FINANCIAL CRISES AND THE POLITICS OF MACROECONOMIC ADJUSTMENTS

When are policymakers willing to make costly adjustments to their macroeconomic policies to mitigate balance-of-payments problems? Which types of adjustment strategies do they choose? Under what circumstances do they delay reform, and when are such delays likely to result in financial crises? To answer these questions, this book examines how macroeconomic policy adjustments affect individual voters in financially open economies and argues that the anticipation of these distributional effects influences policymakers' decisions about the timing and the type of reform. Empirically, the book combines analyses of cross-national survey data of voters' and firms' policy evaluations with comparative case studies of national policy responses to the Asian financial crisis of 1997–8 and the recent global financial crisis in Eastern Europe. The book shows that variation in policymakers' willingness to implement reform can be traced back to differences in the vulnerability profiles of their countries' electorates.

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For Jörn, Nils, and Lukas

Financial Crises and the Politics of Macroeconomic Adjustments

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Preface

In 2001, I spent the summer working for a small political foundation in Ecuador. It was an interesting period in Ecuador's history, because just a year earlier, the country had unilaterally adopted the U.S. dollar as the country's official currency. Dollarization occurred amid a major political and economic crisis, characterized by rampant inflation, bank failures, and a coup d'état. Dollarization and its consequences were a frequent conversation topic between my Spanish language teacher and myself. This was perhaps not surprising, because he was outraged about a particular feature of the dollarization decision: The government had replaced the country's national currency, the sucre, with the U.S. dollar at a much depreciated exchange rate. My Spanish teacher had bought a car a few months before this decision, and because he had been unable to secure a loan in sucre, he had taken out a loan denominated in U.S. dollars. Depreciation had massively increased his debt burden, and he explained to me how much he disapproved of his country's exchange-rate policy.

Two years later, when I started working on my dissertation at ETH Zurich in Switzerland on the political economy of currency crises, I was surprised to find out that my Spanish teacher's experience was virtually absent from the political science literature on exchange-rate policymaking. Research on the determinants of exchange-rate policy preferences was full of discussions about competitiveness and purchasing power concerns, as well as the trade-off between exchange-rate stability and monetary policy autonomy, but the financial difficulties experienced by holders of foreign-currency denominated debt fit nowhere in these discussions. This gap in the literature aroused my interest, and I began to look closer into the issue and its consequences for exchange-rate policymaking.

A second gap in the literature increasingly began to puzzle me during my graduate studies. In Switzerland, I lived in a country in which the exchange rate was a daily feature on the front page of most newspapers and in which the ups and downs of the currency constituted a topic of considerable interest for ordinary citizens. Nonetheless, the vast majority of work on exchange-rate policy preferences I was reading talked about the preferences of economic sectors and other special interests and implicitly assumed that the exchange rate was a topic of minor importance for voters. At U.S. conferences, I was repeatedly confronted with the question "Who cares about exchange rates?!" And yet, most of the Swiss I met did care about the value of their currency.

As a result of these puzzling observations, my interest in the exchange-rate policy preferences of ordinary citizens began to deepen. Concentrating first on this narrow topic, I gradually broadened my focus to include voters' preferences regarding the trade-offs exchange-rate policy poses with regard to other economic policies, especially at times of economic crisis. This wider focus sprang in part from the developments that accompanied the writing process of the book. Although currency crises seemed a problem mainly for emerging markets and developing countries when I started working on my dissertation, the global financial and economic crisis, which began in 2007 and gathered full speed in 2008, demonstrated forcefully that this was by no means the case. Instead, policymakers in many developed countries, such as Iceland, Ireland, and Greece, found themselves faced with difficult trade-offs as the crisis swept over their countries. Citizens have been hard hit by this crisis. As a result, their vulnerabilities to different types of policy responses, be it in terms of exchange-rate, monetary, or fiscal policy or in the realm of structural reforms, have gained political significance and have influenced policymakers' crisis management.

Most crises produce their profiteers, and I feel like one of them as the ongoing crisis has provided me with both intellectual food for thought and new empirical data. The main questions I was trying to answer in my book were suddenly at the forefront of the daily news: When are policymakers confronted with economic problems willing to make costly adjustments to their macroeconomic policies? Which types of adjustment strategies do they choose? Under what circumstances do they delay reform, and when are such delays likely to result in currency or other financial crises?

Although an encompassing answer to these questions is probably too much to ask from a single book, this book broadens our understanding of the politics of crisis management by sharpening our understanding of the role of domestic voters. Using a political economy perspective and focusing on domestic politics in democratic countries, it examines how the distribution of voters' vulnerabilities to different types of adjustment strategies influence policymakers' incentives to address macroeconomic imbalances. To this end, it concentrates on balance-of-payments problems in which delayed adjustment followed by a crisis has been a particularly frequent phenomenon. The book identifies the sources of voters' direct and indirect vulnerabilities to changes in macroeconomic policies in economically open economies and shows how these vulnerabilities affect national policy decisions. It argues that policymakers facing an electorate more vulnerable to exchange-rate (or external) adjustment are more likely to adjust monetary, fiscal, and structural policies (i.e., internal adjustment) to address balance-of-payments problems, and vice versa. When sizable parts of the electorate are vulnerable to both external and internal adjustment, policymakers face strong incentives to delay adjustment, especially when electoral incentives discourage timely reform. However, in the long run this strategy frequently ends with a financial crisis.

Empirically, the book examines both the microlevel and the macrolevel to evaluate this argument, concentrating on the two most prominent crisis episodes in recent times: the Asian financial crisis of 1997–8 and the global financial and economic crisis that began in 2007. At the microlevel, quantitative analyses of cross-country survey data from individuals and firms show that both voters and employers evaluate different macroeconomic adjustment strategies in light of their specific vulnerabilities to changes in the exchange and interest rates. At the macrolevel, comparative case studies of four Asian countries affected by the Asian financial crisis of 1997–8 and eight Eastern European countries experiencing balance-of-payments problems in the wake of the global financial and economic crisis that began in 2007 demonstrate that the variation in policymakers' willingness to adjust their macroeconomic policies in response to such problems can be traced back to differences in the vulnerability profiles of the countries' electorates.

The book's main contribution is to show how macroeconomic policy adjustment affects individual voters and how the anticipation of these distributional effects influence policymakers' choice and timing of adjustment strategies. By developing a microfoundation for the effects of adjustment on voters and tracing the consequences of these individual-level distributional effects on national policy decisions, the book emphasizes the distributional conflicts surrounding the domestic politics of adjustment in financially open economies.

Of course, such a book is rarely written in isolation, and I consequently have accumulated a large debt of gratitude over the ten years in which I have worked on this project. The project started with my dissertation research, which examined different aspects of the politics surrounding policymakers'

responses to speculative attacks. I was lucky to conduct this research in an intellectually stimulating, demanding, and yet supportive environment, Thomas Bernauer's research group at ETH Zurich. As my main dissertation advisor, Thomas provided guidance and advice, while also encouraging me to present at conferences and to seek input from others. I particularly valued his readiness to read and critically comment on my work whenever I needed feedback. At the Center for International and Comparative Studies (CIS) in Zurich, I also benefited from discussions with Stefanie Bailer, Lars-Erik Cederman, Robin Hertz, Simon Hug, Vally Koubi, Hanspeter Kriesi, Patrick Kuhn, Dirk Leuffen, Thomas Sattler, and Markus Stierli. As a member of my dissertation committee, Katja Michaelowa also gave many helpful comments on my initial ideas for this project.

Big thanks also go to Tom Willett, who served as my second dissertation advisor and has continuously pushed me to take my ideas further, which was at times frustrating, but always productive. Tom not only welcomed me to his research group on international money and finance at Claremont Graduate University, where I spent several months in 2005 and 2006, but he has been a great mentor with his supportive, demanding, and fun character. His comments on early drafts of this book manuscript provided me with many fruitful suggestions.

The actual work on the book began during a post-doc fellowship at the Weatherhead Center for International Affairs (WCFIA) at Harvard University during the 2008–9 academic year, which allowed me to concentrate on my research in a highly welcoming and inspiring research environment. At Harvard, I particularly benefited from discussions with Jeffry Frieden. Not only has Jeff's work on the distributional consequences of economic policies in open economies inspired much of my thinking on the topic, but he also invited me to a number of research seminars in political economy, where I was exposed to many new ideas (as well as intensive lessons in American politics and baseball) and had the opportunity to present my own research. Jeff's sure instinct to put the finger on an argument's weak spot and his interest in both theoretical and real-world developments in economic policymaking, coupled with his encouragement and support, proved extremely inspiring, and the critical discussions we had about my thoughts for the book greatly helped me to carry the project further. My second stay at the WCFIA in spring 2010 marked the beginning of the actual writing process of the book. These two months at Harvard were a highly productive period, and I am enormously grateful to Steve Bloomfield and Michelle Eureka at the WCFIA for making it possible for me to return to this hospitable and intellectually stimulating place. My second visit in Cambridge also

marked the beginning of a regular and fruitful exchange with David Singer, who has read and commented on every single chapter in this book. Our frequent discussions in coffee shops or over the phone resulted in many improvements in this manuscript, because David has the ability to get at the depth of an argument, expose potential weaknesses, and propose good and viable alternatives in a highly constructive and gracious manner.

Most of the book was written during my time as a junior professor for international and comparative political economy at the Institute for Political Science at Heidelberg University, Germany, which provided a friendly and supportive atmosphere and a generously funded setting. At Heidelberg, Ruth Beckmann in particular provided me with great support in research and teaching and made many useful suggestions on the manuscript.

Many others have also contributed to the successful completion of this book. At various stages of the project, Bill Bernhard, Bill Clark, Mark Copelovitch, Daniel Finke, John Freeman, Mark Hallerberg, Eric Helleiner, Simon Hug, Nahomi Ichino, Hanspeter Kriesi, David Leblang, Lucas Leeman, Thomas Oatley, Tom Pepinsky, Peter Rosendorff, Gerald Schneider, Ken Shepsle, David Steinberg, Mike Tomz, Christoph Trebesch, and Joshua Walton gave me detailed and helpful comments on ideas from or parts of the manuscript. Mark Copelovitch, Silja Häusermann, David Leblang, and David Singer additionally gave me much appreciated advice and support on the publication process. My editors at Cambridge University Press, most notably Eric Crahan and Scott Parris, have patiently accompanied the writing process and have been generously providing advice and support. Two anonymous reviewers carefully read the first version of the manuscript and made many useful suggestions, which have made the final product much stronger.

I also received valuable feedback from many participants at conferences and workshops at which I presented parts of the manuscript: the Research Workshop in Political Economy at Harvard University, the International Political Economy Society meeting 2009, the Midwest Political Science Association Meeting 2009, the American Political Science Association Annual Conferences 2009 and 2010, and the Politics in Times of Crisis Workshops in Heidelberg in December 2009 and 2010. Generous funding for this book project and preliminary work was provided by ETH research grant 0–20206–04 and the Fritz-Thyssen-Foundation, which funded both my stay at Harvard's WCFIA in the 2008–9 academic year with a Fritz-Thyssen-Fellowship and my research project "The Politics of Delayed Reform and Crisis: Interests, Elections, and Macroeconomic Adjustment" (Az. 20.10.0.003). Over the years, Laura Allendörfer, Jessica Baker, Renate

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My greatest thanks go to my family. My three wonderful sisters, Kerstin, Amelie, and Christina, maybe provided the earliest impetus for this project by being the first to raise my interest in distributional conflict. My parents, Hans-Michael and Monika Walter, have been my greatest supporters from the start. They instilled in me the desire to learn and understand and have provided a safe haven of unwavering love and support from all the twists and turns of an academic career. In very practical terms, it would have been impossible for me to finish this book without my mother's help in recent months. The many hours she has looked after our little sons Nils and Lukas together with their devotion to their "Oma" gave me the time and peace to work on my book. Nils and Lukas, who sometimes grudgingly, sometimes happily, accepted my absences have supplied me with the great gifts of keeping me firmly rooted in reality and allowing me to completely forget about the book in my free time. Most importantly, my husband Jörn deserves thanks: for his patience with me working on what at times seemed like an endless project, for his willingness to discuss my argument and to contribute the economist's view on it, and above all for being there.