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Fixed exchange rates with escape clauses: The political determinants of the European Monetary System realignments

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ABSTRACT

This paper studies the political economy of realignments to fixed exchange rates and suggests that the use of realignments is less likely when there are political benefits from stable exchange rates and when linkages across other issue areas increase the costs of realignment. More specifically for the case of the European Monetary System (EMS), the expectation is that realignments are related to partisanship, support for the broader European integration, trade integration, resource transfers from the European Community, as well as countries reacting to the political and economic costs of realignment in other EMS members. Hypotheses are tested using binomial logit models on monthly data on exchange rate realignments for all EMS countries from 1979 to 1993. I find lower realignment risk for left wing policy-makers and countries with more trade links to Germany, whereas more intra-European Community resource transfers appear to go to countries facing higher realignment risk. Also, realignments are less likely when the rest of EMS member countries have stable international reserves and their governments are pro-European.

1. Introduction

A large literature explores the reasons behind countries' choice of fixed exchange rates.[1] Yet such fixed rates are subject to being devalued or abandoned altogether. Early research on currency crises points to lax monetary and fiscal policies and a steady loss of international reserves as key determinants of fixed exchange rate adjustment (Krugman, 1979). More recent work views exchange rate choices as a continuous cost–benefit analysis (Obstfeld, 1996; Ozkan and Sutherland, 1998; Eichengreen et al., 1995; Klein and Marion, 1997; Ozkan, 2003). Predominantly in this more recent research, however, the optimizing calculus of governments is focused on the effect of macroeconomic variables. My paper analyzes the political determinants of exchange rate realignments with specific application to the European Monetary System.

The argument is that the costs of using exchange rate realignments are higher for those policy makers that derive political advantages from stable exchange rates and are able to link exchange rate policy to a broader set of issues.[2] Specific hypotheses are derived and tested for the use of exchange rate realignments in the European Monetary System (EMS). Extensive research has studied the EMS, yet there is little systematic evidence about the political use of realignments.[3]

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[1] The literature on the choice of exchange rates is extensive (Klein and Schambaugh, 2010).

[2] Politician cost–benefit calculations are used to explain decisions like maintaining fixed exchange rate regimes (Simmons, 1994; Berdiev et al., 2012), responses to speculative attacks (Leblang, 2003), currency depreciation (Simmons, 1994, Frieden, 2002) or currency union membership (Stasavage and Guillaume, 2002).

[3] Eichengreen et al. (1996) and Ozkan (2003) relate the probability of EMS realignments to a set of macroeconomic fundamentals. Other work investigates the determinants of realignment expectations (Rose and Svensson, 1994; Chen and Giovannini, 1997; Siklos and Tarajos, 1996).

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Applied to the context of European fixed exchange rates in the 1980s the argument yields several testable hypotheses. The previous theoretical literature has conflicting expectations about the relationship between partisanship and exchange rate practices (Broz and Frieden, 2001). However, I argue that fixed exchange rates in the context of the EMS offered the European left both a way to purchase credibility in an economic environment favoring neo-liberal solutions and the ability to placate its political constituency. This leads to the expectation that greater left wing representation is associated with relatively infrequent exchange rate realignments. In addition, I derive multiple plausible mechanisms linking exchange rate policy to parallel areas of policy in the European Union. A first mechanism is that domestic actors favorable to European integration more broadly may be willing to bear the costs of fixed exchange rates in the EMS and realign their exchange rate less. Similarly, more trade integration in Europe likely increases the benefits of exchange rate stability, thus reducing incentives to use realignments. Another policy linkage may operate through the European Community budget, and I consider whether intra-community resource transfers are linked in a quid pro quo manner to less realignment or whether such resources go to the countries with high adjustment costs to monetary cooperation. Finally, if realignments damage the credibility of the EMS and European integration more broadly, members can be expected to attempt to reassure markets by showing a united front that projects confidence in the newly negotiated exchange rate parities. This should lead countries to respond to each other's cost/benefit assessment of such realignments.

Logit models and monthly data for all EMS countries (1979–1993) are used to estimate the likelihood that member currencies are realigned against the German currency. The empirical estimations support the political economy hypotheses above. Most robust, realignments are less likely when the left is in power; for countries with more manufactured exports to Germany; for countries with few resource transfers from the European Community; when other EMS countries do not experience international reserve losses and their governments are more pro-European. Some evidence also exists, but is less robust, that realignment risk is reduced by a county's own more positive position on European integration or more left wing representation in rest of EMS member countries.

These results speak to the literature on the politics of exchange rates. In extant work partisanship has not been linked in a consistent manner with exchange rate politics (Klein and Schambaugh, 2010),[4] very likely because the relationship is context driven (Broz and Frieden, 2001). The evidence here is robust in showing that country membership in the EMS changed the interests of the European left making it more adverse to exchange rate realignments. Moreover, while there is evidence for the role of linkage politics in other areas of European integration (Aspinwall, 2007; Carrubba, 1997), for exchange rate cooperation the evidence has been anecdotal.[5] The empirical findings here suggest strongly that exchange rate realignments in the EMS were also the result to the nested nature of the monetary game into the greater European integration. Finally, realignments in particular countries are shown to react to the political and economic costs of other member countries' governments, supporting Gros and Thygesen's (1998) descriptive analysis of EMS realignments as negotiated events.

The paper proceeds as follows: Section 2 describes the working of the EMS. Section 3 lays out the analysis of costs and benefits of realignments and derives testable hypotheses about the actual use of realignments in the EMS. Section 4 describes the data, methods and variables used in the analysis. Section 5 describes the baseline results of the econometric analysis. Section 6 performs robustness checks for the baseline estimates. Section 7 concludes.

2. The European Monetary System

The European Monetary System became operational in 1979 by Resolution of the Brussels European Council and its core feature was the Exchange Rate Mechanism (ERM), which worked as fixed but adjustable exchange rates among the participating countries.[6] To defend exchange rate stability, countries were required to use foreign exchange intervention, domestic monetary policy and economic policy adjustment. While on face value counter to exchange rate stability, adjustment of parities (realignments) were allowed in the EMS, subject to agreement of member countries and the European Commission. In these realignments weak currencies were devalued and strong ones revalued, resulting in a loss of value against the de facto anchor currency — the German Deutsche Mark (DM). The size of realignments varied from the smallest (1% — Belgian franc, 1/1987 to the largest (10.6% — French franc, 6/1982), but their overall size is non-trivial: Over their ERM membership, the Italian lira lost 63% against the DM, the French franc lost 45.2% and the Irish pound 41.4%. Also non-trivial is the frequency of realignments shown in Table 1: For example, Italy realigned ten times, Ireland eight times and France six times.

The origins and the management of the EMS are largely viewed as political rather than economic, yet a systematic examination of the politics of realignment is missing. Frieden (2002) explains that, broadly, Europeans pursued monetary integration despite low labor mobility and asymmetric reaction to shocks. Specifically for EMS' inception, others emphasize the political circumstances of the leaders of Germany and France, the inclusion in the governing coalition in Italy of the Communist Party, a desire to escape the volatility of the US dollar or Chancellor Schmidt's attempt to circumvent the Bundesbank's independence (Gros and Thygesen, 1998; McNamara, 1998). EMS currency realignments continued to be a political enterprise. The Brussels Resolution required that realignments be treated as a common concern, in that "adjustments of central rates will be subject to mutual agreement by a common procedure which will comprise all countries participating in the Exchange Rate Mechanism and the Commission" (Art. 3.2). As Gros and Thygesen (1998: 73–79) point out, realignments, especially when comprehensive, were decided through negotiation rather than unilaterally. Examples involve the successive realignments initiated by France in 1981–1983 in which intense Franco-German negotiations

[4] See also Simmons (1994), Frieden (2002), and Berdiev et al. (2012).

[5] Dyson (1994), Frieden (2001), Martin (2001) and Cohen (2001).

[6] Each currency had a bilateral central rate vis-à-vis all other ERM currencies, with a fluctuation band around it of $\pm 2.25\%$ (6% for Italy, the UK, Spain and Portugal).