autonomy. However, the Swedish peg was very flexibly constructed and Sweden devalued the

---

⁹ Consistent with this view is the fact that the many within the SAP became “more critical of the prospect of full membership, arguing that the non-socialist government headed by Carl Bildt would prioritize the wrong aspects in any ensuing negotiations with the Union” (Miles 1997, 226).
krona for competitive reasons on a regular basis, especially in the early 1980s. As Bernanke (1999, 176) concluded the “changes over time in the definition of the [Swedish] exchange-rate target, in response to changing circumstances, illustrate how a degree of flexibility may be introduced even into supposedly inflexible monetary regimes.”

Indeed, the ECU peg, made by the SAP as “a symbolic gesture by Sweden towards the notion of eventually joining the Community” Miles (1997, 185), was short-lived. After borrowing heavily from private markets to defend the krona during the November 1992 ERM crisis, the new center-right government (more committed to exchange rate stability than their predecessors) reluctantly decided to float the currency.10 Thus, “Sweden has a long history of maintaining an autonomous monetary policy, it has actively employed flexible exchange rates in the past to help secure its internal balance, and the 1992 devaluation was very beneficial (both politically and economically). As a result there is general support for maintaining flexible rates into the foreseeable future” (Moses 1998, 207).

Upon returning to power after the 1994 elections, the SAP was divided on the EU question. While Carlsson, resuming his duties as prime minister, was cautiously pro-EU, much of the rest of his party was not. In preparation for the November 1994 EU referendum in Sweden, the SAP adopted a “dual approach” (Miles 2000, 228)

---

10 Predictably, the center-right government put a very high priority on currency stability. But because they did not have access to ERM stabilization funds, they were forced to borrow heavily from private markets to defend the krona in 1992 (Miles 1997, 211). The Bildt government went so far as to ask the EC’s monetary committee for a public statement of support for the krona (Aylott 1999, 161-2). In the end, the krona defense failed and the ECU peg was abandoned in November 1992.
running two separate campaigns: one for membership and another campaign against. The LO was also divided on the issue with unions in differently-oriented sectors of the economy. As Aylott (1999, 152) reported “those [unions] representing workers in export-orientated industries tended to support EU membership. For example, members of the Metal-Workers’ and Paper-Workers’ unions were especially active... On the other hand, those that were not concerned with manufacturing or exports, and especially those in the public sector, tended to be much more skeptical.”

The referendum did pass with 52% of the voters opting for EU membership. Sweden then joined the Union in January 1995 along with Finland and Austria. Once inside the EU, Sweden was expected to participate in EMU. “Two states, Britain and Denmark, negotiated “opt-out” clauses, which permitted them to stand back from stage 3 [of the EMU project]—the irrevocable locking of exchange-rates and the transfer of monetary decision-making. Sweden, however, like the other new member states, had no such provision. The project’s automaticity, which its chief proponents considered so crucial if it was to be realized, applied—in most legal opinions, at least—as much to the new members as to all but two of the others” (Aylott 1999, 157).

Despite such expectations and international pressure, the SAP government decided it would remain outside of EMU to retain Swedish policy autonomy within the European Union. The Carlsson government even decided against immediate participation in the ERM of the European Monetary System as a trial run for eventual EMU membership. A brief examination of the EMU convergence criteria helps explain the SAP’s choice in this regard. In order to prepare for the new European monetary
policy and common currency, the EU attempted to achieve policy convergence in advance. Five convergence criteria, reflecting a neoliberal policy orientation, were established.

The convergence criteria emphasized inflation control through fiscal contraction as prospective EMU states were required to achieve an average inflation rate no more than 1.5% above the three best-performing EU economies. To accomplish this goal, budget deficits could be no more than 3% of GDP and public debt reduced to 60% of GDP. With inflation control through fiscal contraction, the other two convergence criteria focused on monetary/exchange rate policy. Prospective EMU states needed average long-term interest rates to fall so that they were no more than 2% above the three lowest-inflation economies. The final criteria specified that the national currency should operate within the ERM of the EMS for two years with no devaluations.

For a leftist government interested in a new growth policy mix under capital mobility, these convergence criteria would be difficult to meet. Indeed, they would be expected to alienate the left’s domestically-oriented electoral base if moves were even made in that direction. At the end of 1995, Sweden had achieved only the low inflation criteria (Moses 1998, 208). Since it had achieved its inflation control through monetary, rather than fiscal contraction, Swedish interest rates were too high for monetary convergence. Watson (1997, 183) reported that Swedish long-term rates were almost 11% in 1995, with only Italy and Greece holding higher rates. In terms of demonstrated exchange rate stability, Sweden was not even participating in the ERM.
On the fiscal side, Swedish policy remained too expansive. At the end of 1995, its budget deficit held at 11% of GDP and public debt at about 90% (Watson 1997, 131; Barnes 1996, 181). In order to meet the fiscal criteria, Sweden would have to cut government spending. When the government attempted this strategy, its leftist societal principals vigorously objected. Miles (1997, 267) noted “a rise in strike action throughout the country demonstrating against cuts in welfare, and job losses. From January 1995, for example, there were numerous strike actions by the public sector unions – Kommunal and SKTF - protesting at the loss of services in the country’s 288 municipalities, including kindergartens, refuse collection, dental surgeries and sporting clubs.” The lesson here is clear: societal principals preferring policy autonomy can be expected to put political pressure on their leftist agents when it appears that leftist governments might shirk their economic policy interests.

Conclusion

This chapter has examined three important cases of policy autonomy under capital mobility. The French and Swedish cases illustrate how, consistent with the interests of their often labor-intensive domestically-oriented societal principals, leftist governments choose an autonomous policy mix, accepting the sacrifice of exchange rate stability. The Italian case reveals how multiparty governments with proportional representation electoral systems opt for fiscal expansion with an eye towards targeted growth and redistribution in an effort to maintain sometimes fragile, and often diverse, governing coalitions. Monetary policy, in turn, becomes more autonomous and
exchange rate stability harder to achieve under capital mobility, even with formal exchange rate commitments.

These cases also show how leftist governments (and multiparty governments) work with their central banks. Rather than forcing their subordinate central banks to expand monetary policy, leftist governments in the post-Bretton Woods era of international capital mobility have allowed monetary authorities to keep nominal interest rates relatively tight. Such high nominal interest rate differentials will be acceptable for leftist governments provided that fiscal policy can be expanded to meet ideological objectives and the preferences of core electoral constituencies. The Italian case also reveals that governments, leftist or otherwise, may move towards greater fiscal expansion when confronted with (greater) central bank independence since expansion through monetary instruments may become effectively foreclosed.

Finally, all three cases reveal that policy autonomy can be maintained even inside European institutions. Consequently, membership in the European Union and, more specifically, the European Monetary System (EMS) should not be treated as evidence that the government necessarily sacrificed policy autonomy to achieve exchange rate stability under capital mobility. The EMS has been a flexible regime, permitting France and Italy to realign their currencies when domestic conditions required. And Sweden, despite not negotiating a formal opt-out with its European Union partners, nonetheless elected to remain outside of Economic and Monetary Union (EMU) when the project was launched in 1999.

Figure 5.1: French Monetary Policy.
Figure 5.2: French Fiscal Policy.
Fiscal policy data from OECD, *Annual National Accounts*.

Figure 5.3: Italian Fiscal Policy.

Figure 5.4: Italian Monetary Policy.
Figure 5.5: Swedish Fiscal Policy.
Figure 5.6: Swedish Monetary Policy.
CHAPTER 6

POLICY CONVERGENCE UNDER CAPITAL MOBILITY:

JAPAN, BRITAIN, AND THE UNITED STATES

The chapter presents three cases where governments have opted for policy convergence with exchange rate stability under capital mobility. I first look at Japan governed by the rightist Liberal Democratic Party (LDP). The second case focuses on Great Britain during Thatcher’s Conservative governments. Both Japan and Britain represent important examples of policy convergence because these countries have traditionally avoided any external commitments to “fix” the value of their currency and maintained relatively commercially-closed economies, thus appearing more interested in policy autonomy than exchange rate stability.

The third case examines the policy mix and exchange rate outcomes of the Reagan Administration. Scholars often argue that the United States during the Reagan years followed a “autonomous” loose fiscal/tight monetary policy mix, resulting in substantial exchange rate instability. As such, it would appear to represent an anomalous case for the partisan policy mix framework and, thus, merits special consideration to consider the limitations of the framework. This analysis will show, however, that the Reagan governments followed a more “convergent” policy mix than is commonly
understood, although their societal principals were not always satisfied with Reagan’s
economic outcomes as discussed in chapter four.

LDP Governments in Japan

A series of rightist Liberal Democratic Party (LDP) governments have led Japan
in the post-Bretton Woods. The policy mix framework predicts that such rightist
governments, especially when they do not share power, will opt for a tight fiscal/loose
monetary policy mix in order to achieve exchange rate stability under capital mobility.
Indeed, the LDP with Japan’s majoritarian electoral system has consistently followed this
neoliberal policy mix in support of its external goal to stabilize the value of the yen. On
its face, Japan might appear more interested in securing monetary policy autonomy than
stabilizing exchange rates since it has a relatively closed economy with exports plus
imports relative to GDP being only 21% from 1973-1997 (compared to the 46% OECD
average over the same period).

Japan is also an interesting case to consider with regards to its choice for
exchange rate stability under capital mobility since the LDP governments have avoided
any formal exchange rate commitments, either in the form of a unilateral peg or
membership in a multilateral currency arrangement. Yet, as Henning (1994, 121)
summarized, “exchange rate policy has consistently been an element of overall economic
strategy in Japan.” Likewise, Cargill, Hutchison, and Ito (1997, 62) concluded:
“International factors, such as the exchange rate, the balance of payments, and efforts to
coordinate policy internationally, have influenced the conduct and control of Bank of Japan policy. Even after the breakup of the Bretton Woods system, but especially after the Plaza Agreement of 1985, the Bank of Japan remained very much concerned with external factors in formulating monetary policy despite the lack of formally binding exchange-rate and balance of payment constraints.”

*The LDP Policy Mix*

Although Japan’s current public debt might suggest otherwise, the LDP has generally pursued a strategy of strong fiscal contraction in the post-Bretton Woods era.

Figure 6.1 shows the level of government consumption expenditures in Japan relative to its GDP from 1973 to 1997. As a comparison, the Japanese fiscal policy measure is shown with the OECD average, which stands substantially above that of Japan. Indeed, Japan has the tightest fiscal policy orientation of any country in the OECD sample during the period under study in this project.

This tight fiscal stance has contributed substantially to the low inflation macroeconomic outcomes in Japan since 1975. Inasmuch as fiscal policy is directed towards the internal goal of price stability, monetary policy instruments can be targeted towards economic growth and used for exchange rate stability (low nominal interest rates to promote private investment and reduce differentials from the low “world” interest rate). As Cargill, Hutchison, and Ito (1997, 187) argued: “The Ministry of Finance [MOF] is indeed conservative in the sense of being very reluctant to use fiscal policy to manage aggregate demand [promote economic growth]. This reluctance to use
discretionary policy, known in Japan as the ‘Ministry of Finance view,’ may be characterized as anti-Keynesian [neoliberal]. It is rooted in the early postwar experience with near-hyperinflation and in the wild inflation [of the early 1970s].

Business groups in Japanese society (the “principals”) have kept pressure on the LDP governments (their partisan “agents”) to maintain a tight fiscal policy stance in order to promote lower interest rates and private investment. As Henning (1994, 136) argued, such fiscal tightness has meant that monetary policy would be used for economic expansion: “With fiscal policy immobilized as a countercyclical instrument... monetary policy carried the burden of restimulating the Japanese economy.” Until recently, LDP governments maintained the tight fiscal stance demanded by their domestic principals despite international pressure to expand the Japanese economy. For example, in the late 1980s facing international pressure to expand its economy and boost imports, the LDP loosened monetary policy while continuing to tighten fiscal policy. As one Japanese insider stated: “[the Ministry of Finance] MOF never compromises to foreigners on fiscal policy, only on monetary policy” (cited in Henning 1994, 174).

The LDP’s tight fiscal policy permitted low nominal interest rates for economic growth and the use of monetary policy for exchange rate stability. Figure 6.2 shows the low (and even negative) interest rate differentials - vis-à-vis the prevailing world interest rate - held by Japan during the post-Bretton Woods era. Indeed, it is Japan’s traditional loose monetary stance that has given rise to its current expansionary fiscal position. Mired in a recession since the mid-1990s with falling prices (deflation), Japanese monetary authorities lowered nominal interest rates to effectively zero percent. Since
domestic prices continue to fall, the LDP has no practical need for inflation control and no way to further stimulate the economy through monetary expansion (the so-called "liquidity trap"). Hence, the LDP reached a point, with capital exiting their stagnant economy, where fiscal expansion became their only real growth option. Nonetheless, it is important to understand that Japan’s current fiscal imbalances are in many ways a legacy of their more traditional neoliberal policy mix.

The LDP’s rigid adherence to a tight fiscal/loose monetary policy mix has not always produced exchange rate stability, especially in the early 1980s as the world interest rate rose. With Japanese interest rates well below the world interest rate (the rare situation of negative monetary autonomy under capital mobility) capital began to exit Japan and the yen depreciated strongly. LDP policymakers responded first to this exchange rate instability - not by raising the Japanese interest rate to meet the world interest rate - but by applying pressure on the United States to lower its interest rates (through budget cuts and deficit reduction) and intervening unilaterally in international currency markets to support the yen’s value (Henning 1994, 136-7).

This period in Japanese monetary history underscores some important policy differences between the Ministry of Finance (MOF), the government ministry in charge of economic policymaking (especially on the fiscal side), and the Bank of Japan (BOJ), the central bank relatively subordinate to the LDP governments. The MOF has been the prime mover behind Japan’s tight fiscal/loose monetary policy orientation. The BOJ, however, has often argued in favor of higher interest rates and a stronger yen to counter both internal and external inflationary pressures.
For the most part, the MOF has won the policy mix struggle because of the BOJ’s subordinate status. Nonetheless, such policy divisions do suggest that rightist governments, more so than leftist ones, may be precluded from achieving their ideologically-preferred policy mix (the neoliberal tight fiscal/loose monetary mix) by independent monetary authorities. One can well imagine that had the BOJ possessed more independence, Japanese interest rates might well have been higher in the post-Bretton Woods era, perhaps necessitating a more expansionary fiscal policy to achieve the government’s economic growth objectives under capital mobility. But the BOJ remained institutionally subordinate to the LDP governments, leading Prime Minister Nakasone in 1983 to reaffirm the LDP’s policy of fiscal contraction, stating that “economic growth would have to be provided by monetary policy” (cited in Henning 1994, 139). In 1992, when “pressure for interest rate cuts came from [LDP societal principals, including] businessmen, and bankers… LDP kingpin Shin Kanemaru said that interest rates should be reduced even if it required removing the BOJ governor” (ibid 169).

*Exchange Rate Stability*

It is interesting to note that, since Japanese interest rates fell below the world interest rate, the BOJ could often appeal to the MOF for higher Japanese interest rates in order to help stabilize the value of the yen. In many cases, such an appeal succeeded since the LDP and its societal principals prized currency stability. As Henning (1994, 168) noted, the “BOJ required support from foreign exchange markets to tighten. Before
the yen weakened, the Japanese central bank had been unsuccessful in persuading MOF to tighten monetary policy. The fall of the yen was important in persuading MOF of the necessity for discount rate increases.”

The BOJ went as far to suggest that the government shift to a more expansionary fiscal policy in order to achieve their economic growth objectives as the yen appreciated. The BOJ research director argued that: “[M]onetary relaxation alone cannot be a solution for international disequilibrium between Japan and the U.S. A policy mix change towards the relatively tighter monetary policy together with an easier fiscal stance could be a solution for the international imbalance” (Suzuki 1985, 8).

Japan tightened its monetary policy in 1985 after the Plaza Accord to halt the yen’s depreciation and help stabilize the currency. Japanese monetary authorities also sold $US 3 billion late in 1985 to aid the dollar’s depreciation vis-a-vis the yen (Cargill, Hutchison, and Ito, 1997, 77). The Plaza Accord monetary adjustments and currency interventions helped reverse the dollar’s and yen’s trajectories. However, yen appreciation continued beyond intended levels, resulting in continued instability but in a new direction. At this point, LDP government agents were delivering neither on the loose monetary policy demanded by their Japanese business principals, nor on the external goal to achieve a stable currency.

Internationally-oriented societal principals thus began to lobby the rightist government in a very public manner for lower interest rates to stabilize the yen at more competitive levels. As Henning (1994, 148) described: “the fear of American protectionism was replaced with the fear of real harm to Japanese industry and traded
good producers generally. Commentators raised the specter of the “hollowing out” of the Japanese economy. A stream of private interests pleaded and pressured Liberal Democratic Party (LDP) politicians to halt the yen appreciation and to relieve some of the pain of adjustment to the new rates.” Monetary policy was thus eased in response to societal pressure (Cargill, Hutchison, and Ito, 1997, 66).

Certain societal principals in Japan, especially banks and multinational corporations, are very influential in determining the course of monetary and exchange rate policy. It is not because these interest groups are particularly large, as the economic pluralist framework suggests, but rather because the sectors are well connected to LDP officials and because Japanese monetary institutions are effectively penetrable. “The organization of the private sector and the structure of government institutions in Japan rendered external monetary policy responsive (or susceptible) to societal pressures. Private actors pressed the government very strongly to oppose the appreciation of the yen during the realignment of the early 1970s, late 1970s, and mid-1980s… The institutional subordination of BOJ provided a powerful channel though which [certain] private-sector preferences regarding the exchange rate were transmitted into policy outcomes” (Henning 1994, 170-1).

Despite appearances to the contrary – its relatively closed economy and lack of formal exchange rate commitments – Japan under the leadership of the LDP has embraced the external goal of exchange rate stability and accepted a loss of monetary (and fiscal) autonomy. “During the 20 years since the breakdown of the Bretton Woods regime, the Japanese government has sought stability in the nominal exchange rate.
MOF and BOJ were not always successful in limiting fluctuations of the yen. But the objective of policy was clear – stability – and Japanese authorities pursued that goal with much greater intensity than did American authorities. Because the dominant trend in the value of the yen since the early 1970s has been upward, the pursuit of stability generally, though not always, entailed resistance to appreciation” (Henning 1994, 171).

Thus, since exchange rate stability in Japan has often meant resisting appreciation pressures, the neoliberal policy mix (tight fiscal and loose monetary) preferred by the rightist LDP governments and their societal principals has generally been the appropriate policy stance. At times when low interest rates and fiscal contraction could not assure currency stability – for example, as the world interest rate rose in the 1980s – Japanese monetary authorities regularly intervened in international currency markets, “leaning with the wind” to slow or reverse the movement of the exchange rate” (Cargill, Hutchison, and Ito, 1997, 64). The evidence is quite clear in this regard as “there is considerable support for the view that the [subordinate] Bank of Japan regards the exchange rate as a policy goal” (Chinn and Dooley 1998, 179-80).

Conservative Governments in Britain

The British Conservatives represent another interesting case to illustrate how rightist governments, particularly in majoritarian electoral systems, opt for exchange rate stability and monetary convergence under capital mobility since Britain, except for a
brief period in the early 1990s, has remained outside of European monetary/exchange rate regimes. For scholars who emphasize the importance of central bank independence is achieving exchange rate stability (e.g. Henning 1994), the British central bank - the Bank of England – remains very subordinate to the British government. Furthermore, in comparison to many of the smaller European states, Britain maintains a relatively closed economy. Conventional wisdom would, therefore, suggest that British, and the Conservative Party that governed Britain from 1979 to 1996, would not be either very interested in monetary convergence or institutionally able to achieve a stable currency. Yet, given the choice between monetary policy autonomy and exchange rate stability under capital mobility, the British Conservatives choose the latter, despite all appearances to the contrary.

This section of the chapter will examine the Conservatives choice for monetary convergence and exchange rate stability by making two primary points. First, the Conservatives generally followed a neoliberal policy mix, which contracted British fiscal policy to allow for lower nominal interest rates and smaller interest rate differentials. Scholars have often identified Thatcher’s policy mix as “tight” on both the fiscal and monetary sides (e.g. Hall 1986), yet I will show that British monetary policy, especially after 1981, was “looser” than is commonly understood, especially on an international basis. Second, due to small interest rate differentials, Britain was able to achieve a relatively stable currency, despite the well-publicized episode of sterling instability in 1992, remaining outside of European exchange rate institutions.

1 Glick and Hutchison (1994, 254) reach a similar conclusion: “Our empirical work indicates that Japan
The Conservative Policy Mix

Margaret Thatcher and the Conservative Party took power in 1979, following five years of Labor Party governance in the United Kingdom. Other than the last years of the Heath government (1970-74), Thatcher’s ascendancy marked the first opportunity for British rightists to govern in the post-Bretton Woods era of international capital mobility. Consequently, the Conservatives had to experiment with their policy mix before finding a combination both friendly to capital interests and consistent with the Conservative’s goal of exchange rate stability. As Thompson (1996, 23) concluded in her study of British monetary policy under the Conservatives, “most fundamentally, Thatcher and Howe [Chancellor of the Exchequer, 1979-83] were committed to the general aim of exchange rate stability.”

The Thatcher government began with a tight policy mix on both the fiscal and monetary fronts, having two policy instruments directed at the same goal of domestic price stability. As argued in chapter two, such an “old right” policy mix (tight fiscal and tight monetary) will not be so friendly in the long-run to capital interests when economic growth begins to suffer, thus eroding the returns on capital even when inflation is low. In the short-run, high interest rates in Britain contributed to the pound sterling’s appreciation in 1980, which made British exports less competitive. Sluggish exports, coupled with fiscal and monetary contraction at home, led to a recession in Britain in late

The Thatcher government thus began to reconsider its policy mix, lowering interest rates to stimulate growth and promote exchange rate stability and, thus, adopting the more capital-friendly neoliberal policy mix that the partisan policy mix framework predicts rightist parties will follow under capital mobility. Thatcher had some initial difficulty achieving the lower levels of government spending that her administration desired. Government spending relative to GDP did not fall as quickly as the Conservative had planned (Boix 1998, 163). Some of this difficulty was certainly due to the recessionary environment in Britain. As Hall (1986, 116) noted, “the high public spending to GDP ratios [in the early Thatcher years] reflect a sluggish denominator as well as a rising numerator.” The numerator rose because Thatcher also “increased expenditure on such traditional Conservative priorities as defense, law and order, and agriculture” (ibid).

As the British economy improved, however, the Conservative’s fiscally contractionary orientation became more apparent. Nigel Lawson, who replaced Howe as the Chancellor of the Exchequer in 1983, began budgeting based on a “slower rate of growth for public spending than the sustainable growth rate of the economy as a whole, with the result that public expenditures would steadily decline as a share of GDP” (Lawson 1992, 305-6). While the Conservative’s orientation toward fiscal contraction is not controversial, many readers may be surprised at the relative looseness of British

---

2 The sterling also appreciated due to its role as a petrocurrency, underscoring the point that its appreciation
monetary policy beginning in 1981. As Bean (1988, 48) responded to the conventional wisdom in this regard, “there is some debate over whether monetary policy was indeed contractionary.”

In fact, Thatcher needed to lower nominal interest rates as part of her privatization program to encourage private investment in the formerly state-owned enterprises. Facing pressure from British export industries, Thatcher also needed to lower interest rates to help stabilize the sterling at more competitive levels. Consistent with the policy mix logic advanced in this project, “the moderate relaxation of monetary policy did not imply abandoning the strict anti-inflationary strategy initially devised by the Conservative government. On the contrary, explicitly rejecting an policy U-turn, Thatcher engineered a significant tightening of the fiscal balance in the 1981/82 Budget” (Boix 1998, 162). Thompson (1996, 23) made a very similar point with regards to exchange rate policy goals: “the Prime Minister and Chancellor had accepted … that monetary and fiscal policy could be used for different purposes. In assigning the former to the exchange rate and the latter to controlling domestic expansion, they formulated policy in the way most compatible with ERM membership [although they remained outside the institution].”

Lower interest rates were also an electoral strategy, being very attractive to key Conservative constituencies. The Conservatives “wanted to stimulate some kind of recovery through manufacturing industry with tangible benefits for voters. The crucial question was, therefore, whether the Prime Minster and Chancellor could afford to tighten fiscal policy again if inflation was to rise. If there were not prepared to raise taxes

________________________________________________________

was due less to investor confidence as the Conservatives focused solely on eliminating inflation, neglecting
or cut expenditure, then some other policy instrument would have to assigned to the task” (Thompson 1996, 30). Thus, they assigned monetary policy to economic growth, cutting interest rates but keeping fiscal policy tight to restrain inflation.  

The Conservatives were able to employ this neoliberal policy mix because the government, specifically the Prime Minister and the Chancellor of the Exchequer, took the primary responsibility for monetary policy, rather than the Bank of England. As Lawson [Chancellor of the Exchequer, 1983-9] later stated, “low interest rates had an unfailing appeal for Margaret [Thatcher]. Despite her reputation as a diehard opponent of inflation, and her dislike of it was undoubtedly genuine, she was almost always in practice anxious to reduce interest rates…” (cited in Thompson 1996, 60).

When the Conservatives held a neoliberal policy mix, membership in the Exchange Rate Mechanism (ERM) of the EMS became potentially feasible for Great Britain. As Thompson (1996, 48) argued, “since it now appeared that ERM membership offered exchange rate stability and lower interest rates for any given inflation rate, there was a clear convergence between the benefits of joining the system and the Treasury’s institutional preferences [for lower interest rates to stimulate economic growth]. Certainly, in Lawson’s view, low interest rates were now a clear policy goal for Treasury officials.” Figure 6.3 shows that despite holding a central bank rate slightly above the prevailing world interest rate, the Conservatives managed to reduce British monetary autonomy substantially during the early 1980s. Indeed, Britain held a central bank rate

---

3 An alternate measure of monetary policy orientation is money supply growth. Hall (1986, 118) shows that sterling M3 growth consistently went above or at high end of the target range from 1979 to 1985, indicating a relatively expansionary monetary policy orientation.
below the OECD average throughout the Conservative’s tenure, except for the period 1989-91, suggesting a relatively convergent monetary orientation.

Many officials within the Thatcher government favored joining the EMS, including those at Treasury (particularly Lawson) and in the Bank of England. Thatcher’s own views regarding European exchange rate regime membership have often been misunderstood. As EC member-states drew up plans for the EMS in 1978, the then-governing Labor Party announced that Britain would not join the multilateral currency arrangement. The Conservatives criticized Prime Minister Callaghan’s unwillingness to join the EMS, with Thatcher lamenting: “This is a sad day for Europe.” Labor is content to have “Britain classified among the poorer and least influential countries’ in the EC” (cited in Thompson, 1996, 14).

After gaining power in 1979, the Conservatives flirted with the prospect of joining European exchange rate institutions. In 1985, a fierce intra-governmental debate erupted concerning the merits of ERM/EMS membership. Thatcher brought the debate to a temporary halt when she unilaterally vetoed any formal fixed exchange rate commitment to external institutions. But her veto was not due to any lack of interest in exchange rate stability per se, but rather to concerns about participation in an exchange rate regime viewed as “anti-dollar” and concerns about the loss of British national sovereignty. Thus, the Conservatives were “operating an economic policy similar in substance to ERM membership [tight fiscal and loose monetary] but at Thatcher’s insistence outside the system and in tandem with a relatively isolationist EC policy” (Thompson 1996, 31).
Exchange Rate Stability outside the ERM

Beginning in 1986, Britain began to shadow the German currency, unofficially pegging the value of the pound sterling to the Deutschmark without announcing publicly any specific targets. This shadowing was understood as a “quasi form of membership. It committed the government to exchange rate stability against the ERM anchor currency, and used both monetary policy and reserve intervention to achieve that end” (Thompson, 1996, 92). Within the British government, Lawson tended to view shadowing as a “dry run” for eventual EMS entry, while Thatcher viewed it as alternative to entry. The 1987 Louvre Accord reinforced Britain’s shadowing policy as the Thatcher government agreed to help stabilize the dollar against the yen and Deutschmark, the ERM’s effective anchor currency. As Boix (1998, 197) correctly noted, the shadowing policy would not have been effective without “substantial cuts in interest rates” made possible by fiscal contraction.

Despite stabilizing the British currency, which offered apparent benefits to exporters on the continent, the shadowing policy engenders criticism from EMS governments that Britain was free-riding on European monetary institutions. This criticism led the Conservative British government to reconsider joining the ERM in large part to help influence European policy regarding eventual monetary union. In 1990, Britain offered its “hard ecu” alternative to the French-led plan for European monetary union. Thatcher’s hard ecu strategy proposed to fix the value of the European Currency Unit (ecu) to each of the EC national currencies, create a European Monetary Fund to
issue “hard ecus”, which would then circulate parallel to the national currencies. Coming from a government that had elected to remain outside of (and even free-ride on) European monetary institutions, the hard ecu proposal received a very cold reception from EMS member-states.

Thatcher eventually agreed to bring Britain within the ERM, largely based on the reasoning that membership would permit lower interest rates, which Thatcher wanted to achieve and core electoral constituencies demanded. As Thompson noted (1996, 171) “The City [the financial service sector] was still overwhelmingly in favour of entry, not simply for its long-standing reasons [currency stability], but as an immediate stimulus to activity. By October 1990 banks, building societies, stockbrokers, fund managers and insurers were all being squeezed by high interest rates and stagnant markets, and all faced cuts in capital spending and jobs. With ERM membership offering lower interest rates and likely to buoy up the stock market, financial analysts believed it could breathe new life in to those businesses driven by sentiment.”

In October 1990, Britain joined the Exchange Rate Mechanism of the European Monetary System. However, it chose to join at the time when British monetary policy was at its most autonomous (i.e. the highest interest rate differential, see Figure 6.3), thus fixing the sterling at an over-valued level. Interest rates were immediately cut and, the following month, John Major replaced Thatcher as the Conservative Prime Minister. Major and his Chancellor of the Exchequer, Norman Lamont, rigidly maintained Thatcher’s tight fiscal policy, perhaps tightening more for inflation control than ERM
membership appeared to require. Even facing a recession, Major and Lamont proposed budgetary cuts, leaving a loose monetary policy as the only possible economic growth option. However, as Germany raised interest rates in the wake of reunification and interest rate differentials between the two countries grew, the sterling faced considerable depreciation pressures. The Bank of England's currency intervention delayed a crisis temporarily until September 1992, when circumstances forces Britain and Italy to exit the ERM.

Back outside of European exchange rate institutions, the Major government maintained its tight fiscal/loose monetary policy mix, achieving relative currency stability while the Conservatives remained in power. Figure 6.4 shows that, despite all the Conservative Party's apparent struggles to stabilize the British currency, it achieved moderate success, excepting the volatility spike in 1992. Even with the 1992 extreme value, Britain's measure of exchange rate stability is no worse than the OECD average during the Conservative's entire tenure. Discounting the ERM crisis year, it is well below the OECD average.

With regards to societal monetary preferences, it is again notable that British society was often quiet about exchange rate stability, but not because the financial service sector and exporters did not have strong preferences in favor of currency stability. "The

---

4 It is interesting to note that Labor supports EMS entry at this time, not so much because they favor exchange rate stability, but rather because they view lower interest rates as a second-best way to stimulate the economy given Thatcher's reluctance to expand fiscal policy (Thompson 1996, 162).

5 In this case, the Britain's neoliberal policy mix led to relative currency instability as Germany under rightist governance hiked interest rates to control inflation, a departure from the preferred rightist strategy to achieve domestic price stability. As Thompson (1996, 183-4) concluded: "if the ERM was rapidly becoming a trap, Major and Lamont imprisoned themselves and the economy further by the nature of the overall macro-economic approach. They were no more willing to use non-monetary means to stimulate the
City [financial services] wanted the security of reduced exchange rate volatility and a counter-inflationary discipline. Multinational companies operating in Britain who tended to rely on importing components from abroad stood to benefit from ERM entry since it would fix sterling at a relatively high rate and provide some insurance against future depreciation. Nonetheless, it could not be said that either sector saw membership [in the EMS] as imperative to their interests” (Thompson 1996, 56). Why was this case? One persuasive answer is that the Conservative governments, for the most part, held a policy mix consistent with stable exchange rates, cutting fiscal policy and lowering interest rates to reduce British autonomy from the low world interest rate.

When their neoliberal policy mix did not promote exchange rate stability and the Conservative agents failed to deliver the stable currency demanded by their societal principals, these interest groups did lobby on behalf of ERM membership as a possible solution to exchange rate volatility. Such lobbying occurred in 1984-5 as the sterling’s volatility grew (see Figure 6.4). Thompson (1996, 40) noted that, “in the City, firms and individuals were becoming increasingly interested in ERM entry. In August 1984, the Lloyd’s Bank of Economic Bulletin argued that the fall in sterling in the previous month could have been avoided inside the ERM. Three months later a group of City bankers and economists published a report highlighting the benefits of membership….“ She continued: “During 1985 a succession of business groups, economic organizations and financial commentators came out in favor of ERM entry….. The sterling crisis had brought the issue of currency volatility to a head. Previously, firms valued exchange rate economy than Thatcher and Lawson had been to control inflation. In the 1991 budget Lamont explicitly
stability, but were confident that it could be better achieved outside rather than inside the ERM” (ibid 51).

Like the US case, detailed in chapter four (with more coming in the sub-section below), the British case reveals that societal preferences for exchange rate stability appears to matter through a principal-partisan agent logic. British Conservative governments opt for policy convergence and exchange rate stability under capital mobility, not because Britain is very commercially open (as economic pluralism would suggest), but rather because core electoral supporters (banks and multinational corporations) of the Conservative Party demand it. As long as the British Conservatives “worked” for policy convergence and achieved stable exchange rates, costly lobbying on the part of these societal principals was largely unnecessary. But when currency stability grew, as in the mid-1980s, lobbying by the financial service sector and British multinational firms did emerge, pushing the Conservative government back towards monetary convergence and greater exchange rate stability.

Reagan Governments in the United States

The final case study examines the US policy mix during the Reagan years. The two Reagan governments, especially the first, have long been identified with a loose fiscal/tight monetary policy mix. As such, they would appear to be anomalous cases for the policy mix framework which predicts that rightist governments will choose a

rule out using an expansionary fiscal policy to assist recovery.”
neoliberal tight fiscal/loose monetary policy mix associated with exchange rate stability, while leftist governments opt for the more autonomous "new growth" loose fiscal/tight monetary alternative. As discussed in chapter four, the first Reagan administration's policy mix generated enough exchange rate volatility that Republican societal principals, especially capital-intensive multinational corporations, exercised their voice option and began to lobby publicly for exchange rate stability.

Yet, the policy mix held by the Reagan governments was not so autonomous that it contradicts the core logic of the partisan policy mix framework, which posits that even rightist governments will move towards policy autonomy when sharing power and when confronted by an independent central bank. The Reagan governments, who shared fiscal policymaking authority with the Democrats in Congress and faced a relatively independent Federal Reserve Board in control of US monetary policy, certainly fit these two conditions.

Going further, the descriptive data to be presented will reveal that blanket characterizations of the Reagan policy mix as loose fiscal/tight monetary may be very misleading. US fiscal policy, as measured by government expenditures relative to GDP, was no tighter than the OECD average during this period. US interest rate differentials vis-à-vis the world interest rate actually fell, at the same time as OECD average interest rate differentials grew, reflecting surprising monetary convergence during the Reagan years. And while US exchange rates were unstable, the dollar's variability consistently

---

6 The Democrats held a majority in the House of Representatives when Reagan assumed office in 1981. The Democrats then won a majority in the Senate during the 1986 elections, making the US government even more divided in terms of fiscal authority.
remained below that of most OECD currencies in the early to mid-1980s, a period of high international financial instability.

_Fiscal Policy_

US fiscal policy during the Reagan years is usually characterized as “loose” because of the enormous budget deficits produced during this era. While deficits – defined as the difference between government tax revenues and government expenditures – have become one standard measure of fiscal policy orientation, they are also a potentially misleading one, especially with regards to the Reagan Administration. The Reagan deficits came about due to the combination of large tax cuts and massive increases in defense spending (Destler and Henning 1989, 18); government spending in other areas fell. Given these shifting spending priorities, figure 6.5 shows that the overall level of US government spending relative to GDP held at the OECD average during the first Reagan administration and moved slightly above the OECD average in the second term as the political divisions between the executive and legislative branches grew.

In fact, the Reagan economic team viewed the tax cuts, which led to the budget deficits, as a way to _constrain_ fiscal policy, not expand it.⁷ As Johnson (1998, 185) argued “Stockman [OMB director] believed that he could browbeat the cabinet into major program rollbacks by holding out tax cuts – and Volcker’s reductions in interest rates – as a reward for pruning spending.” As Stockman (1986, 68) himself wrote: “the prospect of

---

⁷ Reagan’s perspective, shared by other rightist parties in OECD states, reversed the traditional logic about tax cuts as fiscal expansion, underscoring the need in this project to consider alternative measures, such as government spending relative to national product, of chosen fiscal policy orientation. As Weatherford and
needing well over $100 billion in domestic spending cuts to keep the Republican budget in equilibrium appeared more as an opportunity than as a roadblock. Once... Reagan got an electoral mandate for Kemp-Roth and 10-5-3 [two major tax cut plans], then we would have the Second Republic's craven politicians [Congress controlled by Democratic interest groups] pinned to the wall. They would have to dismantle its bloated, wasteful, and unjust spending enterprises -- or risk national ruin.'

Indeed, the Reagan economic team tended to minimize the economic importance of budget deficits, viewing their fiscal policy orientation as contractionary despite them. Johnson (1998, 187) observed a "new and largely sincere White House consensus... in favor of tax cuts as curtailing outlay growth (the Friedman strategy) and distinguished the deficit from total expenditures. As Meese catechized, 'The ultimate burden on the economy is precisely the total amount of government spending. Fixation of the deficit tended to ignore this crucial fact.'"

As noted above, US government spending relative to GDP in this period rose moderately, as was true for many advanced industrial democracies (especially those in NATO), due to increases in defense spending, which offset spending cuts in other areas. While eschewing on ideological grounds a large economic role for the government, rightist parties have long expressed a "dominant" ideological priority in the provision of national defense as a public good (Kirschen and others 1964, 227). Paying for a larger national defense meant spending cuts in other areas, especially the social welfare programs seen by Republicans and other rightist parties as "redistributionist." As

McDonnell (1990, 145) concluded, "for most of his administration, Reagan viewed deficit reduction as a
Weatherford and McDonnell (1990, 131 in Berman) concluded, “No president since Hoover had called for substantially diminishing the government’s role in redistributive social programs; Reagan accomplished it.”

**Monetary Policy**

Concerning monetary policy during the Reagan era, it is important to remember that the Federal Reserve Board had raised discount rates well before the first Reagan Administration (Destler and Henning 1989, 19). Figure 6.6 shows that the greatest American monetary autonomy during the 1978-88 decade came during the Carter years, which is consistent with the preference on the part of leftist governments for policy autonomy under capital mobility. Indeed, despite the impression that monetary policy was very tight during the Reagan years, US nominal interest rates remained very close, and sometimes below, the prevailing world interest rate during the Reagan years. During this same period, the average OECD nominal interest rate differential actually grew.

On a closed-economy basis, US interest rates certainly appeared tight. Initially, the Reagan team welcomed the appearance of tight money to help reduce inflation concerns. Very soon, however, they began to chafe at the Federal Reserve Board’s monetary restrictions. Based on their idea that tax cuts would boost economic activity and ultimately raise tax revenues (the so-called “Laffer curve”), the Reagan Administration wanted lower interest rates so that those benefiting from tax cuts would either consume or invest their new wealth, rather than simply banking it because of high

lever he could use to further his goal of decreasing domestic expenditures.”
interest rates. Even monetarists within the Reagan administration wanted looser money: “Another kind of criticism of the prevailing monetary policy came from the conventional, rigorous monetarists, the disciples of Milton Friedman, who were to be found in the Treasury and the Council of Economic Advisors as well as in the academic branch of the economics profession. From time to time they seemed to be saying that the general trend of monetary was too restrictive, and that the Federal Reserve should be allowing money to rise more rapidly, or at least be slowing down its growth more gradually” (Stein 1984, 303-4).

The policy mix framework predicts that, with an independent central bank, rightist governments will face more difficulty in achieving their preferred policy mix than will leftist governments. Frustrated by Volcker’s apparent unwillingness to accelerate money growth (which would lower interest rates), some within the Reagan team considered measures to reduce the Federal Reserve Board’s political independence.

“Privately, the Treasury Secretary Regan and undersecretary Sprinkel discussed abolishing the Fed. Sprinkel later revealed publicly the lengths to which the monetarists’ skepticism of the Fed might run when he said, ‘There is, on the one hand, an argument to keep the Federal Reserve Board independent to avoid the problem of an administration running away on an inflationary policy. But on the other hand, the president is elected by all the people, and he has a right to put his policies into being and to be held accountable for them’” (cited in Johnson 1998, 186).

Reagan resolved the Treasury/Fed disagreements about the direction of monetary policy through a series of appointments to Federal Reserve Board. By 1986, Reagan had
appointed a majority of Fed governors; all were interested in loosening monetary policy. When these Fed governors overruled Volcker in early 1986 - in an episode known as the “palace coup” (Destler and Henning 1989, 52) – and voted for a discount rate cut, Volcker reportedly threatened to resign. As a compromise, Preston Martin, a Reagan appointee and the reputed coup leader, agreed to step down, while Volcker stayed on as Fed chairman but accepted the administration’s desired rate cut. As Destler and Henning (1989, 93) argued: “Reagan appointees to the Fed Board wielded increasing power. Treasury pressure for easy money reinforced the Fed’s predisposition to loosen…. Without dominating the Fed, Treasury policy certainly contributed to a political and economic environment in which the Fed was pressed to loose monetary policy and found it beneficial to do so.”

On an international basis, US monetary policy was quite convergent (i.e. US interest rates moved close to the prevailing world interest rate), suggesting that US exchange rates during the Reagan years should have been relatively stable. As discussed earlier, the dollar’s variability in an appreciating direction did pose major problems, especially for capital-intensive US exporters. Yet, figure 6.7 also shows that US exchange rates were actually more stable than the OECD average in seven of the eight Reagan years. The early 1980s were a period of high international financial instability, but the United States weathered this storm with greater relative external stability, especially 1982-84, than many of its major trading partners.

With regards to Republican goals concerning exchange rate stability, it is important to recall that many members of the first Reagan Administration opposed the
Treasury Department’s policy, under the direction of Regan\textsuperscript{8} and Sprinkel, of exchange rate neglect (Dester and Henning 1989, 40-1). Administration officials outside of Treasury viewed a stable dollar as a top external priority. Some Reagan advisors even advocated a return to a gold standard fixed exchange rate system, having inserted language into the 1980 Republican party platform concerning the “overriding objective of maintaining a stable dollar value.” Republicans had long argued the Carter’s Administration’s monetary policy autonomy, “in order to pursue economic goals other than dollar stability, has unleashed hyperinflationary forces at home and monetary disorder abroad” (quoted in Stockman 1986, 63).

As Republican societal principals began to complain about exchange rate volatility in late 1984 and 1985, James Baker - Regan’s replacement at Treasury - took concerted international action towards exchange rate stability with the Plaza Accord in 1985, reinforced by the Louvre target zone agreement in 1987.\textsuperscript{9} While one can debate the question of causality, figure 6.7 suggests that the Plaza and Louvre agreements helped stabilize the US dollar. As discussed in chapter four, these multilateral efforts certainly assuaged the concerns of Republican societal principals that the Reagan administration was not working on behalf of their preferences for exchange rate stability under capital mobility.

\textsuperscript{8} Despite his policy of “neglect,” Regan actually called in 1982 for a “new Bretton Woods” conference (Destler and Henning 1989, 25). The dollar/gold standard fixed exchange rate regime in operation until the early 1970s had been established at Bretton Woods in 1944.

\textsuperscript{9} I discuss in the next chapter whether these multilateral exchange rate policy coordination events can be considered cases of genuine international cooperation or simple harmony among the rightist governments in the United States, West Germany and Japan, all of which held preferences for exchange rate stability.
Conclusion

This chapter has examined three cases of policy convergence and exchange rate stability under capital mobility. The Japanese, British and American cases all demonstrate how rightist governments, acting on behalf of their capital-intensive, internationally-oriented societal principals, chose a neoliberal policy mix to achieve relative exchange stability in the post-Bretton Woods era characterized by floating exchange rates and global financial integration.

The US case, in particular, shows how rightist parties may move towards fiscal expansion in divided governments. This fiscal stance can put pressure on monetary policy leading to greater exchange rate variability, which may become unacceptable to internationally-oriented societal groups allied to rightist parties. All three cases show that, while exchange rate lobbying is relatively infrequent, societal groups with preferences for a stable exchange rate will lobby rightist governments when the latter does not work on behalf of the formers’ interests.

The US case also reveals how rightist governments may be precluded by independent central banks, unwilling to monetary instruments for any policy goal other than inflation control, from achieving their preferred tight fiscal/loose monetary policy mix under capital mobility. It is notable in this regard that the Japanese LDP and the British Conservatives were able to hold a neoliberal policy mix with relative exchange rate stability, working with institutionally subordinate monetary authorities.
Finally, all three cases underscore a critical argument made in this project: a government's choice to make a formal exchange rate commitment, often to multilateral institutions, should not be treated as evidence of currency stability (or policy autonomy, for that matter). All three rightist governments investigated here have eschewed formal exchange rate commitments, yet all achieved relative exchange rate stability by following a convergence monetary policy, made possible by fiscal contraction. If we want to know whether a government has chosen either policy autonomy or exchange rate stability under capital mobility, we must first look at its fiscal/monetary policy mix.
Figure 6.1: Japanese Fiscal Policy.

Figure 6.2: Japanese Monetary Policy.
Figure 6.3: British Monetary Policy.
Figure 6.4: British Exchange Rate Variability.
Figure 6.5: US Fiscal Policy.

Figure 6.6: US Monetary Policy.
Figure 6.7: US Exchange Rate Variability.
CHAPTER 7

CONCLUSION

The big question underlying this project asks: what factors lead the advanced industrial democracies towards monetary (and fiscal) policy autonomy and what factors lead them instead towards exchange rate stability in the post-Bretton Woods era marked by international capital mobility? This is an important and politically relevant question since, under capital mobility, states face an important monetary tradeoff. They can either hold a nominal interest rate at or near the prevailing world interest rate, sacrificing the use of monetary policy for certain domestic objectives, to achieve the external goal of exchange rate stability. Or they can set a national interest rate to achieve important domestic objectives (i.e. hold an autonomous monetary policy), sacrificing exchange rate stability.

Political scientists have recently taken a greater interest in monetary politics and understanding the political constraints imposed by international capital mobility. But existing theories have failed to answer the research question posed here. One theory—the neoliberal convergence hypothesis—argued that the advanced industrial democracies have all generally chosen exchange rate stability over monetary policy autonomy due to
the pressures imposed by capital mobility. The empirical evidence, however, shows that monetary policy autonomy has effectively grown in the post-Bretton Woods era and that only certain governments have achieved exchange rate stability, even inside managed-floating exchange rate institutions. Thus, the neoliberal convergence hypothesis only describes the behavior of a subset of advanced industrial democracies, offering an incomplete answer to the research question.

Another theory focused on societal preferences to explain divergent monetary policy choices under capital mobility. Using a simple model of relative economic power and size ("economic pluralism"), these theorists argued that larger societal groups are more likely to obtain their preferred monetary policy outcome and that relative group size can explain when government choose either monetary autonomy or exchange rate stability. Something political, however, is missing from this story that begins with societal preferences. The empirical evidence shows that societal group size generally explains poorly the choice for/against monetary policy autonomy and exchange rate stability.

The answer presented here centered on the role of partisan governments, a domestic factor generally ignored in most studies of international capital mobility. For convergence theorists, capital mobility creates pressures on national governments that override any partisan considerations, leading many scholars to conclude that partisan differences on economic policy have disappeared among the advanced industrial democracies. For societal theorists, capital mobility has such profound distributional implications that societal groups can easily organize themselves to lobby weak
governments on behalf of their monetary preferences. Parties tend not to matter because they are superfluous.

In response, I argue that political parties play an important role in monetary/exchange rate policy, due in part to their important role regarding fiscal policy. Leftist-led governments have domestic ideological objectives that put public goods provision and income redistribution above exchange rate stability. These goals lead leftist governments towards fiscal expansion, which in turn pushes them towards monetary autonomy under capital mobility. Leftist parties also tend to represent societal groups whose business interests are domestically-oriented and, thus, have preferences for policy autonomy over exchange rate stability.

Conversely, rightist-led governments have ideological objectives that favor exchange rate stability over public goods provision and income redistribution. This allows rightist governments to employ a contractionary fiscal stance that better permits monetary convergence. Rightist parties also generally act as agents for capital-intensive economic groups with international business interests and preferences for exchange rate stability. Consequently, rightist governments opt more often for policy convergence (on both the fiscal and monetary sides) to achieve exchange rate stability under capital mobility.
Summary of Findings

How can we identify monetary policy autonomy?

In chapter two, I laid the empirical foundations for the project, creating measures for both monetary policy autonomy and exchange rate stability when capital is internationally mobile. A state’s monetary policy becomes more autonomous as its nominal central bank rate diverges from the prevailing world interest rate. Exchange rate stability is measured as the coefficient of nominal variation of the national currency unit relative to a broad external benchmark: the IMF’s Special Drawing Right.

I showed how these two measures correlate positively and significantly: states with greater nominal interest rate differentials experience greater exchange rate variability. This result is important because it helps demonstrate that the tradeoff between monetary autonomy and exchange rate stability is real. While scholars have long expected that such a tradeoff should exist, very little empirical evidence has been offered in support of such a relationship (Rose 1994, 26, McNamara 1998, 53).

How is fiscal policy linked to monetary policy autonomy?

Perhaps surprisingly, I also showed in chapter two that OECD states in the post-Bretton Woods era have generally sought monetary autonomy in the form of high nominal interest rates, i.e. national interest rates above the prevailing world interest rate. States opt for such monetary policy autonomy because of their fiscal policy choices. I explain this logic in terms of the policy mix framework. Facing the possibility of capital
flight, governments must pursue both *economic growth* and *low inflation* to attract and retain mobile capital. To achieve these two different economic policy goals, states will need two independent policy instruments: *fiscal* and *monetary* policy. If states use fiscal policy for economic growth (fiscal expansion) then they must use monetary policy for inflation control, leading to high nominal interest rates and greater monetary autonomy.

If states wish to achieve exchange rate stability, they must begin with fiscal contraction. Using fiscal contraction as the instrument for inflation control allows states to move national interest rates down (monetary expansion) more in line with the low prevailing world interest rate. This form of nominal interest rate convergence allows governments to achieve relative exchange rate stability under capital mobility.

Thus, a state’s choice with regards to the monetary policy autonomy/exchange rate stability tradeoff under capital mobility can be seen in its fiscal/monetary policy mix. I showed that OECD states in the post-Bretton Woods era have gravitated towards either a loose fiscal/tight monetary policy mix or a tight fiscal/loose monetary alternative. The former policy mix is effectively a choice for policy autonomy under capital mobility with associated costs in terms of exchange rate variability. The latter mix is a choice for policy convergence to achieve exchange rate stability, with associated costs coming from fiscal contraction (e.g. less public goods spending).

*How do domestic political institutions affect the policy mix?*

In chapter 3, I examined how certain domestic political institutions affect the states’ fiscal and monetary policy choices, as well as its exchange rate variability. I
focused here on four institutions: political parties, electoral systems (proportional representation or majoritarian), central bank status (independent or subordinate) and formal commitments made by the government to fix the value of the national currency. Scholars studying capital mobility have recently tended to diminish the importance of the first two factors (partisan and electoral), while elevating the importance of the last two factors. Yet I show that this relative emphasis is misplaced.

As described above, the partisan character of the government in power helps explain not only its fiscal/monetary policy choice, but also the variability of the national currency. Electoral systems also play an important explanatory role. States with proportional representation electoral systems, leading to multi-party coalition governments, tend to engage in greater fiscal expansion for redistribution purposes. Such an expansionary fiscal stance leads them towards greater monetary autonomy with somewhat greater exchange rate instability.

A state’s central bank status and the presence of a fixed exchange rate commitment play a surprisingly small explanatory role. Scholars often posit that these two monetary commitment technologies should both promote monetary convergence (lower nominal interest rate differentials) and help stabilize exchange rates. The empirical results, however, show that they have little effect in this regard. Indeed, the policy mix framework explains this (non)result nicely. Both of these domestic monetary institutions lead governments toward greater fiscal expansion (although for different reasons). As governments expand fiscally, they create pressure for monetary autonomy in the form of high nominal interest rates. Thus, the fiscal expansion induced by
independent central banks and fixed exchange rate commitments tend to negate much of these institutions' expected effect with regards to reducing monetary autonomy and exchange rate variability.

The punchline here is that political institutions “matter” for the conduct of national economic policy. But not all institutions matter equally. Scholars have recently tended to downplay partisan and electoral factors, emphasizing instead the role of independent central banks and fixed exchange rate commitments. The research demonstrated that such a relative emphasis with regards to monetary/exchange rate policy is misplaced.

_Do societal preferences matter?

In chapter four, I considered how societal groups with different preferences for policy autonomy and exchange rate stability might affect a state’s fiscal/monetary policy mix and its exchange rate outcomes. Looking at both factorial and sectoral frameworks, I added to the existing models measures for the relative economic size of seven societal groups: capital, labor, exporters, international investors, import-competing manufacturers, non-tradable services and the financial service sector. The results show generally that the relative economic size of these groups tells us little about actual fiscal, monetary and exchange rate policy outcomes.

The results do not mean, however, that societal factors are unimportant. To the contrary, society preferences do matter but the groups’ economic size misses the most important political consideration. Societal groups face difficulties in overcoming
collective action problems. To affect actual policy outcomes, societal groups need agents, such as political parties. Leftist parties tend to represent domestically-oriented societal groups with preferences for policy autonomy: labor, import-competitng manufacturers, and non-tradable services (including government workers but excluding the financial service sector). Rightist parties tend to represent more internationally-oriented groups with preferences for exchange rate stability: capital owners, multinational firms acting as international investors and the financial service sector. I showed that these societal groups obtain their preferred policy outcomes, not necessarily when they are large (although this may be a secondary consideration) but rather when their respective partisan agents hold the reins of political power.
Theoretical Implications

These questions and answers concern not only monetary policy and politics, but also have important implications for larger theoretical debates in political science. As the title ("Agency Under Capital Mobility") of this project indicates, my answer to the research question deals with the concept of agency. Agency, referring to both the ability of actors to make meaningful choices and to the authority to act on behalf of another actor's interests, is a concept relating to major debates in both international and comparative politics.

Agent/Structure Debate

The agent/structure debate in international political economy asks how much agency, or discretion, do national governments retain at the unit-level in the formulation of economic policy under capital mobility. Capital mobility can be treated as a structural constraint in the international political economy inasmuch as it conditions the behavior of all national governments (Andrews 1994). But is it a strong structural constraint, removing all the ability of unit-level actors to make meaningful economic policy choices, or is it a weaker structural constraint, leaving unit-level actors with at least some discretion about how to conduct economic policy consistent with their own domestic and partisan objectives?

I believe that the latter is a better description of capital mobility as a structural constraint. From a macroeconomic perspective, the Mundell-Fleming framework - from which the research question was derived - says only that when capital is internationally
mobile, governments must choose between monetary autonomy and exchange rate stability. A priori, capital mobility should force governments neither towards the exchange rate stability nor towards monetary policy autonomy. From a political perspective, I have told a story that begins with policy goals. While I believe that capital mobility does push governments to make both inflation control and economic growth their dominant macroeconomic objectives, these governments have some real choices about how to achieve economic growth with low inflation, even with a limited number of policy instruments at their disposal.

Generally consistent with the work of Garrett (1995, 1998), Oatley (1999) and others, this project helps re-establish the concept of political and partisan agency in terms of monetary/exchange rate policymaking under a structural constraint called “international capital mobility.” Thus, scholars should be wary when confronted with hyperbolic statements that governments have lost their economic sovereignty with global financial integration and that leftist governments behave just like their rightist counterparts in the “new” world economy. Both statements are broadly misleading.

State/Society Debate

Political scientists have long debated the relative importance of societal preferences versus statist institutions to explain economic policy choices and outcomes. Societal approaches to the study of a government’s domestic and foreign economic policies often view the government as a simple referee (i.e. a weak state) arbitrating among different interest groups competing to achieve their preferred policy outcomes. In
such a context, societal theorists often assume that larger, richer, and more influential interests groups will prevail in the competition. Conversely, statist approaches do not view the government as a neutral referee. Instead, the government often plays a strong and independent role in determining economic policies, often following the “national interest” and ignoring the preferences of many large societal interest groups.

Concerning societal preferences under capital mobility, Frieden (1991) argued that internationally-oriented sectors of the economy tend to benefit from exchange rate stability, while domestically-oriented sectors prefer an autonomous monetary policy directed toward internal goals. Other scholars (McNamara 1998, Garrett and Lange 1995, Gowa 1988, Odell 1982, Krasner 1978) denied that such societal preferences explain much in terms of actual monetary policymaking. Instead, central banks, often as independent state institutions, set monetary policy and help determine exchange rate outcomes consistent with their own narrow interests or particular conceptions of the national interest.

A common problem with the state/society framework is that it tends to treat statist and societal approaches as competitors, rather than as complements. The framework certainly has problems in handling political factors, such as partisan politics, that do not fit neatly into the state/society, or public/private, dichotomy. Parties, when they win an election, comprise the “state.” And parties, especially after losing an election or being excluded from the governing coalition, function within society to organize interest groups. While this point may be obvious, partisan factors have been sorely neglected in
the long-running state/society debate and the discipline may have missed a parsimonious way to integrate the two approaches.

*Interest Group Theories*

As mentioned above, the political science discipline has several interest groups models of monetary policy preferences under capital mobility; Frieden’s (1991) sectoral model is certainly the most well-known and widely cited. And I presented evidence that this sectoral model offers a reasonably good breakdown of societal preferences under capital mobility, despite claims to the contrary from other scholars (e.g. McNamara 1998).

The real problem with these interest group models is not their description of preferences, but rather their ability to get us from preferences to actual policy outcomes. Of course, many societal theorists claim only to be interested in preferences, but, as political scientists, we should endeavor to understand policy formulation and policy outcomes. Thus, it is perhaps surprising that many political scientists rely on a very primitive model, known as “economic pluralism,” to move from preference to outcomes. The logic underlying economic pluralism is that larger interest groups will win the political fight obtaining their preferred policy outcomes by virtue of their relative size and wealth. Economic pluralism has justifiably come under criticism from some political scientists (e.g. Garrett and Lange 1995), but few alternative models have been developed as a substitute.
I showed here that a principal-agent model helps us understand how societal monetary preferences get translated into state policy outcomes. The principals are the societal groups with different monetary preferences under capital mobility. The agents are political parties, actors given the authority to work on behalf of the interests of certain societal groups. As stated earlier, leftist parties act as agents for the often labor-intensive domestically-oriented groups preferring policy autonomy, while rightist parties act as agents for the usually capital-intensive internationally-oriented groups with a greater preference for exchange rate stability. Thus, societal interest groups, as principals, are more likely to obtain their monetary preferences when their agents hold political power. Even large groups may be denied their preferred policy outcomes when their political agents remain outside of government.

The principal-agent framework also helps explain why we observe relatively little lobbying on the part of societal groups with preferences for exchange rate stability. The lack of such lobbying has long stood as an empirical puzzle for societal theorists with models of monetary/exchange rate policy preferences. If societal preferences did matter systematically, should we not observe regular lobbying from societal groups with particular preferences regarding monetary/exchange rate policy? The lack of lobbying has led several scholars (Krasner 1978, Odell 1982) to conclude prematurely that monetary policy is too arcane and that societal interest groups do not understand their own preferences. Yet monetary policy preferences have been understood as the burst of lobbying in the early 1980s especially in the United States illustrated. It also appears absurd for political scientists to claim that groups fail to comprehend their own interests
under capital mobility. Clearly, we needed a new explanation for the infrequent pattern of exchange rate lobbying.

Since lobbying is expensive, societal principals favoring exchange rate stability should not be expected to lobby the agents of groups preferring policy autonomy (i.e. leftist governments) since the latter is not beholden to the former. Societal principals favoring exchange rate stability should not be expected to engage in costly lobbying of their own agents when those agents are already working on behalf of their preferences. Lobbying is most likely to occur when rightist governments, expected to work for exchange rate stability, ignore the preferences of their societal principals. This framework generally accords with the rise and fall of exchange rate lobbying in the United States in the post-Bretton Woods era.

Thus far, I have reviewed my major findings and discussed their implications for several important debates in political science. It is now important to go further and consider how these results impact other theories in international politics. The debate about international cooperation stands as one of the most important and potentially broadest topics in the field. How do we know when cooperation among nation-states has occurred? What are the conditions under which international cooperation is likely to emerge? A related topic of intense interest to political scientists and policymakers alike concerns international institutions and regimes. When will states abide by their commitments to international regimes?
International Cooperation and Regimes

Many arguments and theories about international cooperation have been built from examples of macroeconomic policy coordination among the advanced industrial economies and with reference to the development of monetary regimes in Western Europe. It is thus important to reconsider carefully some of these arguments in light of the findings presented in this project. I focus first on the 1985 Plaza Accord, which is often treated as the prime example of international currency cooperation in the era of floating exchange rates. I next examine the 1978 Bonn Summit, arguably the leading example of fiscal policy cooperation among the G-3 states: the United States, Japan and West Germany. Finally, I consider the history of European monetary "cooperation" with particular reference to Economic and Monetary Union (EMU) with its common European currency and common European central bank.

Plaza Accord

In September 1985, the new US Treasury Secretary James Baker convened a meeting of G-5 finance ministers at the New York Plaza Hotel. The early 1980s had been a period of unusually high international currency volatility due at least in part to the growing budget deficits and higher interest rates in the United States. The world's major currencies were all relatively unstable: the dollar had appreciated sharply, while the yen and to a lesser extent the DM faced depreciation pressures. During the Plaza meeting, the United States, Japan and West Germany agreed to a coordinated intervention in
international currency markets, selling dollars and buying yen to stabilize and even reverse the prevailing trends. As a practical matter, the dollar did fall in 1985 and yen gained strength. Largely as a result of these developments, the Plaza Accord has been interpreted as an important example of international monetary cooperation in the post-Bretton Woods era (Whyman 1995; Gilpin 1987, 156; Cooper 1994; Humpage 1990; Webb 1991; Webb 1995).

But was this really international cooperation? There is already some debate in economic policy circles about whether the US dollar and Japanese yen would have stabilized absent the coordinated intervention after the Plaza Accord (Schultze 1992, 116). But let us be generous and treat the Plaza Accord as effective (i.e. successful in contributing to international currency stability). Can the effective multilateral currency intervention be explained by a simple harmony of internal interests, rather than as an adjustment of national economic policy objectives to fit the external preferences of other actors, i.e. cooperation (Keohane 1984, 51-2; Milner 1992, 467). As Axelrod and Keohane (1986, 226) clearly stated: “Cooperation is not equivalent to harmony. Harmony requires complete identity of interests, but cooperation can only take place in situations that contain a mixture of conflicting and complementary interests.”

In Cooperation Under Anarchy, Oye (1986, 7) cautioned that scholars must first rule out a simple harmony of national interests to demonstrate convincingly that genuine international cooperation has occurred. With regards to the Plaza Accord, a harmony of interests among the United States, Japan and West Germany will be very hard to dismiss if the analysis presented here has been correct. I have argued that rightist governments
have strong domestic reasons to sacrifice policy autonomy to achieve exchange rate stability under capital mobility. And when their economic policy choices do not promote exchange rate stability, rightist governments will come under strong pressure from their societal principals (internationally-oriented and capital intensive economic groups) to work for currency stability.

It is thus notable that rightist governments led the United States (Republican Party), Japan (Liberal Democratic Party) and West Germany (Christian Democratic Party) at the time of the Plaza Accord. My analysis does not mean that economic adjustments were not made by the G-3 states, but rather that these adjustments were consistent with the rightist governments’ internal preferences for exchange rate stability. As already detailed in chapter six, the second Reagan Administration, under pressure from its internationally-oriented societal principals, abandoned the Treasury Department’s policy of currency non-intervention policy and took a greater interest in exchange rate stability before the 1986 elections. Japanese exporters were also eager for the LDP to stabilize the yen’s descent in order to forestall protectionist sentiment in the US Congress.

In Europe, the German Christian Democrats had such strong domestic interests in exchange rate stability that they began unilaterally intervening in international currency markets even before the multilateral Plaza Accord interventions (Henning 1994, 202). Finally, it is also notable that France, the one G-5 economy led by a leftist government played only a “secondary” role in the Plaza Accord (Funabashi 1989, 173). Such a role is
consistent with the French Socialists' preferences for policy autonomy over exchange rate stability under capital mobility.

_Bonn Summit_

The 1978 G-5 summit meeting held in Bonn produced a coordinated effort at global reflation led by the locomotive economies in the United States, West Germany and Japan. As the American economy was mired in recession, the Carter Administration wanted to achieve a multilateral economic expansion including the major US trading partners since growth in the US alone would likely increase American trade deficits and produce balance of payment difficulties. The Bonn Summit agreement focused on a coordinated strategy of fiscal expansion. The Schmidt government in West Germany agreed to increase government consumption by one percent of national product. The Fukuda government in Japan agreed to a growth target of seven percent.

Scholars have long identified the Bonn Summit as a prime example of international macroeconomic adjustment. Putnam (1988, 428) concluded that "the key governments at Bonn adopted policies different from those that they would have pursued in the absence of international negotiations...." Putnam and Bayne (1987, 270) awarded the summit an "A' grade in terms of its degree of international cooperation.

But the analysis presented in the project suggests that we should closely examine the partisan context underlying the Bonn coordination before identifying the multilateral adjustments as anything more than a harmony of national interests. Leftist governments led the US and German economies, while a rightist government ran the Japanese
economy. As the partisan policy mix framework argues, leftist governments have strong
domestic reasons to use fiscal expansion to achieve their economic growth objectives and
rightist government face domestic pressure to employ monetary expansion with fiscal
contraction for inflation control.

Thus, the Bonn Summit strategy would be cooperative if the rightist government
in Japan engaged in real fiscal expansion despite its internal preferences for monetary
expansion with fiscal contraction. Yet as Henning (1994, 128) concluded, Japanese
expansion came primarily on the monetary side, consistent with the LDP's domestic
preferences for monetary over fiscal expansion. As a Japanese government official later
stated, the LDP finance ministry “never compromises to foreigners on fiscal policy, only
on monetary policy (quoted from ibid, 174). Thus, as Smyser (1993, 18) argued,
“Fukuda [the LDP Prime Minister] did not stimulate the Japanese economy as much as he
had promised. Germany stood alone in carrying her share of the bargain….”

Furthermore, the fact that Germany did engage in fiscal expansion can easily be
explained by the German Social Democrats ideological and electoral preferences for
income redistribution and public goods provision. As Putnam (1988, 428)
acknowledged, “the Bonn deal was not forced on a reluctant... Germany. In fact,
officials in the Chancellor’s Office and the Economics Ministry, as well as in the Social
Democratic party and trade unions, had argued privately in early 1978 that further
stimulus was domestically desirable, particularly in view of the approaching 1980
elections.”
The implication to be drawn here is that political scientists should be careful about pronouncing episodes of international monetary and fiscal coordination — including, but not limited to, the Plaza Accord and Bonn Summit — as “cooperation among nations” without a careful consideration of partisan domestic objectives. What may appear to be an adjustment conforming to external pressures (often from the US government) may be more easily explained as an adjustment consistent with internal preferences (based on both ideology and core electoral supporters). I thus agree with Richard Cooper (1994, 291), who wrote that macroeconomic policy coordination “will occur only when at a particular moment there happens to be a convergence of interests among major countries that makes it possible to put together a deal. That is what happened at the Bonn Summit in 1978, and at the Plaza in 1985” (emphasis added).

Bonn and Plaza are not atypical in this regard. As Henning (1994, 156) wrote about the apparent cooperation between the second Reagan government and LDP government in Japan to stabilize exchange rates after the 1987 Louvre Accord: “The perception is now commonplace [especially] in Japan that interest rates were kept at all-time lows throughout 1988 out of deference to the Reagan administration and international cooperation…. But there is no evidence of either overt or covert American pressure on Japan [at this time].” At other times, when the United States did pressure Japan for economic stimulus, Japan answered with adjustments more consistent with partisan domestic objectives than with external policy preferences. “Japanese officials responded with supplemental budgets that contained far less real stimulus than advertised. The dominant trend in Japanese fiscal policy was contractionary. In other
words, MOF [the Japanese Ministry of Finance] successfully deflected the pressure for extra demand onto BOJ [Bank of Japan] and monetary policy” (ibid, 158).

EMU

There have been three European monetary regimes in the post-Bretton Woods era: the Snake (1973-78), EMS (1979-98) and now Economic and Monetary Union (EMU), launched on January 1, 1999. The analysis presented here clearly focused more on the first two regimes, arguing that the Snake and the Exchange Rate Mechanism of the EMS were both flexibly constructed institutions, allowing governments to assert monetary autonomy when needed, while at the same time remaining inside the institution. Consequently, membership in the Snake and EMS should not be treated as evidence that the government had necessarily sacrificed policy autonomy or accepted the external goal of exchange rate stability under capital mobility.

EMU, however, is a different animal. This European monetary institution is not a managed-floating exchange rate regime like the Snake or EMS. Rather, EMU requires member-states to give up their national currencies, adopt a common European currency, and take the interest rate set by the European Central Bank (rather than the interest rate set by national central banks). There is not much flexibility built into this institution, although there may be some further bargaining and compromises with regards to how the common European monetary policy is set (and who will head the European Central Bank, setting that common interest rate).
I also argued in this project that the Snake and EMS were only weakly associated with exchange rate stability because these institutions tended to induce fiscal expansion, which then made exchange rate stability harder to achieve. But this is not likely to be the case with EMU as its convergence criteria clearly specified a contractionary fiscal stance in advance. For reference, the five EMU convergence criteria included: 1) low inflation, 2) reduced budget deficits, 3) reduced government debt, 4) low nominal interest rates, and 5) exchange rate stability within EMS.\(^1\) In February 2001, the EU Commission even publicly reprimanded Ireland for having loosened its fiscal policy (Economist, February 17, 2001, p. 24). The next month, the Portuguese Socialist government received a similar reprimand for its fiscal expansion in response to slowing economic growth in Portugal (Economist, March 17, 2001, p. 51).

The point here is that, unlike Snake or EMS membership, EMU membership does force government towards neoliberal policy convergence to achieve exchange rate stability in the form of a common currency, accepting all the sacrifices that such a stance entails. Governments must work for inflation control (criteria 1) using fiscal contraction (criteria 2 and 3) to help achieve lower nominal interest rates (criteria 4) more consistent with exchange rate stability (criteria 5) under capital mobility.

The EMU project was finalized during a period of European politics characterized largely by rightist dominance (i.e. the left was out of power in most Western European states). Thus, it is not surprising that EMU convergence came about on neoliberal terms. In theory, the European states could have converged on different economic criteria, ones

---

\(^1\) See Watson 1997 for a fuller discussion of the specific criteria.
more consistent with leftist preferences for a loose fiscal/tight monetary policy mix under capital mobility. And to the extent that these European states all held similarly high nominal interest rates, *intra-*European exchange rates (although not necessarily exchange rates with non-European currencies) would have been expected to stabilize following the interest parity condition. But with rightist political dominance in the 1990s, European convergence occurred on neoliberal terms.

However, the political left has returned to power in many Western European states and I expect that many of these leftist governments will find EMU neoliberal convergence difficult to reconcile with their domestic interests and ideological objectives. For example, EMU fiscal criteria make it harder for leftist governments to increase government spending on worker training, education, infrastructure projects and R&D, consistent with the new left’s goal for greater public goods provision. Even EMU optimists have acknowledged that the apparent European neoliberal consensus is weak. As McNamara (1998, 171) concluded: “More problematic is what EMU signifies more broadly for the political economies of Europe, in particular its demands on the fiscal policies of the EU states and the impact of these demands on the monetary consensus.” Indeed, another European observer wrote: “After years of belt-tightening, a new raft of center-left governments are increasing eager to lift spending and [even] let their budget deficits nose upward once again” (Andrews 1998, C1).

Inasmuch as the left is denied fiscal expansion as its policy instrument for economic growth objectives under capital mobility, the new left may be expected to demand monetary expansion as a “second-best” alternative. The new leftist government
in Germany, for example, reportedly pressured the European Central Bank for monetary expansion since fiscal expansion carries penalties under the terms of Stability and Growth Pact signed in 1998 by the then-prospective EMU member-states (Andrews 1998).

If the European Central Bank does not yield on monetary expansion as an alternative to fiscal expansion, then many leftist governments may begin to consider options outside of EMU. Already, there are signs that the leftist governments in the two biggest EMU states – France (Jospin) and Germany (Schroeder) - have been unsatisfied with the conduct of the common European monetary policy (Economist, March 17, 2001, pp. 74). As one commentator wrote: “How long before the Germans start yearning for a central bank of their own?” (ibid, p. 75).

Of the 15 European Union states, only 11 joined EMU on January 1, 1999. It is notable that leftist governments led the four states remaining outside EMU (Britain, Denmark, Greece and Sweden). Of course, Greece was initially excluded because it failed to meet the convergence criteria (it later joined EMU in early 2001). But the other three states elected to stay outside of the Euro zone, despite having nominally qualified for EMU membership. Observers often see Blair’s Labor government in Britain as pro-Europe. In many issue areas, this may be true. But not only did the Blair government choose to stay outside of EMU, it is now opposing the EMU states in their effort to develop a greater economic policymaking capacity (Economist, March 24, 2001, p. 65).

One could argue that these three states, especially Britain, simply stayed out because there is strong societal opposition to the EMU project within their borders. But there is societal opposition to EMU is all European states, generally coming from
economic groups whose business interests are domestically-oriented (the non-tradable service sector, for example) and whose profits may be unimproved by a common currency and even hurt by the loss of policy autonomy. Since these domestically-oriented sectors generally look to leftist parties to advance their economic interests, leftist governments must pay special attention to their preferences for policy autonomy or risk losing a primary electoral base. Rightist governments, less beholden to domestically-oriented business sectors and more allied with internationally-oriented economic groups standing to benefit more from a common currency, will be more committed to EMU neoliberal policy prescriptions and more able to ignore societal demands for policy autonomy under capital mobility.

Policy Implications

There are numerous policy implications emanating from this research project. To begin, there is real evidence that the often-hypothesized tradeoff between monetary autonomy and exchange rate stability under the condition of capital mobility is real. While we have long had strong theoretical reasons to believe that this relationship would be empirically valid, very little hard evidence has been offered in support of the Mundell-Fleming framework (Rose 1994). I have shown that OECD governments holding a high national interest rate diverging from the low prevailing “world” interest rate have paid a penalty in terms of exchange rate variability.
Second, government under capital mobility have not been so restricted in policy terms as many political scientists and economists believe. While governments must maintain both economic growth and low inflation in order to retain and attract mobile capital, they have some real latitude in how to achieve these policy goals. In policy terms, governments can move towards a “convergent” tight fiscal/loose monetary policy mix or an “autonomous” loose fiscal/tight monetary policy mix. The first policy mix remains a popular option as exemplified by the EMU convergence criteria. But the other policy mix can be capital-friendly, especially when fiscal expansion pays for the provision of public goods (infrastructure, worker training, research and development projects) and monetary contraction keeps inflation in check.

This latter policy mix does come with associated cost of greater exchange rate variability (just as the convergent policy mix comes with the potential cost of under-supplied public goods). To the extent that governments are willing to live with some exchange rate variability, they have policy options beyond what neoliberal advocates would suggest. This becomes especially true as the evidence mounts that exchange rate stability is not a pre-requisite for international trade and investment. Indeed, cross-border economic activity has flourished in the post-Bretton Woods era despite “floating” exchange rates. As one review of the economic literature concluded, “we can fairly say that the research has not produced any one-sided evidence that exchange rate variability has any particular effect on the volume of international trade (Edison and Melvin 1990, 27).
Finally, economists and policymakers alike have long been asking about the viability of regional economic integration efforts with particular focus on the EMU project. To answer this viability question, analysts have generally focused on whether or not the European Union states fit the criteria for an optimum currency area (OCA). Are the EU economies similarly structured so that they are affected in more-or-less the same way when hit by an exogenous shock? If the EU national economies are not so similarly structured, then a common monetary (and fiscal) policy will not suffice as a response to the exogenous price/growth shock; the common adjustment will be appropriate for some economies, but inappropriate for others.

Even if the EU national economies are similarly structured (and given the varying levels of economic development within the EU, this is a doubtful proposition), policy analysts may be omitting some important political criteria for an optimum currency area – that all national economies within a common currency area be governed by ideologically-similar governments. For when hit by an exogenous shock, this research suggests that governments of the left will want to respond in different ways than governments of the right, even if a common adjustment might be “economically” feasible.

Take, for example, a rise in energy prices. Such an exogenous shock is likely to have both inflationary and recessionary implications, as evidenced by the oil shocks in the 1970s. Consequently, governments will need to respond to both rising inflation and slowing economic growth. These two economic policy objectives will require two independent policy instruments. The political left will likely prefer greater government
spending to counter the economic recession, while raising interest rates to deal with inflation. Conversely, the political right appears to prefer the neoliberal response: monetary expansion for economic growth, while contracting fiscally for inflation control.

Thus, I conclude that the long-term viability of the EMU project may depend critically not only on the economic composition of European states, but also on their political composition. Unless the political right returns to power in the region, European leftist governments are likely to be, at best, only weakly committed to EMU neoliberal policy prescriptions. Of course, some leftist governments appear now to be surviving within EMU strictures, but economic times have been relatively blissful since the early 1990s. It remains to be seen how leftist governments will accommodate EMU when economic times become tougher, greater economic adjustments are required, and societal groups lobby more strongly for policy autonomy.

Further Research

This project focused exclusively on the advanced industrial democracies: how do the OECD states resolve the monetary autonomy/exchange rate stability tradeoff under capital mobility? Inasmuch as the neoliberal convergence hypothesis – the so-called "conventional wisdom" about monetary convergence under capital mobility – staked the developed world as its theoretical domain, there were strong theoretical reasons to focus first on the advanced industrial democracies. Furthermore, due to data limitations with
regards to the developing economies, there were also strong empirical reasons to restrict the analysis here to the developed world.

However, as more and better data becomes available on exchange rates, capital account openness, and the sectoral composition of non-OECD states, it becomes possible – and even necessary – to test the many hypotheses advanced here on the developing world. Thus, let me speculate in advance about how autocratic states and transitional democracies might be expected to resolve the monetary autonomy/exchange rate stability tradeoff as they open their capital accounts and join the global financial community.

I expect (many) autocratic states to opt for exchange rate stability. Clearly, states would like to have both monetary autonomy and exchange rate stability, but they must make a choice under capital mobility. Inasmuch as autocratic states, by definition, are less responsive to their societies than democratic ones, autocrats may be more able to deflect societal pressures for policy autonomy. Some research (e.g. Broz 1999) has shown that autocratic states are more likely to fix their exchange rates than democratic polities. While I showed here that fixed exchange rate commitments are not necessarily good predictors of actual exchange rate stability in the developed world (and this should be doubly true in the developing world), such commitments may nonetheless indicate a strong interest in currency stability and a potential willingness to sacrifice policy autonomy when necessary.

I also expect transitional democracies may opt more frequently for policy autonomy. As societal groups playing a growing political role, organizing political
parties to overcome collective action problems and developing political/economic ideologies to support government intervention in the domestic economy, it should become increasingly difficult for state leaders in the transitional democracies to ignore societal demands for policy autonomy and, thus, maintain their commitments to fixed exchange rate institutions. With reference to the interwar years (1914-44), Gilpin (1987, 129) noted that governments began to subordinate the external goal of exchange rate stability when they were forced to pay greater attention to “domestic welfare objectives such as [internal] economic stability and full employment....” For Gilpin, this meant a breakdown of international monetary cooperation. But I would argue, in response, that there are often very sound reasons to pay attention to domestic welfare objectives and that democratic governments should take always seriously (although not necessarily heed) calls from its society for policy autonomy.

With regards to the expectation that transitional democracies will move towards greater policy autonomy, I do expect some important regional differences. For example, it appears likely that the new democracies in Central and Eastern Europe, who are interested in joining the European Union, will move instead towards policy convergence and exchange rate stability, consistent with EMU ideals in Western Europe. The state’s interest in policy convergence may put these European transitional democracies into a political bind vis-à-vis their societies. Many societal groups within lesser-developed European economies will certainly demand greater government spending not only on public goods, but also on social welfare programs, leading the state towards an autonomous policy mix. Yet EMU membership will require fiscal restraint and even
contraction, pulling the state in the opposite direction. If governments can convince these important societal groups that EU membership merits the price of fiscal contraction, then the European transitional democracies may be able to extricate themselves from this political bind, perhaps by shifting blame for fiscal contraction from the national capitals to the European headquarters in Brussels. If societal groups cannot be convinced, this may set the stage for new governments, less interested in the Western European ideals, to emerge in these transitional democracies.
APPENDICES

Chapter 2 Appendix

To illustrate how the loose fiscal/tight monetary and tight fiscal/loose monetary policy mixes affect the interest parity condition, it can be helpful to examine the policy mix choice using the standard macroeconomic IS-LM models. The IS-LM framework operates under the assumption of fixed prices. The assumption is most valid when focusing on the short-to-medium term effects of adjustments to fiscal and monetary policy, as is the case in this project. Despite criticism raised by the “rational expectations” school, the IS-LM framework remains a workhorse in basic macroeconomic analysis (Mankiw 1994).

The IS schedule shows the combination of nominal interest rates (i) and real output (Y) where the goods market remains in equilibrium (investment = saving). Fiscal expansion shifts the IS schedule up, raising interest rates and output. Fiscal contraction shifts the IS schedule toward the origin, reducing both interest rates and economic output. The LM schedule illustrates the combination of nominal interest rates and real output where the financial market remains in equilibrium (the demand for money [L] = the supply of money [M]). Monetary expansion shifts the LM schedule down, lowering
interest rates and increasing output. Monetary contraction shifts the LM schedule up, increasing interest rates and reducing output.

The effect of the loose fiscal/tight monetary policy mix is illustrated in Figure A.1. Consistent with the evidence in Figure 2.5, monetary authorities begin with a nominal interest rate \((i_0)\) above the “world” interest rate \((i^*)\). Increased government spending – loose fiscal policy – moves the IS schedule up to IS’. This economic expansion tends to increase monetary autonomy from the world interest rate \((i^*)\) as interest rates move from \(i_0\) to \(i_1\). This increase in monetary autonomy does reflect the “crowd out” effect of fiscal expansion, and is determined by the slope of the LM schedule (if the LM schedule has zero slope, then no crowd out occurs). To counter any inflationary expectations, monetary authorities may seek to tighten monetary policy moving the LM schedule up to LM’. The higher interest rate (from \(i_1\) to \(i_2\)) further increases monetary autonomy \(((i_2 - i^*) > (i_1 - i^*) > (i_0 - i^*))\), contributing to exchange rate variability consistent with the interest parity condition.

The tight fiscal/loose monetary (neo-liberal) policy mix is illustrated in Figure A.2. As government spending is reduced, the IS schedule shifts down to IS’, lowering interest rates (from \(i_0\) to \(i_1\)) and reducing economic output (from \(Y_0\) to \(Y_1\)). Monetary autonomy decreases as domestic interest rates move toward the world interest rate \((i^*)\). If the government desires to expand the economy using monetary instruments, the LM schedule shifts down to LM’. Not only does this monetary expansion increase output
(from $Y_1$ to $Y_2$), but monetary autonomy vis-à-vis with the international price-setters further declines $[(i_2 - i^*) < (i_1 - i^*) < (i_0 - i^*)]$ contributing to currency stability following the interest parity condition.

Chapter 3 Appendix

As shown in Figure A.3, monetary expansion to from LM to LM’ (the interest rate falls from $i_{1\text{(fixed)}}$ to $i_2$) may lead to currency depreciation as money exits the domestic economy in search of higher nominal returns elsewhere. If depreciation occurs, monetary authorities must intervene in currency markets to maintain the fixed exchange rate commitment, selling foreign exchange reserves and buying the national currency. This will decrease the money supply and raise interest rates, shifting the LM schedule back from LM’ to LM. Thus, fixed exchange rates theoretically preclude monetary expansion.

Conversely, fiscal expansion under fixed rates can be a highly effective strategy to increase economic output. Consider the effects of an outward shift in the IS schedule to IS’ in Figure A.4. This shift raises output (from $Y_0$ to $Y_1$) and interest rates (from $i_{1\text{(fixed)}}$ to $i_2$), possibly leading to currency appreciation as capital flows into the domestic economy to take advantage of the higher nominal returns. In order to maintain the commitment to fixed exchange rates, monetary authorities must, in turn, loosen monetary policy, selling the domestic currency (increasing the money supply) and buying foreign exchange. This monetary expansion shifts the LM schedule down to LM’, which has the
effect of further expanding economic output from $Y_1$ to $Y_2$. Thus, fiscal expansion is theoretically a highly effective growth strategy with fixed exchange rates because fiscal expansion must be met with monetary expansion.
A->B: Fiscal Expansion
B->C: Monetary Contraction

Figure A.1: Loose Fiscal/ Tight Monetary Policy Mix.
Figure A.2: Tight Fiscal/ Loose Monetary Policy Mix.
Figure A.3: Monetary Expansion under Fixed Rates.
Figure A.4: Fiscal Expansion under Fixed Rates.
REFERENCES


Green, Donald P., Soo Yeon Kim, and David Yoon. 1999. "Dirty Pool." Typescript, Yale University.


