Financial Crises and the Politics of Adjustment and Reform*

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ABSTRACT

This chapter is a critical survey of the literature on international financial crises and their consequences for national politics, with a focus on national-level policy choices and political outcomes. After distinguishing conceptually among adjustment, reform, and political change as three broad families of political consequences to financial crises, it reviews three broad analytical approaches to the study of post-crisis political outcomes. *Interest*-based approaches center on the specific economic consequences of different kinds of financial crises, and look to policy outcomes as a consequence of the interaction between distributional pressures and national political-economic profiles. *Institutional* approaches address the ways in which institutions mediate the articulation of interest group pressures. *Ideational* approaches emphasize the constitutive power of ideas in making sense of financial crises. The concluding section identifies several promising areas for future research, highlighting in particular the importance of international context for conditioning the effects of international financial crises on domestic politics. It also highlights some general methodological problems with studying the highly complex economic and political consequences of financial crises.

Introduction

The chapter is a critical survey of the literature on international financial crises and their consequences for national politics, with a focus on national-level policy choices and political outcomes. The types of financial crises covered in this chapter encompass any crisis that has causes or features that span national borders, and therefore include global or regional financial crises, national banking crises caused by cross-border contagion (due to their cross-border causes), and stand-alone currency and debt crises such as that experienced by Argentina in the early 2000s (due to its cross-border features).

The chapter is organized around the idea that responses to financial crises are necessarily political. While governments' responses to financial crises are surely affected by the severity of the crisis or the precise technical constraints surrounding policy choice, these factors never solely

determine policy responses. Instead, financial crises should be understood to be the sources of political battles, and policy responses must be understood in light of the political context in which adjustment policy decisions are made.

I organize the politics of adjustment policy and reform around three analytical frameworks. The first of these is the *distributional consequences* of financial crises. Financial crises are economic phenomena, and as such, it makes sense to start with their economic effects and the distributional costs that various adjustment and reform strategies entail. The second framework encompasses the *institutional constraints* on economic policymaking. These refer to features such as the distribution of veto players in a political system and the autonomy or insulation of decision-makers from societal demands. Third are the *ideational structures* that mediate policymakers' understanding of what financial crises mean and what a response ought to entail.

This focus on adjustment-and-reform-as-politics draws on the early 1990s literature by policy-oriented economists on the political economy of policy reform (Haggard and Webb 1993; Rodrik 1996; Tommasi and Velasco 1996). However, unlike much of that literature, most of the following discussion will bracket the question of the origins (political or otherwise) of financial crises. Doing so helps to focus the analysis on how policy responses to crises vary, and why. Nevertheless, it is surely true that the same factors that shape national responses to financial crises also determine whether countries fall victim to financial crises in the first place. Acknowledging the conceptual and empirical of studying policy responses to financial crises in isolation from their causes, this chapter maintains a primary focus on post-crisis policy response while reserving a discussion of the origins of financial crises for the conclusion.

The chapter proceeds as follows. The next section provides a brief overview of different possible political consequences of financial crises, both in terms of policy responses and the broader political effects of crises. In doing so, I distinguish the between the short-term process of economic adjustment from the more substantial process of policy reform. An important theme that emerges from this brief discussion is the complex and interactive relationships between crises, policy responses, and political outcomes, which cross-national statistical approaches are not well-suited to exploring. The next section gives more attention to the three analytical frameworks through which to understand the political consequences of financial crises in more detail, addressing the different perspectives that each provides. The final section identifies several promising areas for future research, returning to some general methodological problems with studying the highly complex economic and political consequences of financial crises.

Political Effects of Financial Crises

To fix ideas, it is helpful to classify the consequences of financial crises into changes in policies and changes in politics, and within the former, between adjustment and reform. Table 1 contains a summary of the three different types of consequences, a definition for each, and two examples, one from monetary policy and the other from labor markets.

Table 1: Political Consequences of Financial Crises

Type	Definition	Example: Monetary Policy	Example: Labor Markets
Adjustment	Change in policy settings	Interest rate cuts, quantitative easing	Temporarily extend unemployment benefits
Reform	Change in policy	New monetary policy rule to prioritize low inflation over low unemployment	Change employment regime to provide greater incentives for firms to retain workers
Political Change	Change in distribution of	Elect new government	Relative decrease in

	political power	which will reduce central bank autonomy	bargaining power of non-unionized workers

The conceptual distinction between adjustment and reform lies not only in the duration of the policy change (temporary or permanent), but also in the intention of the policy: to restore or otherwise recreate the pre-crisis status quo (adjustment), or to change the nature of the pre-crisis status quo which created the crisis (reform). Illustrated through the monetary policy example, then, monetary easing is an adjustment measure designed to return the economy to a pre-crisis growth trajectory, while reforming the monetary policy rule conceives of the pre-crisis policy status quo to have been somehow unsuitable for achieving a country's long-term growth potential. This distinction between adjustment and reform will be particularly important in the subsequent discussion of how ideas mediate the relationship between financial crises and their political consequences, for the very understanding of what a crisis is will shape beliefs about the proper responses to it.

Unlike either adjustment or reform, political change describes changes to the relative distribution of political power among various actors within a polity. These changes in relative power or may not generate such observable political events as electoral victories for opposition parties or regime breakdowns. In fact, to the extent that crises shift relative prices (as argued by Frieden et al. 2011), and relative prices affect the material power resources held by social actors, then crises generate political change—by the above definition—almost mechanically. But Frieden et al.'s approach begins by *defining* crises as changes in relative prices, while the approach in this chapter considers changes in relative price changes to be one of many *consequences* of financial crises, which are defined differently according to their specific type

(which include currency crises, banking crises, external debt crises, and others as well; see Reinhart and Rogoff 2009: 3-14).

Distinguishing among adjustment, reform, and political charge conceptually helps to clarify the difficulties in providing any simple theoretical or empirical account of the political consequences of financial crises, due to the complex causal relations among the various potential political consequences. In general and across different national contexts, political conflict over adjustment policy may reflect changes in relative political power among domestic pressure groups. The outcomes of these adjustment policy conflicts, in turn, may not only change the nature of the financial crisis itself (see e.g. Brunnermeier and Oehmke 2012 on "diabolic loops"), they may also shape electoral outcomes or regime trajectories. The new political coalitions that follow may provide opportunities for broad-based economic reform. In short, financial crises may prompt policy changes that lead to political change, or political upheavals that shape policy outcomes, or both at the same time, all while the crisis is ongoing.

From a research design perspective, such massively interactive and endogenous relationships among adjustment, reform, and political change in the wake of financial crises make it difficult to make straightforward causal inferences about the political effects of financial crises. On the whole, it is easier to show statistical associations between financial crises and changes in policies and politics than to provide rigorous theoretical arguments linking one to the other. Cross-national statistical analyses of post-crisis political outcomes (Remmer 1991; Gasiorowski 1995; Wright 2010) or policy reforms (Abiad and Mody 2005; Pepinsky 2012a) will estimate, at best, some sort of average treatment effect (perhaps conditional, perhaps local) of crises on various policy and political outcomes. By focusing on average effects across subpopulations rather than the theoretical mechanisms that mediate the relationships among

crises, policies, and politics, these approaches may implicitly reinforce the perspective that the effects of financial crises on politics and policies are obvious or inevitable. To remedy this, in the next section I focus on the theoretical mechanisms implied by the three analytical frameworks for understanding the political consequences of international financial crises, at the expense of general empirical findings derived from cross-national statistical research.

Frameworks for Crisis Politics

Interests

Financial crises are economic phenomena that have tangible economic effects. In conceptualizing the political effects of crises, it makes sense to focus first on these economic effects. In outlining these effects, it will become clear that lumping together different kinds of financial crises can be highly problematic for the obvious reason that different kinds of financial crises have different economic effects.

Analyzing how economic interests and distributional conflict shape the political effects of financial crises has a long pedigree. It encompasses the “political sociology of political economy” of Peter Gourevitch’s seminal *Politics in Hard Times* (1986), and a focus on distributional politics was one key analytical building block in the classic qualitative comparative literature on crises, reform, and political transitions (Nelson 1989, 1990; Frieden 1991; Haggard and Kaufman 1992, 1995; Schamis 1999; Haggard 2000a; Horowitz and Heo 2001). This approach is also found more recently in analyses of distributional politics during and after financial crises (Pepinsky 2009; Walter forthcoming 2013). More generally, a focus on the economic consequences of financial crises can be grouped under general analyses of stabilization

(Alesina and Drazen 1991) and reform (Rodrik 1996) that emphasize at least in part the distributional consequences of policy choice.

Begin first with currency crises. These can be defined as either “rapid outflows of financial capital in anticipation of a possible currency depreciation” (Athukorala and Warr 2002: 1467)[1] or “a large change of the nominal exchange rate that is also a substantial increase in the rate of change of nominal depreciation” (Frankel and Rose 1996: 351). This two-part definition reflects the circular logic of currency crises, in which beliefs about the sustainability of currency exchange rates may themselves lead to the very exchange rate pressures that make current rates unsustainable.

By the increasing the price of foreign currency relative to the domestic currency, devaluation has clear distributional implications. The direct effect of nominal depreciation is an increase in the domestic price of imported goods, alongside a corresponding increase in the competitiveness of exports. We therefore see a cleavage between import-competing and export-competition sectors in terms of the distributional costs of currency crises. Yet it warrants immediate observation that the distributional “gains” of currency devaluation for export sectors may be swamped by the attendant costs of currency crises as *crises*, which have real effects on economic output through so-called balance sheet effects (Krugman 1999; Frankel 2005), especially in countries which cannot borrow in their own currencies (Eichengreen et al. 2003). In most currency crises, then, the distributional “winners” from currency devaluation are only winners in the relative sense. The most obvious distributional losers include both import-

[1] Authokorala and Warr also hold that these rapid outflows have the effect of “inducing depletion of reserves, financial instability and subsequent economic contraction.” I consider these to be possible effects of currency crises rather than part of the definition of a currency crisis: some countries may float their currencies in order to avoid depleting their reserves, yet we would still consider such countries to have experienced a currency crisis. Note also that this definition excludes pure speculative attacks—those markets by speculation alone, without actual capital outflows—unless these attacks happen to be successful, in which they will be observed as large changes in the level and change of the nominal exchange rate.

competing sectors (through the direct effects of depreciation) and firms that hold foreign currency liabilities (through the balance sheet effect).

Understanding the political implications of currency crises, then, requires mapping these distributional concerns onto existing political configurations. All else equal, importers and foreign debt-dependent firms will find common cause in combating currency collapses. For them, short-term adjustment is critical, whereas the only reforms with obvious policy relevant involve the regulation of foreign-currency borrowing. It should also be true that to the extent to which monetary authorities are aware of the currency composition of their country's private debt (and some may not be, at least prior to the outbreak of the crisis itself) countries with more extensive foreign currency liabilities and larger and more politically powerful import-dependent sectors will be more likely to fight off speculative attacks before they become actual currency crises. There is no real constituency that embraces currency crises, even if some export-competing sectors favor depreciation. However, due to their unequal distributional costs, currency crises should shift the relative balance of political power in favor of exporters. Also relatively favored will be firms that can obtain adequate financing from domestic sources, perhaps through preferential arrangements with the state or protected financial institutions. More generally, the domestic political effects of a currency crisis should be more serious in countries that cannot borrow in their own currency than in the U.S. or the U.K.

Debt crises represent a very different type of financial crisis. In the case of external debt crises (the concern of this chapter) , they can be defined as "outright default on a country's external debt obligations" (Reinhart and Rogoff 2009) as well as the acute threat of such a default.[2] External debt crises pit governments as borrowers against global markets as lenders,

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[2] This additional provision helps to capture cases such as Argentina 1999-2002, in which the crisis been ongoing for years before the actual default.

and for this reason central axis of distributional conflict is international in nature. But citizens of borrowing countries care about external debt crises as well, for two reasons. Governments borrow to (among other things) finance domestic spending, so a borrowing government's sovereign credit rating affects its ability to spend in the future. But repaying external debt means finding the funds to do so, and it is common for negotiated settlements to external debt crises to include spending cuts and other austerity measures. These are designed both to free up the funds for external debt repayment and to discipline profligate spenders.

Does the concern about sovereign borrower's reputation (and therefore the supply of future loans) outweigh short-term concerns about the effects of debt repayment on public spending? Tomz argues that both reputation and adjustment costs matter, but that the distributional costs of sovereign debt repayment fall more heavily on "public sector employees, the unemployed and the poor" (2004: 5) because these groups disproportionately suffer from the costs associated with the sorts economic reforms necessary to facilitate loan repayment. The distributional costs of sovereign default, on the other hand, are highest for groups such as "bankers who borrow abroad and relend at a markup… [and] those who anticipate borrowing for future consumption or investment" (2004: 15). Accordingly, the distributional conflicts activated by external crises differ markedly from that of currency crises, with neither export orientation nor the currency composition of private firms' debt playing an important role in shaping preferences over default, renegotiation, or repayment. As before, understanding the political implications requires mapping these distributional conflicts onto existing political forms. Opposition to external debt repayment during debt crises should be strongest in countries with large public sector wage bills, strong public sector unions, and heavy public dependence on government-provided unemployment and poverty assistance. Unlike currency crises, where

short-term adjustment measures are critical, external debt crises suggest the need for more thoroughgoing economic reform.

Banking crises, again following Reinhart and Rogoff (2009), involve bank runs that lead to either the closure of or government intervention in systemically important financial institutions. Most banking crises are domestic in nature, with a national government intervening in a domestic financial institution using domestic resources. However, domestic banking crises frequently have international causes, which may include "sudden stops" in foreign capital inflows, regional financial contagion, global interest rate shocks, or many others (Kaminsky and Reinhart 2000). For this reason, banking crises are central to most discussions of international financial crises.

In banking crises, the central political cleavage is between creditors and debtors. There are several kinds of debtor-creditor relations, however, which differ according to cross-border relationships and the role of the bank. Table 2 illustrates various types of banking activities and the nature of the creditor-debtor relationship implied by each.

Table 2: Domestic and Foreign Creditor/Debtor Relations

		Creditor	
		Domestic	*Foreign*
Debtor	*Domestic*	**Deposit Taking** Banks as Debtors **Credit Provision** Banks as Creditors	**Intermediation** *Example*: Bank Central Asia in Indonesia **Deposit Taking from Foreigners** *Example*: Landesbanki in Iceland
	Foreign	**Credit Provision by Foreign Banks** *Example*: Allied Irish and Swedbank in the Baltics	N/A

The first set of creditor-debtor relations is domestic: between local banks as borrowers and local depositors as creditors, and between local banks as lenders and loan-recipients as borrowers. Banking crises imply that at least one systemically important bank is unable to service its debt, which for commercial banks implies insufficient funds to cover demand withdrawals. Blanket deposit guarantees are common in advanced industrial economies but rarer in emerging and developing economies; even so, the Global Financial Crisis beginning in 2008 revealed that even advanced economies can find themselves with insufficient deposit protection when it is most needed. The central distributional conflict activated by banking crises is therefore between those for whom bank deposits comprise a substantial portion of their assets and those for whom bank deposits are relatively unimportant. However, this conflict is nearly always muted by the credit making function of banks. Bank failures, which lead to effective decreases on the supply of domestic credit, have aggregate economic consequences such that even non-depositors wish to avoid bank failures. For the purposes of adjustment, then, the policy conflict is over the question of to whom, to what extent, and who what sorts of financial products should deposit insurance be extended.

Of course, resolving banking crises also requires a decision about whether insolvent financial institutions should survive as independent entities. Rosas (2006) colorfully describes the choice as "Bailout or Bagehot."[3] Domestic distributional conflict is more acute on this dimension of policy choice, but perhaps less encompassing (conditional on the successful provision of deposit guarantees). Owners of insolvent banks favor bailouts to takeovers, whereas most everyone else is more likely to support takeovers. This is, again, a question of short-term adjustment to protect financial system stability.

[3] The latter is a reference to Walter Bagehot's (1873) recommendation that banks without an asset base of sufficient quality should be closed rather than bailed out.

The second type of creditor-debtor relationship is between domestic banks as debtors and foreign creditors. Intermediation between foreign lenders and the domestic market is one example. In countries which regulate the commercial presence of foreign banks but maintain open capital accounts (Pepinsky 2012b), this is a common and particularly lucrative practice. Alternatively, banks may take deposits from foreigners, as did Iceland's Landesbanki prior to the 2008 financial crisis. In both Iceland and Indonesia, banking crises created distributional conflict foreign creditors who demand repayment or compensation, and the domestic population tasked with providing those funds when the failed bank cannot—through taxes, austerity, or some other mechanism. Domestically, the distributional conflict parallels that of an external debt crisis, where those groups which benefit disproportionately from public spending suffer relatively more from compensating foreign creditors. Also paralleling external debt crises, resolving such conflicts implies a more serious task of reform than do bank bailouts.

Unlike purely domestic creditor-debtor conflicts, these cross-border distributional conflicts between citizens and non-citizens are much more controversial. As Radelet and Sachs observed with respect to the 1990s emerging market crises, "when a financial crisis arises, it is the debtors who are asked to take the blame. This is odd, since a loan agreement invariably has two parties" (1998: 1). Nevertheless, and again paralleling the case of external debt crises, it is common to argue that the reputation of a national financial system is a public good from which all citizens will benefit. This would imply, for example, that it was in the direct interest of Icelandic citizens to guarantee the deposits of British savers.

The final type of creditor-debtor relationship is between foreign banks operating as lenders within a domestic economy. Since the early 2000s, this has been common in much of the Baltics and Eastern Europe. A banking crisis where the foreign bank is domiciled may generate credit

shortages in the local economy even if there are no other signs of domestic economic distress. The resulting credit crunch, then, can be considered an “exported” banking crisis. In the case of the Baltics in 2008, the global credit crunch following the collapse of Lehman Brothers sharply exacerbated existing financial weaknesses (Åslund and Dombrovskis 2011). In these circumstances, the distributional politics of banking crises are precisely the opposite of the Icesave case: Baltic citizens had a direct interest in the orderly resolution of banking crises elsewhere.

This discussion of currency, debt, and banking crises has demonstrated that each has distinct distributional costs. Rarely are there clear distributional winners to financial crises in absolute terms—each type of financial crisis is a *crisis*—but the costs of adjustment always fall unequally. As such, these economic costs are surely political. Yet even holding aside the effects of institutions, ideology, or the international system, three facts complicate any straightforward prediction about the effects of distributional costs on politics or policy outcomes during financial crises.

First, different types of international financial crises can take place at the same country and at the same time. In fact, this may even be normal: banking crises frequently co-occur with currency crises (so-called “twin crises"; see Glick and Hutchison 1999), and many external debt crises occur with currency crises and/or banking crises (although compared to banking or twin crises, “triple crises” remain comparatively rare; see Laeven and Valencia 2008). Twin crises and triple crises lead to much complicated cleavages, for as Pepinsky (2008: 446) notes with reference to twin crises, the “independence of currency and banking crises mean that decisions to manage one have consequences for the other” (see also Brunnermeier and Oehmke 2012). During twin crises, cleavages form based on cross-border asset mobility, with fixed capital

favoring capital controls to facilitate expansionary macroeconomic policy alongside a managed exchange rate. Yet even those predictions might not hold in the context of a simultaneous external debt crisis, when capital controls might be considered intolerable by foreign creditors.

Second, for many if not most individuals, interests can be hard to describe in any direct way because of multiple overlapping economic interests—a citizen may be an employee *and* a depositor *and* a borrower *and* an investor, all at the same time. The relative importance of each interest can be hard to know, leaving an important role for ideas, information, motivated reasoning, cognitive heuristics, and other non-interest-based factors in determining individuals' expressed preferences. This may help to explain why Tomz (2002) finds that mass public opinion over debt default changed as the Argentine financial crisis of 1999-2002 unfolded.

Third, even when distributional interests are clear, their political effects may be difficult to observe. Even Frieden's (1991) interest-based approach to Latin American politics and policy from the 1960s through the 1980s makes reference to the structure of class conflict, sectoral organization, and other factors that condition the relationship between economic interests and politics during financial crises. This reminds us that economic interests need politics to become policy, and existing cleavages and economic structures will often mask the political effects of distributional costs, or condition the types of political action that are feasible.

Drawing together the above discussion, three general conclusions emerge about the ways in which economic interests shape the political consequences of financial crises. First, the exact nature of the crisis matters: the menu of adjustment policy options differs for countries facing currency and debt crises, and to the extent that incumbent politicians seek to remain in office, the types of domestic political support that they will seek in the context of such a crisis will differ. On the whole, short-term adjustment is most relevant to currency crises and simple banking

crises, whereas cross-border banking crises and external debt crises raises the possibility of deeper structural reforms. Second, given otherwise identical financial crises, national political responses will differ across countries due to existing political configurations and national economic profiles—Gourevitch's "political sociology of political economy." Third, characterizing any individual's "objective" interests during times of financial turmoil can be very difficult. None of these three conclusions should be seen as particularly controversial, but for many scholars, especially those working in the Open Economy Politics (OEP) tradition (Lake 2009), they are the core building blocks for the political analysis of international financial crises.

Institutions

In the policymaking process, institutions are best understood as aggregating preferences, or as a mediating variable that maps interests to outcomes. This perspective does not deny that institutions have a causal role in the policymaking processes: given the same distribution of preferences, different institutions should produce different policy outcomes, and institutions can help to lock in existing economic configurations (Garrett and Lange 1995). But it does conceive of institutional approaches as secondary to interest-based approaches, at best complementing but never replacing a close analysis of distributional interests. In the context of financial crises, then, institutional analysis can help to explain why interests are or are not articulated as a part of policy choice.

Those analytical preliminaries aside, institutions play a central role in the political analysis of financial crises. Especially in cross-national statistical research, it is simply easier to observe domestic political institutions—in particular formal political institutions such as presidentialism-versus-parliamentarism, veto players, elections, and others—than distributional politics. Moreover, it is straightforward to extend standard arguments from comparative politics

to the study of financial crises, adjustment, reform, and political change. Here, I review three forms of institutional variation found to be particularly important in the context of financial crises: democratic accountability, decisionmaking autonomy, and veto players. Despite their centrality to the study of financial crises, across most crises types and most policy choices, very few consistent patterns emerge.[4]

Does democratic accountability or democratic representation affect how countries respond to financial crises? One hypothesis is that democratic regimes should be more likely to channel the interests of a broad section of society than non-democratic regimes (allowing for variation between truly autocratic regimes and party-based or competitive authoritarian regimes, the latter being more responsive than the former). Sovereign defaults, for example, may be relatively more likely in democracies, to the extent that democracies are more responsive to the poor, to public sector employees, and to others who oppose the structural reforms associated with debt repayment. An alternative perspective on the effects of political regimes, however, is that precisely because non-democratic regimes do not benefit from orderly procedures for channeling political discontent, political elites in non-democratic regimes fear the political effects of domestic economic unrest more than do democratic political elites.

Given these two plausible mechanisms that make opposing predictions, it is unsurprising that quantitative evidence on the effects of regime type on post-crisis policymaking or regime transitions remains scarce. For example, in one early and influential study that encompasses much of what literature has followed, Remmer (1986), finds that IMF standby agreements

[4] These three types of formal political institutions, of course, are hardly representative of all "institutional" approaches in comparative political economy. Other approaches, including the Varieties of Capitalism (Hall and Soskice 2001), treat the institutions that undergird capitalist economies as much more encompassing than simply formal political institutions. It is also possible to characterize national "financial system structures" (Allen et al. 2012) as institutional variables as well. The relationship between these more encompassing economic and political institutions and crisis politics is beyond the scope of this short chapter. I thank Mikko Huotari for raising this point.

programs in Latin America were no better implemented in democratic than authoritarian regimes. Construed more narrowly and focusing on adjustment to banking crises in particular, however, there is evidence that democratic regimes are more likely to close insolvent banks than to bail them out (Rosas 2006), that democracies resolve banking crises on terms more favorable to the general public (Keefer 2007), and that the effects of democracy on the orderly resolution of banking crises depend on the severity of the crisis (Montinola 2003). Another twist is Oatley (2004), who embraces both mechanisms and probes how they interact with distributional conflict to argue that authoritarian regimes have more latitude to stabilize (due to fewer constraints) but less motivation to do so (due to less representation).

A second basic debate in comparative political economy considers the benefits of insulating policymakers from democratic politics. This can be done through authoritarianism, as through the "Chicago Boys" in Chile and Harberger's (1993) other "heroes"; or through delegation to autonomous regulatory agencies within a democratic regime, as with independent central banks tasked with maintaining low inflation (see Fischer 1995 for an early review). The question is simple: do technocrats or other policymakers make better decisions if they are given the discretion to "protect the national interest," and to make policies based on long-term economic objectives rather than short-term partisan, electoral, or distributional concerns? In the context of financial crises, this question is particularly acute for two reasons. First, across countries, monetary authorities are among the most independent of policymaking institutions. Second, by their very existence, financial crises suggest a *failure* of regulation or policymaking by monetary or financial authorities, meaning that they themselves must be the targets of reform.

As a result, financial crises threaten the independence of monetary policy authorities and financial regulators. This highlights a central challenge to insulating policymakers from

democratic political pressure: their insulation is most likely to be successful when the political pressure they face is lowest. As Posen (1995: 254) notes, "the preferences for price stability embodied by CBI [central bank independence] require political support. If CBI does not embody such preferences, it will not affect inflation over the long run; if such preferences were universally supported, independence would be unnecessary." Especially in authoritarian regimes and young or fragile democracies, legal independence succumbs quickly to political pressure during financial crises. Of course, this phenomenon is not confined to those cases alone. Most recently, in the United States, the Global Financial Crisis was accompanied by an unprecedented growth in calls for popular oversight of monetary authorities—notably in Congressman Ron Paul's *End the Fed*. The result is that while existing literature in comparative political economy asks about the effects of regulatory autonomy on policymaking, financial crises render that autonomy a central *dependent* variable (see also the discussion in Parsons 2013). Singer (2007) argues that monetary authorities often respond to financial shocks—which can threaten their political independence—by seeking reforms elsewhere, through international regulatory standards that are less vulnerable to domestic political pressure in any one country.[5]

A third institutional factor which can shape the political consequences of financial crisis is the distribution of veto players in a government (Tsebelis 2002). Macintyre (2001) argues that governments may suffer from one of two kinds of policy syndromes during financial crises: volatility or rigidity. Where politicians are constrained by only one or two veto players, policy swings and rapid changes are possible as crises unfold. These volatile policy swings themselves can worsen financial crises by confirming markets' fears that politicians and policymakers are unable to commit to any one course of action. Alternatively, where there is an overabundance

[5] Interestingly, financial crises are also considered to be one main factor driving the *creation* of the Federal Reserve system (Broz 1998). However, Broz's analysis also demonstrates that this institutional reform was driven by the particular interests of New York bankers.

institutional veto gates, the consequence is policy sclerosis: no policy responses to an unfolding crisis are possible, even reasonable and potentially effective ones. In the Asian Financial Crisis of 1997-98, democratic Thailand's inability to respond to rapidly deteriorating economic conditions exemplifies the problems of policy rigidity in the context of short-term adjustment, while the wild swings of Indonesian economic policy in the final months of the highly centralized New Order regime illustrate the problems of policy volatility.

Veto players analysis has proven widely useful in comparative political economy, but the specific theoretical predictions from veto players analysis are about policy volatility rather than specific policy content (see also Ganghof 2003). Thus while Macintyre provides convincing qualitative evidence of the role of veto players in explain rigidity and volatility in Southeast Asia's financial crisis, and Henisz (2004) finds that veto players are associated with decreased policy volatility in the context of macroeconomic shocks, predictions about specific policy choices during financial crises are few.[6] Keefer (2007) finds no evidence that checks and balances affect the resolution of banking crises, and Pepinsky (2012a) finds no evidence that veto players shape capital account policy after currency crises. Van Rijckeghem and Weder (2009) do find that countries with many veto players are less likely to default on their sovereign debt, but only under the precise conditions of lower levels of debt and high financial openness; in other words, in non-crisis conditions.

The summary conclusion from institutional approaches to the political effects of financial crises is that there is surprisingly little evidence that political institutions affect the content of post-crisis adjustment or reform. The partial exception is in the resolution of banking crises. The balance of the evidence places greater weigh on political institutions in explaining the

[6] The same is not true about general findings on the effects of veto players in non-crisis conditions; see e.g. Keefer and Stasavage (2003) on veto players and inflation.

occurrence of financial crises, in particular currency crises (see e.g. Leblang and Satyanath 2006), rather than their resolution. There is evidence that political institutions shape the likelihood of democratic political turnover after financial crises, but once again the effects differ by the specific type of crisis, and all governments, in democracies and dictatorships alike, are threatened by financial crises (Chwieroth and Walter 2010, 2013).

Ideas

Ideational approaches to crisis politics—unlike institutional approaches—are direct competitors to interest-based explanations for post-crisis political change and policy responses. While the ideational turn in comparative and international political economy has a long pedigree (Goldstein and Keohane 1993; McNamara 1998; Wendt 1999; Abdelal et al. 2010), the influence of ideas on the political effects of international financial crises is most forcefully and articulately defended by Blyth (2002, 2003, 2013). Blyth's target is materialist approaches in political science, but finds particular resonance in for crisis politics. In his words, "ideas…provid[e] the authoritative diagnosis as to what a crisis *actually is* and when a given situation *actually constitutes a crisis*. They diagnose 'what has gone wrong' and thus 'what is to be done'" (Blyth 2002: 10, emphasis in original). This challenges the very basic presumption in discussions of economic interests and distributional politics that one can look at crisis types objectively to discern what actors' interests are. It also challenges the analytical distinction between adjustment and reform as based in objective economic conditions.

To be clear, ideational approaches such as Blyth's transcend the perspective that during crises, ideas help actors to select among multiple equilibria, or provide shortcuts to simplify complex interest calculations. That perspective is on the whole sympathetic to the project of OEP. Rather, the perspective is more akin to Wendt's " ideas all the way down" (Wendt 1999). It

is not possible to speak of interests without first addressing how they are constituted by ideas. This is a fundamentally ontological position, and addressing it is beyond the scope of this chapter (for such treatments, see the full texts by Wendt 1999; Blyth 2002). For present purposes, the main implication is that not all ideational approaches for understanding financial crises can be simply tacked onto interests-based approaches in the way that institutions were in the previous section, as helping to explain outcomes above and beyond what material interests can explain. The synthetic, middle-ground perspective found in works such as Horowitz and Heo (2001) is not representative of the broader literature.

The role of ideas in shaping the *origins* of international financial crises, in particular the recent Global Financial Crisis, has been well-covered (see Helleiner 2011 for a review). In characterizing the political effects of financial crises, it is helpful to catalog specific moments at which ideas shape the political effects of financial crises.

First, conditional on the broad acceptance of that a country is experiencing a crisis at all (which may itself be contested), ideas shape understandings the crisis's nature. The economic policy debate in the U.S. since 2008 illustrates this well. This debate involves sharp disagreements about whether the U.S. has experienced a banking crisis, or more seriously, a looming debt crisis (Bohn 2011). Policy debates around the debt ceiling showdown of mid-2011, and the fiscal cliff showdown of late 2012, reveal the centrality of ideas in diagnosing the "true" crisis facing the U.S. economy.

If ideas shape understandings of the nature of crises, then they also shape the logic of policy responses. For example, if a financial crisis is understood to be just a banking crisis, then fiscal consolidation is unnecessary—the task is to adjust, and perhaps to implement some financial reforms. If the crisis is actually an incipient debt crisis, then the long term viability of

the economy is in question—beyond whatever short-term adjustment measures are necessary, this will almost certainly require fiscal consolidation and broader structural reforms. Such a debate is characteristic of the U.S. experience since 2008. The recent Euro crisis illustrates related dynamics; the crisis can be understood as a consequence of fiscal profligacy and weak institutions in peripheral Euro-area economies such as Greece (Petrakis 2012), or of the structure of the Eurozone as a "monetary union without…a political union" (Grauwe 2010). So too the Asian Financial Crisis, as a based on "fundamentals" or "panic" (Noble and Ravenhill 2000). In general, much of the "politics of ideas" in the wake of financial crises involves declarative arguments about what meaning policymakers should attribute to financial crises, and as a consequence, what adjustment measures (or broader reforms) should follow (Demirgüç-Kunt and Servén 2010).

Moreover, even given a common understanding of what the crisis is and whether the task is to adjust or reform, ideas also determine what course of policy is recommended. For example, a Keynesian believes (more or less) that governments can stimulate aggregate demand, especially in a deeply depressed economy where monetary policy has pushed interests rates near the "zero lower bound" (Eggertsson and Krugman 2012). Others believe that this is wrong, so expansionary fiscal policy is not actually expansionary (Taylor 2011). Among economists such debates are pitched in technical terms, but it interesting to read, for example, the reactions and commentary to Delong and Summers' (2012) proposal that expansionary fiscal policy at the zero lower bound is self-financing. Even in this technical discussion of a theoretical model, basic disagreements about what the actual values of key model parameters are many. With such wide latitude for disagreement even among experts, and the highly abstract and technocratic nature of the claims about what basic government policies will do, one suspects that ideological beliefs lie

at the root of actors' understandings of their own policy preferences. Ideas, not objective economic interests or conditions, are what motivate political action.

Macroeconomic policy is just one example among many. In the context of the most severe financial meltdown in the U.S. since the Great Depression, amidst wide agreement that the U.S. faced *at least* a banking crisis (if not something much more) requiring some sort of financial policy response, ideology has played a central role in politicians' advocacy for and against specific packages of financial regulatory reforms (McCarty et al. 2010). Ideas about the desirability and feasibility of controls on short-term capital flows have proven contentious for decades. Most famously, capital controls in enacted by crisis-hit Malaysia in 1998 were considered a highly unorthodox adjustment measure, while Iceland's capital controls enacted amidst its 2008 financial meltdown came with approval from the IMF and the United States Treasury. Gallagher (2012) and Grabel (2013) review the ways in which dominant international ideas about their effectiveness and utility have shifted over time and in relation to major financial upheavals.

The role of ideas in shaping political change after crises—rather than adjustment and reform—is perhaps most significant for political economists. Blyth's (2002) analysis of institutional transformation in Sweden and the United States studies economic crises, but not specifically financial crises; it nevertheless may be interpreted as arguing that the exact nature of changes in relative political power following crises depend on the ideational resources available to different actors. Hall (2003) argues that orthodox economic and financial ideas were instrumental in discrediting the broad mix of policies and political institutions known as an "Asian development model" after the Asian Financial Crisis. More generally, ideas are central to

a recent re-interpretation of the concept of critical junctures (Collier and Collier 1991), as one step in the causal chain between economic shocks to political change (Hogan and Doyle 2007).

In sum, there is broad space for ideas to play a foundational role in adjustment, reform, and political change following financial crises, especially given the complex and contested nature of economic policymaking in conditions of financial meltdown. But as the preceding discussion highlights, there are countless ways in which ideational explanations can be brought to bear to understanding politics after financial crises. The risk here is that the explanatory scope of ideational approaches becomes endless, raising the thorny question of what would constitute evidence that ideas do *not* determine policy responses or political change? Also endless is the collection of ideas that could plausibly exert causal power. For committed advocates of ideas as the constitutive basis for political action, neither of these things is problematic; for scholars seeking to follow Goldstein and Keohane (1993), for whom ideas are one set of variables that interact (or compete) with interests and institutions in explaining policy change and political outcomes, some strategy for dismissing the casual power of ideas or delimiting the scope of ideational variables is necessary for research to progress.

The Agenda Ahead

The Global Financial Crisis of 2008-? has put international financial crises back on the map for scholars of international and comparative political economy (Mosley and Singer 2009; Helleiner 2011; Bermeo and Pontusson 2012; Kahler and Lake 2013; Streeck and Schafer 2013). The ongoing nature of the crisis reinforces that financial crises have political consequences, but also policy responses and political contestation happen under the shadow of interests, ideas, and domestic institutions. The preceding section has reviewed how these three analytical perspectives characterize existing research on the political consequences of financial crises. In this concluding

section, I outline some future directions for research while outlining some methodological concerns that emerge from this discussion.

Perhaps most obviously missing from the preceding discussion has been any serious attention of the international context in which financial crises unfold. There is abundant evidence that financial crises are contagious across national borders (Eichengreen et al. 1996; Kaminsky and Reinhart 2000), and that external borrowing can drive financial crises in various ways (e.g. Bordo 2006; Chinn and Frieden 2011). But international context also shapes policy responses, and perhaps political change as well.

Consider first systemic position. System leaders such as the United States since WWII, or alternatively countries that house money center banks (which would include the United Kingdom and Japan and one or two additional advanced industrial economies today), enjoy a degree of policy flexibility that smaller economies do not.[7] Due to their size and systemic importance, they do not act as price takers in international financial markets, which may free them from the constraints of that small open economies face. Concretely, the distributional costs of monetary easing in the U.S. differ from Mexico, Argentina, or Thailand because the U.S. does not face the threat of massive capital outflows and the accompanying exchange rate pressure. Moreover, system leaders may be able to exert greater ideational pressure against fundamental reforms or political change. For scholars of neoliberalism as a hegemonic idea, the association of neoliberalism with U.S. power may explain its resilience in the face of a systemic financial meltdown which ought to have thoroughly discredited it (for initial evaluations, compare e.g. Duménil and Lév 2011; Mirowski forthcoming 2013).

[7] Such economies also can borrow in their own currencies, meaning that they are less vulnerable to certain types of financial crises in the first place.

The European debt crisis illustrates a different sort of international constraint, one rooted in the specific characteristics of the regional monetary union. As Armingeon and Baccaro (Armingeon and Baccaro 2012a, 2012b) argue, Greece, Ireland, Italy, Portugal, and Spain (GIIPS) simply do not have the adjustment policy options that they would outside of the Eurozone. The implied menu of policy choices available to the GIIPS is internal devaluation, leaving the Euro, or greater fiscal union; the third choice, moreover, is not a decision that any one country can take unilaterally. Given the high costs of internal adjustment—which, despite its name, will require economic reform, especially in countries such as Spain which had not run large deficits prior to the crisis—the ideological power of a common European identity is almost certainly instrumental to the monetary union's persistence. In one recent analysis, "as students of European integration we are intrigued by a currency upheld as a symbol of European integration that is purportedly worth saving at any cost and by the political implications of the recast architecture of European economic governance" (Menz and Smith 2013: 196). The perception that German interests have dominated EU policymaking before and during the crisis (Moravcsik 2012), moreover, reinforces the conclusion that (regional) system leaders have distinct policy advantages in times of crisis.

International constraints also come from international financial institutions, most notably the IMF. Existing research has catalogued well the political motivations of IMF lending (Thacker 1999; Vreeland 2003). Vreeland's research also demonstrates, though, that receiving countries' own motivations for obtaining an IMF loan must be taken into account to understand the effects of IMF participation. Scholarship on how international financial institutions such as the IMF constrain or shape post-crisis policymaking must be similarly attentive to such dynamics, even

when recognizing that the IMF is certainly most influential in countries experiencing financial crises.

Finally, the very “network structure” of the international system might affect the constraints that its constituent members face. Oatley et al. (2013) propose that a network-theoretical approach offers a more explicit understanding of the very structure of the international financial system, one that escape traditional “actor-centric” views. They convincingly argue that states’ position in the international financial network will influence the possibility of cross-border contagion during banking crises, but network structures may have other effects on crisis politics as well. One possibility is that the policy choice set for the United States during the recent financial crisis may differ not because the U.S. economy is large, but because it is a central node in the international financial network. Future research may help to develop clear expectations about such relationships between the network structure of the international financial system and states’ policy responses to financial crises.

Beyond systematically integrating the international environment into the study of adjustment, reform, and political change, future research will also profit from taking seriously the interactions of interests and ideas. In the context of financial crises, one useful alternative to debates about the ontological primacy of interests versus ideas is to develop falsifiable accounts of, first, the structural conditions under which financial ideas find resonance across actors, classes, polities, and world-historical epochs; and second, the concrete strategies through which actors use economic ideas as political resources. Various research programs in political science, international relations, and sociology may be of use in conceptualizing these issues, and Farrell and Quiggin (2012) have probed these issues in the context of Keynesian ideas during the Global Financial Crisis, but falsifiability is the key to advancing what we know about the interaction

between ideas and interests. Surveys and survey experiments might offer one new source of data with the possibility of falsifiable research designs, but in the context of big questions in international monetary relations, individual decisions, beliefs, or preferences may not be particularly relevant (Pepinsky 2013).

A different direction for future research is the cognitive foundations of crisis decisionmaking. The evidence from political psychology, behavioral economics, and related fields is overwhelmingly clear that individuals make systematic departures from standard models of utility maximization.[8] Financial crises—which feature fast moving events, rapidly changing conditions, and information-poor environments embedded in complex strategic interactions—are one context in which instinctual, reactive, and otherwise "non-rational" decisionmaking may prevail. This possibility is a challenge to both interest-based and idea-based approaches to the politics of adjustment and reform, for especially in the context of critical and immediate policy challenges—think of speculation against the Thai baht, or the collapse of Lehman—decisionmakers may be following no "principles" at all.

A final point considers the methodological challenges of studying adjustment, reform, and political change following financial crises. Above, I described the "massively interactive and endogenous" interrelationships among crises, policies, and political outcomes. The challenges of estimating average causal effects using cross-national data are accordingly immense. For any causal relationship, each potential interaction, selection mechanism, or feedback loop increases the sample size required for statistical identification—even assuming away the design challenges for *causal* identification. There just are not enough country-year observations available for cross-

[8] This point is distinct from the critique that utility functions are not hyper-egoistic and exclusively materialist.

national regressions that investigate the complex, conditional, and endogenous relationships that characterize financial crisis politics.[9]

It is striking, in this regard, to observe that most of the standard references on financial crises and post-crisis politics and policy—in economics as well as in political science—are primarily qualitative in orientation (e.g. Gourevitch 1986; Eichengreen 1992; Haggard 2000b; Kindleberger 2000). The same is true of the most important new contributions to understanding the Global Financial Crisis and its political consequences (e.g. Bermeo and Pontusson 2012; Kahler and Lake 2013; Streeck and Schafer 2013). These are works which cannot, by design, test causal claims across time and space.[10] They do, however, combine theory, history, contextual understanding, and frequently statistical data as well to make bounded inferences about the political effects of financial crises, recognizing the inherent complexity and indeterminacy of crisis situations. The result is less a comprehensive and progressive research program where findings build upon one another, and more an increasingly rich understanding of how and when financial crises affect politics.

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[9] The alternative is to ignore the interactions and to define the research question as focusing on unconditional average causal effects. Such approaches tend to yield null results, perhaps precisely because they ignore interactive causal relationships.

[10] Even Reinhart and Rogoff's (2009) quantitative comparative history of financial crises is primarily descriptive.

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