International Political Economy (SOCS-SHU 222)

A SOCIETY-CENTERED APPROACH TO MONETRY AND EXCHANGE-RATE POLICIES

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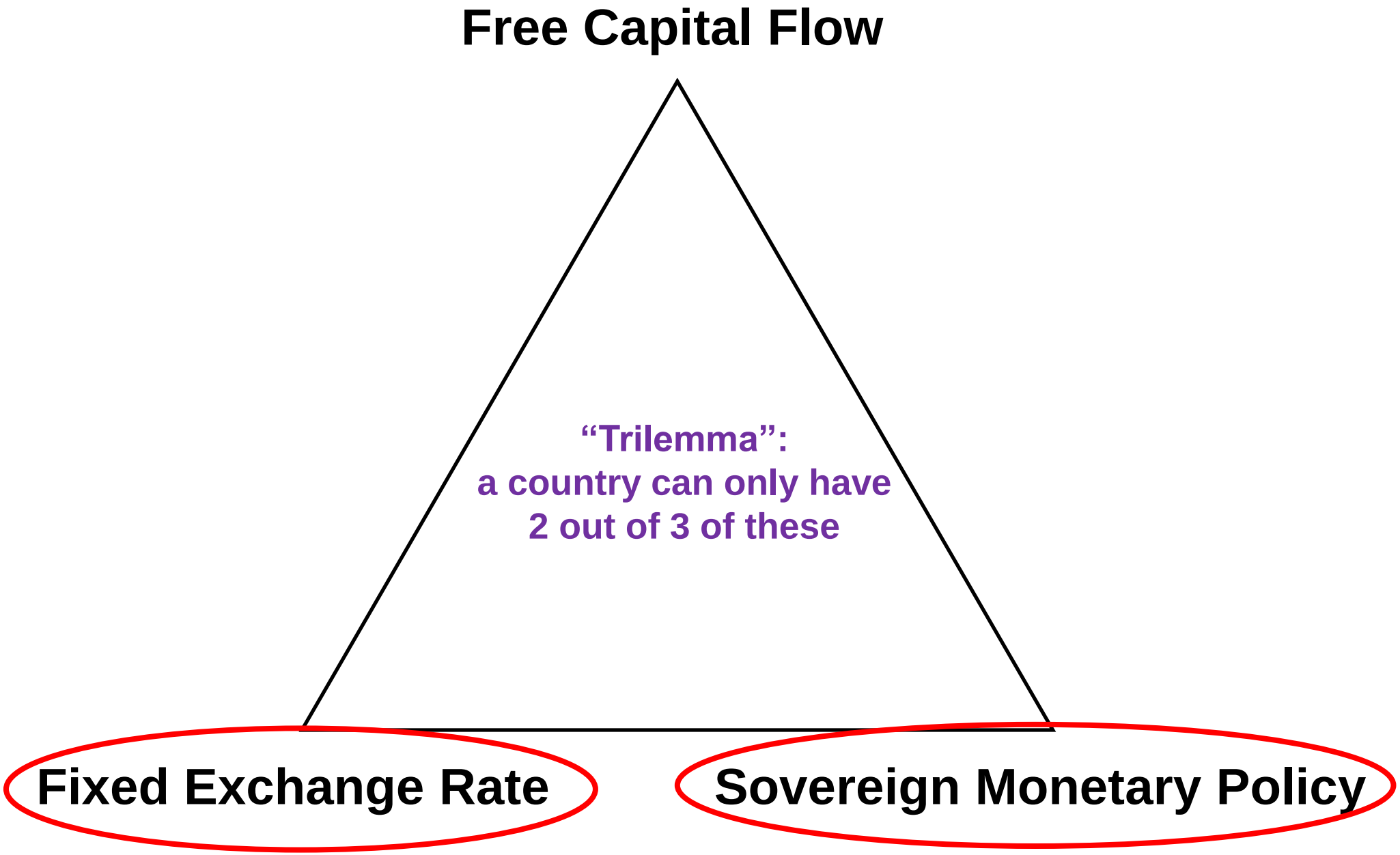
Do you prefer a strong/weak dollar?


Free Capital Flow
“Trilemma”:
a country can only have
2 out of 3 of these
Fixed Exchange Rate
Sovereign Monetary Policy

A Society-Centered Approach to Monetary and Exchange-Rate Policies

READING ASSIGNMENT:

Oatley Chapter 12

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Why would you want…

- Free Capital Flow?
  - Draw on the savings of the rest of the world
  - Investment opportunities abroad
- Fixed Exchange Rate?
  - Reduce uncertainty in trade
- Sovereign Monetary Policy?
  - Address inflation/unemployment

Trade & international capital flows lead to imbalances

How do governments deal with these imbalances?

- Fixed exchange rate ➔ sacrifice monetary policy

OR:

- Floating exchange rate ➔ sacrifice certainty in international exhanges

Trade-off between

- exchange rate stability

versus

- domestic price stability with monetary policy autonomy

What will governments choose?

Society-based models of monetary & XR politics

1. Electoral models

2. Partisan models

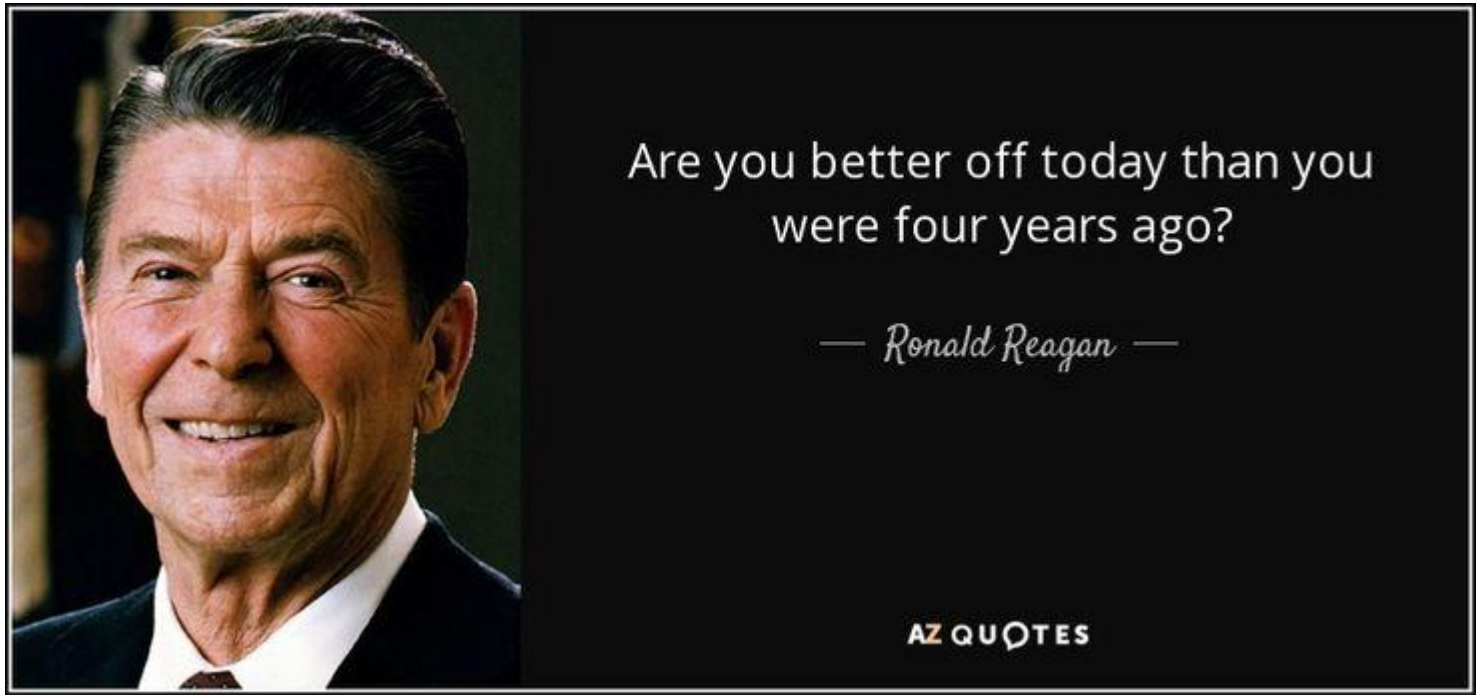
3. Sectoral models

Assuming free capital flows…

Governments must choose between

- monetary policy autonomy
- XR stability

1. Electoral Models



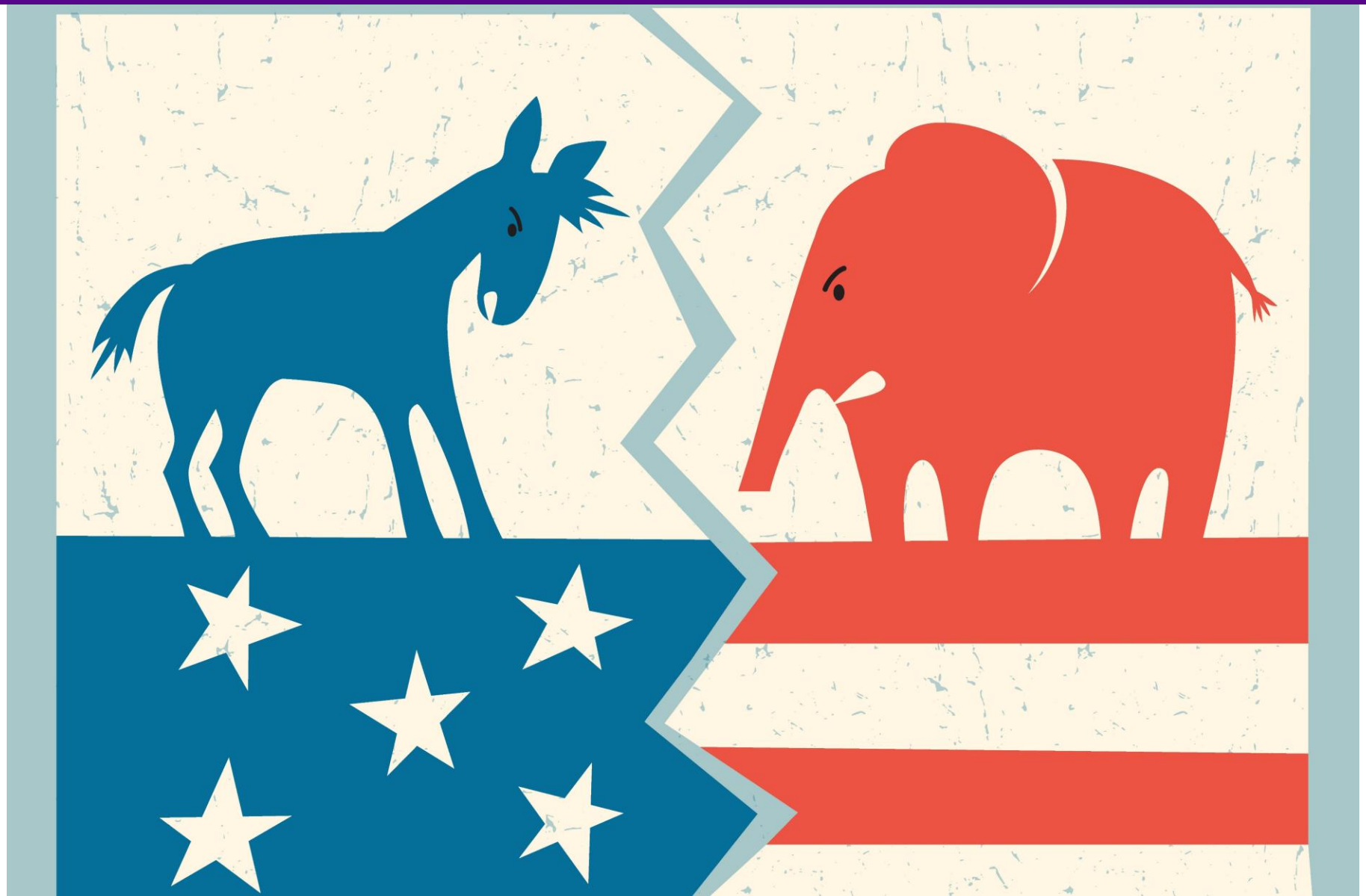
1. Electoral Models

- Prediction: Democracies choose floating XR ➔
  - monetary autonomy used to manipulate political-business cycles (PBC)
  - PBC: adopt expansionary policies in election years
- If there is a fixed XR ➔
  - commitment may not be credible before elections (elections like the Sirens!)
- Pocketbook voter model – people vote according to changes in their income
  - http://www.youtube.com/watch?v=loBe0WXtts8
- Sociotropic model – voters consider macro performance (economic growth, unemployment, inflation)

Political-business cycles (PBC)?

- Governments may be less willing to accept monetary policy constraints before an election
- Problem 1: empirical – debate over whether we really observe PBCs
- Problem 2: theoretical – if voters are rational, they shouldn't be fooled by a PBC (short-run employment eaten up by eventual inflation)
- Kaplan: Lately in Latin America, we see COUNTER-PBCs!
  - International explanation: lack of international finance since Latin American Debt Crisis
  - Domestic explanation: Hyper-inflation history makes voters ***"inflation-averse"***

2. Partisan Models

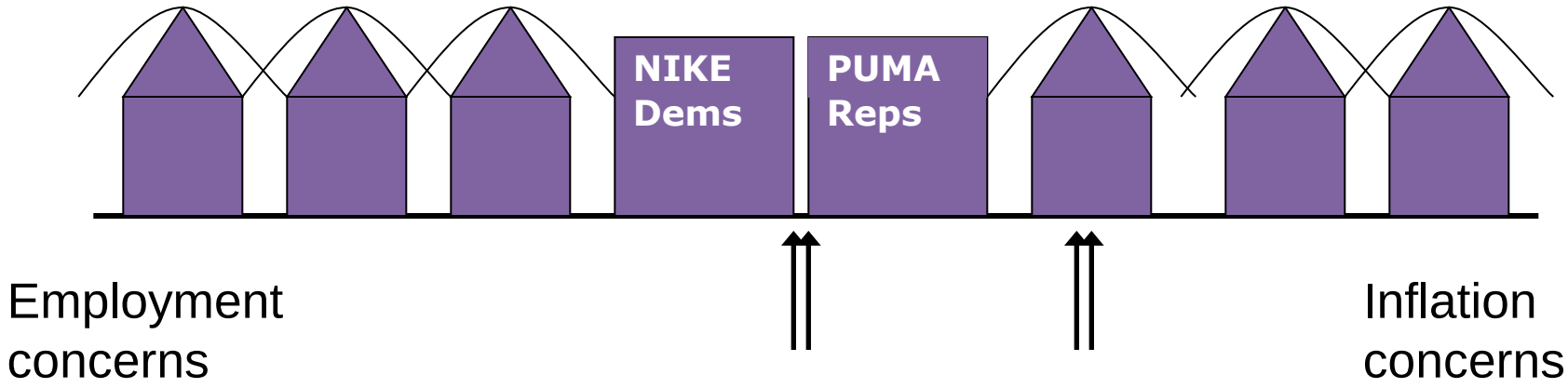


2. Partisan Models

- Left-wing parties are “pro-employment”
  - Tied to organized labor
- Right-wing parties are “anti-inflation”
  - Tied to business interests
- Prediction:
  - Right-wing governments more likely than left-wing governments to establish & maintain a fixed XR
- It is possible to connect this to the electoral model:
  - Voters choose left-wing parties during recessions & right-wing parties under inflation
- Some partisan models suggest, however, *convergence* of party positions (specifically in 2 party systems)

Downs offers a “spatial” model of party competition

- Based on Hotelling’s (1929) model
  - Where should PUMA locate if people shop at stores closest to their house?



Vote single-peaked preferences

In a 2-party system, where will the left & right parties locate?

What happens when somebody decides not to vote?

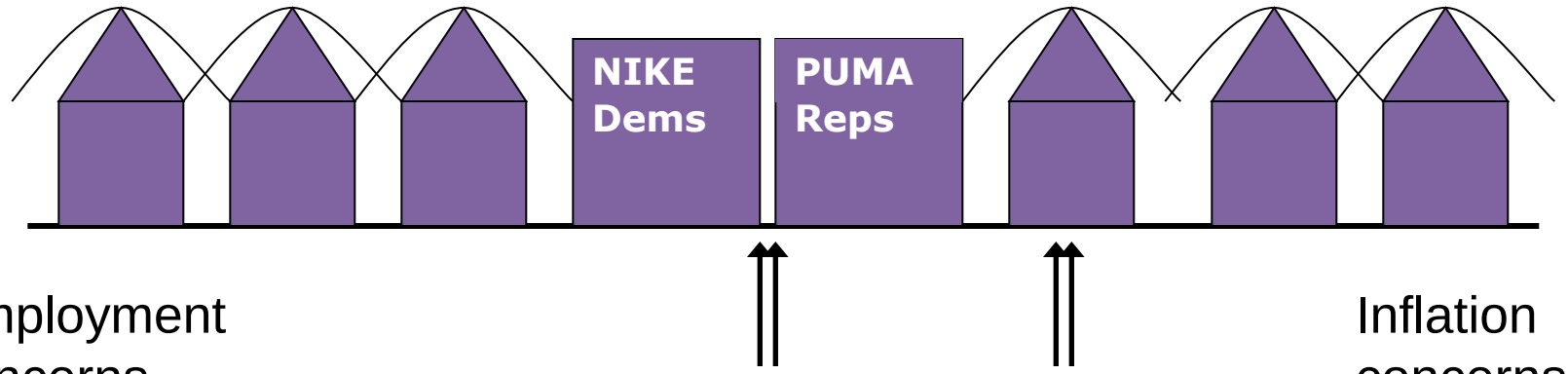
Median preference shifts away from the absent voter

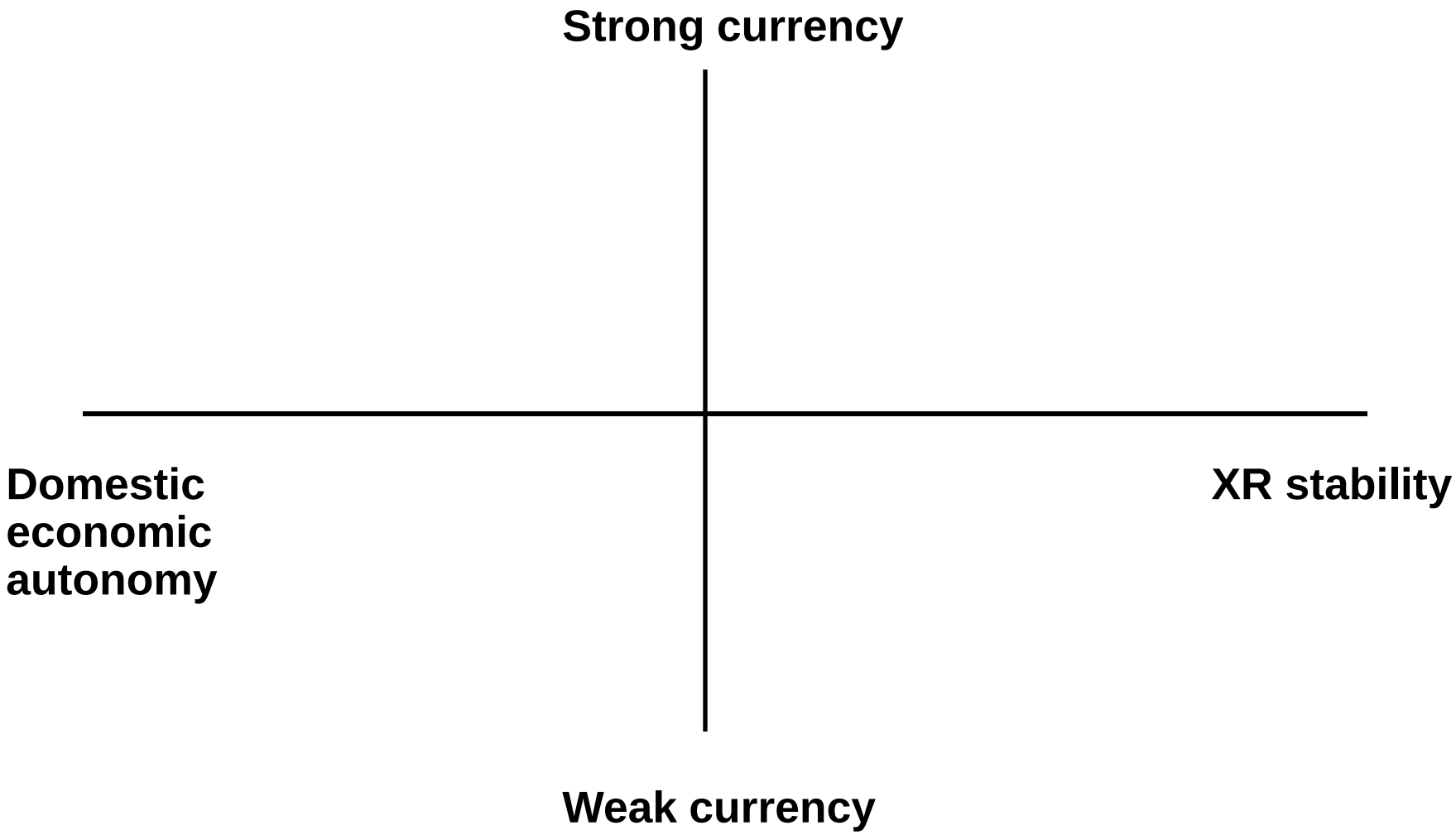
Final thought on “partisan” models

- As we move into “sectoral models,”
- Consider that in the “partisan” model, we have
  - Left – labor-oriented – parties
  - VS
  - Right – business oriented – parties
- What does this “ontology” recall from our trade models?
- What model is based on labor & owners of capital?
- FACTOR MODEL
- So, you can think of the “partisan model” as analogous to the “factor model”

3. Sectoral Models

- Interest groups have different preferences on the trade-off between domestic
  - economic autonomy & XR stability
- Some groups prefer XR stability
- Others groups prefer domestic economic autonomy (sovereign monetary policy)
- Obviously (given the name of the model) the interest groups are based on *sector*


NIKE
Dems
PUMA
Reps
Employment
concerns
Inflation
concerns


Strong currency
Domestic economic autonomy
XR stability
Weak currency

Four domestic interest groups

1. Export-oriented producers
2. Import-competing producers
3. Nontraded-goods producers
4. Financial services industry

Four domestic interest groups

1. Export-oriented producers: Boeing, etc.
2. Import-competing producers: US steelmakers, etc.
3. Nontraded-goods producers: Local hair salon, etc.
4. Financial services industry: Goldman Sachs, etc.

1. What exchange rate regime does your sector likely prefer—fixed or floating?
2. Would your sector benefit more from a strong or weak currency?

Fixed or Float / Strong or Weak?

- Export-oriented producers prefer…
  - **Fixed XR**: stability for their international transactions
  - **Weak XR**: keeps the price of their products world markets low (keeps demand high) ☺

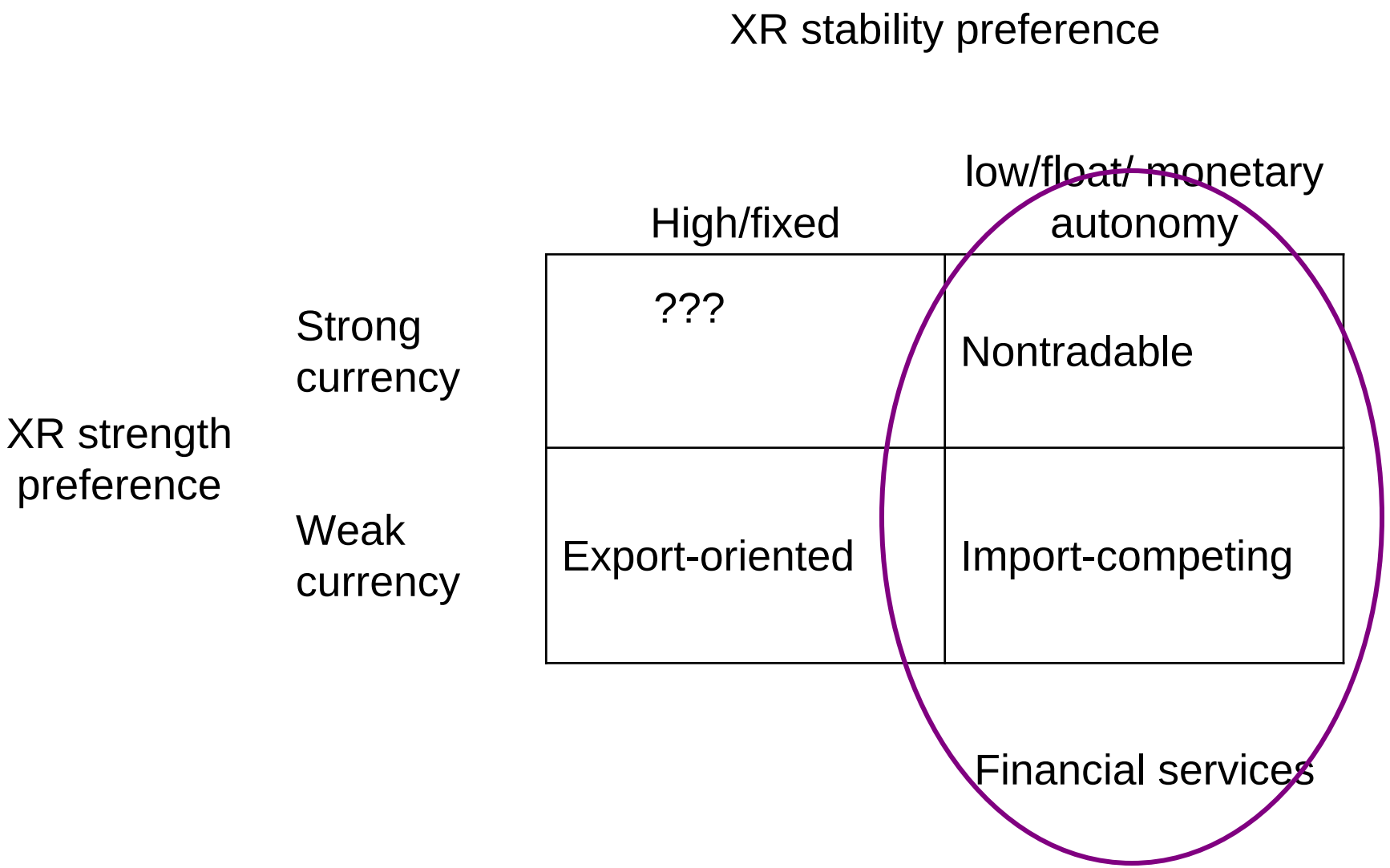
- Import-competing producers prefer…
  - **Floating XR**: prefers monetary policy to address recessions/inflation
  - **Weak XR**: keeps the price of imports high! This spurs domestic demand ☺

- Nontraded-goods producers prefer…
  - **Floating XR**: prefers monetary policy to address recessions/inflation
  - **Strong XR**: consume more traded goods, travel more, pay for tuition ☺

Fixed or Float / Strong or Weak?

- Financial services industry prefer…
  - XR stability leads to more international transactions…
  - But XR volatility leads to XR-risk business…
  - And monetary autonomy helps maintain a stable domestic banking system, low inflation, and more stable interest rates
  - **So: A weak preference for Floating XR**
  - As for currency strength: buy foreign assets when XR is strong, repatriate returns when the XR is weak
  - **So: No preference on XR strength**

Sectoral XR Preferences Summary



Thank You!

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Take-away

1. Electoral models – democracies prefer floating XR
2. Partisan models – left prefers float, right prefers fixed
3. Sectoral models:
   - export-oriented prefers weak, fixed
   - import-competing prefers weak, float
   - non-tradable prefers strong, float
   - finance prefers float (strength doesn’t matter)