The Political Economy of International Financial Crises

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Abstract

In an era of rapid financial globalization, international financial outcomes are increasingly becoming subject to political competition; this has increasingly been corroborated with empirical evidence. However, most research has adopted an approach that is premised more on *ad hoc* extensions of established international macroeconomic models to allow for political phenomena, rather than incorporating political-microeconomic foundations explicitly via the interaction of heterogeneous agents in the political economy. This paper describes three interrelated essays that examines the circumstances surrounding the formation, resolution, and consequences of international financial crises from the perspective of interacting heterogeneous agents in the political economy.

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1 Introduction

At one level, there appears to be very little that links international trade with international finance. The discipline has regarded trade as largely involved with the microeconomic implications of international goods exchange, whereas international finance tends to be more concerned with the macroeconomic impact of exchange rates. However, this distinction is misleading. Modern open-economy macroeconomics has increasingly gravitated toward microfoundations, together with a renewed interest in the real side of the economy. Similarly, the research frontier in international trade include topics such as multinational corporations and economic geography, issues that have significant macroeconomic implications. This theoretical marriage of trade and finance reconciles academic research with a stylized fact: That a large part of international finance is in fact driven by international trading relations, and the underlying motivations for international finance are complementary extensions of those for trade.

Likewise, it may seem that there is a very thin relationship between politics and international finance. After all, in an era of hot money flows, electronic trading, and market-driven financial capitalism, international finance seems to be driven by purely economic forces. However, accepting the proposition that international finance and trade are inextricably linked, one begins to see the potential for political influences. Trade policy is profoundly influenced by political frictions; as a result, the trade literature has accepted into the mainstream the major role of political economy on trade. If political factors such as special interest lobbying, legislative bargaining, and electoral competition are important in determining outcomes in trade policy, it is a small intellectual leap to imagine that, in an era of rapid financial globalization, these groups might have an interest in changing international financial outcomes as well.

Moreover, the weight of empirical evidence is increasingly pointing to the reality that political factors do matter for international financial phenomena (Alesina & Wagner 2006; Blomberg *et al.* 2005; Edwards 1996; Eichengreen *et al.* 1995; Klein & Marion 1997; Leblang 2003; Stein *et al.* 2005; Sturm *et al.* 2005). This has led researchers toward the formalization of insights from these analyses. Although the literature that incorporates the tools of political microeconomics is rich in the field of international trade, this trend has not, in general, spilled over into international finance and open-economy macroeconomics. As a result, most published research has tended to adopt an approach that is premised more on *ad hoc* extensions of established open-economy macroeconomic models to allow for political phenomena, rather than explicitly incorporating political-microeconomic foundations via the interaction of heterogeneous agents in the political economy.

The goal of this dissertation is to redress this imbalance. With three interrelated essays, we examine the political economy that surrounds international financial crises, which have been increasing both in frequency and magnitude in recent times. By providing foundations that clarify the political-economic factors and channels that come into play, we hope to be able to illuminate the processes underlying the formation, resolution, and consequence of such desta-

bilizing crises.

2 Overview

Financial crises involve significant redistributive effects, at both the macroeconomic (Baldacci *et al.* 2002; Halac & Schmukler 2004) as well as microeconomic levels (Frankenberg *et al.* 2003; McKenzie 2003), and are reminders of the fragile relationship that exists between international bank lending, developing country borrowing, and IMF intermediation. The existing literature has not adequately addressed the channels for this redistribution. If there is redistribution within the developing country, does this occur purely within the developing country, or from developing country taxpayers to developed country banks? Is there redistribution as well from developed country taxpayers to the banking system in the developing and developed world? Moreover, the different factors that influence the formation of post-crisis resolution policy are often unclear: Given the redistributive effects, what are the factors that come into play in the formation of post-crisis resolution policy? Who are the players that matter, and how do they interact with one another?

Chapter 2 seeks to clarify the channels and factors that influence the formation of post-crisis redistributive policy. It develops a two-country open-economy model with *ex ante* heterogeneous groups in each country. This theoretical model captures the influence of domestic special interest lobbying and international bilateral bargaining on the formation of equilibrium lending, bailout, and reallocation decisions. The model predicts that the post-crisis consumption of groups in the economy is dependent on, *inter alia*, whether the group was politically organized: The crisis changes the power structure of groups and allows certain ones to take advantage of their relationship with policymakers to extract a larger part of the bailout pie. The model also predicts that equilibrium lending decisions by developed countries—through the medium of the IMF—take into consideration both the likely post-crisis redistribution outcomes, as well as any political capital accruing to policymakers for not giving in to the the other country.

These two key propositions are then taken to the data. It uses household-level microeconomic data from Bulgaria and Indonesia collected just prior to and immediate after crises in those countries as a "natural experiment" for the first proposition. For the second, it draws on international financial, macroeconomic, and political data in tests of the amount of crisis lending undertaken by the IMF over a thirty-year period. Both theoretical predictions find support in our empirical analyses. The chapter then closes with reflections on international financial reform—in particular the role of the IMF—in light of the model's findings.

In Chapter 3 we take a step back in the timeline of a crisis and ask *how* such crises may result from the interaction of political agents. More specifically, how do special interests, government policymakers, and the monetary authority interact in the determination of revaluation or devaluation decisions in a man-

aged peg regime? Do these interactions engender particularistic conditions that may possibly usher in a currency crisis? After all, the choice of an exchange rate regime is, ultimately, a political decision; moreover, the empirical record has strongly pointed to the importance of politics in speculative attacks and devaluation decisions in both the developed and developing world (Bernhard & Leblang 2000; Leblang 2002; Leblang & Satyanath 2006).

This chapter explicitly introduces special interest lobbying activity into the exchange rate policymaking decision. It uses, as its point of departure, a model of monopolistically competitive agents in the small open economy. With *ex ante* agent heterogeneity, coupled with short-term price stickiness, exchange rates generate a real effect on agent welfare and hence are amenable to political competition. The model then predicts that a partially independent monetary authority will respond to both economic as well as political pressures in its decision concerning the extent of a revaluation or devaluation. In addition, to the extent that such a managed peg solution becomes disconnected from economic fundamentals, a classic first generation-style crisis (Krugman 1979) erupts.

The notion that exchange rate regime changes—and currency crises more generally—are affected by political pressure is then taken to the data. It finds, using a measure of political risk as a proxy for special interest influence, that the probability of a regime switch is, indeed, influenced by the extent to which special interest pressures exist.

One of the most dramatic consequences of the Asian financial crisis in Indonesia was the political transition that toppled the thirty-two-year presidency of General Haji Mohammad Soeharto in May 1998. The devastating conditions of the Asian financial crisis brought opposition groups together in an unprecedented fashion, leading to the social movement known today as the Indonesian Revolution. However, existing formal models of social movements tend to subscribe—either implicitly or explicitly—to the resource mobilization model (Acemoglu & Robinson 2000; McCarthy & Zald 1977), or to a variant of the collective action model (Kim & Bearman 1997; Oliver 1993). Both of these class of models require either active elite involvement, or a critical mass of boundedly-rational movement participants.

Chapter 4 (coauthored with Thorsten Janus) develops a model of social movement emergence and political change that is not critically dependent on either active elite support or limited rationality. Social movements involve, rather, strategic interactions among movement actors as they are impacted by exogenous shocks—such as those experienced during a financial crisis—and moderated by the social relationship effects that exist in participating groups. We introduce two separate mechanisms involved in driving social change: Social movement emergence premised on inter-group formation under a political entrepreneur, and intra-group dynamics based on a system of endogenous contract enforcement. Our framework is also flexible enough to incorporate multiple contracting mechanisms, informational imperfections, as well as potential interactions with elites.

We then consider the historical validity of the model with case studies of

Indonesia during the crisis and conflict in the Congo. These studies suggest that features that we highlight in our model, such as strategic interaction among movement actors, the importance of exogenous shocks, as well as the existence of political entrepreneurs, were both necessary and important in the genesis and perpetuation of these social movements.

3 Common Themes

The essays in this dissertation are all distinguished by a common methodological approach: That it is *ex ante* economic heterogeneity that births political activity, and this political activity in turn gives rise to *ex post* outcomes in the political economy that differ from those that would otherwise result in the absence of such activity. The idea that *ex ante* heterogeneity can be the basis for political-economic dynamics is a recurring theme in Drazen (2000); we take this a step further by embedding this heterogeneity firmly in the economic characteristics of agents.

Just as economics is multidimensional in its nature, politics is likewise not unidimensional: Political agents are organized in different ways, and government policymakers and legislators, lobbying groups, and the electorate at large may all be regarded as being engaged in special interest politics over desired policy outcomes (Persson & Tabellini 2000). We focus, in particular, on the ways in which special interest lobbying activity often exert a non-negligible impact on international financial policymaking. One workhorse tool that we employ continuously is the menu auction framework of Grossman & Helpman (1994), which in turn builds on the common agency model of Bernheim & Whinston (1986).[1]

Putnam (1988) was the first to articulate the importance of how domestic political constraints shape international interactions and outcomes, and *vice versa*. Our marrying of the new open economy macroeconomics literature—as exemplified by (Obstfeld & Rogoff 1996)—with the new political economy à la Grossman & Helpman (2001) reiterates the international-domestic nexus, at least as it applies to financial crises.

Our investigation strategy is characterized by the need to confront the propositions developed in the theoretical models against the hard reality of data. As far as such testing goes the approach is more eclectic. By and large, the analytical mode of choice is that of econometric analysis; this, however, has been liberally supported by detailed historical case studies that provide additional nuances that may be lost in the aggregate data.

Finally, economists are in the business of understanding, and bettering, the world. Consequently, all the essays in this dissertation provide policy implications and prescriptions based on the models that have been developed.

[1] The alternative school of thought argues that, with rational voters, special interest concerns are washed out on aggregate (Wittman 2006).

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