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# The political economy of adjustment and rebalancing☆

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ABSTRACT

Debt and balance of payments crises are politically controversial. In the aftermath of such crises, conflict typically breaks out over how the burden of adjustment will be distributed. There is international conflict, between debtor nations and creditor nations, over how outstanding debts will be resolved. And there is conflict within nations, over who will make the sacrifices necessary to get economies back on track. These political conflicts often become so bitter and protracted that they impede productive bargaining over the adjustment process. The characteristics of socio-economic and political divisions within societies affect the battles over economic adjustment, as well as who will emerge victorious from these battles, and how difficult it may be to arrive at a productive resolution of the crisis.



The world's recovery from the Global Financial Crisis (GFC) was extraordinarily slow and difficult. In the United States, it took some fifty months for employment to return to pre-crisis levels. This contrasts dramatically with the norm in American recessions: since the 1930s, employment has on average taken about ten months to return to pre-recession levels.[1] Output, similarly, regained its pre-crisis levels far

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[1] Employment reached pre-recession levels in May 2014. For previous experiences, see http://www.pewresearch.org/fact-tank/2013/09/25/at-42-months-and-counting-current-job-recovery-is-slowest-since-truman-was-president/, accessed May 16, 2014.

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more slowly than in other post-Depression recessions. And five years after the crisis began, median household income was still over 8 percent below its pre-crisis level.[2]

Recovery in Europe was even slower and more difficult. The region fell into a second recession soon after the first one ended; unemployment soared in many countries, and has remained extremely high for a very long time.

The painful recovery was due in part to the severity of the crisis itself. The Global Financial Crisis was, after all, the longest downturn since the 1940s, and the steepest downturn since the Great Depression.[3] But the principal reason for the different experience in the aftermath of this crisis was that this was not a typical cyclical recession, such as developed economies have experienced periodically for hundreds of years. It was, instead, a debt crisis – in fact, a series of inter-related debt crises. We are familiar with debt crises, of course, as they have afflicted developing economies and emerging markets on a regular basis since the 1820s. But the GFC was the first debt crisis in a rich country in decades, at least since Germany in the 1930s. And it was the first debt crisis in history to hit a whole host of rich countries at once.

Debt crises are different from garden-variety recessions, and recovery from them is much more troubled; this much has been extensively documented, especially and most recently by Carmen Reinhart and Ken Rogoff (2009). The differences are both economic and political. Economically, debt crises leave the affected societies with a debt overhang that exercises a serious drag on the economy. Both creditors and debtors focus on restoring their damaged balance sheets rather than on lending and spending, respectively. This much is well-known, and helps explain why recovery from the average debt crisis takes, according to Reinhart and Rogoff, on the order of five to seven years rather than a few months (Reinhart and Rogoff, 2014).

But the intractability of debt crises is not only economic, for every debt crisis leads to political conflicts. These conflicts impede recovery both in and of themselves, and their continuation impedes the ability of policymakers to address the crisis. As an example, a quick look at a recent Reinhart-Rogoff listing of the 30 most serious systemic (national) banking crises since 1857 (not including the GFC) indicates that at least half of them were associated with major political upheavals: revolutions, civil wars, the collapse of democracy into authoritarianism or vice versa.[4] Recent work by Mian, Sufi, and Trebbi shows empirically that financial crises are associated with increased political polarization (Mian et al., 2014). Causation is never obvious – did the severity of the crisis cause political turmoil or did the political turmoil make the crisis more severe? – and probably the arrows point in both directions. Nonetheless, the connection between debt crises and political unrest is clear.

Debt crises typically dissolve into political conflicts over how the burden of adjustment will be distributed. Conflict erupts on two dimensions. Internationally, creditor countries face off against debtor countries over the division of the costs of cleaning up bad debts. Domestically, both within debtor countries and within creditor countries, groups struggle over who will be asked to make the sacrifices necessary to resolve the debt problem. These international and domestic political struggles seriously constrain attempts to arrive at productive and constructive policies that might facilitate a more rapid recovery.

In what follows, I analyze the domestic and international politics of economic adjustment to a debt crisis. These regularities also apply to related balance of payments crises, and to current discussions over "rebalancing," which have to do with the international dimension of adjustment. First, I suggest and analyze the kinds of socio-economic and political divisions we can expect to emerge in the battles over economic adjustment, as well as the factors that help determine who will emerge victorious from these battles. Then I discuss why it is that the political conflicts often become so bitter and protracted that they impede a sensible resolution to the crisis. I start with international conflicts over adjustment, then move on to domestic political battles. In much of what follows, I elide adjustment by debtor and

[2] http://www.pewresearch.org/fact-tank/2013/09/18/four-takeaways-from-tuesdays-census-income-and-poverty-release/, accessed May 16, 2014. For useful data and graphics on these and related comparisons see http://www.minneapolisfed.org/publications_papers/studies/recession_perspective/index.cfm, accessed May 16, 2014.

[3] http://www.nber.org/cycles/cyclesmain.html, accessed May 16, 2014.

[4] Reinhart and Rogoff, 2014, Table 1.