Escaping the Trilemma: Exchange Rates and the Domestic Politics of Cheap Credit

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Abstract

Recent work (e.g., Schularick and Taylor 2012) highlights surges in private domestic credit as the primary correlate of financial crises yet offers few explanations for the substantial variation in credit growth across time and space. We argue that governments encourage credit growth as an instrument of economic stimulus when they face constraints on the use of traditional monetary and fiscal policies because of their exchange rate, monetary, and financial commitments, in line with the Mundell-Fleming “trilemma.” Specifically, we argue that governments under more stringent trilemma constraints will be more likely to reduce legal reserve requirements for banks—a key policy instrument which increases banks’ incentives to provide credit—in order to compensate for their inability to pursue expansionary monetary and fiscal policy. We test this argument on a sample of more than 50 middle- and high-income countries from 1970 to 2014, and find strong evidence that more extensive trilemma constraints have a significant effect on both private credit growth and legal reserve requirements for banks. This effect is especially pronounced within the Eurozone, as well as within the broader subsample of countries with “permanent” currency pegs (monetary union, dollarization, currency boards), where exchange rate regime choice is plausibly exogenous to credit growth. Furthermore, we find that this effect is conditional on government partisanship and the state of the economy: trilemma constraints “bind” most tightly for left-wing governments and in times of rising unemployment and inequality. These results strongly suggest that the credit booms underlying financial crises have deeply political roots in countries’ trilemma choices and the “golden fetters” which these impose.