International Political Economy, POLS2094
WEEK 7 2026

Australian National University
School of Politics & International Relations
Richard Frank

General questions for this week

The goal for Week 7 is to expand our understanding of international monetary policy. The main questions we will focus on this week are: What is money? What is the difference between monetary and fiscal policy? How are exchange rates determined, and what are their effects?

Reading notes and questions

Please read the assigned chapter before lecture and tutorial. We will be referring to them repeatedly during the week. For week 7, please read:

Hallerberg et al. 2021. "Chapter 6: Political Economy of International Finance." pp 129-153. [25 pages]

This chapter examines how politics shapes international monetary and exchange rate policies. It begins by explaining key concepts: the balance of payments (tracking international transactions), monetary policy (managing money supply and interest rates), and exchange rates (the price of one currency in terms of another).

It then outlines two main exchange rate systems—floating (market-determined) and fixed (government-pegged)—and explores their respective benefits and costs. It introduces the 'impossible trinity' dilemma whereby countries cannot simultaneously maintain fixed exchange rates, free capital flows, and independent monetary policy.

The historical evolution of exchange rate regimes is traced from the Gold Standard through the Bretton Woods system to today's mixed arrangements. The chapter then analyses why countries choose particular exchange rate policies, considering economic factors (inflation, trade openness), domestic politics (interest group preferences, regime type), and international cooperation mechanisms. Throughout, it emphasizes how exchange rate choices reflect trade-offs between competing economic and political objectives.

Akcay, Ümit, and Ali Riza. 2019. *The Making of Türkiye's 2018-2019 Economic Crisis*. Güngen Working Paper, No. 120/2019. Berlin: Institute for International Political Economy Berlin. [19 pages]

After reading this paper a few times, I am less of a fan of it than I had hoped. A few recommendations when approaching this paper: (1) skip the technical details—don't get bogged down in complex financial data or terminology and focus on the overall narrative. (2) Use figures and tables—pay special attention to Figure 3 (showing relationship between foreign inflows and GDP growth) and Table 1 (showing capital flows). (3) Connect to class

concepts—try and relate the paper to the other reading's discussion of exchange rates, capital flows, and monetary policy independence. (4) Look for political factors—note how elections influenced government decisions to postpone addressing economic problems.

Remember that you are not expected to understand every detail but rather expected to grasp the main arguments about why Türkiye experienced this crisis and what it tells us about similar economies. Namely, economic crises in emerging markets often result from dependency on foreign capital; short-term political considerations can prevent necessary economic adjustments; currency crises can trigger broader economic problems through debt mechanisms; and policy responses often address symptoms rather than underlying structural issues.

This paper analyses Türkiye's 2018-2019 economic crisis, framing it within the concept of 'dependent financialisation'—i.e., when a country's economic growth becomes reliant on capital inflows and cheap credit. The authors identify four phases of Türkiye's financialization since 1989, with the most recent phase (post-2013) characterized by increasing vulnerability to global financial conditions.

The crisis unfolded in three episodes of intensifying economic pressure. While the government successfully postponed collapse in the first two episodes (2013-2014 and 2016-2017) through various interventions, the third episode culminated in the August 2018 currency crisis when the Turkish lira lost 23% of its value. This triggered high inflation, interest rate hikes, and eventual recession.

The government's response included stabilizing the currency, restructuring corporate debt, and enacting temporary tax reductions. The authors argue this crisis reveals the inherent contradictions and limits of dependent financialization, where economic growth becomes unsustainable when global financial conditions tighten.

Reading questions

Remember

1. What is the difference between the current account and capital account in a country's balance of payments? What does a deficit in each account signify?
2. What is the 'impossible trinity' (or trilemma) in international finance? Why can countries only achieve two of the three objectives simultaneously?
3. What were the key features of the Bretton Woods system (1945-1973)? What factors contributed to its eventual collapse?
4. Define and distinguish between the main types of exchange rate arrangements discussed in this chapter: free float, managed float, crawling peg, currency board, and dollarization.

Understand

5. Chapter 6 presents evidence that countries with fixed exchange rates have experienced lower inflation rates. Analyse the causal mechanisms that might explain this correlation. Is it necessarily the fixed rate causing lower inflation?
6. Compare the arguments about whether democracies or autocracies are more likely to adopt floating exchange rates. Which theoretical perspective do you find more convincing based on the evidence presented?

7. How does the concept of 'time-inconsistency problems' help explain why flexibility provisions are built into exchange rate arrangements? What examples can you take away from this chapter.
8. According to Chapter 6, how does political partisanship (left-wing vs. right-wing) affect exchange rate policy choices? What economic and political factors explain these different preferences?

Apply, analyse, and evaluate

9. Consider Figure 6.2 showing average inflation rates across different exchange rate arrangements. How might critics challenge the conclusion that fixed exchange rates lead to lower inflation? What additional data would you want to see?
10. Chapter 6 discusses how remittance flows influence exchange rate policy choices in developing countries. Apply its insight to analyse the exchange rate policy options for a specific country of interest to you that receives significant remittances.
11. The European Union's creation of the Euro represents one of the most ambitious monetary cooperation projects in history. Using Chapter 6's framework, analyse the political and economic factors that motivated this project and the challenges it has faced.
12. Chapter 6 mentions that cryptocurrencies like Bitcoin represent a new feature of the global financial system. How do cryptocurrencies potentially challenge traditional exchange rate policies and central bank authority? What implications might this have for the future?
13. Consider a recent currency crisis in an emerging market (such as Türkiye in 2018-2019, discussed in the other reading). Using concepts from this chapter, analyse what exchange rate policy options were available to policymakers and the trade-offs each option presented.

LECTURE—International monetary relations

Part I: Introduction—What is Money?

Semester topic overview

Week 1: Introduction **(RF)**
Week 2: Classical perspectives and contemporary approaches **(KZ)**
Week 3: Free trade and domestic preferences **(KZ)**
Week 4: Trade from preferences to policies **(KZ)**
Week 5: Global trade governance **(KZ)**
Week 6: Foreign direct investment **(KZ)**
Week 7: Money **(RF)**
Week 8: Finance **(RF)**
Week 9: Foreign aid and development **(RF)**
Week 10: Energy and the environment **(RF)**
Week 11: Illicit economies **(RF)**
Week 12: Conclusions **(RF)**

The first half of the semester explored the interaction between economics and politics.

Specifically, we focused on two fundamental areas of IPE overlap—trade and foreign direct investment.
The second half of the term turns to governmental monetary and fiscal policies and their impacts on development, the environment, and illicit trade.

Today's motivating questions

What is money?
What is the difference between monetary and fiscal policy?
How are exchange rates determined, and what are their effects?

What is money?

A medium of exchange
A store of value
A unit of account

Money as a medium of exchange

Money functions as a medium of exchange by serving as an intermediary in transactions, which eliminates the inefficiencies of direct barter.
This is perhaps the most fundamental function of money in an economy.

We have seen trade as a form of exchange

As a medium of exchange, money allows people to trade goods and services indirectly.
Rather than having to find someone who both has what you want and wants what you have (the "double coincidence of wants" problem in barter systems), money creates a two-step process: you sell your goods/services for money, then use that money to buy what you want.

Key characteristics of a medium of exchange

General acceptability—People must be willing to accept it in exchange for goods and services. This acceptance can be based on government decree (legal tender), social convention, or inherent value.
Portability—Money needs to be easily transported to facilitate trade.
Divisibility—It must be possible to make change for different transaction values.
Durability—Money should not deteriorate quickly with handling.

Applicability of mediums of exchange

In the international monetary system, currencies vary in their effectiveness as mediums of exchange beyond national borders.
The US dollar serves as the primary international medium of exchange for several reasons:
It is used in pricing and settling international trade (especially commodities).
It dominates interbank transactions.
It is widely accepted across borders even in informal transactions.

Network effects

This international medium of exchange function creates what economists call network effects: the more people accept a currency, the more valuable it becomes as a medium of exchange, reinforcing its dominance.
This helps explain why dominant international currencies are difficult to displace, even when their issuing countries' economic weight diminishes.
The medium of exchange function also interacts with exchange rate regimes.

Countries often manage their exchange rates partly to ensure stability in the purchasing power of their currency for international transactions.

Money as a store of value

Money serves as a store of value through its ability to preserve purchasing power over time.
As a store of value, money allows individuals to defer consumption from the present to the future.
When you earn income today but do not need to spend all of it immediately, money provides a way to store that economic value for later use.
For money to function effectively as a store of value, it needs to maintain relatively stable purchasing power.
This is why inflation is so problematic.
When the general price level rises significantly, money loses its effectiveness as a store of value because the same amount of currency purchases fewer goods and services over time.

Different forms of money vary in their effectiveness as stores of value

Fiat currencies (like the USD or euro) rely on central bank policies maintaining price stability.
Commodity-backed money (like the gold standard) derives its store-of-value function from an underlying commodity.
Cryptocurrencies like Bitcoin aspire to be stores of value
Their fixed supply may make them superior to fiat currencies.
Price volatility currently undermines this function.

International store of value

The store-of-value function is particularly critical in international contexts.
When countries experience high inflation or currency crises, their citizens often seek alternative stores of value, whether foreign ‘hard’ currencies, precious metals, or digital assets.
In the international monetary system, the relative effectiveness of different currencies as stores of value creates hierarchies, with reserve currencies at the top. This contributes to what economists call the ‘exorbitant privilege’ enjoyed by issuers of reserve currencies and shapes the dynamics of global financial flows and exchange rate regimes.

Money as a unit of account

Money functions as a unit of account by providing a standard numerical measurement of the value of goods, services, and assets.

Money allows economic actors to:

Price goods and services—When everything is denominated in the same unit (dollars, euros, yen, etc.), comparing relative values becomes straightforward.
Calculate profits and losses—Businesses can measure performance over time using consistent monetary units.
Record debts and credits—Loans, financial assets, and liabilities can be precisely quantified.
Make economic calculations—Complex decisions involving multiple goods and time periods become tractable.

A unit of account in the international monetary system

Invoice currencies—International trade is often denominated in certain currencies (particularly the USD) even when neither the importer nor exporter uses that currency domestically.
Currency anchors—Many countries peg their exchange rates to a major currency, effectively borrowing its stability as a unit of account.
International accounting standards—Multinational corporations must choose which currency to use as their primary unit of account for financial reporting.

Importance of an international unit of account

The selection of which currency serves as an international unit of account has significant implications.
It provides the issuing country with advantages, as foreign entities must acquire that currency or hedge against its fluctuations.
This is one aspect of the exorbitant privilege enjoyed by reserve currency issuers.
When a currency becomes unstable due to high inflation, its unit of account function breaks down.
This can lead to domestic 'dollarization' where another currency takes over this function, limiting monetary policy effectiveness and complicating exchange rate management.

Why is money useful?

Money is a system of value that facilitates the exchange of goods.
The use of money eliminates the problem of bartering where both parties must have something the other wants or needs.
Historically, the first forms of money were agricultural commodities, such as grain or livestock.
Today, most money systems are based on standardized currencies that are controlled by central banks.
Recent years have witnessed the digitisation of money.

Part II: Monetary policy, fiscal policy, and exchange rates

The international monetary system

> The international monetary system defines the world of global finance in which countries and other economic actors exchange currencies for the purpose of investment or buying and selling goods and services.
>
> The monetary system consists of rules and agreements that govern the use and exchange of money between countries. Each country has its own currency and money.
>
> The international monetary system governs the rules for valuing and exchanging these currencies. Therefore, the international monetary system revolves around exchange rates and the institutions that help countries in financial distress.

What value money has and how it is spent are determined by monetary and fiscal policy.

What are the important elements between monetary and fiscal policy?

	Monetary policy	**Fiscal policy**
Definition	Actions taken by a country's central bank to influence the money supply, interest rates, and credit availability.	Government decisions about taxation and spending to influence the economy.
Who implements?	Central banks (like the US Federal Reserve, European Central Bank in the EU, or the Bank of England	Government legislative bodies and executive branches
Main tools	Setting interest rates; Buying/selling government securities (open market operations); Changing bank reserve requirements; Quantitative easing during extreme circumstances	Government spending (infrastructure, social programs, etc.); Taxation (income taxes, corporate taxes, consumption taxes); Transfer payments (social security, unemployment benefits); Government borrowing/debt management
Goals	Controlling inflation; promoting economic growth; ensuring financial stability; managing unemployment	Economic growth and stability; Income redistribution; Public goods provision; Employment creation
Speed	Generally faster than fiscal policy	Generally slower to implement due to political processes

Key differences

Authority—Monetary policy is typically implemented by independent central banks, while fiscal policy is enacted by elected governments.
Political influence—Fiscal policy is directly subject to political processes and voter preferences, while monetary policy is generally more insulated (though still influenced by politics).
Flexibility—Monetary policy can be adjusted more quickly, sometimes within days or weeks, while fiscal policy changes often require lengthy legislative processes.

Target precision—Fiscal policy can be targeted at specific sectors or groups, whereas monetary policy affects the entire economy more broadly.
International constraints—In currency unions like the Eurozone, countries surrender independent monetary policy but retain fiscal policy autonomy (though with constraints).

Exchange rate policy

Exchange rate policy exists at the intersection of monetary and fiscal policy, though it is more closely aligned with monetary policy.

Relationship to monetary policy

Exchange rate policy is primarily connected to monetary policy for several reasons:
- Central banks typically implement both monetary and exchange rate policies.
- Interest rate decisions directly affect currency values.
- Foreign exchange market interventions involve the same institutions that conduct monetary policy
- The 'impossible trinity' (trilemma) demonstrates how exchange rate regimes constrain monetary policy options

When a country commits to a fixed exchange rate, it effectively surrenders monetary policy independence under conditions of free capital flows.

Relationship to fiscal policy

Exchange rate policy also interacts with fiscal policy through:
- Government borrowing in foreign currencies affects exchange rate vulnerability.
- Fiscal deficits can put pressure on exchange rates.
- Fiscal policy may need to adjust to support exchange rate targets.
- Government spending decisions influence inflation, which affects real exchange rates.

Different exchange rate regimes

The choice of exchange rate regime reflects broader macroeconomic policy priorities:

Fixed exchange rates—Prioritize price stability and trade certainty over monetary autonomy.
Floating exchange rates—Prioritize domestic policy independence over exchange rate stability.
Managed floats—Attempt to balance these competing objectives.

Institutional considerations

In most countries, exchange rate policy involves multiple institutions:
- Central banks implement day-to-day exchange rate management.
- Finance ministries/treasuries often set broader exchange rate strategy.
- Legislative bodies may establish the legal framework for exchange rate regimes.
- International organizations (i.e., the IMF) provide oversight and coordination.

This institutional complexity makes exchange rate policy a unique domain that bridges monetary and fiscal policy while adding distinctive international dimensions to macroeconomic management.

The Monetary Trilemma

Fixed exchange rates
Independent monetary policy
Free capital mobility

It is impossible to achieve all three simultaneously.

PART III: A brief discussion of the historical evolution of exchange rate regimes

The Gold Standard Era (1870s-1914)

Fixed exchange rates with currencies pegged to gold.
Pros: Exchange rate stability promoting trade and investment
Cons: Limited monetary policy autonomy, susceptibility to banking crises
Financial stability was not guaranteed despite fixed rates.
Banking panics occurred regularly (e.g. 1873, 1907)

The Interwar Period (1918-1939)

Failed attempts to restore gold standard
Great Depression and competitive devaluations
Financial instability and banking crises
Deflation and financial collapse accelerated by rigid adherence to gold.

The Bretton Woods System (1944-1971)

Fixed exchange rates with the US dollar as anchor, dollar pegged to gold.
Capital controls enabling monetary policy autonomy.
Creation of international institutions: IMF and World Bank
System prioritized exchange rate stability but neglected financial stability.
It collapsed due to:
- Growing capital mobility eroding policy autonomy
- 'Triffin Dilemma': a conflict between US domestic goals and international role
- Dollar overvaluation and imported inflation for other countries

The Post-Bretton Woods Era (1973-Present)

Floating exchange rates among major currencies
Gradual capital account liberalization
New forms of financial instability despite greater exchange rate flexibility

Some examples of exchange rates over time

Australia/US exchange rate over time

UK/US exchange rate over time
China/US exchange rate over time

PART IV: Theoretical frameworks

Monetary Trilemma

Originated with works by Fleming (1962) and Mundell (1963) on open economy macroeconomics

The fundamental constraint

A country cannot simultaneously maintain fixed exchange rates, independent monetary policy, and free capital mobility

Historical choices
- Gold Standard era—Fixed rates + capital mobility (sacrificed monetary autonomy)
- Bretton Woods—Fixed rates + monetary autonomy (restricted capital flows)
- Post-Bretton Woods—Monetary autonomy + capital mobility (flexible exchange rates)

Empirical evidence on the trilemma

Monetary autonomy (Obstfeld, Shambaugh & Taylor 2005)
- Fixed exchange rates with open capital accounts show high interest rate correlation with base countries
- Floating rates or closed capital accounts provide monetary autonomy

Real economic effects (di Giovanni & Shambaugh 2008)
- Economic growth in pegged regimes more affected by base country monetary policy

Exchange rate flexibility is a shock absorber
- Evidence from terms-of-trade shocks (Broda, 2004)
- Commodity price fluctuations better absorbed under floating regimes

The "Dilemma not Trilemma" challenge

Global financial cycle dominates regardless of exchange rate regime (Rey 2013)
US dollar affects others' exports due to exchange rates (Bruno & Shin 2015)
- Dollar appreciation tightens global financial conditions via bank balance sheets

Exchange rate flexibility still provides partial insulation, but financial variables show greater co-movement across regimes (Obstfeld, Ostry & Qureshi 2019)

Distributional politics of exchange rates

Financial sector interests vary with international exposure.
Sectoral interests can shape exchange rate preferences.
- Exporting sectors favour stable exchange rates.

Non-tradable sectors and import-competing industries prefer monetary autonomy.

Exchange rate policy is thus a distributional conflict between domestic interests.

Domestic political institutions filter interest group pressures.

"Where political decision making is opaque (autocracies), governments must look to a commitment that is more transparent and constrained (fixed exchange rates) than the government itself. The transparency of the monetary commitment substitutes for the transparency of the political system to engender low inflation," (Broz 2002: 861)

"In systems where the cost of electoral defeat is high and electoral timing is exogenous, politicians will be less willing to forgo their discretion over monetary policy with a fixed exchange rate. In systems where the costs of electoral defeat are low and electoral timing is endogenous, politicians are more likely to adopt a fixed exchange-rate regime," (Bernhard & Leblang 1999: 71).

Central bank independence correlates with floating regimes (Bearce 2008).

Partisan politics and exchange rate preferences

Left-leaning governments typically favour monetary autonomy.

Right-leaning governments often prioritize exchange rate stability.

Time inconsistency problems and credibility

Politicians face incentives to renege on monetary commitments. (Kydland & Prescott, 1977; Barro & Gordon, 1983)

Exchange rate pegs can serve as commitment devices.

"Importing credibility" from anchor countries

Evidence from post-inflation stabilizations in Latin America

Institutional design innovations

Currency boards and dollarization serve as extreme commitment mechanisms

Inflation targeting as alternative credibility strategy.

Cryptocurrencies and the international monetary system

Decentralized digital currencies are potential challengers to state monetary sovereignty.

Bitcoin and other coins are private alternatives to national currencies.

Central Bank Digital Currencies (CBDCs) as policy response.

Regulatory approaches range from prohibition to accommodation.

Crypto's monetary implications

Cryptocurrencies represent both technological innovation and a fundamental challenge to the state-centric international monetary system

Capital flight facilitated and reduced monetary control in emerging economies

Exchange rate volatility and transmission mechanisms

Financial stability and regulatory arbitrage

International payment systems and cross-border settlement

PART V: Türkiye case study

Türkiye case study

It illustrates the challenges faced by emerging market economies in the international monetary system
It demonstrates the practical constraints of the monetary trilemma
Its experience highlights how domestic politics intersects with international financial pressures
The country has experienced multiple phases of financial development that align with global trends

Four phases of Türkiye's monetary and financial evolution

Phase 1 (1989-2001)

1989—Capital account liberalization without adequate institutional safeguards
High inflation, volatile capital flows, and fiscal dominance
Banking system primarily channelled resources to government debt.
Culminating in the 2001 crisis

Phase 2 (2001-2008)

IMF program implementation
Central bank independence
Inflation targeting regime adoption
Banking sector restructuring
Türkiye tried to adopt all three—floating exchange rate, capital mobility, independent monetary policy

Phase 3 (2008-2013)

Türkiye was initially successful in navigating the global financial crisis
Massive capital inflows due to quantitative easing in advanced economies
Credit boom and increasing household debt
Growing current account deficit
Non-financial corporate sector increased foreign currency borrowing

Phase 4 (2013-now)

Gradual erosion of central bank independence
Growing political influence over monetary policy
Currency crises (especially 2018)
Inflation roared back.
Demonstrates the limitations of dependent financialization

The monetary trilemma in practice

Türkiye tried to navigate the corners of the trilemma over time.

2001-2013—embraced floating rates, monetary independence, capital mobility
Later attempted to maintain all three elements, creating tensions
Eventually sacrificed monetary independence for political objectives.

Financial stability and exchange rate policy

Corporate foreign currency borrowing created financial fragility.
Currency depreciation exacerbated debt problems

Lessons from Türkiye's experience

The challenges of emerging market monetary policy in a globalized world
The importance of institutional independence for central banks
The risks of dependent financialization
The role of political factors in monetary policy decisions
Electoral cycles influenced policy decisions.
Reliance on foreign capital creates vulnerability
Global monetary conditions affected this and other emerging markets.
A manifestation of the monetary trilemma
The limitations of exchange rate flexibility as a shock absorber

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Part VI: Conclusions

Today's motivating questions

What is money?
A medium of exchange
A store of value
A unit of account

What is the difference between monetary and fiscal policy?
How are exchange rates determined, and what are their effects?

Important terms (in no particular order)

Week 7		
Balance of payments (BOP)	Gold standard	Foreign exchange reserve
Capital account	International Monetary Fund	Monetary policy
Current account	Remittances	Exchange rate
Central bank	Unit of account	Spot/forward exchange rate
European Monetary Union	Store of value	Appreciation/depreciation
Fixed/floating exchange rate	Medium of exchange	Crawling/adjustable peg
Pegged within a band	Dollarisation	Bretton Woods system
Fiscal policy	Cryptocurrency	Monetary trilemma