

## CHAPTER I

# Introduction

International capital mobility is an undeniable fact for the advanced industrial democracies in the post-Bretton Woods era. Whether capital mobility is measured in terms of fewer government restrictions or in terms of growing financial flows, one can easily observe that it has reemerged as a leading feature of the international monetary system after attempts to restrict capital movements across national borders during the Bretton Woods regime.<sup>1</sup> After a long debate about the causes leading to the return of international capital mobility—focused largely on whether this development was due more to technological advances outside of government control or to deliberate government choices for capital liberalization<sup>2</sup>—political scientists are now focused on understanding its consequences.

The political science discipline has made substantial progress in understanding the political consequences of international capital mobility and economic globalization more broadly. But many important questions remain largely unanswered, especially those related to national monetary politics and policy.

How does international capital mobility constrain the monetary policy choices of national governments: in terms of policy goals (such as inflation), in terms of policy instruments (such as interest rates), or both?

If international capital mobility constrains national monetary policy choices, has it produced systematic monetary policy convergence?

1. For evidence on capital restrictions, see Quinn and Inclan 1997. For evidence on capital flows, see Simmons 1999.

2. On technological advances, see Bryant 1987. On deliberate government choices for capital liberalization, see Helleiner 1994.

## 2 Monetary Divergence

Can we observe monetary policy convergence in the exchange rate regimes constructed by the advanced industrial democracies in the post-Bretton Woods era?

If systematic monetary policy convergence has not occurred, what factors help explain the patterns of monetary policy divergence after 1973?

These questions remain largely unanswered because the economic globalization research program tends to focus more on government spending and related fiscal policy choices than on national monetary policy and related exchange rate outcomes. To see how this has been the case, it is useful to group the growing political science literature on the consequences of international capital mobility into three broad waves (see table 1).

Beginning in the early 1990s, the first wave of relevant literature proposed the broad macroeconomic policy convergence hypothesis, including the proposition that international capital mobility constrained both fiscal and monetary policy choices of national governments.<sup>3</sup> While this policy convergence argument was supported by interesting case examples, it effectively eluded systematic empirical testing until the mid-1990s. At this time, the second wave of research began more rigorous testing of the policy convergence hypothesis. But most of the empirical work focused on government spending choices, where political scientists concluded that fiscal policy divergence remains possible in the post-Bretton Woods era,<sup>4</sup> at least for the advanced industrial democracies.<sup>5</sup> Much less empirical work was devoted to national monetary policy and de facto exchange rate stability.

**TABLE 1. Three Waves of Political Science Literature on Monetary Policy Convergence**

First wave Early 1990s	Offered the broad macroeconomic policy convergence hypothesis, including both fiscal and monetary policy convergence
Second wave Mid-1990s	Tested the macroeconomic policy convergence hypothesis, finding evidence of fiscal policy divergence Less research devoted to monetary policy and exchange rate stability
Third wave Late 1990s	Offered new explanations for monetary cooperation and integration, generally accepting the monetary convergence hypothesis

3. For key academic works, see Scharpf 1991; Garrett and Lange 1991; Kurzer 1993; Cerny 1995. For extensions into more popular literature, see Ohmae 1995; Greider 1997; T. Friedman 1999.

4. For key works, see Garrett 1995; Garrett 1998b; Iversen and Cusack 2000; Burgoon 2001.

5. Rudra (2002) shows how this conclusion may not apply to less-developed countries.

This research trajectory has produced an interesting tension in the political science literature concerning the effects of international capital mobility. While most scholars now accept the conclusion of fiscal policy divergence, many also accept the largely untested hypothesis of systematic monetary policy convergence. As Mosley (2000, 739) observed in her review of this literature, scholars have demonstrated “cross-national diversity in such areas as government consumption spending, government transfer payments, public employment, and the level of government tax revenues” yet acknowledge a “growing cross-national similarity in aggregate monetary [policy].” Yet without completely divorcing monetary policy decisions from those of national fiscal policy, how can we sustain a story of systematic monetary policy convergence next to all the evidence of fiscal policy divergence?

Indeed, rather than directly confronting the proposition of systematic monetary policy convergence, a third wave of literature in this research program seems to treat the phenomenon largely as given, debating instead the possible causes of monetary cooperation and integration, especially with regard to events in Western Europe.<sup>6</sup> Thus, political scientists are currently focusing their attention on whether European monetary convergence—and, by extension, that of the other advanced industrial democracies—stems more from the role of transnational neoliberal ideas or from political pressure applied by international exporters and investors who favor monetary integration to achieve exchange rate stability. But trying to explain monetary policy convergence becomes problematic if we cannot establish that the supposed phenomenon is actually occurring. On this point, Clark (2003, 2) argued, “while this ‘convergence’ view of the current international political economy is widely accepted, there is virtually no evidence to support its main dynamics.”

## **I. Research Puzzles**

Although this book explores all the questions posed in the introductory section of this chapter, it is usefully organized around two primary research puzzles. First, can we observe systematic monetary policy convergence among the advanced industrial democracies in the post-Bretton Woods era? The analysis that follows will focus primarily on this cross-sectional and temporal domain, because it is where those who argued for systematic monetary policy conver-

6. For two major third-wave contributions, see McNamara 1998; Frieden 2002. I would also put Oatley’s 1997 book into the third wave, since that study sought to explain monetary cooperation in Western Europe, although Oatley was careful to acknowledge divergent cases.

#### 4 Monetary Divergence

gence staked their theoretical and empirical claim. This first research question is harder to answer than it may appear, because the political science literature on international monetary policy has not developed a suitable operational measure for external monetary convergence or for the corresponding loss of domestic monetary autonomy. As I will demonstrate later, the rough measure that our discipline has sometimes employed—membership in a regional monetary regime or other *de jure* commitments to fix the value of the national currency—is rather poorly suited to the task. Thus, it is hard to make confident inferences about the loss of domestic monetary autonomy and external monetary convergence by looking at institutional commitments alone.

If—after developing more suitable operational measures for these concepts—the answer to the first research question is yes, then we can place the systematic monetary convergence hypothesis on a much more solid empirical footing. This would surely be a valuable scholarly contribution. But if the answer is no—that is, if the advanced industrial democracies have pursued different monetary policies with little evidence in favor of systematic monetary policy convergence—then we need to explore a second and related research question: what factors can explain the patterns of monetary policy divergence among the advanced industrial democracies in the post-Bretton Woods era?

In this book, I use the term *monetary policy divergence* to refer to the situation where the advanced industrial democracies used their national monetary policy to achieve different economic objectives, with some governments working toward external currency stability and other governments using monetary policy for more domestic purposes.<sup>7</sup> This conception of monetary policy divergence borrows heavily from a prominent macroeconomic model known as the Mundell-Fleming framework. This macroeconomic model posits that when capital is internationally mobile—as it has been for the developed countries since at least the early 1970s—governments must choose between exchange rate stability and domestic monetary policy autonomy. If they choose external currency stability, they give up the ability to direct their monetary policy instrument toward certain domestic economic objectives. If governments use their monetary policy for certain internal objectives, then the external goal of exchange rate stability will ordinarily become unachievable given international capital mobility.

Thus, the second research question can be restated using language from the Mundell-Fleming framework. In the post-Bretton Woods era, what factors have led national governments to choose domestic monetary policy autonomy,

7. For an earlier statement on this subject, see Bearce 2002.

accepting greater exchange rate variability with international capital mobility? Similarly, what factors led them to opt instead for exchange rate stability, accepting the loss of domestic monetary autonomy?

## 2. The Argument in Brief

With regard to the first research question, whether there has been monetary policy convergence among the advanced industrial democracies in the post-Bretton Woods era, I will make the case that there has been much less than the conventional wisdom of systematic monetary policy convergence would expect. To reach this conclusion, I first create operational measures for both domestic monetary policy autonomy and exchange rate stability, using the interest parity condition from open-economy macroeconomics. The interest parity condition suggests that domestic monetary autonomy can be identified by a nominal interest rate differential: the extent to which the domestic interest rate differs from the prevailing external interest rate. A larger interest rate differential indicates greater domestic monetary autonomy, while a smaller differential indicates more external monetary policy convergence.

The empirical evidence reveals that many advanced industrial democracies have maintained relatively large interest rate differentials since 1973, the beginning of the post-Bretton Woods era. Indeed, there has been no strong trend toward smaller interest rate differentials, as would be expected by the systematic monetary convergence hypothesis. To the extent that monetary convergence can be measured indirectly by looking at exchange rate stability, the evidence also shows no pattern of more stable exchange rates for the advanced industrial democracies since 1973. Consequently, the post-Bretton Woods era is better understood as a period of monetary policy divergence, defined as the situation where the advanced industrial democracies use their national monetary policy to achieve different economic objectives, with some governments working for greater external currency stability and other governments using the monetary policy instrument for more domestic purposes.

I will also make the case that this situation of monetary policy divergence is directly related to the well-documented phenomenon of fiscal policy divergence among the advanced industrial democracies after 1973. With this goal in mind, I offer a theory based on the government's fiscal and monetary policy mix to show how a government's spending decisions help explain the national interest rate and related policy outcomes. This policy mix theory posits that when governments choose to spend more to promote economic growth, provide public goods, or engage in income redistribution, they must also raise the

## 6 Monetary Divergence

domestic interest rate for inflation control. A higher domestic interest rate usually translates into a larger interest rate differential, relative to the nominally low “world” interest rate. A larger interest rate differential, in turn, means greater exchange rate variability in an era of international capital mobility.

The policy mix framework allows us to define a set of economic policy choices consistent with domestic policy autonomy in the post-Bretton Woods era: more government spending, a higher national interest rate, a larger interest rate differential, and greater exchange rate variability. If governments desire external policy convergence, they must move in the opposite direction with regard to fiscal and monetary policy. Less government spending permits a lower national interest rate, which, in turn, facilitates a smaller interest rate differential and reduced exchange rate variability, or greater external currency stability.

Consistent with the theme of policy—including monetary policy—divergence, I will show how different governments belonging to the Organization for Economic Cooperation and Development (OECD) have made policy decisions in both of these directions since 1973: some governments have opted for domestic policy autonomy, while others have worked for greater external policy convergence. Indeed, to the extent that there has been any dominant trend since 1973, it appears to be toward greater domestic policy autonomy; hence, the present book is subtitled *Domestic Policy Autonomy in the Post-Bretton Woods Era*. While there has been some policy convergence on the part of certain national governments, it has not occurred on any widespread basis. Put somewhat differently, episodic choices for external policy convergence cannot be treated as evidence of systematic policy convergence when there are as many, if not more, governments who have made the opposite choice for domestic policy autonomy.

For some political scientists, this may appear to be an unsurprising conclusion. Indeed, it might be argued that monetary policy divergence has been obvious in the post-Bretton Woods era: some governments have chosen external policy convergence by joining the “fixed” exchange regimes set up in Western Europe since the early 1970s, and other governments have retained domestic policy autonomy by avoiding any *de jure* exchange rate commitments. But I will show how the choice for external policy convergence or domestic policy autonomy is only weakly reflected in the exchange rate commitments and non-commitments of OECD governments in the post-Bretton Woods era. This is true because such exchange rate regimes as the European Snake and the exchange rate mechanism of the European Monetary System (EMS) were relatively flexible institutions, permitting substantial domestic monetary auton-

omy if member states so desired to assert it. Similarly, governments outside these exchange rate regimes could achieve relative exchange rate stability if they were willing to make the fiscal and monetary choices consistent with this external policy goal.

After discussing the evidence of policy—including monetary policy—divergence after 1973, I will address the second research question. What factors led national governments to choose domestic policy autonomy, accepting the loss of exchange rate stability with international capital mobility? Similarly, what factors pushed other national governments to move toward external policy convergence for greater exchange rate stability, sacrificing the benefits of domestic policy autonomy with international capital mobility?

My statistical analysis of government spending, national interest rates, interest rate differentials, and exchange rate variability point to the importance of the partisan character of the government in power. Leftist governments in the OECD have tended to spend more, hold higher nominal interest rates with larger interest rate differentials, and experience greater exchange rate variability than rightist governments, who tend toward the choices associated with external policy convergence. This suggests that many leftist governments have effectively chosen domestic policy autonomy with international capital mobility, while rightist governments have moved more toward exchange rate stability. The statistical models also show how political power-sharing arrangements have pushed OECD governments toward greater fiscal expansion and exchange rate variability, while central bank independence has helped them to reduce nominal interest rates and interest rate differentials.

To illustrate this partisan divergence with regard to the trade-off between domestic policy autonomy and exchange rate stability in the post-Bretton Woods era, I will employ two detailed case examples. The first shows how Socialist governments in France effectively opted for domestic policy autonomy even after Mitterrand's so-called U-turn in 1983. While in power, the Socialists maintained relatively high levels of government spending. With the international capital mobility constraint, this expansionary fiscal policy required higher national interest rates and larger interest rate differentials for the French national economy. Such a policy mix meant that the French franc was relatively unstable, even within the exchange rate mechanism of the EMS. Certainly, the Socialists could have cut government spending to achieve greater monetary convergence and reduce external currency variability, but they chose not to follow this strategy. While French policy independence imposed certain costs, the Socialists were willing to bear these costs for domestic political reasons.

## 8 Monetary Divergence

The second case study shows how Conservative governments in Britain effectively chose external policy convergence for greater exchange rate stability, even while they remained outside of European exchange rate regimes. To achieve greater exchange rate stability, the Conservatives cut government spending. This allowed lower interest rates and smaller interest rate differentials for the British economy, helping to reduce external currency variability. This choice for external policy convergence also imposed costs on certain segments of British society, but the Conservatives were willing to pay these costs given the political support that they received from internationally oriented segments of the British economy, who desired exchange rate stability with international capital mobility.

These two examples function as least-likely cases, following Eckstein (1975). If we think about monetary policy divergence simply in terms of a government's *de jure* exchange rate regime commitments, we might reason that the French Socialists chose external policy convergence, since they were inside the EMS. We might also reason that the British Conservatives chose domestic policy autonomy, since they stayed outside of the EMS, except for a brief period in the early 1990s. But when we look carefully at the domestic fiscal and monetary policy choices made by these governments, we can better understand why the French Socialists had relatively unstable exchange rates within the flexible EMS regime and why the British Conservatives were able to achieve surprisingly stable exchange rates outside it.

### 3. Theoretical and Empirical Significance

The significance of this research project is threefold, and each of the three contributions addresses a different target audience. First, the research lays out clearly why the monetary convergence hypothesis is theoretically misleading and empirically wrong. It might be argued that such a demonstration is unnecessary, since many scholars, notably those in the field of comparative political economy (CPE), never really believed the argument in the first place. But many other scholars, especially in the field of international political economy (IPE), have seemingly accepted the logic of systematic monetary convergence.<sup>8</sup> It is

8. I suspect that IPE scholars have been more willing than their CPE counterparts to accept the monetary convergence hypothesis, because the basic argument builds from structural constraints on unit-level behavior, a logic with deep roots in the international relations tradition (see, e.g., Waltz 1979). One important exception in the IPE literature, arguing against the convergence hypothesis, is Oatley's 1999 article. Comparativists, trained to focus on unit-level differences, have appeared more willing to recognize policy divergence among national political economies; see, for example, Clark and Hallerberg 2000.



thus valuable to demonstrate, once and for all, why this “conventional wisdom” (Crystal 2004, 467) cannot be supported with regard to national monetary policy, the issue area that arguably represents the strongest case for the macroeconomic policy convergence argument.

Second, in uniting fiscal, monetary, and exchange rate policy into a common theoretical framework, this research project offers a new understanding of partisan economic differences in the capitalist global economy. If the first point is of little interest to CPE scholars, this second point should offer much greater appeal to this research community, because partisan models of national economic policy-making have recently come under strong attack (see, e.g., Clark 2003). It is thus useful to demonstrate how partisan arguments can be revived using a somewhat different and adapted theoretical framework.

Third, this policy mix framework also offers a new way to apply the Mundell-Fleming model to the context of domestic economic policy-making. Scholars of monetary politics in both the IPE and CPE traditions have tended to treat a country’s exchange rate regime (usually categorized as either fixed or floating) as exogenously determined. But the policy mix framework explicitly makes exchange rate stability into an endogenous policy outcome, thus providing a framework that scholars may find useful in addressing the observed gap between *de jure* and *de facto* exchange rate regimes (see, e.g., Reinhart and Rogoff 2004; Levy-Yeyati and Sturzenegger 2005).

On the first point, speaking to those in the field of international relations, this research shows how and why monetary policy convergence is not inevitable with international capital mobility and global financial integration. This conclusion, however, does not mean that policy convergence could not occur due to deliberate choices on the part of national governments. But if it emerges from deliberate government choices, policy convergence is likely reversible when new governments, with different ideological perspectives and representing different societal interests, make purposeful choices for fiscal and monetary policy autonomy and accept the associated costs with regard to exchange rate stability.

This understanding bears on the familiar “agent-structure debate” in the field of international relations. Capital mobility is often treated as a structural condition of the international system,<sup>9</sup> thought to impose substantial constraints on national governments, the main agents in the international system. Especially with regard to international monetary politics, the debate thus far—dominated by the monetary convergence hypothesis—has been structure-heavy and agency-thin. The evidence presented in this book strengthens the

9. See Andrews 1994b; Webb 1995.

case for domestic economic agency, without denying the structural constraint of international capital mobility. International capital mobility certainly imposes some real constraints on national governments, leading them to pursue similar domestic policy goals, such as economic growth with low inflation. But national governments nonetheless retain a significant measure of political agency, since they can use different policy instruments—when properly coordinated—to meet these economic policy goals. This helps explain more precisely how international capital mobility constrains domestic economic policy-making: it constrains governments in terms of policy goals but not in terms of the policy instruments used to meet these goals.

This logic leads to the second contribution of this research project: establishing a new framework for understanding partisan politics with international capital mobility. To explain economic policy divergence in the post-Bretton Woods era, I will show some important partisan differences, at least with regard to the choice for domestic policy autonomy versus exchange rate stability. However, my partisan argument is a nuanced one, and I do not suggest that we should expect to observe partisan differences in terms of all economic policy choices and outcomes. To the contrary, while my theory of economic policy-making under international capital mobility predicts and finds partisan differences in terms of government spending (namely, government consumption), nominal interest rates, national interest rate differentials, and exchange rate variability, it also posits that we should not expect strong partisan differences in many other areas.

For example, if leftist governments balance greater spending with more tax revenue, then we should not expect to see significant partisan differences with regard to either budget deficits or public debt. Similarly, for reasons that will be discussed in later chapters, we should not expect to observe significant partisan differences in terms of real interest rates, actual inflation rates, or economic growth rates. Thus, my theory of partisan economic differences situates itself between those presented by Garrett (1995, 1998b), who argued for growing partisan differences on a wide variety of economic indicators, and Clark (2003), who argued that there are no significant partisan economic differences at all.

The third contribution of this project addresses political scientists studying the observed gap between *de jure* and *de facto* exchange rate regimes, a growing area of research in political economy. Central to this research program is the Mundell-Fleming framework imported from open-economy macroeconomics. So far, political science applications of the Mundell-Fleming framework to the context of domestic economic policy-making tend to begin with a country's exogenously determined exchange rate regime (assumed to be either

fixed or floating) in order to explain its single “effective” domestic policy instrument—either fiscal policy with fixed exchange rates or monetary policy given a floating regime (see, e.g., Oatley 1999; Clark and Hallerberg 2000; Clark 2002).

While this is a very reasonable application of the Mundell-Fleming framework, it does have certain limitations, especially for the aforementioned research program. First, the approach tends to treat exchange rate regimes as one of two types, either fixed or floating. But until the introduction of the euro in 1999, OECD national economies have had neither truly fixed exchange rates nor purely floating ones in the post-Bretton Woods era. Most advanced industrial democracies, as well as most developing countries, have been somewhere in the muddy middle—between adjustable pegs and managed floats. Second, and more important, this approach treats a policy outcome (i.e., exchange rate stability) that the discipline is now trying to explain as exogenous. Furthermore, it does so generally in terms of the country’s *de jure* exchange rate regime, a variable that has been shown in practice to be only weakly correlated with *de facto* exchange rate stability.

However, the policy mix framework presented in the present study directly addresses the issue of exchange rate stability, or *de facto* exchange rate regimes. It begins with the government’s spending choice and nominal interest rate decision, showing how this combination, or policy mix, affects national exchange rate stability, effectively treating the country’s *de facto* exchange rate regime as an endogenously determined variable. This direction of reasoning (from policy instruments to exchange rate stability) may help explain the surprisingly low correlation between exchange rate “words and deeds” (Levy-Yeyati and Sturzenegger 2005). If a government makes a fixed exchange rate commitment but then follows a fiscal and monetary policy mix expected to increase interest rate differentials and exacerbate external currency variability, we can better understand why the government’s commitment to fix national exchange rates will be very hard, if not impossible, to achieve. Likewise, we can better understand how a government without any formal exchange rate commitments can achieve relatively stable exchange rates: it has chosen a fiscal and monetary policy mix that minimizes the national interest rate differential, thus reducing external currency variability.

#### **4. The Organization of This Book**

This book proceeds with six additional chapters. In this introductory chapter, I have presented the research questions and outlined my answers to them.

Chapter 2 (“The Monetary Convergence Hypothesis”) develops the theoretical foundations for this project, including the Mundell-Fleming framework from open-economy macroeconomics and the systematic monetary convergence hypothesis from the field of international political economy.

Chapter 3 (“Evidence of Monetary Divergence”) first offers and then validates some new operational measures for evaluating external monetary policy convergence and domestic monetary policy autonomy. Using these measures, I demonstrate that many, but certainly not all, OECD countries have maintained domestic monetary autonomy in the post-Bretton Woods era, thus producing a situation of monetary policy divergence (as opposed to monetary policy convergence) after 1973. Chapter 4 (“From Fiscal to Monetary Divergence”) shows how this situation of monetary policy divergence is related to the well-documented phenomenon of OECD fiscal policy divergence in the post-Bretton Woods era. This chapter builds a theory based on the government’s chosen fiscal and monetary policy mix, uniting differences in relative government spending to differences concerning nominal interest rates and exchange rate variability.

Given such policy divergence after 1973, chapter 5 (“Explaining Divergence in the Policy Mix”) explores the determinants of domestic policy autonomy and exchange rate variability among the OECD countries in the post-Bretton Woods era. The statistical results show the importance of the partisan character of the government in power with regard to government spending, nominal interest rates, interest rate differentials, and exchange rate variability. Chapter 6 (“Illustrating Partisan Divergence in the Policy Mix”) further demonstrates the importance of government partisanship through two detailed case examples: the example of the French Socialists from 1981 to 1995 and the example of the British Conservatives from 1979 to 1996.

Finally, chapter 7 (“Expanding the Argument”) discusses the broader theoretical and policy implications of this research. In particular, it shows how the pressures for domestic policy autonomy are likely to reemerge within Europe’s Economic and Monetary Union (EMU). With such pressures, it may be hard to sustain the EMU project unless member states can reacquire some lost policy autonomy, especially on the fiscal side. But at the same time, greater fiscal policy independence within the Eurozone will make it harder for the new regional central bank to set a common European monetary policy. Consequently, the EMU project may rest on more fragile foundations than many observers seem willing to acknowledge.