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The Political Economy of Monetary Followership in
Surplus Countries. The divide between Small and
Middle Powers

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Introduction

This research is about the impact of states' financial size on their choices in the field of monetary and exchange rate policy. The main argument of the thesis is that small countries, under certain conditions, can be counterintuitively more autonomous in these policy dimensions than middle-sized states. This conclusion, and its corollaries, proceed from the unsatisfactory explanation given by the present literature, in both economics and political science, to the policy outcomes observed in small states, and results from an original application of the Collective Choice Theory to strategic interactions within asymmetrical monetary systems. A model is designed to depict an international payment system led by a leader country with significant balance-of-payment problems, surrounded by minor states characterised by a persistent record of current account surplus. The model investigates the impact of financial size on the bargaining among small and medium-sized states for the preservation of policy autonomy vis à vis an interdependent economic environment. States are supposed to select one of two alternatives between following the leader's policies, so as to support the stability of the system, or remaining neutral, so as to pursue domestic-oriented goals. The results, both on the theoretical and the empirical side, show that small surplus countries, under the assumptions of the model, are averagely more autonomous than middle powers, that is, less prone to take on responsibility for the smooth functioning of an international payment system. In turn, this makes traditional theories incomplete in the explanation of monetary followership in small countries, while the present model explains this phenomenon through the action of neighbouring middle powers in providing selective incentives.

Besides the specific contribution of International Political Economy (IPE), the issue of states' size and its impact on international politics has been widely addressed by both economics and International Relations. On the one hand, early studies on alliance formation have since the beginning investigated the peculiar incentives and constraints of small states in the choice over different alliance strategies such as balancing, bandwagoning and neutrality vis à vis major powers. Similarly, another strand of literature looks at the effect of dimension over policy outcomes considering size as a proxy for a state's relative capacity for influence. This rational-choice approach, derived

from Collective Choice Theory, has contributed since the 1960's to improve our interpretation of state-to-state negotiations within military alliances showing an unsuspected bargaining advantage in favour of small states, summarised in the well-known «*small-exploit-the-large*» statement common to its major works. Within asymmetric alliance arrangements, small states can actually escape their contribution in terms of military spending thanks to the insignificance of their contribution for the overall balance of power.

On the other hand, economic theory offers a completely different perspective, as the role of dimensional constraints is at the base of open macroeconomics through the divide between *price-makers* and *price-takers*. The former indicates a large market whose trade or financial flows are able to modify international prices and other significant variables simply by changing their volume and direction. The latter defines a small market acting under the exogenous constraint of prices taken as immutable and decided by international markets. In studying the effect of domestic-market size on trade policy, currency movements and vulnerability to external shocks, international economists have always remarked that what may be profitable for larger price-makers, such as applying an optimal trade tariff or manoeuvring on exchange rates to gain competitiveness, can be bad or at best useless for small price-takers, where restrictions to trade and financial interdependence are more likely to backfire through raising prices and increasing unemployment. Contrary to IR studies, economic theories have assumed a rather pessimistic stance, where being a price-taker has practically no advantages in international economic relations, and turns small states into passive receivers of policies and decisions made by major foreign actors, whether good or bad for the local economy.

In this context of ambiguous and contradictory predictions, the IPE literature, particularly in the subfield of international monetary relations, has frequently reproduced the different conclusions of either economics or International Relations. On the one hand, early theories on the functioning of the international monetary system, focusing on the impact of systemic-structural variables and the interactions between great powers and followers, have taken the size-optimist stance of security studies. The most famous example is Charles Kindleberger's Hegemonic Stability Theory, suggesting that dominant states provide unilaterally the instruments for the stability of an

international financial system, while in periods of economic distress smaller states would indiscriminately free-ride through beggar-thy-neighbour policies. On the other hand, econometric studies on large panels, focusing on domestic variables and cross-country variance, found on the contrary that small economies renounce to exchange-rate flexibility and policy autonomy more often than large developed states, promoting instead a size-pessimist interpretation borrowed from international macroeconomics. Similarly, 'coercive' hegemonic theories, from the contribution of Robert Gilpin to the recent 'passive leadership' approach to asymmetric monetary systems, have stressed the bargaining weakness of minor states against major powers and its negative consequences on their policy-making autonomy.

Overall, both approaches suffer from two evident and significant shortages. The first is to make no efforts to reconcile the contrasting views of size-pessimism and size-optimism. Even though scholars have collected evidence in one sense and the other, it is still unclear under which conditions 'smallness' can be an advantage or a disadvantage. The second is to ignore the different position of middle-sized states within the group of minor countries, and especially, the interactions between middle and small powers as potential co-determinant of policy choices besides the univocal relation with the dominant great power. The purpose of this research is to fill these gaps shading new light on the effect of states' size (that is, being small or middle states) in the struggle to preserve autonomy against the cage of financial interdependence and the pressure of great powers. My argument is that neither size-optimism nor size-pessimism should be given for granted when approaching the issue of monetary relations. Rather, a country's external financial position vis à vis the world economy – namely, whether it is a net debtor or a net creditor – leans the condition of minor states towards one of the two archetypical models. While deficit or debtor economies tend to reproduce the expectations of the macroeconomics literature, with small states disadvantaged by the insignificant size of their financial markets, the situation is reversed for countries with a structural current account surplus, whose situation strikes as better depicted by the small-size advantage suggested by Collective Choice Theory. Given the lesser attention received so far by these countries, the thesis deals precisely with strategic relations in the group of surplus states.

Obviously, such a clear-cut definition of the relevant actors can create problems and inconsistencies concerning the thresholds and indicators used for their identification. On the one hand, the divide between surplus and deficit countries refers to the solvency position of a country vis à vis international financial markets. However, the one-year trend of the current account is hardly a sufficient indicator of this condition, and solely a persistent or prolonged accumulation of imbalances will be considered to make a country solvable or potentially insolvable on international markets. In turn, this opens another discussion on how long the trend on the current account should be for causing significant effects on a country's external position. For simplicity, I assume that after some years of structural current account surpluses or deficits all economies start experiencing significant market pressures to adjust, as testified by numerous studies on cross-border financial crisis and macroeconomic imbalances. Nonetheless, I disregard any attempt to provide a precise quantification of this period. Accordingly, I suppose that other things being equal surplus states show a long-term upward pressure on the local currency, and vice versa for deficit states.

On the other hand, also the dichotomy between small and medium-sized powers can be traced along several dividing lines. *Prima facie*, the international politics of money and exchange rates may seem a field where looking at the effect of states' size on policy outcomes is somewhat puzzling. In the contemporary world economy, small states like Singapore, Sweden or Norway can look at themselves as relevant powers in the financial field despite lagging far behind major states in terms of population and ruling over a comparably small territory. However, the fact that size in terms of population or landmass may not coincide, sometimes, with a country's dimension in the financial system means simply that the concept must be rearranged to fit the environment of monetary politics. In this domain, the relevant dimension to assess countries' influence on the system is indeed their capacity to be price-makers, that is, to effect with their decisions the prices of financial assets or liabilities held by foreign economic actors, included currencies and exchange rates. As before, I observe that most of the countries actually calibrate their moves taking into account the fact of being influential on uninfluential on systemic variables, and I conclude that assuming such a clear-cut distinction is perfectly consistent with the exigencies of a theoretical modelization.

The model of strategic interactions among minor states develops around a series of assumptions that are carefully justified in following chapters. The base assumption is the *maximisation of policy-making autonomy*, especially as regards macroeconomic decisions, as a primary objective of all states in the politics of the monetary system, included small and middle powers. The conflict on this basic good arises from the fundamental contradiction between economic interdependence and autonomy highlighted by the well-known Mundell-Fleming trilemma of open economies. I suppose that states prefer to create wealth through economic openness and then conflicting over the management of the inevitable systemic imbalances, assuming in the model a moderate or high degree of *capital and trade mobility across countries*. The third assumption is the focus on the functioning of an *asymmetrical monetary system*, that is, a system characterised by the presence of a great power in the role of monetary leader and two or more minor states playing as either neutral or followers.

Notably, monetary followership in minor states entails the surrender of a country's national policy-making autonomy, included the freedom of manoeuvring the exchange rate, in order to manage the system's macroeconomic imbalances. In such context, I assume the main imbalance to be the leader's *chronical currency overhang* on international markets – caused by either a persistent current account deficit or the mechanism known as Triffin Dilemma – which threatens an excessive depreciation of the core-currency and the consequent collapse of the whole arrangement, although the leader is not necessarily the issuer of a global key currency. In this context, contrary to previous theoretical models, I consider the conflict on policy autonomy to take place at two levels. In the first, a great power deploys its bargaining weapons, included ideological and impalpable inducements, to drive as many minor states as possible into its sphere of monetary influence. In the second, small and middle powers, against the implicit or explicit pressure of the would-be leader, face a collective choice dilemma *among themselves* given by the crossing preferences between remaining autonomous or supporting through monetary followership a monetary arrangement revolving around a regional or external great power, in which they have presumably an interest.

The public good in this specific bargaining is the stability of the core-currency (i.e. the leader's money), on which both small and middle-sized states can be assumed to be interested although willing to pay the lowest possible price for it. The nature of

this interaction makes possible to develop an analogy with the debate on the 'burden sharing' in military alliances. Indeed, in that framework scholars have already faced both problems analysed here: the free-riding of small states and the puzzling compliance of these actors despite strong incentives to defect. Consistently, monetary followership represents the effort to produce currency stability as well as a military build-up contributes to conventional deterrence in alliance theory. Conversely, monetary neutral states 'consume' the smooth functioning of the international payment system while not paying the price of followership, as well as allied, but defective countries, 'consume' deterrence without paying the price of a higher military spending. The result of the modelization is two-fold. On the one hand, small surplus states (here called 'small holders') show a greater tendency to free-ride than middle-sized surplus states (here called 'major holders'), which are considered as Olson's privileged group or, collectively, as Schelling's k-group. On the other hand, small states are more likely to follow, notwithstanding baseline disincentives, when major holders are present and willing to intervene in their regional area.

The findings of this research shed new light on the motives driving states' choices in the conflict for macroeconomic adjustments in asymmetric systems. The implications of this model encompass a great variety of present and historical situations of primary importance for both economic and security relations. Just to mention a few, the politics of the so-called Dollar Standard after the demise of Bretton Woods is based on the relation between the US and a handful of major holders, each playing their own parallel game on a regional scale populated by small surplus states. The politics of the Sterling Area following the weakening of the British coinage after World War II is a combination of precarious followership by a few major actors and the continuous defections of small states. Likewise, relations in the German-centred clearing union, which dominated international economic relations in the 1930's in eastern and central Europe, is readable through the lens of this model. In all these cases, the focus on the major/small holder divide and its proposed explanation for monetary followership in surplus countries is able to account for a significant unexplained variance in the past and present functioning of interstate monetary systems.

The thesis is divided into six chapters. In the first, I give a general overview of how the condition of small and middle powers have been discussed in economics, political economy and security studies. I then evaluate how the hierarchical distinction employed in other fields to classify states' size can be rearranged to depict the hierarchy of a monetary system and I outline the tenets of my research proposal. In the second chapter, I justify the core assumptions of the model through a cogent review of the scholarly reflection on the relation between power, wealth and money in international politics. The discussion is mainly conducted within the realist paradigm, emphasising *inter alia* the different perspectives adopted by realism in International Relations and International Political Economy on this topic. In the last sections, I provide a technical account of how states interact in the monetary arena, justifying the choice to focus on monetary policy coordination rather than fiscal policy.

The third chapter identifies the binary dependent variable of the model (follower/neutral) discussing the anatomy of monetary leadership, neutrality and followership in past and present instances of asymmetrical monetary systems. In the case of surplus countries, followership implies the management of official reserves or interest rates in a way to 'prop up' the core-currency, and some extent of stabilisation of the exchange rate. A neutral position, on the contrary, is characterised by an inward-oriented monetary policy, a risk-averse diversification of foreign assets and a management of exchange rates coherent with domestic policy objectives.

In the fourth chapter, I provide a wide and cogent review of the factors emphasised by the existing literature to explain how minor countries choose between monetary followership and neutrality. In particular, after a general overview of current theories, I focus on the few hypotheses dealing with the case of surplus economies. Trade dependency, military dependency and financial dependency are the three elements analysed with significant examples and case-studies to stress their strengths and weaknesses in explaining monetary followership.

Subsequently, in the fifth chapter I develop the model to investigate the behaviour of small countries and the possible interactions with intermediate powers. Through a discursive theoretical elaboration and a simple game-theoretical representation of strategic interactions, I demonstrate, first, that small holders do enjoy a greater room for neutral strategies than major holders and second, that the deviation

of small holders from this general pattern is more likely to be result of a major holders' action than of a leader's attempt to influence.

Finally, chapter six tests the two hypothesis on an innovative case study presenting ideal characteristics to detect the role played by the two key variables of the model. The analysis performs a qualitative comparison of the monetary and currency policy of the six countries members of the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates), especially during the troubled years of the 2008 subprime mortgage crisis. Their similar characteristics in terms of political and economic structures, the strong military relations with the Unites States and the common external position as net international creditors make this regional context the ideal place to detect the major/small holder interactions at work without further causal interferences. Eventually, both hypotheses derived from the model turn out consistent with data, facts and documental evidence provided in the case study.

CHAPTER I

Small and Middle Powers in the International Monetary System. A Critical Assessment of the Literature

1.1 Challenges and opportunities of 'smallness' in International Relations

The study of small countries, and of their troubled relationship with the international system, has developed within International Relations as early as the 1960's. In those times, the interest of scholars was triggered by the emersion of numerous weak states as a consequence of the de-colonization process, as well as by the curiosity for the way some historical subjects of the European international system, such as Sweden, Switzerland or Austria, were dealing with the unprecedented bipolar structure of international politics. It is not a coincidence that for at least two decades the issue of small states in IR was largely related to that of alliance politics, and particularly to question of the viability and effectiveness of neutrality as a long-term strategy for small actors (Baker Fox 1959; Keohane 1969, 1971; Rothstein 1968; Vital 1967). Successively, other issue-areas such as economy, inter-governmental organizations and the international rule-making have been analysed with a special attention for the featherweights of the interstate system. From the perspective of economics and political economy, the study of small countries has often focused on the paradox between the extraordinary living standard reached by some of the smallest states in the world (suffice mentioning cases like Singapore, Qatar or the Cayman Islands) and the rhetoric on the weakness and vulnerability of these actors that often characterises past works on his topic (Bishop 2012; A. F. Cooper and Shaw 2009; Handel 1981; Keating and Harvey 2013; Prasad 2009).

The issue of the inherent vulnerabilities of small states is so pervasive in the literature to put in the background even the definition of these actors, which usually occupies a large space in social science debates. Among the few attempts in this respect, at least three main approaches can be identified: the elaboration of quantitative thresholds, the so-called behavioural criterion, and the impact of state actors on the whole system. In the first strand, authors opted for a combination of multiple quantitative indicators, classifying as 'small state' all countries behind a specified population threshold – which may arrive at 20-30 million inhabitants – and below a certain per-capita income threshold (Handel 1981; Neumann and Gstöhl 2006; Vital

1967). The second group of definitions, instead, identifies small powers¹ with their recurrent behaviours in the conduction of foreign policy. According to Neumann and Gstöhl (2006), small powers would be more prone to promote the development of supranational institutions as a fundamental counterweight to crude power imbalances against the system's larger actors. Vidal (1967) and Rothstein (1968) suggest that the self-perception of political elites must be a prime indicator of 'smallness' or 'greatness' in the international power hierarchy. Lastly, a third way to define not just small countries, but the entire power hierarchy of an international system, is the influence-based definition proposed by Keohane (1971). In his four-level hierarchy, this author classifies states as: a) *system determining*, when they are able to modify directly the polarity, the institutions and other foundational characteristics of an interstate system; b) *system influencing*, when they cannot have a constitutive role in the system, but are able to change some of its key features even acting in isolation; c) *system affecting*, when possessing sufficient resources to be somehow useful or indispensable to the system's major actors (for example, raw materials producers), but without the same strength as system influencing countries to modify important systemic variables; d) *system in affecting*, these are the small and micro-states limiting themselves to ratify changes and choices imposed from outside.

The theoretical discussion has been wider and deeper about the role and regularities of the foreign policy of small states in the international system. In an article for a recent collective volume, Baldacchino (2009) summarised the terms of the debate in a single question: «Thucydides or Kissinger?». To these two authors he links two opposing views of what portrays the action of small states in the international arena. For the first, who is particularly inspired by the famed episode of the Massacre of Melos, small states would have no destiny but to be, sooner or later, absorbed or subordinated to major states. Vulnerability is the most frequent word in the 'Thucydidian' writings on small states, in which the patent technological, productive and dimensional inferiority of these actors results too attractive for great powers, ready to exploit this intrinsic weakness to eliminate, explicitly or implicitly, the sovereignty of their weaker

¹ Same authors (Handel 1981) have contested that the term 'small power' is an oxymoron, and thus should not be used in this debate. In this research, this doubt is not considered, and terms power, state and actor will be used interchangeably.

neighbours. The general expectation of this scenario is that the life of small powers, if not short and prematurely interrupted, be characterised by frequent interferences in their domestic politics, and continuous attempts of coercion or annexation by great powers (A. F. Cooper and Shaw 2009). This attitude, that someone has insightfully defined 'size-pessimism' (Handel 1981), is found in the opening sections of almost every work on the issue, as authors enlist the most-known factors of vulnerability affecting these actors in the military field or the global economic competition: absence of strategic depth, land-lockedness or isolation, scarce return on capital investments, absence of strategic resources, diseconomies of scale and so on (A. F. Cooper and Shaw 2009; Handel 1981; Keating and Harvey 2013; Prasad 2009).

The size pessimism of classical realism is anyhow largely balanced, in the literature on small states, by the 'Kissinger side' of the debate. In his 'Years of Upheaval' of 1982, indeed, the former US Secretary of State coined the expression 'tyranny of the weak' to stress how often, in the history of international relations, small states actually succeeded in surviving and prospering in spite of their apparent weakness. If anything, Kissinger suggests, they have well performed precisely *because of* their weakness, being able to affect the decision of greater powers or at least to extort them privileges and compensations. The «"exploitation" of the great by the small» (Olson 1965) has been a longstanding argument of collective choice theories, and the idea that the systemic irrelevance of small actors may also grant them more room for neutral and autonomous policies has been extensively discussed, *inter alia*, in seminal contributions from the theory of alliances (Baker Fox 1959; Olson and Zeckhauser 1966; Rothstein 1968). The leitmotiv of most part of the literature devoted to these actors is indeed related precisely to this puzzling paradox in the performances of the most vulnerable states of the international system. Beside the few actors that actually realised the gloomy expectations of size-pessimist theories – like pre-colonial states in Asia and Africa, pre-unification German states, central-American states under the constant interference of the United States and so on – a large group of countries has well performed in the economic and diplomatic field, getting to preserve important spaces of external and domestic autonomy despite the initially disadvantageous conditions.

The *fil rouge* of most of the 'size-optimist' literature has been precisely the capacity of weak states «to exploit their smaller size in a variety of ways to achieve their

intended, and [...] unintended outcomes» (Baldacchino 2009). The 'equalising' elements that allow the most likely losers of international politics to get much more than their condition would realistically predict have been detected in at least two general factors. The first is the control of some exclusive resources that can be used to 'blackmail' an allied great power and obtain from it a less asymmetrical relationship than the crude power relations would have guaranteed. It is omnipresent, for example, the exploitation of a geographically favourable position as a bargaining chip, subordinating its use by major allies to a set of politico-economic concessions that could not have been obtained otherwise. This is the case, amongst many others, of the so-called 'maverick diplomacy', through which the Maltese prime minister Mintoff succeeded in his negotiations with London in 1971-72. In that instance, he obtained from the Britons a three-hundred percent increase in official aids just by credibly threatening to expel the British personnel from their strategic outpost on the island.

The second balancing element of the situation of small states is their geographical distance or strategic insignificance from the epicentre of a conflict or crisis involving great powers. Baker Fox (1959) analyses the cases of Sweden and Switzerland during the Second world War, identifying precisely in this element the main cause of success of their neutral stance during the conflict, despite a general political background decisively unfavourable. Likewise, Prasad (2009) and Hey (2003) account for similar episodes exalting the ability of weaker states to exploit «the importance of being unimportant». In conclusion, what this longstanding reflection suggest is that small states may undertake at least two general strategies to cope with their outsized neighbours in world politics. On the one hand, small states should make themselves indispensable to major powers, carving out an economic, political and military niche from which to extract a positional rent. On the other hand, they could become irrelevant and invisible, so that the gap between the expected gain from a small country's followership and the expected costs to coerce, induce or convince minor actors to have a stake in the great game of international politics results too large for the great power².

² Truly, there exists a third possibility highlighted by the literature, which is the old-fashioned practice of exploiting the rivalry of two great powers to offer one's collaboration to the best offering. However, this should be considered as a tactics, more than a strategy, because this possibility allows minor states to take advantage of great power rivalry both when their objective is to maintain neutrality vis à vis the two

1.2 *Small states in the international economic system*

The study of economic policy in small powers, and specifically of the survival strategies of smaller countries in a strongly competitive context, is probably the issue areas that posed the greatest challenge to the dominance of security studies in past decades. Like in other works, the theoretical reflection on the economic sphere focuses first on identifying the persistent disadvantages of small states in the international economic arena. Successively, also in this field scholars have noted the evident gap between economic expectations on the performances of small states and the greatly differentiated performances of these actors. For example, endogenous growth theories stress the role of the size of the population, labour and capital productivity, and the numbers of employees in research and development sectors on which small actors are by definition disadvantaged. Yet, within this category one can find some of the richest countries in the world as well as many among the most underdeveloped economies.

The list of the weakness factors of small powers in international markets, and of the special exigencies of their economic development is long and complex. Nonetheless, the greater vulnerability of small actors to balance-of-payment problems is an undoubtable *trait d'union* among different economic sectors and structural shortcomings. Among the characteristics impeding the catching-up of small states in terms of per-capita income, a large part is related to the obstacles posed by the balance-of-payment constraint concerning the equilibrium between inflows and outflows of goods, services and capitals. On the one hand, small states experience, at the same time, a greater demand for imports for the scarce domestic productive diversification, and greater difficulties in exporting their products due to the high costs of sea trade, the possible absence of access to the sea and the trade barriers erected by their larger neighbours. On the other hand, small states suffer from greater diseconomies on private and public capital investment, or in other words, they cannot exploit a large domestic

parties and when they aim at mitigating the asymmetry of privileges and prerogatives within an existing symbiotic relation.

market to generate enough aggregate demand to remunerate capital investments, while the access to foreign demand may be precluded by previously mentioned factors. In turn, the low average yield of investments, the scarce depth of local financial markets and the greater vulnerability to natural disasters discourage the integration of these countries with international financial markets, preventing, *inter alia*, the possibility to compensate on the financial account the tendency to chronic deficits experienced on the current account (A. F. Cooper and Shaw 2009; IMF 2013).

The consequences of this condition on economic policy, and particularly on the management of interest rates and exchange rates show a prevalence of fixed exchange rates, mainly hard pegs or strongly-stabilised managed floating regimes. The material exigencies of local populations, in economic systems limited by dimensional and productive constraints, bring on average to a high ratio between national income and imports, while diseconomies of the public sector and the necessity to borrow in foreign currency contribute to an averagely higher public debt if compared with developed large countries (IMF 2013). The dependency on imports, the scarce currency flexibility, the high sovereign debt and the problematic access to international markets for goods and capitals are the causes of the chronic problems with external accounts in small states – statistically connoted by frequent current account deficits, low level of foreign-exchange reserves, high indebtedness rate and higher interest rates (Handel 1981; Neumann and Gstöhl 2006).

1.3 'Size-optimism' in international economy. Explaining the economic successes of small states

Despite the apparent disadvantage of small economies when taking part to international economic flows, also in this field, like in security studies, decision makers in small states have historically pursued several strategies to turn their weaknesses into strength. Among the fifteen countries with the world's highest per-capita income, just three have more than ten million inhabitants, and no one is above two millions among the top five. With regard to the net foreign asset position, among the twenty countries that are net creditors vis à vis the rest of the world, at least half are small states with scarce

demographic, land and military resources. These stylised facts suggest that the usual list of disadvantages, common to all actors, do not exhaust the overview of capabilities affecting the hierarchical position of a state and its likelihood of success in the international economy.

Generally, any 'survival strategy' of small actors within the context of open and competitive international markets is based on the alternative between specialisation and diversification. In the actual economic policies of small states have been identified so far five ways of specialisation. Firstly, Bishop (2012) posits that the states' capacity to resilience to externally-generated economic shocks increases with the level of technological advancement, favouring those countries that have been able to carve out a niche in *highly-specific* and *high-value-added domains* of the international economy. The second practice of productive specialisation, which has become extremely common in the world of microstates, is the so-called *creative agency* or *commercialisation of sovereignty*. This encompasses the sale to private or public foreign agents of the country's air routes, internet domains, satellite orbits and of the flag on international cargo ships. Thirdly, another well-known specialisation strategy is the transformation of a small isolated economy in an *offshore financial centre* or a *tourist destination* focused on a particular kind of clients. Fourth, a peculiar form of specialisation of small states is the search for *official state-to-state and multilateral aids*, which is often associated to the fifth form: the encouragement of *remittances from national migrants* living abroad (Prasad 2009).

As to diversification, it is the preferred strategies for those countries aiming to minimise the impact of economic external phenomena on their structural shortcomings (Handel 1981). It can be realised in several areas of economic exchange, including trade, finance and money. As far as commercial relations are concerned, states can avoid the dependency on a single producer or consumer in order to reduce their vulnerability to idiosyncratic supply shocks and reduce the risk of a possible political subordination to a single economic partner. Historically, there is no better example than the many instances of failed trade wars, embargoes and custom blockades to illustrate the efficacy of this strategy. One of the most known episodes in this sense is the so-called 'Pigs War' of 1906, through which the Austrian-Hungarian Empire intended to roll-back the Serbian expansionism in the Balkans and the Slavic territories of the empire. The small kingdom

was imposed a full custom blockade both on outflows and inflows of goods, which represented respectively the 83% of Serbian exports and the 53% of Serbian imports, included important military procurements. However, the Austrian trade-based coercion went far from damaging the Serbian economy and inducing Belgrade's strategists to reshape their ambitions. Rather, thanks to a rapid commercial diversification towards France, the United Kingdom and even Germany, Vienna's attempt turned out astonishingly unsuccessful. Paradoxically, at the end of the 'war' in 1907 Serbia had increased and diversified further its overall trade volumes with the rest of Europe. Likewise, IMF studies on the financial and monetary diversification of small countries show that the adoption of flexible exchange rates is able to increase their resilience to external economic shocks, if not granting a complete isolation, at least reducing negative effects on the national income (IMF 2013).

In conclusion, both strategies aim at attracting the greatest possible inflow of foreign currency (whether it derives from the exchange of goods or an influx of capitals) in order to cover the country's imports. In the case of specialisation, the purpose is to generate structural currency inflows from markets that are insensitive to price fluctuations and external shocks. The downside of this positioning, however, is the risk of become inflexible with respect to big demand and supply-side shifts in the main reference market. In the case of diversification, conversely, states accept a greater sensitivity to external macroeconomic shifts in exchange for a reduced vulnerability on idiosyncratic economic and political shocks. Overall, the dichotomy between specialisation and diversification overlaps with the already mentioned difference between followership (or symbiosis) and neutrality. On the one hand, small states can specialise in the production of a small set of goods or services or diversify in a multiplicity of products and sources of income. On the other hand, both strategies can be pursued within a general framework characterised by the focus on a single external market – which can be a source of imports, a destination for exports or a source of investment – or within an alternative situation where actors rely on multiple foreign markets for the same purposes. Obviously, all choices can be equally effective on a country's economic development depending on its own structural characteristics and the opportunities offered by the international system. However, the four strategic combinations may have a very different impact on political and economic autonomy for small countries.

Intuitively, while a combination of productive specialisation and symbiosis with a single market makes a small economy extremely vulnerable to intended or unintended troubles in the reference market, the combination of productive diversification and multiple economic partners shields the small economy, at least in principle, from both economic shocks and the risk of political influence.

1.4 Middle powers in International Relations: the system's responsible stakeholders

The middle power, or middle-sized state, is unquestionably the actor whose contours are most blurred in the hierarchy of an interstate system. As reminded by on the most prolific author on this topic, Carsten Holbraad (1984), when studying these actors researchers risk to be entrapped in a high-heterogeneity middle ground, where gathering all actors that are neither too weak to be considered small states nor too strong to be seen as great powers. Among the few robust conclusions achieved by the theoretical reflection of middle-sized states, one of the most important is the fact that this category comprises at least three kinds of actors different for power, identity and role: a) once primary powers in a phase of irreversible decline; b) rising powers with a future in the highest layers of the international hierarchy; c) traditionally intermediate actors between major powers and the irrelevance of small states (Gilley 2011; Holbraad 1984; Jordaan 2003).

Like the similar but wider literature on small countries, the label of middle power can be linked to three alternative criteria. The first is that of relative capabilities, measured in quantitative terms through a combination of economic development and demographic weight. Handel (Handel 1981) distinguishes middle powers through a combination of demographic size and per capita income. In general terms, he considers as such those countries having either a low income combined with a high demographic potential or a high per-capita income with below-the-mean geographical and population size. Neack (1993) realises a similar classification refined through the cluster analysis: population, per-capita military spending, per-capita GDP, literacy rate and infant

mortality are combined to produce different clusters of states among which she counts until forty middle powers (Valigi 2014).

The second criterion is the so-called 'behavioural model' (Chapnick 1999), where middle powers are identified through their recurrent behaviours and attitudes in the international arena. In particular, a middle power is defined as an actor «[demonstrating] a propensity to promote cohesion and stability in the world system» (Jordaan 2003). The same author remarks that middle-sized states would be more prone to conduct an interventionist policy beyond their regional narrow interests, most of times aimed at reducing conflict between great powers and strengthen the role of international organizations (Jordaan 2003; Lopes, Casarões, and Gama 2013). This behavioural evidence, actually recurrent in the foreign policy of intermediate actors, would be the main responsible for the common image of 'responsible stakeholder' of great powers, or the 'good citizen' of the international system, through which IR theory has looked at middle powers since its first reflections. Namely, a state which never threatens, and if anything promotes, the status quo in the economic, normative and politico-military field with the purpose of legitimising the existing international order (Gilley 2011; Jordaan 2003; Valigi 2014). Nevertheless, the choice of identifying the middle power with its actual behaviour on international politics presents a number of primary epistemological loopholes, tied in particular to the circular and tautological nature of this definition. In other words, the characteristic behaviours of intermediate actors – such as a legitimising, conservative and conflict-reducing attitude toward a given political or economic system – cannot be at the same time the main characteristics of the actor and the object of a theoretical investigation aimed at explaining their recurrence.

The third and last criterion identifying middle-sized actors in an international system is the one proposed by Keohane, based on the influence of state actors on major systemic variables. In the hierarchy elaborated by this author, the middle power is equated with the so called system-affecting state, which «is a state whose leaders consider that it cannot act effectively by itself, but may have a systemic impact in a small group or through an international institution» (Keohane 1969). However, this excessively narrow definition is reshaped and, to some extent, radicalised, by Holbraad (1984), for whom middle powers can be considered as 'occasional great powers', since

they are able to modify directly, even unilaterally, the system's power equilibria and fundamental variables. However, they are still prevented from redesigning the polarity or the pivotal institutions of an international system, enjoying instead a sort of (potential) destructive power on the status quo thanks to their natural, economic or military resources. In this research, middle powers or middle-sized states will be discussed assuming as correct this last definition, which identifies these actors for their power on the '*pars destruens*' of a political or economic system. Indeed, this approach satisfies the requisite of mutual exclusivity in the definition of social phenomena since the possibility to destroy and support a political or economic system is in the power of great power as well as of middle powers, but the second lacks the capabilities to construct the alignments, hierarchies and institutions of an international system. On the contrary, small powers would enjoy neither of the two prerogatives.

The second relevant question in the literature on middle powers is the explanation of the recurrent outcomes and behaviours characterising the foreign policy of these actors. According to Carlo Maria Santoro, in a famous study on Italian foreign policy, middle-sized powers are endowed with a peculiar combination of strength and weakness (Santoro 1991). This author considers intermediate actors as affected by a singular paradox: on paper, they are more powerful than small states, but do not get to translate that power into political influence or simply in autonomy for themselves against external pressures. If anything, middle-sized states have to pay this potential for influence with a much greater pressure on the part of great powers and relevant actors to sacrifice their own goals for the governance of the international system. Without the screen of a microscopic insignificant power, the intermediate actor can no longer rely on the disregard of major states for its alliance politics, for the development of its military force, for the direction of its financial and trade flows, and is more vulnerable to their pressure. Admittedly, there are particular systemic conditions where middle powers can gain some room for autonomy, but for the abovementioned reasons, these breathing space is averagely inferior to that at the disposal of small states.

To conclude, instead of the strategic dilemma facing small states – between symbiosis/followership and irrelevance/neutrality – there seems to be no alternative for middle-sized powers than a reluctant yet reliable followership.

1.5 The hierarchy of power in the international monetary systems. Rethinking Cohen's 'Monetary Power'

The choices of small and middle-sized powers in monetary and currency affairs propose again the same dilemma addressed by these countries about productive and commercial issues: that between symbiosis and neutrality. Nonetheless, to understand political choices in these field is first necessary to grasp what defines the hierarchy of a monetary system, or in other words, which indicators classify countries as great, middle or small powers in this domain of international politics. In traditional IR analyses, especially within the realist paradigm, states are assumed either to maximise pure military power (Mearsheimer 2001), or to maximise security in a broader sense (Waltz 1979). Coherently, in both approaches power is measured in relation to these objectives, through a set of factors enhancing a state's capacity to exploit its military capabilities for defensive or offensive purposes: demography, technology, manufacturing production, firepower, territorial size and many others. Likewise, to understand which dimensions affect the measurement of power, and thus determine the hierarchy, in monetary systems, it is sufficient applying the same criterion and assuming a realistic objective of state actors when interacting in this field of international politics. This overriding goal is assumed to be *macroeconomic policy autonomy* vis à vis the spillovers of financial and trade interdependence. Consequently, the traditional demographic, geographical and military variables would become less determinant, whereas the position of states in the monetary hierarchy would come to depend on two additional dimensions marking a state's capacity to withstand against financial markets and to influence major economic variables within the relevant system. The first dimension is related to a country's creditor or debtor position with the rest of the world economy, while the second dimension is measured through the 'market power' of an actor on fundamental systemic variables such as exchange rates, prices, interest rates and aggregate demand.

Benjamin Cohen is the author who most insisted on the link between power in the monetary system (or 'monetary power') and macroeconomic policy autonomy, which he conceive as both precondition for the exertion of influence and a primary good in

itself, being the key goal of economic statecraft in the international relations of the monetary system (Cohen 2006, 2008, 2013). Generally, autonomy is defined as an actor's room for manoeuvring in its own monetary and fiscal policies against the constraint posed by the balance of payment. In Cohen's worlds, «[for] state actors in the monetary system, the key to autonomy lies in the uncertain distribution of the burden of adjustment to external imbalances. [...] Excessive imbalances generate mutual pressures to adjust, which can be costly in both economic and political terms, [and] no government likes being compelled to compromise key policy goals» (Cohen 2008, 457).

Accordingly, Cohen creates the concept of 'monetary power' to analyse (and potentially predict) the distributive outcome of monetary relations relative to this pivotal issue. Actors with a greater monetary power can afford to accumulate macroeconomic imbalances for a longer time span, and obtain their partners' cooperation in order to adjust the system's currency misalignment or contain their most malevolent effects. This two-fold capacity for autonomy and influence represent two moments of the conflict on macroeconomic adjustments, which the author defines as «the two hands of monetary power». The first, called 'power to delay', measures an actor's autonomy in the sense of being able to ignore the pressure for adjustment coming from international financial markets. The second, called 'power to deflect', concerns an actor's capacity to shift these adjustments onto other states by mobilising a wide range of bargaining weapons including the distortion of economic variables (prices, trade and capital flows etc.) and non-economic ones (military cooperation, ideological convergence). Between these two, however, there would be a clear hierarchical relation, as autonomy from financial markets (the power to delay) is necessary and sufficient to measure a country's monetary power and exists independently from influence, while influence (the power to deflect) would be unconceivable without a prior establishment of autonomy.

However, this conception of power in monetary relations presents at least two loopholes, which are more difficult to note in major powers, but emerge with particular evidence when the concept is applied to small and middle-sized countries. The first is precisely that, contrary to Cohen's main argument, actors may happen to be influential before becoming more autonomous. According to the author indeed, «the power to delay is largely a function of a country's international liquidity position relative to others,

comprising both owned reserves and borrowing capacity» (Cohen 2008, 457). Nonetheless, the capacity of an economic system to borrow abroad to cover balance-of-payment deficits cannot be conceived as independent from the will of other actors, and especially of sovereign actors and central banks, of investing their money for this purpose instead of diversifying their assets in an economically-convenient fashion. Secondly, the case is even more evident for the power to deflect, where to be autonomous states have to convince or coerce others to bear the transitional cost of adjustments in their place, that is, influence comes first and produces autonomy through the others' subordination to the policy preferences of a powerful state.

In this research, I argue that Benjamin Cohen's conceptual construction needs to be revised to be translatable into the world of small and medium powers. Rather than assuming autonomy as a premise of monetary statecraft, I suggest that autonomy from the external constraint is the key goal states can reach through the two hands of monetary power. Accordingly, I avoid the automatic equation between a country's position in terms of reserves, net foreign assets (NFA) and current account balance with its ability to govern autonomously the levers of macroeconomic policy. Instead, I define these three components of monetary power as a country's *solvency* or *balance-of-payment position*, which measures the capacity of a country to resist against market pressures for adjustment without the coordination of other states. Secondly, I consider the capacity of influencing fundamental systemic variables (i.e. the country's market power and its role in non-financial issues) as a second essential element of power in monetary affairs, increasing further a country's capacity to delay and deflect macroeconomic adjustments thanks to the benevolent coordination of other actors. Accordingly, I consider policy autonomy as the outcome of a zero-sum strategic interaction with the monetary power of other states in the system.

In conclusion, if non-material capabilities play a remarkable role in defining an actor's policy autonomy, the hierarchy of the international monetary system can assume a fairly different shape compared to traditional assessments based on military power, especially in its lower layers. In the top positions, indeed, great powers with outstanding economic and military capabilities remain the sole actors able to play the role of *monetary leaders*. These actors hold a constitutive power on a regional or global monetary system, above all, because they are able to induce other states (followers) to

cooperate for the adjustment of macroeconomic imbalances. Below monetary leaders, however, small and medium states cohabitate under the shadow of powerful hegemonic actors. Taking into account the two-fold nature of monetary power – comprising solvency and influence – in the next section I explore how these two dimensions combine to generate four typologies of minor state³ with a different ability to gain autonomy in the conflict over macroeconomic adjustments.

1.6 Small and middle Powers in international monetary relations

Small and medium-sized powers, engaged in a system-wide struggle for autonomy, act in a web of incentives and constraints which looks very different from the that of great powers with the potential to play as monetary leaders. On the one hand, in the case of great powers a favourable balance-of-payment position can be the consequence of *sound macroeconomic results* – such as a strong current account surplus, large official reserves, low inflation or efficient financial markets – but also of the privilege of issuing the international key currency of an international system. Contrarily, minor state can rely solely on the first option, and with greater difficulties, in order to reduce their vulnerability to the pressure of financial markets. On the other hand, the influence capacity of monetary leaders impinge on purely monetary-financial mechanisms – like capital flights and devaluation of weak-currencies – as well as on alternative instruments not related to the monetary game such as military and security issue, trade flows (e.g. the threat of closing one’s market to other countries’ exports), or ideological like-mindedness. On the contrary, non-financial mechanisms are much less viable for minor states, whose reliance on financial weapons remains preponderant.

As concerns a country’s solvency position vis à vis international investors, the main elements to consider are the trend of its current account balance⁴ and the stock

³ For the rest of this writing, with the term minor states I mean small and middle states considered collectively.

⁴ Notably, the current account balance records the flows of foreign currency entering or leaving a country for transactions on goods, services, remittances, tourism and interests on foreign investments. Conversely, the net foreign asset position (NFA) or net international investment position (NIIP) shows the difference between the stock of foreign-owned domestic liabilities and the stock of domestic-owned foreign assets. If positive, it indicates that the country’s overall economy holds more credits abroad than debts owed to foreigners, and thus is fully solvent without mobilising domestic assets. However, even though the second is in principle more suitable to identify the solvency position of a country, the two

of official reserves. The first, however, is by far the most relevant, since the accumulation of persistent current account surpluses is both the cause and the reinforcement of a country's credibility on financial markets. Benjamin Cohen represented clearly this condition as follows:

«[a state] presumably has to show a positive balance of international indebtedness, an excess of foreign assets over foreign liabilities. More importantly, it probably would also have to be a capital exporter on a fairly large scale, with a corresponding tendency toward surplus on current account of the balance of payments in order to assure potential users of its currency that solvency would be maintained into the future» (Cohen 1971)

Ceteris Paribus, these countries are more autonomous than their deficit counterparts for at least three reasons. First, the persistent accumulation of foreign assets characterising surplus economies reduces sensibly the risk of capital flight and severe depreciation that generally supports the leader's influence against weak-currency followers. If anything, surplus countries are more likely to be the recipients of flying capitals, and experiencing an appreciation of their currency in case of currency crisis. Second, if the breakup of the system's currency stability because of unbearable imbalances produces recessionary effects, for example due to the fall of the country's export revenues, these problems can be offset via domestic reflation as surplus countries do not risk falling into trade deficit with a shortage of capital inflows or foreign reserves. Third, central banks in surplus states are better placed to intervene in the foreign exchange market to stop, although in the short term, the unwanted appreciation of their national currency even in presence of policy divergence and capital mobility. Empirical tests confirm the widespread effectiveness of this practice especially as far as emerging economies are concerned (Al-Jasser and Banafe 2005; Disyatat and Galati 2005; Fatum and Hutchison 2003; Fratzscher 2005; Hassan, Nakibullah, and Hassan 2013; Levy-Yeyati, Sturzenegger, and Gluzmann 2013; Schnabl and Chmelarova 2006; Siklos and Weymark 2007; Turner and Mohanty 2006).

Deficit actors, on the contrary, stockpile liabilities owned to foreign investors contributing to deteriorate their external position as potentially insolvent debtors. The

couples of terms (creditors and surplus, debtor and deficit) will be used interchangeably in this research given that the NFA is simply the medium- and long-term effect of the trend on the current account (net of valuation changes).

dynamic of current transactions generate an over-supply of the local currency, which, in turn, creates expectations of depreciation that markets will sooner or later bandwagon. If deficit nations want to avoid the exchange rate consequences of their balance-of-payment condition, they can temporarily sell foreign reserves to buy the local currency on international markets. However, they have a constraint in the available reserves of hard currency, which once depleted leave the local coinage undefended against speculative attacks (Kaelberer 2001).

The 'influence' side of monetary power in minor states, assuming a limited role for non-financial tools, concerns entirely the price-maker/price-taker cleavage, that is, their capacity (or incapacity) to affect the price of international goods, assets and currencies. In the definition of international hierarchy adopted by Keohane (Keohane 1969, 1971), it was already implied that a country's demographic-territorial size may be not necessarily correlated with its importance for the international system, while the most relevant factor, according to this scholar, is the extent to which power resources are translated into concrete systemic changes. This cleavage between price-makers and price-takers is precisely the keystone of the divide between small and middle powers in the monetary system, considering the second as those actors whose financial wealth or liability is able to trigger variations in the price of assets and major currencies of the international monetary system.

Contrary to the common wisdom, though, big creditors, like China towards the US Treasury are not the sole actors capable of shocking the monetary system through a massive manoeuvre on their financial exposure. Countries with a large debtor position vis à vis foreign economies are also able to cause severe changes in the other actor's wealth and income by refusing to undertake the fiscal and monetary adjustments needed to restore their solvency or not intervening in the currency market to prop up their money through massive sales of foreign exchange. This may cause the debtor's currency to devalue, de-facto depreciating also the value of creditors' assets and potentially hurting their export revenues via import substitution. The scheme below provides a summary of the four hierarchical layers of the monetary system for minor countries along the two dimensions of monetary power – solvency (BoP position) and influence (market power). The next section provides a detailed description of their expected behaviour.

		MARKET POWER	
		HIGH	LOW
BOP POSITION	SURPLUS	MAJOR HOLDER	SMALL HOLDER
	DEFICIT	BIG DEBTOR	SMALL DEBTOR

1.7 The two typologies of deficit countries

Small and middle powers are engaged in the struggle for autonomy in an international system prone to the chronic accumulation of currency misalignments. In this context, the conflict for the distribution of the burdens of adjustment imposes itself recurrently as a zero-sum game between great powers and minor states, where the renounce to autonomy by one of two sides implies a gain of autonomy for the other according to the well-known *nth-country mechanism* (Mundell 1968). As already explained, within this highly competitive structure, small and middle-sized states act prevalently by influencing the price of either debts or credits held by the leader country. In case of deficit actors, big debtors enjoy some room for extorting better conditions to the supposedly creditor leader. In the case of surplus economies, instead, market power holds exactly the opposite effect, favouring small holders and disadvantaging big creditors. This state of things impacts on the leader's monetary power as well, which notwithstanding the strength of non-financial coercion, is indeed more advantaged when playing as creditor rather than debtor. The equation below formalises what has

been said so far about the impact of influence and solvency position on a country's monetary power.

$$\text{MONETARY POWER} = \text{SP} - (\text{CA}) * \text{MP} (+ \text{NFM})$$

$$\text{AUTONOMY}_i = \text{F}(\text{MONETARY POWER}_i - \text{MONETARY POWER}_{1-i})$$

SP= solvency position CA=current account MP= market power

NFM=non-financial means= issue-linkages with trade, military affairs; ideological biases

NFM_{Great Powers} >> NFM_{Minor powers}

Proceeding from these considerations, the four typologies identified above enjoy the following set of constraints and advantages vis à vis potential leaders in an interstate monetary system.

The '*big debtor*' is a country with a negative net foreign asset position or a structural and protracted deficit in the current account accompanied with constant capital inflows allowing national investment and consumption to overcome the limit of export proceedings. This situation, which determines a chronic dependency on foreign capitals and thus a country's vulnerability to changes in the monetary policy of creditor countries, turns into a bargaining advantage of the big debtor when it comes to distribute the burdens of macroeconomic adjustments to address an incipient currency crisis. If the stock of liabilities owned to foreign actors is sufficiently wide and concentrated on a few markets, the leader's gains as creditor in terms of autonomy and positive financial flows can be easily outweighed by the economic costs of a default or devaluation by the debtor follower. Deficit middle powers can indeed break a currency parity and let the exchange rate devalue or repudiate payments and arrears on liabilities owed to foreign subjects. This would cause a net capital loss on foreign investments for the surplus leader and a likely contraction of exports and national income as well. Other conditions held constant, this situation might be sufficiently serious to guarantee the leader's intervention with a countercyclical flow of capitals and a public or implicit guarantee on the solvency of the follower state. In other words, the leader can arrive to renounce to its first-best situation (the unilateral coordination of followers) to increase the debtor's 'power to delay' on international markets. However, it remains unlikely that the leader adapts its own domestic policies to restore the

equilibrium of trade balances across countries⁵. A typical example of this situation is that of France after the 2010 Eurozone crisis. The strong interdependency of the French and German banking and financial sectors, where the first is actually the second's major debtor, has allowed the *République*, so far, to enjoy interest rates almost as low as German ones, and avoiding imposed conditions on matters such as public spending, labour regulation and public budget. This has been possible in spite of the decennial accumulation of foreign indebtedness by France and the serious difficulties of its own banks and financial firms in recouping their investments in Southern Europe and other Eurozone's peripheral countries.

The '*small debtor*' faces the same situation of potential insolvency of big debtors, but with enormously greater liquidity problems. On the one hand, these countries combine a strong propensity to import – often irreducible because composed of a too large share of essential goods – with a greater distrust of international financial markets. These actors have indeed a structural incapacity to play these cards, being their financial markets scarcely influential or completely irrelevant in the total credit exposure of major markets. Actually, most of the existing literature on the causes and the consequences of monetary followership in minor countries is built on the archetype of the small debtor. This evidently emerge from different strands of research such as studies on currency anchorage with anti-inflationary function (Calvo and Reinhart 2002; Giavazzi and Pagano 1988), the reflections on the 'punitive' function of financial markets in currency politics (Abdelal 1998; Andrews 1994a; Goodman and Pauly 1993; Pauly 1995), the role of import dependency in the choice of the nominal reference in fixed exchange rate regimes (Meissner and Oomes 2008; Plümper and Neumayer 2011). Historically, this typology describes some of the best-known cases of sovereign default or balance-of-payment crisis of the last thirty years. For instance, the 'Tequila Crisis' in 1980's and 1990's Mexico, the Finnish and Swedish baking crisis of the early 1990's, the ERM crisis of 1992, the East Asian Crisis of 1997, Brazilian Crisis of 1998 (c.d. 'Samba Effect') and the Argentinian Depression of 1999-2002.

⁵ This strategy would be in patent contradiction with the key objective of monetary leadership, that is, the autonomy of macroeconomic policies by means of a parallel renounce of autonomy by follower actors. It is not a coincidence, in this respect, that available case studies about the European Monetary System show that the pressures of debtor countries over Germany for reflating its economy have never turned out successful. Rather, up against the dilemma between revaluing the deutschmark and allowing for more expansive policies, Bonn has *always* chosen to preserve its policy freedom through currency realignments.

1.8 The characteristics of major and minor holders and the literature gap on surplus countries

The positive effect of a large market power on the bargaining advantage of middle states is reversed when the case of surplus countries is assessed. In terms of solvency position, these actors are characterised by a structural and persistent inflow of foreign currency from current account transactions, which allows paying for imports and accumulating net foreign credits. Should an unexpected shock hit the country's exports, it could preserve its level of consumption and investments by selling foreign assets and reflate the domestic market without necessarily undertaking fiscal and monetary tightening to restore a positive balance in the short term. Moreover, if well integrated in financial markets, it is not excluded that a country's currency becomes an international safe haven, proving the economic system with liquidity in a moment of shrinking domestic demand.

However, once the influence side of monetary power is taken into account, small surplus countries, or *small holders*, show a great positive divide with middle powers in the same balance-of-payment position, the so-called major holders. With respect to these actors, small holders are advantaged in at least two ways. Firstly, they are better placed to pursue a general strategy of currency diversification in the allocation of foreign investment portfolios. Indeed, because of the irrelevance of their economic moves on the stability of the core currency and other international coinages, small holders are not subject to the same pressure from great powers in order to support a leader's currency with sound monetary, fiscal and exchange-rate policies. Secondly, even when diversification is unviable, small holders can neglect pressures and invitations to adjust their policies to address global macroeconomic imbalances given the irrelevance of their contribution to the systemic governance. In brief, small holders are on average more autonomous in the choice of economic policies than major holders. Among the most common empirical cases, it is worth mentioning the currency and investment policy of the small Arab monarchies of the Persian Gulf, the adoption of a flexible exchange rate and a partial diversification of assets in the last decade in Singapore or the currency

allocation of foreign investments managed by the gigantic Norwegian sovereign wealth fund, coupled with the free floating of the Norwegian krone.

An opposite mechanism, instead, constrains the actions or '*major holders*'. These actors are characterised by a positive external position on the current account, and enjoy a powerful 'negative' influence in the system that constrains their actions and locks the range of autonomous policies they can bring forward in the monetary and exchange rate field. Charles Kindleberger, in an article on French currency policy in two historical moments (the period 1926-1936 and the period 1960-70) distinguishes state actors into three categories based on their role in the international economic system: great powers, near-great powers and small powers. Within this schema, near-great powers represent the actors that «have the power to hurt the system, [but] generally insufficient [...] to steady it in the face of disruption on wide scale» (Kindleberger 1985). This definition is coherent with the previously established criterion of influence to identify the cleavage between small and middle powers in the different domains of international politics. Major holders are indeed those actors whose official reserves or private portfolio of foreign investments allow the country to modify, negatively as well as positively, the price on international markets of the coinage in which its assets are denominated.

This status, however, even though apparently advantageous, is in fact deleterious for the major holder's policy autonomy once its drawbacks are taken into consideration. On the one hand, the baseline advantage of these actors, in that solvent economies, is counterbalanced by the set of conditionings put in place by the leader with the purpose of promoting the loyalty of systemically relevant subjects such as major holders. On the other hand, even in the hypothetical absence of non-financial bargaining tools, major holders are much more vulnerable than small actors to the so-called entrapment mechanism (Kirshner 1995). In his hypothesis, Kirshner links minor countries' followership in interest rates and currency policy to the tendency of many surplus economies to accumulate foreign assets and reserves denominated for a large part in a single core-currency. By doing so, local authorities end up making the whole country's financial wealth vulnerable to a collapse of the leader's coinage, and since the cost of exchange rate adjustments outweighs the benefits of autonomy, the follower's central bank becomes a reluctant stakeholder of the system's currency stability. With this transformation in a stakeholder of a hegemonial power's outstanding foreign debt,

major holders are in fact unable to allow for excessive exchange rates fluctuations for not risking to evaporate the value of their financial wealth both domestically and against other major currencies. Finally, also the opportunities for currency diversification, which was a consistent way out of this conundrum for small holders, are remarkably reduced given the greater systemic relevance of these middle powers in the international monetary system. Major holders, indeed, may have an interest beyond the entrapment mechanism in guaranteeing the stability of the core-currency and the smooth functioning of the payment system – for example the connection between a leader’s role as security provider and its economic conditions, or the necessity to preserve their market share in a great power’s market for goods and services. The clearest examples of major holders in today’s monetary system are Saudi Arabia, Japan, Taiwan, South Korea and China towards the United States. In the past, South Africa and Canada have played this role within the post-war British sterling area (1945-1960), while Japan, Russia and the British colonies in the Indian subcontinent had a similar position in the heydays of the UK-centred Classical Gold Standard.

1.9 Literature gaps and research design

In previous sections, the fundamental criteria for mapping the power hierarchy of international monetary relations have been cogently illustrated. Consequently, it makes sense at this point to summarise the main strategic dilemma of small and medium-sized states in this domain of international relations. Drawing a parallel with the scheme already observed for military alliances, trade relations and development policies, on one extreme we find the symbiotic specialisation with a great power, which corresponds in this domain to monetary followership, especially in its more tight variant involving both fixed exchange rates and a unilateral adaptation of domestic policies to govern the spillovers of imbalanced payment systems. This alternative is practically a one-way choice for small countries with a chronic payment deficit, a situation that is over-explained by an abundant literature. On the other extreme, we find autonomy-maximising strategies of neutrality, characterised in the monetary arena by financial and trade diversification, by the freedom to set inward-oriented monetary policy moves, and, if necessary, by exchange-rate flexibility. Among small countries, surplus

economies are the best-placed actors to practice the various forms of monetary neutrality given their scarce influence on currency values and the substantial protection against the negative feedbacks of financial interconnection.

Nevertheless, despite the good theoretical groundings embodied in this typization, current models conceived to explain the foreign economic policy of surplus countries in monetary affairs tend frequently to underestimate or neglect the positional divide between major and small holders in their relation with great powers. Generally, at least two branches of studies have addressed the choices of minor countries, and both have consistently ignored this distinction. The first includes explanatory models of monetary followership analysing the leader-follower bargaining, while the second, less common, implies a game-theoretical assessment of intra-followers relations in asymmetric monetary systems. Among the firsts, the dominant bias is to consider surplus followers, by definition, as systemically relevant actors with little prospects for diversification (i.e. major holders). This is the case in the so-called 'mercantilist theories' linking monetary followership to a country's dependency on a larger end-market for exports, but also in the abovementioned hypothesis of financial entrapment, where the author assumes that follower's policies have a wide effect on the value of the core currency. Equally, in hypotheses identifying a link between security affairs and choices of macroeconomic policy coordination, scholars presuppose that followers' moves hold some effect on the leader's military effectiveness. As regards the second strand on intra-followers bargaining, there is a blatant prevalence of heuristic models based on a two-player static Prisoner's Dilemma. In such models, surplus followers are assumed to have symmetric incentives to defect through currency diversification on foreign exchange reserves, predicting an outcome similar to the mutual-defection Nash equilibrium of the famous game-theoretic dilemma. However, this approach assumes once again that each actor's diversification would trigger a run on the core currency and cause the collapse of the existing system.

The purpose of this research is to bridge the gap about the comprehension of the effects of the small/major holder divide from two fundamental perspectives. Firstly, by providing a theoretical demonstration and a set of empirical corroborations to the hypothesis that the weaker market power of small holders determine also a greater policy-making autonomy as regards monetary and exchange-rate issues. Secondly, I

hypothesise that major holders do not simply wait to be free-ridden by small holders while providing the public goods for the smooth functioning of an imbalanced payment system. Rather, I suppose they are the only actors with motives and instruments to induce reluctant small surplus states to contribute with their negligible financial wealth to the governance of a system characterised by deep macroeconomic imbalances.

In next chapters, the issue of the conflict for autonomy and the causes of monetary followership in small states will be framed within the wider theoretical debate inside the International Relations (IR) and the International Political Economy (IPE). In detail, the next chapter illustrates the reasons why, especially from a realist standpoint, policy autonomy emerges as a primary good in anarchical interstate systems, as well for great power as for minor states. This passage is necessary to support the assumption that there is an inherent conflict for autonomy among the actors of international relations, and that the international monetary system is the privileged arena of this competition. In the same chapter, I describe the main technical mechanisms of monetary, fiscal and exchange-rate coordination across countries, and I focus in particular on the policy moves of minor states to isolate a great power's policy-making from the balance-of-payment constraint.

CHAPTER II

The Power of Currency. Macroeconomic Policy Autonomy and Power Relations in the International System

2.1 *The role of economic relations in the 'struggle for autonomy'. A review of state's priorities in the realist framework*

One of the core assumptions of realism, distinguishing this way of thinking from other paradigms of International Relations (IR) – Marxism, constructivism, liberalism – is the saliency of economic issues as an indispensable premise to military power. For example, Kenneth Waltz devoted a large part of his discussion on the concept of polarity to reject, on these bases, the thesis of those historians and IR analysts who conceive international politics as composed of parallel hierarchies: one for economic powers and one for military powers (Waltz 1979). The two, he argues, are nothing but two faces of the same coin, since economic development, far from being important *per se*, is essential above all for nurturing a country's military apparatus. Likewise, John Mearsheimer distinguishes the measures of great powers' capabilities between 'latent power' and 'military power'. The first – given by the product of economic wealth and the size of the population – would be the «sinew» of military capabilities, not relevant in its own, but as an indispensable asset to develop a top-ranked army and compete for hegemony in the international system (Mearsheimer 2001). Within the sub-field of International Political Economy (IPE), the realist strand has certainly observed scrupulously the assumption of indivisibility between the two realms of power, going so far as to theorise, in a famous seminal article by Jacob Viner, their *mutual complementarity*. As the author puts it,

« (1) wealth is an absolutely essential means to power, whether for security or for aggression; (2) power is essential or valuable as a means to the acquisition or retention of wealth; (3) wealth and power are each proper ultimate ends of national policy; (4) there is long-run harmony between these ends, although in particular circumstances it may be necessary for a time to make economic sacrifices in the interest of military security and therefore also of long-run prosperity» (Viner 1948)

If considered in combination with the other base assumptions of the realist paradigm, the mutual complementarity between military capabilities and economic wealth plays the lion's share in the development of the realist view on the impact of economic relations and interdependence on the competition for power and security among sovereign states.

Realism is indeed a wide-ranging umbrella concept, formed by different sub-schools and branches that share nonetheless a handful of core assumptions. First, states are considered *unitary* and *rational* actors, which hold persistent objective interests, and employ their resources strategically to achieve them. Second, when major issues like survival, independence and physical security are at stake, *self-interest* ultimately drives states' policy choices, with little room left for ethical or ideological considerations, and setting aside those sub-state societal interests that classical liberalism, constructivism and Marxism have put under the spotlight in their theories. Thirdly, the distribution of power *among states*, and not among social classes, multinational corporation or multilateral agencies, shapes regimes, patterns of relation and distributive outcomes throughout the international system and all its issue-areas. Finally, any state holds survival, independence and security as its primary and compelling goals, but has to achieve them in a self-help (or self-defence) *anarchical system*, where no superior coercive authorities can be appealed in case of danger or threat from another actor. However, given the importance of an independent military force in such an uncertain environment, and the complementarity between wealth and the capacity for self-defence, it is not sufficient that governments have these economic resources available, they must also be autonomous in the allocation of their wealth to the enhancement of military power (Harknett and Yalcin 2012). As highlighted by Mearsheimer indeed, latent power may be converted into military might with different proportions, ways and timings. Thus, states need flexibility in the use of economic resources, and the possibility to preserve and increase their value throughout time in order to be able to turn wealth into hard power whenever necessary.

If this is the reason why autonomy rises to the top of state's priorities in a realist framework, what makes the issue a puzzling political question is the intrinsic contradiction that may arise between wealth and autonomy. On the one hand, both play as essential premises of a country's self-defence in the anarchical system; on the other hand, the pursuance of wealth implies the parallel need to expand a country's trade in goods, services and capitals to achieve higher standards of income and finance military power. Economic growth, indeed, is based on exchange, and the greater the exchange, even between nations, the greater is the level of wealth reachable through the specialisation and integration of states' productive and financial systems. However,

economic integration undeniably hurts policy autonomy in at least two ways. First, by making states excessively dependent on goods, services and capitals produced abroad, and second – since everyone’s economic policy decisions impact on prices, demand and growth in other countries – by making states subject to pressures for orienting their domestic choices to the ‘general’ welfare rather than to their narrow domestic exigencies. Regrettably, the only alternative solution, which is the planning of autarchic national markets, remains a cure worse than the disease, since it would guarantee the maximum of autonomy, but at the detriment of economic development. Often, until the point of jeopardising a country’s military effectiveness like in 1930’s Italy or North Korea in the current international system. Since this undoubtedly dilemmatic condition cannot be solved with a clear-cut choice on one side of the spectrum – maximising autonomy might damage relative wealth, maximising wealth requires interdependence and thus reduces autonomy – two intermediate solutions can be identified. On the one hand, great powers, which compete for security and control at the top of the international system, must necessarily force to long-term harmony the two contrasting goals: becoming autonomous while maintaining open markets as concerns both trade and financial transactions. To achieve this privileged condition, they have historically exploited the inequality of power with other actors to turn interdependence, intended as a reciprocal phenomenon, into *dependence*, intended as the control exerted by great powers on the economic policy of minor states. Essentially, great powers that hold the leadership of an economic or monetary arrangement obtain to increase their policy autonomy by reducing symmetrically the autonomy of the system’s minor actors.

On the other hand, minor powers re-experience the dilemma already mentioned by the generalist literature on small states. They can either surrender autonomy to become dependent on a leader’s policy choices, or seeking to enjoy the gains of open markets while retaining a good extent of autonomy, not the maximum, on their own policy-making. Generally, minor states’ utility function, given economic interdependence for granted, maximises autonomy as well as great powers. However, the real question is about the level of risk and practicability of neutral strategies. For example, the small or middle-sized state may not be able to stand on its feet in rapidly changing global markets, and prefer to develop a symbiosis with a major monetary partner than risking a hard life as an autonomous actor. In this specific case, autonomy

would be a 'useless luxury', which smaller countries cannot give to themselves in an environment where economic development depends almost exclusively on exogenous flows of products and capitals. Alternatively, the small country can weight autonomy less than great powers because of other compelling reasons like military weakness and the consequent need for external patronage. In this case, it is sacrificing autonomy for security as the two things are actually less connected in small power than they are in great powers.

Nonetheless, in the next section the focus remains on great powers, because if monetary followership is about minor countries abandoning their autonomy to enhance that of stronger states, the first key passage is understanding why policy autonomy holds such an overriding importance for the most important actors of the international system. Subsequently, however, I discuss why the loss of policy autonomy inherent to monetary followership may be, contrary to a widespread common wisdom, a political and economic conundrum also for minor powers, hence creating a conflict between who is going to cede more of its autonomy for the smooth functioning of a system of cross-border economic interactions.

2.2 Autonomous from what? 'Iron and steel' versus purchasing power in the approach of realist IPE

As widely discussed in previous section, the thesis of realist IPE is that the entire life of state actors in the international monetary system revolves around the search and the exploitation of policy autonomy to pursue a greater military spending or other domestically-convenient policies. As regards the issue of transforming economic wealth into military and coercive power, it has to be noted that a lively debate surrounds the nature of power in international relations⁶, while the nature of wealth – that is, which kind of wealth is really valuable in that convertible into military effectiveness or in other forms of political influence – has been decisively the less considered side of the debate.

⁶ In particular, scholars have wandered whether this term should refer merely to concrete military capabilities or to the larger toolbox of 'soft power', including popular culture, ideational seduction, economic incentives and similar indirect strategies (Ikenberry and Kupchan 1990; Nye 2005). Or else, as Susan Strange suggested, states may act both in the direct way generally considered by realist analysts, or through a subtle, yet perhaps more effective form of structural power (Strange 1987, 1994).

Usually, IR neorealism focuses on the development of those sectors of economic activity providing the material bases to build up a strong military for the contemporary mechanised warfare. Accordingly, Mearsheimer and Waltz classify great powers on the base of a composite index of iron and steel production complemented by the consumption of energy. Paul Kennedy, in his *'Rise and Fall of Great Powers'*, uses the share of the world's manufacturing and, again, iron and steel production, to assess the economic fundamentals of military strength (Kennedy 1987). Although none of them would argue that latent power is the only determinant of state influence, both structural and classical realists link states' military might to *what an economic system is able to produce domestically*, especially in the *manufacturing and the heavy industry*. In this respect, it worth noting how the IPE approach, specifically in monetary studies, has often looked at the issue from a remarkably different perspective. Instead of considering the impact of what a countries' can produce by themselves through industrial development, IPE scholars have rather discussed how military power can be affected by what countries can *buy* abroad. Drawing on a vast historical literature on the import patterns of states engaged in military efforts, many authors have concluded that states' domestic industrial capacity is perhaps a necessary but certainly not a sufficient condition to fill the exigencies of great powers playing a major role in international security politics (Cappella 2013b; Cohen 2013; Kelly 1977; Knorr 1975). In IPE realism, the roots of 'latent power' should be rather sought in a country's autonomy in *foreign-products purchases* than (solely) in its capacity for domestic production in military-related manufacturing.

To understand this point, it is a good idea looking at what early mercantilist thinkers wrote in the XVII and XVIII century about the relation between military power and economic resources. As reported by Viner, in their view states should have «sought a favorable balance of trade [...] and the indefinite accumulation of the precious metals solely as means to power» (Viner 1948). What this concise proposition suggests to today's readers is that the economic bases of power, in this perspective, is not manufacturing or industrial production, but the possession of *precious metals*. Second, the way to hoard precious metals is running a *positive trade balance* vis à vis the rest of the world economy. In fact, when the total amount of gold outflowing a home country for paying goods and services in foreign markets (i.e. imports) is below the quantity of

gold that the rest of the world ships to the same country with the identical purpose (i.e. exports), the home economy realises a net accumulation of precious metals. In the age when mercantilist authors wrote, and until the first half of the XX century, sovereign-coined specie were nothing but actual fragments of silver, gold or copper, on which the emblem of kings guaranteed the users about the real content of metal with which those coins were supposedly made of⁷. Through these metals, which were market-based moneys universally accepted *inside and outside* any country, sovereigns could pay, in home or foreign markets, manpower, raw materials, equipment and supplies for their armed forces and police corps, as well as financing art, culture, or technology within their commonwealths.

In the studies of monetary history, the counterpart of such commodity-based system is the so-called *fiat money system*. Under this regime, governments issue papers and coins that have no intrinsic market value or connection with a precious metal, and impose the legal tender of these currencies by accepting the same papers and coins for the payment of taxes and tariffs. Historically, this systems have been less rare than it is commonly thought, since also in the heydays of the Classical Gold Standard many of the non-primary powers (like Italy, Spain or Austria) resort to fiat money to settle domestic transactions and part of their international trade (Gallarotti 1995; Knafo 2006; Martínez-aceña, Martínez-ruiz, and Nogues-marco 2011; Meissner 2002; Di Nino, Eichengreen, and Sbracia 2011). Successively, with the great recession of the 1930's, several major powers, not last Britain in 1931, were forced out of the Gold-Exchange Standard into a fiat money system, and never restored the old regime after World War II. In its place, a semblance of gold-backed monetary system was designed with the Bretton Woods post-war order – where almost all the world's currencies were pegged at a fixed adjustable rate to the dollar, which was in turn exchanged at 35\$ per ounce of gold. Since the definitive fall of Bretton Woods in 1973 though, practically all states have been operating under a fiat money system.

Nevertheless, this poses a problem on how to identify a country's international purchasing power given that wealth is no longer embedded in precious metals, but is measured through a worthless fiduciary currency. If central banks, in the new system,

⁷ Likewise, when both the government and banks issued non-metallic currency, it took the form of notes front-printed with the exact quantity of metal that was redeemable in exchange for it.

are prepared to print as much money as necessary to the Treasury, what is the economic limit that national governments face when trying to finance investments, fund military expansions, or simply to cut taxes? One of their main limits lies in the crude fact that not all the commodities and services necessary to carry out a strong military, a technologically advanced economy or a solid financial system can always be self-produced in a domestic market. Some resort to externally-purchased goods, especially for great powers projecting their presence well beyond national borders, is strictly unavoidable even for the largest and most diversified economies of the international system, and these purchases cannot be realised but using a foreign currency or a universal means of payment. This limit is universally known in the economic and political-economy literature as the *balance-of-payment constraint*. Namely, the limit for which foreign products cannot be bought unless a country's economic actors gain foreign currency through exports or borrow it from international financial markets, international institutions or foreign governments. The concept of purchasing power, no longer tied to the money's content in precious metals, is now identified with a country's *exchange rate* vis à vis other major currencies, since this conversion factor represents the units of foreign products that can be purchased with one unit of local coinage.

The issue of purchasing power stability, measured through the exchange rate, introduces into the picture the last side of the well-known *Mundell-Fleming Trilemma* (Fleming 1962; Mundell 1961, 1963), opposing the pursuance of wealth through economic interdependence to the value of policy-making autonomy. Indeed, exchange-rate volatility is the price to pay for policy divergence in open economies, and can potentially jeopardise the achievements of autonomy when it is excessive and too rapid. Actually, states need to reconcile all the three elements of the Trilemma to be fully capable of pushing forward their own priorities without concerns from the balance-of-payment constraint. For instance, historical evidence is generous in showing how this set of limits is able to restrain states' military effectiveness and determine their success in international politics. Among several cases, that of Britain in the 1950's stands out as emblematic. In assessing the British case, Cappella (2013b) develops an impressive comparison between the conditions at which London had been able to fight and win the 1848 Crimean War and the extreme constraints experienced by Britain one hundred years later during the Korean War. At the heights of the pound sterling's dominance

over the international monetary system, in 1848, with new mines discovered in California and Australia and a net inflow of gold due to the explosion of its manufacturing exports (*economic openness*), Britain had been able to fight an overseas war (*policy autonomy*) without losing even a ton of its gold reserves (*purchasing power stability*). Since the pound sterling was deemed as good as gold, people around the world, included mercenary armies, local suppliers, and sovereigns in the allied countries were prepared to accept sterling IOUs printed out of nothing by the British government as a means of payment for all the supply of goods and services to the United Kingdom and its allies. In fact, London became also the principal financier of the war bills in all its smaller partners, lending its universally-accepted money to Prussia, the Ottoman Empire and the Kingdom of Sardinia from which Britain obtained not just substantial interest payments, but also a good measure of political leverage.

By contrast, one hundred years later a prostrated British Empire had to play its part in the Korean War with a mountain of overseas debt owed to the United States, and a dangerous systemwide oversupply of sterling. Although London would have desired to purchase war-related inputs and pay its troops' presence in East Asia relying solely on the resources of sterling-area countries, «the BCOF⁸ drew heavily from American equipment and services. [...] items as flamethrowers and 3.5 inches rocket launchers [...], support from American engineer, signal, and medical services, and some rations were [...] supplied from U.S. Army sources». Since all these purchases had to be paid in dollars, «if the British were to continue the war effort, they would need to [...] engage in a dollar loan» (Cappella 2013b). The purchase of goods and services from the US army represents trade openness, at least to the extent necessary for the war effort. Pairwise, the necessity of financial assistance by the United States marks the exigency of open markets for capitals, at least concerning state-to-state transactions. The oversupply of British sterling in the colonies and the consequent risk of an abrupt depreciation shows the exigency for currency stability. However, given the extreme bargaining weakness of Britain compared to the Crimean War, policy autonomy was partially saved (as London actually took an active part in Korea) with a costly side-payment about the British politics in the Commonwealth. Indeed, the US extended a conspicuous dollar loan subordinating their financial assistance to a further series of

⁸ British Commonwealth Occupation Force

economic concessions aimed at dismantling the remnants of the formerly self-sufficient British colonial system.

This brief case confirm that a country's domestic industrial capacity is hardly able to sustain a considerable military engagement without inputs (energy, raw materials, metals, intermediate goods etc.) and finite goods (spare parts, equipment, foodstuff and consumption goods) form aboard that can hardly be covered solely by domestic productions. Past cases have effectively shown that when a painful war effort is forthcoming, the resilience on the home front becomes more dependent on basic products such as grain, fruit, meat, alcoholic drinks or cigarettes than it is on propaganda and violent repression. If this is true for major powers, small and medium states are even more dependent on external inputs to wage wars and maintain a strong military, and are more apt to be hungry also for finite weapons and military equipment that they have not the industrial potential to produce autonomously. International purchasing power, once related to gold stocks and now to the stability of the exchange rate, is what makes these goods affordable on foreign markets, but enters in a contradiction with policy autonomy and the openness of national markets which is necessary to their procurement.

2.3 Beyond great powers and security: policy autonomy as a fundamental good of anarchical systems

The convincing narrative exposed in previous section on why major powers seek autonomy as a prime goal of economic statecraft represents a narrow and limited set of cases, concerning above all interventionist dominant powers with global military commitments. On the contrary, this perspective falls short in at least three alternative instances. First, it does not explain why monetary leadership, seen as the main road to full policy autonomy, appears also to be the preferred strategy of non-militarised great powers such as post-1945 Germany. Second, it says little about the need for autonomy of minor states, whose security exigencies cannot be conceived as fully covered by the patronage of external great powers. Thirdly, it diverts attention from other political domains, besides military and security issues, which are strongly touched by the conflict

for autonomy in the international economic system, and affect a country's capability to cooperate or conflict on economic affairs.

On the first issue, the case of Germany after World War II demonstrates that the policy autonomy and the exchange rate stability granted by monetary coordination can be actively sought also by a large country with no intentions to develop and deploy a hegemonic military status. On the one hand, because in case military expansion is prevented by other reasons, monetary leadership can actually play as a substitute of military power in influencing neighbours. On the other hand, because any comprehensive grand strategy on a country's position in the international system implies a set of underlying conditions to manage its consequences on the country's balance of payment. Namely, if military expansionism requires mechanisms to deal with complications like the Triffin Dilemma, extensive trade deficits and shortages of foreign currency, military isolationism coupled with a successful export industry, the model chosen by Germany as of the 1950's, requires the followers' commitment to accumulate trade deficits and eventually bear the burden of deflation and unemployment when intra-systemic imbalances become unsustainable. Paraphrasing the famous adage of classical economists, there is no 'free-lunch' grand strategy in international politics, and major powers can only get allies and neighbours pay for it.

The second point that has been frequently neglected by traditional approaches to the relation between war and economic interdependence is that in some occasions small and medium countries do actually experience the same need for military-oriented policy autonomy as major states. On the one hand, the long-standing debate inside the US government and the academia on the 'paradox of unrealised power', which followed the American defeat in Vietnam, has demonstrated that minor states can prevail on immensely superior adversaries by gaining time through guerrilla warfare and bring the resilience on the great power's home front to the break point. However, precisely an economic analysis of North Vietnam's external constraints during the famed war with the United States reveals that a prolonged war of attrition can hardly guarantee the inflow of foreign currency that a small economy needs to supply electric power to cities, fuelling its vehicles and exploiting its industrial and manufacturing facilities. In facts, the 'victory' of Communist Vietnam could not have been possible without the Soviet Union and China's will to finance heavily Hanoi's policy autonomy until the US threat was finally

defeated. Instead, if they had asked North Vietnam to adjust its huge external indebtedness, prioritising economic over security concerns, Hanoi's ability to fight would have collapsed far before the US decided to withdraw their military support to South Vietnam.

On the other hand, policy autonomy against balance-of-payment troubles is a key asset for minor countries, included small states, in that military rivalries and security threats are as likely to come from major powers as from other minor states. As a matter of fact, in the post-Cold War international system 5 out of 9 interstate wars have taken place among minor powers, and long-standing disputes among small states and regional powers are generally more diffuse and concerning than threats coming from major powers. The Greek-Turkish rivalry, the standoff between Saudi Arabia and Iran, the conflict between Armenia and Azerbaijan on the Nagorno-Karabakh, the skirmishes between Peru and Ecuador over the Cenepa valley are few but remarkable examples of this possibility. In many of these cases, the mediation of the United States or another external power (e.g. Russia in the Caucasus) plays a significant role in containing the conflict, but does not imply that the minor power feels completely and perpetually secure against regional threats without the possibility to manoeuvre an autonomous military shield against high-priority regional threats.

Lastly, the third reason of incompletes of great-power-centred approaches is the role of fiscal and monetary instruments in appeasing societal unrests and remunerating domestic constituencies in democratic as well as autocratic contexts. In this respect, the sacrifice of economic autonomy is both economically and politically costly for a government's domestic popularity notwithstanding the position of the country in the hierarchy of the international system. Examples are plentiful. In 1970's Italy, the government and the employers' associations allowed nominal wages to grow above productivity while capital controls and a managed depreciation of the lira made the country afford its rising energy imports and avoided running out of foreign currency. The measure was part of a series of successful policies made necessary to placate the waves of social unrests, unions' strikes and the proliferation of extreme-left parties that invested the country from the so-called 'hot autumn' of 1969 to the onset of the 1980's. Similarly, the Arab oil monarchies provide an example from the perspective of a surplus country, as they paid the fixed exchange rate to the dollar during the subprime mortgage

crisis with a strong wave of inflationary pressures that triggered the complaints of many relevant constituencies between 2007 and fall 2008. In diplomatic cables sent to Washington, American diplomats relate of the Saudi monarchs' concern for the accusations coming from prominent clerics for not being able to stop the rising inflation and powerful bank managers suggesting an abandonment of the peg and a revaluation of the riyal. Qatari leaders were anxious with the leak of indispensable foreign workers damaged by the nominal and real depreciation of their wages. Bahraini central bankers refer of an insistent press and popular campaign for de-pegging the dinar from the dollar and relieve pressure on the price of imported commodities led by local business tycoons with established contacts in the government.

2.4 Monetary policy, payment imbalances and policy autonomy in asymmetrical monetary systems

The stability of a country's purchasing power under conditions of divergent macroeconomic policies is the keystone of autonomy in the politics of an open international system. If exchange rates oscillate excessively in presence of divergent (autonomous) policies, a state pays its greater decision-making autonomy at a price that can be higher than potential benefits. Vice versa, if the stability of exchange rates is maintained through policies aimed at correcting or offsetting the system's macroeconomic imbalances, the absence of autonomy is *in re ipsa*. On the contrary, when the two elements are successfully pursued at once, and currencies remain stable despite self-oriented policies in an interdependent economic context, the main threat to this precarious equilibrium is the emergence of *macroeconomic (or payment) imbalances*, also known as *currency misalignments*. Payment imbalances entail the hoarding of symmetric stocks of international debts and credits in different countries as a consequence of the persistent deficits or surpluses on the current account generated by divergent policies and not corrected through exchange-rate fluctuations. For example, military expansionist states are more likely to accumulate international debts (like Britain in the Korean War) because they need to import goods and services beyond their capacity to export. Since they cannot bear an excessive currency devaluation to

maintain a balanced current account, deficit states are forced to borrow foreign currency from abroad to fill their import gap. However, sooner or later international debts must be paid back with a process that international economists define *macroeconomic adjustments*. This phenomenon entails a large threat to policy autonomy for weaker countries, and generates the perennial conflict on the burdens of policy adjustments among states which is the core object of this research.

In this section, I outline the three policy strategies that according to Michael Webb's classification (Webb 1995) allow states to face currency misalignments. Successively, I provide examples of how these three instruments can be concretely used either for a fair distribution of the costs of adjustment (cooperation) or in an asymmetrical way to shift the costs onto one of the parties of the game (unilateral coordination). In his outstanding discussion of the political economy of macroeconomic adjustments, Webb systematised the wide range of policies aimed to manage or eliminate external imbalances in three main categories. First, '*external policies*' denote the cases when «controls [are] imposed or adjusted on trade and capital flows, and exchange rates can be adjusted. Deficit countries might restrict imports and capital outflows or devalue their currencies; surplus countries might encourage imports and restrict capital inflows or revalue their currencies». The second way to manage external imbalances are the so-called *symptom-management policies*. Under such framework, «governments might intervene in foreign-exchange markets and balance-of-payment borrowing might be used to manage or offset the international market flows generated by different macroeconomic policies». Lastly, *internal policies* encompass those situations when «governments [...] adjust monetary and fiscal policies to eliminate imbalances between savings, investment, and consumptions that generate trade imbalances and to avoid crossnational interest-rate differentials that generate speculative international capital flows».

However, none of the three strategies present an inherently asymmetrical character. External policies can be symmetrically applied on both sides, providing a moderate and sustainable diversion of trade and capital flows. Symptom management policies can be pursued in a mutually beneficial way by acting simultaneously on currency markets (strong-currency countries buy weak currencies while deficit countries sell off their exchange reserves to upkeep their coinage), and balance-of-payment

financing can be provided at reasonable conditions as regard interests and maturity. Finally, also domestic policies can be adjusted symmetrically by finding a middle ground between a painful fiscal and monetary retrenchment in deficit units and an inflationary expansion in surplus countries. The problem though, is that in cases of symmetrical adjustment autonomy is put in a secondary place, as states are supposed to sacrifice their domestic needs to govern cooperatively the spillovers of trade and financial interdependence. Instead, in the following pages I illustrate how adjustment strategies actually turn out to be when are states are considered as unequal actors, with monetary leaders, by assumption, supposed to get their own way by pushing other countries to bear a greater cost for managing external imbalances.

2.4.1 External policies in an asymmetrical perspective

External policies tend to be rather efficacious in correcting trade imbalances, since they hit directly the absorption capacity of indebted actors while making export competitiveness decline and people to consume more in surplus countries. For this reason, for example, monetary leaders in a deficit position frequently resort to the asymmetric application of external policies to cure deep payment imbalances between them and potential followers. The decennial US-Chinese diatribe on the alleged undervaluation of the yuan and its supposed detrimental effect on the US manufacturing is probably the most recent and evident instance in this respect. In that case, the American request was formulated so as to preserve the dollar's resilience vis à vis other currencies while forcing the Chinese to bear the consequences of a revaluation on their export competitiveness in North America and Western Europe. The asymmetrical application of external policies manifests itself in two elements: first, which country actually makes the intervention and second, the magnitude of the intervention, whether on currencies, tariffs or restrictions. Usually, leaders require other actors to undertake an exchange rate realignment, so as to preserve the home country's purchasing power against the rest of the system and avoid being blamed for bargaining weakness by domestic constituencies. Furthermore, past cases suggest that the required adjustment would probably be less intense than the discrepancy in macroeconomic fundamentals suggests, and would take place at a slower pace than if market forces would have realised it.

On the contrary, when tariffs and restrictions are applied asymmetrically, they are usually realised domestically by a deficit country in the attempt to reduce imports or stop the drain on domestic capitals caused by currency misalignments. Large countries usually reduce imports to enjoy an 'optimal tariff' effect, which makes their terms of trade improve due to the feedback effect on global prices (Conybeare 1984; Gowa and Mansfield 1993; Norrlof 2010; Pahre 1999). Small countries resort to tariffs and restrictions on trade to reduce their import absorption (although they pay a price in terms of greater costs), and resort to capital controls to avoid an abrupt currency depreciation and a painful credit crunch during balance-of-payment crisis. Recently, exchange controls have been heavily rediscovered by small countries affected by disruptive financial crisis: Malaysia and Thailand imposed comprehensive capital restraints during the Asian crisis of 1997, while China had never relaxed the panoply of controls on its financial account that have long restricted the inflow or outflow of capitals from the country (Bussiere et al. 2013; Cohen 2003, 2007). Intuitively, while the imposition of an optimal tariff is a leader-biased form of external adjustment, the unilateral imposition of trade and exchange controls is one of the few weapons in the hands of small countries to cushion the effects of a currency crisis at the detriment of the leader's investments in the country.

However, the implementation of these recipes faces also a set of political and economic disincentives that make it sometimes problematic when an asymmetrical leader-follower relation is in place. Firstly, it is not always possible, nor desirable, blocking trade in services and commodities that might be essential for a country's economic life, highly valuable for its industrial supply chain, or necessary to fight a military campaign and maintaining an effective military instrument. When imports like energy products, military equipment and other raw materials, for example, play the lion's share in dragging down a country's current account, the impracticability of this perspective sounds over-clear. Exchange rates realignment, likewise, might be a smoother way to reach the adjustment goal, but it is equally unviable in numerous situations. Particularly, both deficit and surplus countries can hold different reasons to reject changes in the exchange rate as a solution to payment imbalances. First, weak-currency states tend to have an ideological bias which considers currency downward instability as a 'shame', a symbol of weakness and declining international prestige

(Eichengreen 2008; Helleiner 1998). Second, actors with relevant military commitments, affected by chronic payment deficits, might suffer the consequences of a loss of purchasing power on their military efficiency. Third, export-oriented countries can be restrained by the detrimental effect of a currency realignment on the international competitiveness of their main national products.

2.4.2 Symptom-management policies and the spectre of conditionality

Moving on to the second group of solutions, foreign-exchange intervention and international lending bypass the exigency for a concrete rebalancing of trade and investments to face immediate liquidity needs and ward off occasional speculative attacks. In principle, their use to increase the policy autonomy of major and minor powers facing temporary difficulties with their balance of payment is both possible and remarkably effective in the short-run.

It has to be noted that intervention in currency markets and international lending can be applied symmetrically or asymmetrically as well as external policies. On the one hand, open market intervention can be realised symmetrically when the main actors buy and sell their currencies coordinative on foreign markets. On the contrary, in an asymmetrical system the country with the greater monetary power imposes to other actors most of the costs and risks of foreign exchange intervention. If the weaker part is in deficit, it will burn its wealth in foreign assets in the attempt to delay as much as possible the day of reckoning with financial markets. Contrarily, if the weaker part is in surplus it will bear the risk of capital losses and inflationary consequences on its domestic markets to save the stronger state's purchasing power on international markets. On the other hand, bilateral or multilateral lending may take the form of a de-facto subsidy in case no policy conditions are imposed on the deficit actor in need for financing. Big debtors and countries with a high relevance from the diplomatic or military point of view usually possess the bargaining chips to achieve this condition. On the contrary, financial assistance can be a prime instrument to redistribute the burden of adjustments from capital-rich countries to deficit actors by imposing conditions to grant the loan. Small debtors are the more likely to be subject to this kind of financial blackmail.

Overall, both strategies are not exempt from limits and contradictions especially in the middle and long-run. On the one hand, *foreign-exchange intervention* shows serious problems of sustainability in the long term for both deficit and surplus economies. For the former, the key issue is the evident quantitative constraint given the necessary presence of hard currency reserves for the intervention. For the latter, the accumulation of foreign exchange is limited by the rise of inflationary phenomena which risk vanishing the efforts to keep the real exchange rate stable⁹. Moreover, foreign exchange accumulation on appreciating currencies implies a large credit and exchange-rate risk on accumulated financial stocks. Indeed, the mass of foreign liabilities that is collected in central bank's vaults is likely to generate capital losses for monetary authorities should the exchange rate ratio brake unexpectedly or even be orderly realigned. Likewise, foreign debtors may default on their obligations forcing governments to intervene to fix the balance-sheet losses of central banks.

On the other hand, multilateral or bilateral lending (e.g. IMF loans or currency swaps agreements) is certainly a viable way to fill temporary shortages of international liquidity in deficit countries, but may potentially contradict the idea of autonomy as the primary goal of sovereign states in international relations. Past records show that unconditional lending is a rare exception marked by high political motives. In any other case, especially when small underdeveloped countries are involved, international loans have been made contingent on internal reforms and austere macroeconomic policies. Examples range from the Latin American crisis of the 1980's to the Asian Crisis of 1997, characterised by the strong discontent of local populations for the neo-liberal reforms and draconian budget cuts requested by the IMF to grant assistance to troubled states. More recently, EU-backed financial assistance to Greece, Portugal and Ireland have been attached with the same limitations to policy autonomy, subordinating the concession of loans to measures of fiscal retrenchment.

⁹ The sterilisation of the increased money supply due to the open market operations can be an effective short-term safeguard against this risk, but it is hardly sustainable in the long run. Sterilisation implies the issuance of bonds by the central bank and the government that drains part of the oversupply of the national coinage consequential to the purchase of foreign currency on the domestic financial market. Nevertheless, markets can be flooded with bonds until a reasonable threshold, afterwards their value risks falling and economic actors may prefer a more rewarding investment which causes the asset-price inflation in any case.

2.4.3 Domestic policy adjustments

Internal adjustments are carried out with both fiscal and monetary policy instruments. On the one hand, current account deficits are cured through fiscal measures by raising taxes and cutting governments' expenditures. By reducing state-financed infrastructures, cutting public workers' wages or interrupting ordinary financing to public services, the government de facto depresses domestic economic growth, and obtains both a reduction of import consumptions and a disinflation of domestic prices that, other things being equal, can boost exports and realise a trade surplus. A similar outcome is obtained by raising taxes, whose main effect is to divert monetary balances out of citizens and firms into the state's budget, causing households to spend less on present and future consumptions and firms to reduce investments. Both behaviours, *ça va sans dire*, are ultimately aimed at reducing the country's import bill and restore a positive current account balance. Should surplus actors apply the same recipe symmetrically, they would expand the domestic income by lowering taxes, increasing spending and investments and encouraging the rise of salaries and wages.

On the other hand, monetary policy adjustments follow a completely different logic. While taxation and expenditure modify directly economic actors' trends in savings, consumptions and investments, the stronger effect of monetary policy is to channel cross-border financial flows out of surplus economies towards deficit units via a careful use of economic incentives. In this respect, the most important of monetary instruments is the central bank's *discount rate*, which determines the cost, for commercial banks, of borrowing money from the central bank to cover their short-term mandatory liquidity requirements¹⁰. In turn, this cost reverberates on the market interest rate that banks apply to one another and on the lending rate at which they extend credit to households and firms. Hence, a high interest rate in an indebted economy determines higher yields on financial and real assets making investments more palatable to foreign investors. Indeed, although central banks are usually supposed to manage interest rates for targeting inflation, stabilising financial crisis, and guiding the country's GDP as close as possible to its potential level – as testified by the most known inward-oriented policy

¹⁰ Seldom, other instruments such as *REPO rate*, *refinancing rate* and the *deposit rate* are used as main policy instrument or complement of the discount rate. Data from major financial institutions usually provide data on the main policy instrument for each central bank.

rule for monetary policy, the so-called Taylor Rule – interest rates have also a powerful effect on cross-country capital movements and exchange rates. Whenever a central bank increases interest rates, people around the world buy its currency to exploit the *arbitrage* opportunity given by the differential between returns on investments in this country and the cost of borrowing in their own economies. This phenomenon brings to the appreciation of the demanded currency if the country has balanced external accounts, or provokes the stability of the exchange rate when the local currency is already under pressure to depreciate.

In conclusion, both fiscal and monetary policy can be applied symmetrically when both parties set a common ground for a cooperative and opposite response to currency misalignment which is, simultaneously, expansive in surplus countries and restrictive in deficit states. Conversely, asymmetrical systems see one of the two parties pursuing policies in tune with its domestic conditions (leader), while the other is forced to design over-expansive or over-tightening policies to offset balance-of-payment disequilibria (followers). In the next sections, I focus on the specific case of monetary policy coordination, in the attempt to identify a policy pattern to be used as univocal indicator of cases of followership in monetary policy.

2.5 Monetary policy adjustments: Cooperation or Coordination?

Monetary economists and political scientists have developed different approaches to cross-border policy adaptations in monetary affairs. For the firsts, all the acts undertaken by states to govern the spillovers of economic interdependence belong to the general concept of cooperation, of which policy coordination is nearly a synonym. In a seminal policy paper, the economist Ralph Bryant defines cooperation as «an umbrella term for the entire spectrum of interactions among national governments designed to deal with the [...] cross-border spillovers among national economies. “Consultation”, “mutual recognition”, various forms of “coordination” and “explicit harmonization” are varieties of intergovernmental cooperation» (Bryant 1995, Cit. in Andrews 2006).

Initially, the early IPE reflection on the nature of international economic relations offered the same all-embracing notion that, mimicking the conventional wisdom of

economics, ignores coordination and subsumes it into this wide umbrella-concept (Cohen 2000; Keohane 1984; Milner 1992). In the account of these authors, cooperation implies a reciprocal act of policy adaptation that states would not have pursued without the prior establishment of a negotiated agreement. Cooperation is preceded by an explicit negotiation and is fruit of a mutual strategic decision, entailing at least the expectation of mutual gains for the participant countries. Recent works, on the contrary, have decisively criticised this narrow definition specifying that subsuming the notion of coordination into that of cooperation risks to rule out most of the *implicit* and *unilateral* policy adaptations that take place every day throughout the global and regional monetary systems. As reminded by Andrews (2006), the last formal negotiation aimed at coordinating monetary policies among major countries dates back, at best, to well-known episodes like the Louvre and the Plaza Agreements. It is not a coincidence that studies developed around that period endorse such a narrow and formal definition of cooperation based on procedural negotiation and reciprocal adjustments, but that kind of events, both before and after the 1980's, are all but commonplace in the politics of monetary relations.

To counter the view of both economists and the first generation of IPE scholars, Andrews separates cooperation from coordination, and elaborates the concepts of *procedural* and *substantive* coordination (Andrews 2006). While the term 'procedural' designates the concrete act of adapting national policies, 'substantial' indicates the condition where policies are mutually appropriate according to an exogenous criterion set by the parties' political objective. By focusing on the procedural side of the phenomenon, Andrews posits, early IPE scholars would miss that most of the substantive coordination that actually underpins interstate payment systems is in fact *informal, implicit* (i.e. non-previously negotiated), and non-symmetrical in the distribution of costs and burdens. «Instead, much coordination is constructed more or less unilaterally, on the bases of policy *subordination* simply because the weaker party to the interaction considers discord to be excessively costly. [...] in such instances coordination is definitely not cooperative in the commonsense meaning of the term»¹¹ (Andrews 2006, 110). On this basement, Andrews reverses previous conclusions and defines cooperation (or *cooperative coordination*) the situations where the burdens of

¹¹ Emphasis in the original text

adjustment are equally and substantively (not procedurally) distributed among relevant actors. Coordination, instead, would simply designate the general act of policy adaptation (procedural definition), which may take a wide variety of substantial forms in relation to an exogenous policy goal, from cooperation to unilateral adaptation.

In last decades, episodes of formalised and negotiated mutual adjustments have constantly declined, while informal and unilateral substantive coordination have grown increasingly likely as effect of the convergence of economic ideas and the spectacular upsurge of financial transactions across national capital markets (Andrews 1994a, 1994b; Kirshner 1999; Pauly 1995; Rose 1994; Webb 1994). In this respect, monetary policy plays a major role in directing the cross-border flows of financial investments, and is probably the most relevant domain to be affected by a system-wide expansion of capital mobility. Monetary policy coordination, generally, entails the administration of interest rates, official reserves and money supply to the achievement of a shared politico-economic goal, which in an asymmetrical monetary system is the preservation of currency stability against the pressure of financial markets to correct fundamental imbalances.

As predicated by the already-mentioned Mundell-Flaming model, in a system characterised by diffuse capital mobility, the autonomy of monetary policy and the stability of the exchange rate cannot be pursued together at the same time by all actors (Fleming 1962; Mundell 1961, 1963). Whenever two central banks diverge on interest rates, investors move their capitals to the market offering the highest return, and cause the local currency to appreciate in this country and depreciate in the other, or vice versa. In this context, substantive monetary coordination is the adaptation of interest rates to the goal of currency stability, which is concretely realised through the compensation of macroeconomic imbalances. Notably, substantive coordination of interest rates, reserves and money supply should not be confused with a generic cross-country *convergence* of these fundamental monetary variables. In his writing, Andrews illustrates the difference between the two phenomena – coordination and convergence – through the paramount example of British policy during the 1992 EMS crisis.

«[States] participating in the exchange-rate mechanism (ERM) of the EMS during the foreign-exchange crisis of 1992 and 1993 and experiencing speculative capital outflows needed to raise domestic interest rates in order to maintain their exchange-rate pegs to

the deutschmark. In fact, many of them needed to raise interest rates to level far surpassing those in Germany. This constituted an extreme instance of a more general phenomenon that Fritz Machlup once called “*compensatory corrections*” [...] By contrast, monetary authorities in the United Kingdom demonstrated their policy independence by refusing to raise interest rates in order to defend the sterling’s deutschmark parity. Somewhat paradoxically, the result was that UK interest rates were (at least temporarily) more convergent with German rates than were those of several of the states remaining within the ERM» (Andrews 2006)

Therefore, while convergence entails the act of two countries aimed at arriving at the same point, whether it is a policy position such as financial market liberalisation or a quantitative benchmark such as interest rates, to understand whether a policy is actually coordinative or not one must solely look at the political goal implied in their realisation. Substantial coordination of interest rates can entail a deep divergence rather than a convergence if this is consistent with the expected result of such policy move.

The next two sections analyse how monetary policy coordination is supposed to look like according to the very different approaches of monetary macroeconomics and International Political Economy. In the first case, a series of different and mutually contradictory recipes prescribe optimal policy choices aimed at maximising the general welfare of the relevant actors included in complex DSGE¹² models. In the second case, the IPE framework assumes that currency stability and asymmetrical adjustments are the main goals of states engaged in the monetary game, and imagine how monetary policy should be coordinated to achieve these targets.

2.6 *The economics of Monetary Policy Coordination: a brief overview*

As concerns monetary policy coordination, the divide between economics and political science goes even beyond the terminological difference between cooperation and coordination. The two sides of social science have rather a radically different ontology on the main object of research about inter-state monetary policy adaptation. Basically, economic theory has always wondered if policy coordination between central banks is a

¹² Dynamic Stochastic General Equilibrium.

desirable and welfare-improving practice or, contrarily, a counterproductive and groundless attempt driven by misleading political factors. A second and related question pertains the magnitude of economic gains that could possibly arise from a coordinative response to economic shocks. In this section, I provide a brief account of what mainstream economics suggests in terms of optimal practices for a welfare-maximising monetary policy coordination. This digression is necessary to exclude that monetary followership, rather than being a politically-driven phenomenon, is the simple transposition in the practice of the optimal policies suggested by the mainstream of macroeconomics.

The scholarly debate is usually divided into a first and second generation of theories, which produce divergent conclusions about desirability and advantages of cross-border coordination of interest rates. The so-called “first generation” research, from the pioneering works by Hamada to the dynamic games approach by Rogoff and Taylor at the end of the 1980’s, concluded that discretionary cooperation, even taking into account a wide range of intervening factors, can be frequently counterproductive and definitely non-necessary (Rogoff 1985; Taylor 1985). Successively, the so-called “second generation” (also known as New Open Economy Macroeconomics), turned less pessimistic as regards the positive effects of monetary policy coordination. However, most of these studies concluded that the marginal gains of coordinative policies are so feeble to make the choice of internationally-oriented rules almost irrelevant (Canzoneri, Cumby, and Diba 2005; Eichengreen 2013; Obstfeld and Rogoff 2002; Taylor 2013c). Economic theory, in general, prescribes which rules for international monetary policy coordination should be symmetrically applied by interacting countries in order to improve the overall welfare, generally intended as growth in consumption and wealth balances in two hypothetical markets. Balance of payment concerns are assumed to adjust automatically under the assumption of rigid prices and wages offset by pure floating exchange rates. In the end, the result is a babel of different recipes, most of which explicitly sceptical on the desirability of designing outward-oriented policy rules with little and uncertain gains expected in return. Nowadays, there is no of central banks having ever adopted such specific policy rules oriented at improving the global welfare at the expenses of its sovereign prerogatives.

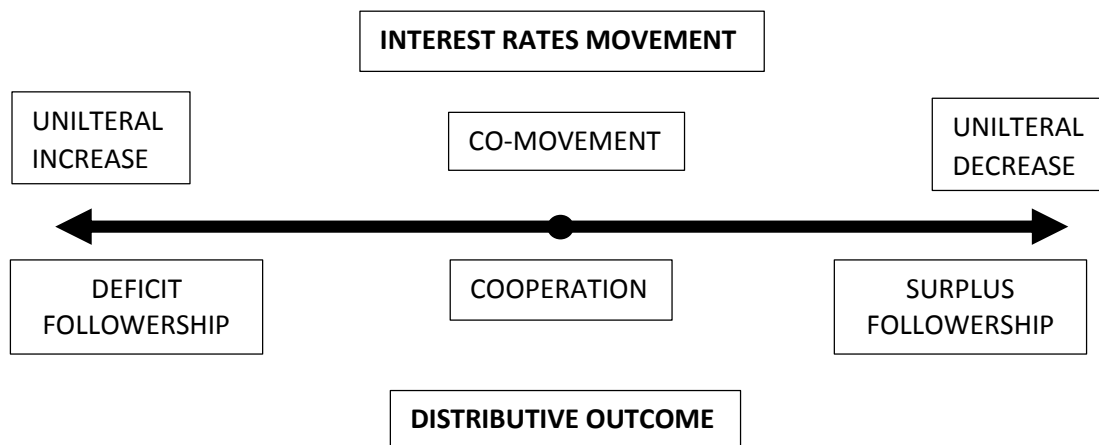
The balance-of-payment implications of monetary policy have been discussed in a series of recent macroeconomic researches in reaction to the peculiarly large imbalances that have characterised the global payment system in the first decade of the XXI century. A small group of authors have tried to design policy rules oriented at easing the correction of payment disequilibria, and they turned out increasingly sceptical about the usefulness of monetary policy in this respect. In McKinnon (McKinnon 2009, 2010a, 2010b), Ferrero et al. (2009), and others (Eichengreen 2011a; Rickards 2011) the main cause of the ballooning post-Cold War American deficit is identified in different patterns of investments and savings between the United States and its creditors countries in East Asia, which would be better cured by fiscal retrenchment rather than interest-rate coordination or exchange-rate corrections. What different economic theories concede, however, is that in case an adjustment through the fiscal channel fails, monetary policy would make the big difference of setting the degree of volatility at which nominal exchange rates will correct to the global oversupply of a weak currency and the shortage of a strong currency. Other authors have written in this respect of the choice between 'slow burn' and 'fast burn' adjustment scenarios, where the second is characterised by a catastrophic volatility of exchange rates (Faruqee et al. 2007; Ferrero, Gertler, and Svensson 2009).

Yet, still little or no political implications can be drawn out of these theoretical reflections. In spite of the welfare-maximising rules that the latest NOEM theory has tried to design, real-world concerns of political elites show a predominant focus on balance-of-payment problems and systematic deviations from 'optimal' theoretically-designed policy rules (Gray 2012; Taylor 2013a). Contrary to the mainstream of monetary economics, which assumes the pure-floating exchange rate regime as given, reality displays a variety of intermediate regimes other than hard pegs and pure floating that presently dominate the stage of currency relations (Klein and Shambaugh 2010; Levy-Yeyati and Sturzenegger 2005). As suggested by unorthodox approaches, the only task on which an internationally-oriented monetary policy is definitely effective is on controlling the pace of exchange rate adjustments to global or regional macroeconomic imbalances. However, the main question of a political-economy analysis of monetary coordination is not which policies maximise welfare or reduce volatility, but to explain who, how and why surrenders its policy autonomy to guarantee currency stability and

slow-burn adjustments to strongly imbalanced monetary systems. The ‘who’ question is implied in the topic of this research: great powers in the role of monetary leaders systematically get their own way, while just a sub-set of minor countries gets to be autonomous. The ‘how’ question is delineated in the next section as regards monetary policy coordination and in greater detail in the next chapter with a complete overview of alternative strategies of monetary followership and neutrality. Finally, the ‘why’ question is answered in the fourth and fifth chapter by established theories of monetary followership and the innovations brought by the small/major holder divide.

2.7 Monetary policy coordination and the Compensation Rule

The way monetary policy serves currency stability should be rather clear at this point of the discussion: the interest-rate differential between two countries affects the geographical allocation of capitals by cross-border investors and supports weakening currencies on the Forex market. Countries in need of financing have to widen the difference between their return on investments and that of surplus countries to attract capitals and cover the hiatus between savings and investments in their economies. Countries with a protracted surplus must encourage, through low interest rates, the outflow of their excessive savings to provide a fruitful engagement for this financial wealth in foreign markets. The mechanism holds equally when central banks centralise the management of the country’s stock of foreign assets through foreign exchange accumulation and reinvest official reserves directly in deficit-state markets. However, the distributive impact of this background in terms of policy autonomy is not given, but contingent on the monetary power of states that must choose along a wide policy range running from followership by the deficit unit (which tightens monetary policy alone) to followership by the surplus part (which relaxes its monetary policy unilaterally). In the middle, the situation that latest reflections in IPE have called ‘cooperative coordination’ or simply cooperation, where surplus countries moderately expand their credit policy while deficit countries tighten the belt, but not as much as they would have done unilaterally.



Monetary power, as defined in the first chapter, is the element determining where the outcome of an adjustment bargaining is placed along the scheme. To recall previous considerations, monetary power depends primarily on a country's solvency and liquidity position (deficit or surplus) and its influence over the monetary system plus the effect of non-financial factors that are more apt to be exploited by currency leaders. These exogenous factors – political, military or economic – can affect a country's proneness to sacrifice policy autonomy unilaterally without a similar move or concession on the other side. Whenever monetary power is structurally and protractedly in favour of one actor, a monetary arrangement is defined asymmetric. The stronger part is the leader, while the choice of other countries is limited to the alternative among followership and neutrality. In asymmetrical systems, followers manage systematically their monetary policy to compensate the capital flows generated by balance of payment fundamentals, while the leader gains, thanks to this follower's will to sacrifice domestic objectives, the privilege to select its first-best policy among a full range of alternatives.

Specifically, followers in a deficit position finance their balance of payment disequilibria with a positive differential of real interest rates, so as to make investments in the domestic market more palatable to international savers and keep the currency stability unchallenged. On the contrary, surplus followers foster investments in the leader's market with a zero or negative interest-rate gap that might be unfitting for their own economies, but incentivises local firms and banks to find investment opportunities abroad for the country's excess of savings¹³. The flows of currency generated by these

¹³ Generally, the purchase of financial instruments denominated in the core-currency follows almost naturally given the greater development of leaders' capital markets in terms of liquidity, depth and complexity.

policy moves maintain the stability of the leader’s coinage despite its domestic policies generate structural imbalance, either in the positive or negative direction. This kind of response to macroeconomic imbalances, for its visible regularity, will be defined henceforward the *Compensation Rule* of monetary policy, because it aims at compensating unilaterally the followers’ current account position. In accordance with the rule, the following scheme sums up the possible policy interactions of a leader-follower framework under different balance-of-payment conditions. In the boxes below, I listed the expected movement of the leader’s currency given any possible follower’s move.

		Follower’s external position				
		SURPLUS		DEFICIT		
		Interest rate differential		Interest rate differential		
Leader’s external position		ZERO OR NEGATIVE	POSITIVE	ZERO OR NEGATIVE	POSITIVE	
		SURPLUS	Stability	Depreciation (weak) or Stability	Appreciation (strong)	Stability
Leader’s external position		DEFICIT	Stability	Depreciation (strong)	Appreciation	Stability

In this research, the empirical focus will be on the mechanisms through which monetary policy is used to compensate macroeconomic imbalances by surplus economies vis à vis a deficit leader. On the one hand, I focus on this situation follows three considerations. The first is the understudy of surplus countries by the political-economy literature, which as I demonstrate in chapter four, is patently biased on cases of small deficit countries with weak financial markets and lacking international credibility. Second, I look to the deficit leader/surplus followers scheme and not to alternative models (surplus leader/surplus follower) because if most of a system’s major actors show a substantial current account surplus all at once, it is unlikely that the leader, whose market is presumably the largest of the entire system, runs the same

performance (for lack of end-markets). Thirdly, in the rare cases where this occurs, evidently the deficit market supporting the simultaneous surplus of both followers and leaders is placed outside the monetary area, and towards that market the two parties experience a convergent of interests rather than a conflict.

On the other hand, the choice of focusing on monetary policy is not to understate the importance of fiscal policy, but simply to provide a wider overlook to the phenomenon of monetary followership¹⁴. Indeed, focusing on monetary coordination is the best way to detect and explain existent asymmetrical relations in the long-run (i.e. more years and data) rather than concentrate simply on the two-three years of the adjustment conflict. Secondly, monetary policy, because it delays persistently the correction of payment imbalances, has been historically the preferred and most frequent form of adjustment by monetary followers, which would rather sacrifice their autonomy on an obscure and complicated thing like central banking than touching directly their citizens' everyday life by operating on taxes and expenses. Last, but not the least, even when fiscal policy becomes a necessary part of the adjustment several factors can make it ineffective compared to monetary policy if leaders and followers belong to diverse models of capitalism or have a different level of economic development. For example, China and Saudi Arabia responded to the 2008 global financial crisis with a huge fiscal stimulus, but the impact of these measures on global imbalances pales in comparison to their monetary complements, like Riyadh's low interest-rate policy or the spectacular accumulation of foreign exchange by the People's Bank of China (McKinnon 2009; Vermeiren 2013b).

The next chapter describes in detail the indicators of the dependent variable of this research, illustrating the concrete economic-policy strategies that minor states have used to remain neutral in the monetary game and the different way in which minor states follow a currency leader in monetary affairs.

¹⁴ Despite being called 'monetary' followership, it is worth reminding that neither in the literature nor in this research this phenomenon is intended to exclude fiscal policy coordination or other strategies unrelated to interest rates and money supply from the study of the politics of money and exchange rates.

CHAPTER III

Leadership and Followership in International Monetary Relations

3.1 Leadership and Hegemony in International Relations: a brief overview

The concept of monetary (or currency) leadership arrives relatively late in the IPE theoretical reflection, and differs fundamentally from the similar concept of 'hegemony' that has commonly characterised the discussion on hierarchy and power in international relations. In the next sections, a review is provided on the way major theorists in different disciplines have dealt with the topic of international primacy or predominance, and if this is the case, on how these authors have differentiated leadership and hegemony from each other. A special focus will be given to neorealism and the English School in IR and to the early debate on Hegemonic Stability Theory in the IPE framework. Afterwards, I explore how the same research has been conducted thus far in the specific field of the international politics of money and exchange rates. Finally, I elaborate a possible classification to distinguish what characterises leadership and hegemony in the international monetary system.

Within the realist theory, hegemony is commonly conceived as one of the possible distributions of power and prestige in an interstate system. Traditionally, this view counterpoises hegemony with balance of power, and discusses about the consequences of the two power distributions on the likelihood of war and peace. Concretely, in this perspective the word hegemony designates a particular shape of the international political system, structured around the military superiority of a single predominant power. For instance, Mearsheimer (2001) defines hegemony as the unrestrained control by a single country over its political space. In this condition, no state in the system is able to oppose to the hegemon's will, while the hegemonic power is always able to obtain the others' compliance by using a wide range of levers, included military coercion. Hedley Bull (1977) considers hegemonic systems as an intermediate form of hierarchical international system, placed between the tighter form known as dominance and the looser form known as primacy. As he puts it, «[where] a great power exercises hegemony over the lesser powers in a particular area or constellation, there is resort to force and the threat of force, but this is not habitual and uninhibited but occasional and reluctant.» (Bull 1977).

After the Cold War, theories of unipolarism have generally used the terms hegemony and leadership interchangeably, but have maintained, on the conceptual ground, the equation between unipolar and hegemonic systems (Krauthammer 1991;

Mowle and Sacko 2007; Wohlforth 1999). If anything, the post-Cold War 'unipolar moment' was indeed the quintessential of a hegemonic system, concentrating as much military, economic and ideational power in the hands of the United States as it was never observed before in the history of international relations. In sum, the views of realist IR scholars on the nature of leadership and hegemony seem to share at least three common elements: first, they see hegemony as a mere condition of the system, connoted by the exercise, by a single actor, of an overly superior military capability. Second, it is widely irrelevant how the stronger state exerts its military predominance, while the hegemonic condition is merely defined by the incapacity of other states to challenge, or even simply resist, the hegemon's will. Lastly, the concept of leadership is either subsumed into hegemony or simply not used.

An alternative view on the issue emerged after the Cold War when a renovated interest for the topic brought scholars to ask for a purposeful action of the dominant power in order to forge and govern a pattern of institutional relations beneficial to the whole system. For this second strand, the mere exertion of power preponderance is not sufficient to make a hegemonic country. Rather, a major state should «purposefully [exercise] its overwhelming power to impose order on the international system» (Layne 2006), or engage actively in «building, developing, and sustaining [...] international institutions [...] which reflect the negotiation and renegotiation of hegemonic bargains with other states in the system» (Jesse et al. 2012). Furthermore, a wave of interest for the concepts of hegemony and leadership has come with the rise of regional powers in the non-western world. The authors dealing with this topic have frequently emphasised the distinction between hegemons and leaders based on the extent of force and coercion, rather than economic incentives and ideational convergence, which the strongest states uses to advance its own interests. Accordingly, hegemony would be the coercive and exploitative face of an asymmetrical power relation, while leadership involves a reciprocal flow of benefits, a pre-existent convergence on shared interests or the socialisation of followers through the internalisation of common norms and ideas (Burges 2008; Destradi 2010; Malamud 2011; Nabers 2010; Schirm 2009; Wiener 1995).

Finally, it is worth noting that the concept of leadership has received a special attention in the field of alliance politics. Here, the term 'leader' refers to asymmetric alliances where military and diplomatic assistance is unidirectional, with a major power

providing most of the alliance's common resources, and one or more minor powers consuming the leader's security in exchange for some valuable compensation (Cesa 2010; A. F. Cooper, Higgott, and Nossal 1991). In this context, the leader is the state 'in command' of an alliance, which retains the last word about the exercise of force against the enemy and the organisation of the alliance's armed forces in peaceful times (Colombo 2001). In this minority, but relevant perspective, leadership implies an outcome of political subordination – originated out of a situation of asymmetrical vulnerability – between a single strongest state and one or more minor actors playing the role of 'followers'. For example, no one would deny the United States is the hegemonic power in the American continent or the Persian Gulf. Likewise though, no one would ever argue it is the leader of such countries like Venezuela, Cuba or Iran, which are subject nonetheless to the influence of the American hegemonic power.

3.2 Hegemony and Leadership in the monetary system: the early debate

Thus far, I explored how the literature has dealt with the concepts of leadership and hegemony looking mostly at IR, realist-minded, authors. However, the topic of asymmetrical relations in monetary and exchange-rate affairs has been one of the most discussed in IPE theory since its establishment as early as the 1970's. Essentially, two approaches to the study of hierarchical monetary systems have been developed. One aims at identifying the international role of national currencies to infer power relations from this positioning. The other analyses directly the patterns of economic interaction between great powers and minor states to understand preferences and strategies of leaders and hegemons.

A noteworthy contribution in the first field is undoubtedly Susan Strange's "*The Politics of International Currencies*", where the British scholar elaborates a four-tailed taxonomy of national currencies based on their status on international markets including, trade, finance and central banking. In order of relevance, national coinages are defined as: a) Top Currency; b) Master Currency; c) Negotiated Currency; d) Neutral Currency (Strange 1971). These conditions, in Strange's view, are useful to indicate the currency's market-based role in international transactions, but include also the political influence of the issuer country over the actors conducting most of their transactions in

its core-currency. For example, the difference between Master Currency and Top Currency is illuminating in this respect. On the one hand, with the first Strange describes those coinages enjoying a vast international use thanks to the leader's recurrent politico-military pressure. On the other hand, the condition of Top Currency is about the use that international market actors make of a certain currency, in particular, as a store of value by investors and central banks, as a means of exchange in international trade and foreign exchange interventions and as unit of account for internationally traded commodities. Today, the US dollar is the only money enjoying this pivotal position, which is more commonly defined *international key currency*. Exactly like Strange's Top Currency, the greenback is characterised by a massive worldwide use as unit of account, means of exchange and reserve of purchasing power by worldwide private and public actors. Regarding the other two categories, a Negotiated currency follows more or less the dynamics of a Master Currency, but this kind of political construction emerges when the followers' compliance is bought through ad-hoc side-payments and bribes instead of being exhorted by means of military threats and economic deprivations. Lastly, the category of Neutral Currency would simply collect all the other countries that, for many reasons, do not enjoy any political control either on other countries' policies or on transnational economic actors.

Throughout successive decades, just one major scholar attempted to refine and update Strange's taxonomy. In his *'The Geography of Money'*, Benjamin Cohen extended the possible currency positions to seven, ranging from the over-dominant Top Currency to the almost inexistent Pseudo-Currency (Cohen 1998). At the top layer, expectably, the definition is the same as in Strange's work. The second layer is labelled *'patrician currency'*, and subsumes Master and Negotiated Currencies, plus non-politically imposed coinages enjoying nonetheless a wide international use. Within this broad category, the author puts today's widely-traded currencies like the Japanese yen or the euro and core-currencies of monetary aggregations such as the former French franc and German deutschmark. The third layer devised by Cohen is that of *'Elite Currencies'*. To this group would belong all that coinages «sufficiently attractive to qualify for significant international use but of insufficient weight to carry much direct influence beyond their own national frontiers». To give an idea, widely known moneys like the British pound, the Swiss franc, the Italian lira, the Canadian and Australian dollar, although with

different degrees of strengths and credibility, are considered part of this group. Below this level, other categories hardly offer any insight into the concept of leadership or hegemony in the monetary system¹⁵.

As regards the second approach to the study of leadership and hegemony in the monetary system, the most pertinent theoretical reflection is the longstanding debate around the hypotheses of the Hegemonic Stability Theory. Charles Kindleberger is unquestionably the main advocate of a clear distinction between these two phenomena, which he links to their diverse distributive attitude vis à vis potential followers. In his seminal writings, the author identifies two ways for great power to exploit the condition of 'dominance', namely a preponderant economic power over the rest of the system: *leadership* and *exploitation* (Kindleberger 1973, 1981). In the first ideal-type, the leader is supposed to renounce voluntarily to manage discretionally its own economic policy to provide order and stability to an international financial system prone to recurrent imbalances and crisis. Kindleberger predicts the non-cooperation of minor actors due to the effect of a collective action dilemma for the production of public goods. In international monetary relations, the public goods are identified in the stability of exchange rates and a safeguard mechanism against the risk of a Great Depression-style generalised deflation. Accordingly, in such context the leader is expected to procure unilaterally «a market for distress goods, a steady if not countercyclical flow of capital, [...] a rediscount mechanism for providing liquidity when the monetary system is frozen in panic [and] a degree of coordination of domestic monetary policies» (Kindleberger 1981). By this way, the larger country internalises the cost of its partners' defection and avoid a worldwide uncoordinated and competitive adjustment of systemic imbalances. Conversely, in exploitation the dominant actor abuses of its capacity to treat public goods – such as emergency lending or the access to its domestic market – as private goods, so that it can selectively exclude minor actors from enjoying the advantages of being part of the system. By playing on this form of pressure, the 'exploiter' extorts unequal gains from other countries as a consequence of its pivotal role in a monetary arrangement. In some of his successive works, to conform to the existing trend in IPE

¹⁵ 'Plebeian Currencies' firmly retain the legal tender inside their issuing countries, but play no role outside nor generate any significant volume of transactions. Behind this, three residual categories (Permeated, Quasi- and Pseudo-Currency) mark different degrees of descent into the hell of currency markets, where the market's distrust for a national coinage affects local users and not solely international investors.

literature, Kindleberger redefines exploitation as 'hegemony' (Kindleberger 1986). In this way, he prefigured that distinction between an egoist and exploitative hegemony and a benign and farsighted leadership, underpinned by an ethical and moral afflatus¹⁶, which informed decades of scholarly debate on hierarchy in the international economic system.

On the fundamental divide between a benign leader and an exploitative hegemon, others have built their own interpretation of this dichotomy. Knorr states that hegemony implies «supremacy in an area that the hegemonial state controls by superior coercive power, whereas leadership would entail a form of *one-sided non-coercive influence* characterised by a *mutual flow of benefits* between leaders and followers»¹⁷ (Knorr 1975). The same pessimistic view on the distributive outcome of hegemonic systems is given by the so-called 'coercive' version of the HST. In this context, widely known thanks to the works of Robert Gilpin (Gilpin and Gilpin 1987; Gilpin 1976, 1981), the conceptual separation between leadership and hegemony is almost irrelevant. The economic hegemon, indeed, is intended as a multi-role superpower, which organises international economic relations to support its military and diplomatic grand strategy with the ultimate end of maintaining a top position in the system's power hierarchy. Intuitively, this kind of actor leaves no or little space for renouncing to its policy autonomy for guaranteeing the smooth functioning of the international payment system. According to Gilpin, those countries coupling a hegemonic role in the monetary arena and a primary power position in the international system present at least three characteristics: a) a large domestic market; b) a dynamic and technologically-advanced economy; c) the role of key/top currency for the national money (Gilpin and Gilpin 1987).

In the latest part of the debate on hegemonic stability and the monetary system, other authors have tried to overcome the dichotomy between an exploitative hegemony and a benevolent non-violent leader by considering coercive power as a tool

¹⁶ To give an idea of the degree of self-restraint that monetary leaders should possess to make the system function as Kindleberger imagined, he blamed hegemonic actors for not leaving «room for conscience, duty, obligation, or such old-fashioned notions as noblesse oblige [...]». And he continues, referring to the exercise of dominance in the monetary system: «A hegemon presumably wants to do it in its own behalf. A leader [...] is forced to "do it" by ethical training and by the circumstance of position» (Kindleberger 1986a)

¹⁷ Emphasis mine

to enforce established monetary agreements rather than a mere instrument of exploitation. In his game-theoretic study on the *'Hegemonic Stability Theories of the International Monetary System'*, Eichengreen (1989) identifies an ideal hegemonic power of the monetary system characterised by the issuance of the «internationally dominant currency» and in a greater relative size compared to its partners. He draws a dynamic game of incomplete information where the hegemon devalues its currency in mixed strategy to retaliate the episodes of beggar-thy-neighbour devaluation pursued by its smaller neighbours. Through this mechanism, it maintains stable exchange rates, which for simplicity is assumed as the sole and unique political goal of a monetary arrangement.

Andrew Walter (1991) devoted an entire book to the issue of hegemony and leadership in the monetary system – using the two terms interchangeably. In this work, he performs a review of the main forms of international liquidity management, conjecturing on two major tasks that would characterise a «hegemonic governance» of the monetary system. The first is the establishment of international regimes by the definition of specific «ground rules of the game», complemented by the will to spend material resources to secure their enforcement. The second would be about «encouraging policy coordination» among the system's members. In the empirical part of his work, the author sheds light on how hegemonic powers ought to support policy coordination by describing the historical controversy, known as 'locomotive dispute', between Japan and Germany on the one side, and the United States on the other. Walter, along with Eichengreen and, far later, Henning (2006), suggests that exchange-rate manipulation is the key weapon in the hegemon's hands to force its partners to the symmetric adjustment of systemic imbalances.

3.3 Capital mobility and 'passive leadership': the second generation of theories on asymmetrical monetary regimes

The set of definitions, regularities and hypotheses accompanying the early scholarly debate on asymmetrical monetary arrangements has been shocked, as of the 1990's, by the profound structural change opened by the enormous increment of capital

movements across developed and developing countries. Slowly, scholars began to observe that public-goods and coercive theories of asymmetric monetary systems proved equally ineffective in accounting for some episodes where followers renounced to their policy autonomy to enhance the leader's or hegemon's position. For example, policy coordination in the European monetary system during the 1980's was led by the German Bundesbank, which set interest rates for the whole continent while other countries followed passively. However, contrary to both coercive and benevolent ideas on leadership, this was neither the result of military coercion nor an expression of Kindleberger's 'rational altruism' from Germany to European neighbours (Andrews 1994a; Kaelberer 2001). Pairwise, the wave of dollarization, hard pegs and capital market liberalisation that invested developing countries in the early 1990's (especially Latin American and South-East Asian countries) has little or nothing to do with colonial-fashioned bullying or the role of United States as public-goods provider in the sense conceived by Kindleberger. The 'second generation' of theoretical works on hegemony and leadership in international monetary relations brings a significant contribution to this puzzling evidence.

These researchers have developed radical innovations in traditional models of asymmetric monetary arrangements introducing the role of cross-border capital flows as an intervening exogenous variable in the conflict between leaders and followers for the distribution of macroeconomic adjustments. To simplify the novelty of this approach, the studies on monetary leadership (or passive leadership) rely on a different heuristic tool than the traditional Prisoner's Dilemma used in the early debate: the so-called 'Game of Chicken'. Unlike the previously over-present dilemma, the Chicken Game does not produce a unique and stable Nash equilibrium, but two alternative equilibria (the cooperation-defection and the defection-cooperation outcomes) with three Pareto optimal solutions (the two NEs plus the cooperation-cooperation case). However, if all players are undoubtedly worse-off in case of mutual defection, which could be identified in monetary affairs with the consequences of a balance-of-payment crisis, as long as the game is static and players are assumed of equal bargaining power, there is no way to predict which of the two equilibria prevail.

The Game of Chicken sketches a remarkable picture of strategic incentives in a monetary system with high capital mobility, but as testified by its dual Nash equilibrium,

it remains unable to predict outcomes as long as players are assumed as equal in bargaining power. Second-generation authors argue that major players' key bargaining tool is their asymmetric vulnerability to the consequences of currency and financial instability. In other words, stronger parts are able to deflect the adjustment onto weaker actors not solely by coercing or inducing other countries directly and purposefully, but simply by letting market forces work. In the classical example of a deficit country forced to follow interest rates of a surplus leader, the greater monetary power of the strong-currency state lies in the different losses expected with an abrupt correction of exchange rates and capital flows to the large systemic imbalances. For a deficit actor indeed, the consequences of not preserving exchange-rate stability through internal deflation usually entail capital flight, shooting-up borrowing rates, volatile currency depreciation and high inflation. Up against its worst-case scenario, the weaker state usually minimises its policy autonomy and applies the Compensation Rule in order to make the local currency more palatable to international investors and avert the risk of economic shocks, even if this can be sub-optimal for its home economy.

Abdelal tries to reconcile the old HST with the novelty of leadership theory distinguishing between an *active leadership*, which is able and willing to provide the public goods proposed by Kindleberger in his works, and a *passive leadership*, which provides a mere focal point around which potential followers must unilaterally adjust their interest rates to achieve currency stability (Abdelal 1998). The idea of passive leadership as the everyday currency of the international monetary relations has been endorsed by Andrews as well, for whom «parties that are better prepared to endure [policy] discord's consequences [...] simply by inaction [oblige] their more vulnerable partners to adapt their policies instead», then adding «This is what I mean by passive leadership» (Andrews 2006).

3.4 Monetary Leadership as control over macroeconomic adjustments

In previous sections, I reviewed how different generations of theoretical studies in IR and IPE have defined and distinguished the two phenomena of international leadership and hegemony. To summarise the main dividing lines crossing the scholarly reflection on the issue, at least three interpretations can be drawn on these two concepts. First, a

structural definition common in IR realism and the studies on unipolarism, considers hegemony as the material fact of systemic power preponderance, where the military or economic power is directly and willingly exerted by the hegemonic power irrespective of its distributive implications, tools and outcomes. Leadership, when mentioned, is nothing but another, perhaps weaker synonym for hegemony. In the monetary arena, the main problem with this choice is to exclude, or ignore, the non-intentional and structural coordination highlighted by the studies on passive leadership, whose importance for monetary and exchange rate policy is astonishingly greater than in other sectors of international relations.

Secondly, the *distributive* definition is the traditional dividing line adopted in the early IPE debate and revived by the studies on emerging non-western powers in the last decade. At one extreme, the 'benevolent' leader remunerates followers' participation in the system by tolerating their free-riding for the sake of financial stability. At the other extreme, the 'coercive' hegemon exploits the bargaining tools of its apical position, including the use of force, to reap a disproportionate slice of the system's wealth and preserve its relative power position. As an intermediate position, as highlighted by Walter and Kindleberger, hegemonic powers can use their overwhelming strength to guarantee an equal distribution of the burdens of systemic governance through the enforcement of existing agreements. In this strand, the main problem is about demonstrating that such a self-defeating leader as the one hypothesised by both Kindleberger and recent studies on regional powers could ever appear in the real world. As many supporters of coercive theories have stressed indeed, there is a patent contradiction between the supposed farsightedness of this actor, which sacrifices immediate economic benefits and even its own policy autonomy to avoid currency instability and competitive deflation, and the inevitable *hegemonic decline* that this altruistic behaviour implies, which risks to jeopardise its capacity to play the same role in the future (Grunberg 1990; Norrlof 2010).

Lastly, a *relational* definition can be constructed on the second generation of studies in monetary IPE and on the traditional understanding proposed by alliance theory in International Relations. Generalising their views, hegemony is identified with a *capability-based* criterion: a hegemon is a single actor exercising a preponderant power advantage over second-tier powers, whether in the military, financial or trade

arena. Unlike the aforementioned structural definitions, however, relational definitions imply also an autonomous idea of leadership grounded on an *outcome-based* criterion: the leader is an actor (not necessarily hegemonic) able to coagulate successfully one or more followers around its political goals in a given policy area. Hegemony offers a privileged position to exert leadership, but it is neither a necessary premise nor a synonym of this status. In concrete, in the politics of monetary relations the literature has identified rather clearly two elements characterising a monetary hegemonic country: the issuance of the system's *key currency* and a *vast and open domestic market*. This are the two key resources allowing a hegemonic actor, also implicitly and unintentionally thanks to the chain of transmission of financial markets, to play its game for autonomy in the monetary system with an advantage on other major powers.

For the reasons exposed above, in this research I develop a relational definition of monetary leadership, defining this phenomenon as *the condition of a pivotal country which is willing and able to convince other countries – by coercion or induction, directly or simply by inaction – to adjust unilaterally their monetary or fiscal policy in order to compensate the system's payment imbalances*.

In the recent history of the monetary system, the most known cases of monetary leadership, with mixed success, are Germany in Eastern Europe (1930-1945) and Western Europe (1979-1992 and 1999-today), France in Western Africa (1945-today), Britain in the global system (1870-1914) and within its colonial space (1870-1960) and the United States in the global system (1944-today).

3.5 Between Neutrality and Followership: small and middle powers vis à vis dominant currencies

If the nature of international pre-eminence, hegemony or leadership has been one of the most discussed, defined and contested issues in international studies – whether economic, political, or even juridical and philosophical – the position, roles and motives of the lower layers of the international hierarchy have always received much less attention. Many of the few scholars who analysed the foreign policy dilemmas of small and medium powers introduce their works with complaints about the underestimation

that these actors normally receive in International Relations theory. In his 'After Hegemony' Keohane points out as «concern for the incentives facing the hegemon should also alert us to the frequently neglected incentives facing other countries in the system [...] Theories of hegemony should seek [...] also to explore why secondary states defer to the leadership of the hegemon» (Keohane 1984). For Cooper et. al. (1991), who authored a pioneering study on the foreign policy of US's smaller allies during the Gulf War, «An examination of different strands of the scholarly literature reveals that the focus is almost exclusively on the leader or the hegemon. Smaller states or the hegemon's followers do not occupy a position of prominence in these analyses».

This deficiency, according to Cooper et al., is due precisely to one of the dominant conceptions of leadership and hegemony illustrated in previous sections, the so-called 'distributive definition'. In that perspective, given that an asymmetrical system can be organised either on the availability of the leader to provide public goods unilaterally, or on the coercive imposition of a stronger hegemonic actor, wandering about how and why small and medium states should take a different position than free-riding, in the first case, or blind compliance in the second instance, is almost a non-sense. In the public good framework, the follower has an undoubtable interest in enjoying the leader's cooperative effort, as it consumes the public goods of currency stability, market openness and countercyclical liquidity while escaping any contribution for their production. By contrast, in coercive models including punishment and side-payments by the leader, the question is correctly posed, but the room for a different response by followers due to diverse size, position and domestic constraints is rarely and badly discussed (Alt, Calvert, and Humes 1988; Eichengreen 1989). In this models, all the attention is drawn away from the minor state's dilemmas and put on the hegemon's capacity to punish.

However, some attempts to rationalise and explain the practice of followership by the system's small and medium powers is present in both IR and IPE, with monetary followership being a particularly appropriate domain for studying this behaviour. While the abovementioned literature tend to understate minor actor's range of policy choices, and thus to explain their behaviour just as a mechanical by-product of the leader's action, other authors dealt with the issue under the premise that monetary followership, as any other political decision, is picked up among a range of multiple

policy choices (Abdelal 1998; S. Cooper 2006). This means that the leader's will and capacity to coerce, bribe or punish the system's minor actors is a necessary but insufficient part of the equation, while a huge number of factors – ideological, institutional, positional, dimensional and so on – determine policy outcomes both at the systemic and the agent level.

In the literature, a few authors gave a comprehensive definition of followership, which tend frequently to mirror the definition given by the same author to leadership or hegemony. For example, Knorr (1975) mentioned the category of 'clients' as the lesser members of a patron-client relationship characterised by the absence of coercion, a reciprocal flow of benefits and a regular and agreed durability. Cooper et. al. (1991), who intend leaders as the 'organisers' and 'coordinators' of international multilateral actions such as Desert Storm in 1991, wrote that «followership involves an understanding that leadership necessarily means making political choices for the group; followers appreciate that decisions made on behalf of the collective in pursuit of worthy goals». Destradi (2010), for whom the leader «guides [...] a group of states in order to realise or facilitate the realisation of their common objective», defines the follower as an actor which voluntarily decides to shadow the leader's actions and policies because the major country's objectives and goals are in its own interest. Nabers (2010) sees followers as states whose political elites «acknowledge the leader's vision of international order and internalise it as their own». Against the tide, Schirm (2009) endorses a material definition considering followership as the act of «supporting the goals and positions of another country which were not shared previously and/or accepting a relative loss of status and power».

This puzzling heterogeneity of positions is simply an expression of the same confusion ruling on the other side of the coin about the concepts of leadership and hegemony. In this research, I mimic the same strategy adopted by major scholars, proceeding to define followership from my own definition of monetary leadership. Accordingly, *Monetary Followership denotes the policy behaviour of a minor state that undertakes a unilateral policy adjustment on either exchange rates, monetary or fiscal policy to stabilise the international purchasing power of the core-currency.*

In concrete, unilateral policy adjustments consist in the asymmetrical application of the wide range of strategies depicted in the first chapter and defined external policies,

symptom-management policies and internal adjustments. Generally, monetary followership manifests itself with two evident pillars: the stabilisation of the local currency around an explicit or implicit *exchange rate parity* and the *adaptation of domestic policies* to compensate payment imbalances and delay undesired adjustments for the leader. However, this definition would not be complete without giving an account of what monetary followership is not, or in other words, of how the aforementioned policy instruments can be used against or irrespectively of the leader's balance-of-payment exigencies. Considering the whole spectrum of viable strategies in which monetary, fiscal and currency policies may combine with one another, two macro-positions can be identified: *monetary followership* and *neutrality*. These two general positions, in turn, can be concretely realised with different degrees of intensity ranging from the more hostile (*monetary coercion*) to the more subordinate the leader's will (*binding followership*), as will be illustrated with relevant historical examples in the next sections.

The three following sections provide an original taxonomy, besides the mere dichotomy between free-riders and loyal followers, of the different policy patters that minor actors adopt to deal with the cumbersome presence of hegemonic top currencies and would-be monetary leaders. First, in the next section I describe how small and medium countries can challenge monetary leaders and hegemons by means of currency weapons. In section 3.7 I illustrate the two most common strategies used by minor states to preserve some extent of policy autonomy without necessarily rising to the status of monetary leader. Finally, I provide in the last section an overview of how states combine their currency and monetary policy to tie themselves to major monetary actors.

3.6 Targeting the leader's money: currency warfare and monetary coercion

In this first situation, the minor state plays as a hostile actor¹⁸ striking the leader's coinage through exchange rate manipulation, inflationary policies or threatening the

¹⁸ The term 'hostile' should not be considered as synonym of 'enemy'. Currency warfare may well take place among allies, as case studies like the American currency attack to Britain in 1956 testifies. Nonetheless, one could hardly deny both that the US was hostile to British major political objectives at

counterpart's foreign exchange reserves in order to undermine the collective trust in the value and the acceptability of the core-currency on international markets. The broader category of currency manipulation implies two different strategies diverging on means, intensity and political objectives. In the first, known as '*strategic disruption*', the follower acts with the political purpose of gaining some privileges or rebalancing the burdens and responsibilities inside an existent monetary arrangement. In the second, known as '*subversive disruption*' (Kirshner 1995), the acting country aims at provoking the collapse of a currency system or jeopardising the target's purchasing power on international markets with the ultimate end of weakening its military and economic power in the conduct of foreign policy.

Given the strongly hierarchical nature of international monetary relations after World War II, episodes of this last kind are extremely rare. Disruptive monetary warfare is indeed hardly practicable by small countries, and is mainly an instrument for rising powers which find themselves in the position to challenge an incumbent monetary leader. The paramount example of this process is the American policy of creeping demolition of the British sterling's transactional network in the aftermath of the Second World War, when the US exchanged their extensive financial support with the early dismantlement of the thick normative web underpinning the dominance of the sterling within the British colonial space (Cappella 2013a; Hudson 1972; Schenk 2010).

Actually, the most common form of currency warfare fought by minor states, which by the way represents an example of monetary neutrality, is not the disruptive, but the strategic manipulation. To recall it briefly, strategic disruption consists in manipulating the leader's core currency devaluing or revaluing its exchange rate, undermining the trust of financial markets and exhausting the country's official reserves in order to obtain, rather than a collapse of the leader's power, a rebalancing of benefits and burdens within an existent monetary system. Concretely, the *dumping* of foreign exchange reserves (namely, the massive sell of balances in the core currency on international markets) is the privileged strategy to put pressure on deficit monetary

that time and that they were close allies against the Soviet threat. In addition, an all-out currency warfare among allies, as the attack on sterling suggests, is much more likely to take place between an established leader and its followers than as a form of challenge to an existing leadership. In this last instance, the practice of currency warfare by minor states is much more likely to characterise as strategic disruption or 'boatrocking'.

leaders by threatening to withdraw followers' fundamental support to the core currency. Historically, cases of this fashion characterised the policy of recalcitrant followers in both the sterling area and the Bretton Woods system.

For instance, in the period 1945-1960 the weakness of the pound and the presence of the US dollar as a reliable alternative fostered the appetites of the newly independent British colonies, which rushed to gain a series of economic and political concessions in exchange for their continuing permanence in the sterling area. The most cited case is perhaps the tense diplomatic game that opposed, on the one side, South Africa and former Rhodesia, and on the other side the black-ruled state of Zambia, in their reciprocal attempt to influence Britain's policy towards South-East Africa (Kirshner 1995; Schenk 2010). On the one hand, Zambia hoped to convince Britain to intervene militarily against the hostile government of Rhodesia by threatening the conversion of its massive sterling balances into dollars and cause a sharp depreciation of the British currency. On the other hand, the white-led regime of South Africa supported Rhodesia with exactly the same threat and together with the Portuguese colony of Mozambique provided its white-ruled ally with oil and food. In the end, both South African counter-threat and the disastrous financial conditions of Britain made it desist from surrendering to Zambia's boatrocking. However, the small black state obtained side payments and aids for its unfortunate geographical position, resulting in an overall win-win game for African countries at the expenses of the British leadership.

3.7 Monetary Neutrality though structural accumulation of current account surplus

When a country lacks the necessary power resources, the market size, the political will or a favourable economic and geopolitical environment to threaten currency manipulation, the strategy of monetary neutrality is still available to middle and small powers provided a favourable international environment and the implementation of a consistent set of policies. Neutrality, in general, does not guarantee the same extent of unbounded autonomy characterising monetary leaders, and yet allows neutral countries to manage their economic policies much more freely than monetary followers

do. Concretely, minor states can engage in monetary neutrality in two ways: the first is a long-term *accumulation of current account surpluses* and the second is a structural policy of *investment attractiveness*. This section is definitely devoted to the first strategy, while the second is addressed in the next one.

As Janet Kelly remarks in her seminal contribution on the relationship between national security and the monetary system, «while economists continue to berate them for it, most states continue to follow mercantilist theory when they can [...]. Within any system, states will work to grant them the most reserves even while using liberal rhetoric to declaim the virtues of free markets and non-interference» (Kelly 1977). In previous sections, the advantages of surplus countries in the international rush for policy autonomy have been extensively outlined. Countries with a positive balance of foreign assets over foreign liabilities are less subject to speculation given their strong position of solvency. In case of turmoil on currency markets, they retain the possibility to preserve an export-led growth or turning to one driven by domestic demand and state intervention. If they are concerned with an undue exchange rate appreciation, short-term symptom-management measures such as foreign exchange intervention are more effective and durable for these actors given the absence of a reserve constraint. In particular, small countries can be thought as specifically advantaged by this strategy. In fact, the smaller the market size of a country, the more it is free of practicing surplus accumulation, since the compression of its domestic investments and consumption does not drain a significant share of the world's aggregate demand, has little effects on global growth, and does not generate political pressures to adjust.

However, surplus accumulation is subject to some evident limits and one fundamental condition, which must be necessarily present to consider this policy option as a form of neutral strategy. The first limit, already recalled in previous chapters, is that countries can find necessary to intervene in the foreign exchange market to curb their currency's appreciation in order not to threaten a strong record of current account surplus. Nevertheless, this may cause inflation when the monetary agency is not able to sterilise the excess of liquidity, and shift on the real exchange rates the effect of appreciation that the intervention is aimed to avoid in nominal terms. The second limit is that the perpetual hoard of foreign exchange by central banks, and foreign assets by the private sector, makes the country's financial wealth vulnerable to the ups and downs

of currency fluctuations and credit risk, generating potential mismatches between domestic liabilities and foreign-currency assets. For example, several banks and financial firms were bailed out or bankrupted in rich autocracies such as the Persian Gulf monarchies, Singapore or Malaysia during the subprime mortgage crisis. After the 'Lehman shock', indeed, their foreign-currency assets, especially financial instruments denominated in US-dollar, turned from a safe source of cash flow and collateral for domestic borrowing in a mass of potential non-performing loans.

The third limit of this strategy concerns the whole idea behind surplus accumulation, representing a paradigmatic example of fallacy of composition. For someone with a positive balance between purchases and sales on international markets, indeed, there must be other units mirroring this position with an excess of imports over exports. Should all actors in an international system aim at collecting a protracted payment surplus, the risk is that no one, in the end, could achieve this goal satisfactorily.

Finally, the condition for surplus-accumulation strategy to be a cornerstone of monetary autonomy is a *careful and risk-averse diversification* with regard to currency, maturity and typology of foreign assets and reserves. On the contrary, when assets and reserves are mostly denominated in the core-currency, the build-up of current account surpluses plays as the most powerful support to a leader's macroeconomic autonomy. For instance, when countries like China, Saudi Arabia, or Hong Kong¹⁹ realise current account surpluses for as much as seventeen percent of their annual GDP, but invest the bulk of that savings in US dollar securities, the whole strategy has no beneficial effect on their policy autonomy, while it supports the American privilege to print as much money as necessary to revive an economy in crisis or avoiding cuts on military spending.

Contrarily, monetary neutral countries avoid making themselves vulnerable through the excessive exposure on one single country or currency by acting on three main variables. First, their *investment portfolio*, both in the private sector and the central bank, should be equally distributed between real commodities and financial assets, and these, in turn, ought to be diversified into bonds, equity and derivative instruments denominated in multiple currencies. Second, *Monetary policy* should be conducted looking exclusively at domestic exigencies about inflation, output and the

¹⁹ Hong Kong, although politically dependent on China, has so far conducted an autonomous currency and monetary policy.

solvency of the banking system, so to avoid that financial institutions find economically convenient investing their capital surpluses in a single country attracted by arbitrage opportunities with foreign markets. Thirdly, the node of *exchange-rate policy*. Generally, surplus actors deriving their export revenues from a single large market prefer fixed exchange rates to preserve their market share. In other cases, like the currency baskets adopted by countries such as Russia, Kuwait or Singapore, they prioritise the preservation of purchasing power vis à vis a multiplicity of world markets so as to diversify trade patterns. Notably, the first position should not be confused with monetary followership, where subordinate actors do not simply peg their currency to the leader, but are also prepared to adjust asymmetrically their domestic policies or hoarding reserves in a single currency to defend the established parity regardless of domestic exigencies. Neutral surplus countries, when fixing nonetheless the exchange rate to an external anchor, practice a sort of ‘*opportunistic followership*’, exploiting the advantages of a currency peg without bearing any balance-sheet risk on financial assets or any constraint on their domestic policy autonomy. Historical evidence of such a possibility is abundant, and today is represented by surplus countries like Singapore, Venezuela, Norway, Russia, Philippines and many others.

Among these, a particularly noticeable case is that of the extraordinary shift occurred to Norway in the last twenty years. As the largest oil and gas producer in Western Europe, Norway experiences a constant and substantial current account surplus, which skyrocketed at the onset of the 21st century following the generalised rise

Norway - Current Account to GDP

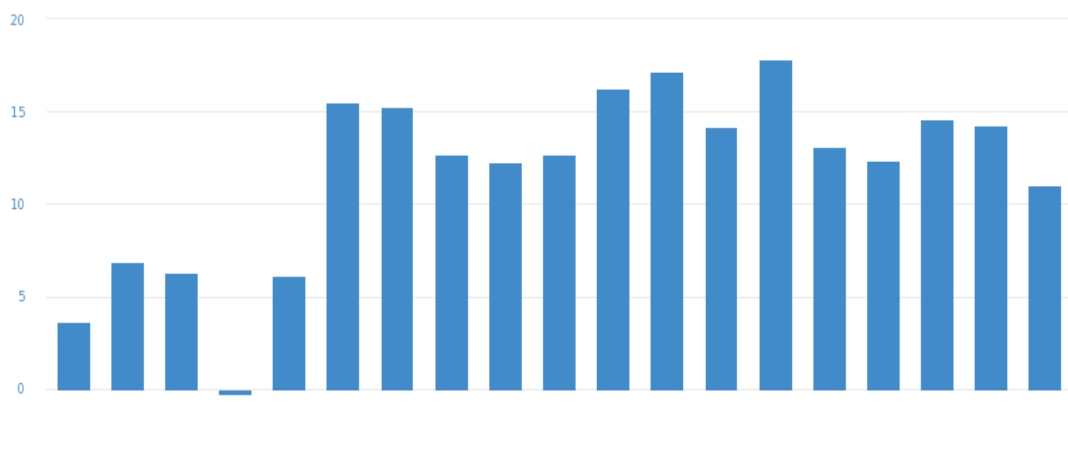


Figure 1 – Norway current account balance to GDP (annual 1995-2014)
Source: IECONOMICS.com

of energy prices. The Norwegian state is the largest shareholder of Statoil, the eleventh oil-and-gas company worldwide, and has chosen to manage the immense foreign-currency inflows that flooded the country with the explosion of energy exports through a careful portfolio diversification through the world's third largest sovereign wealth

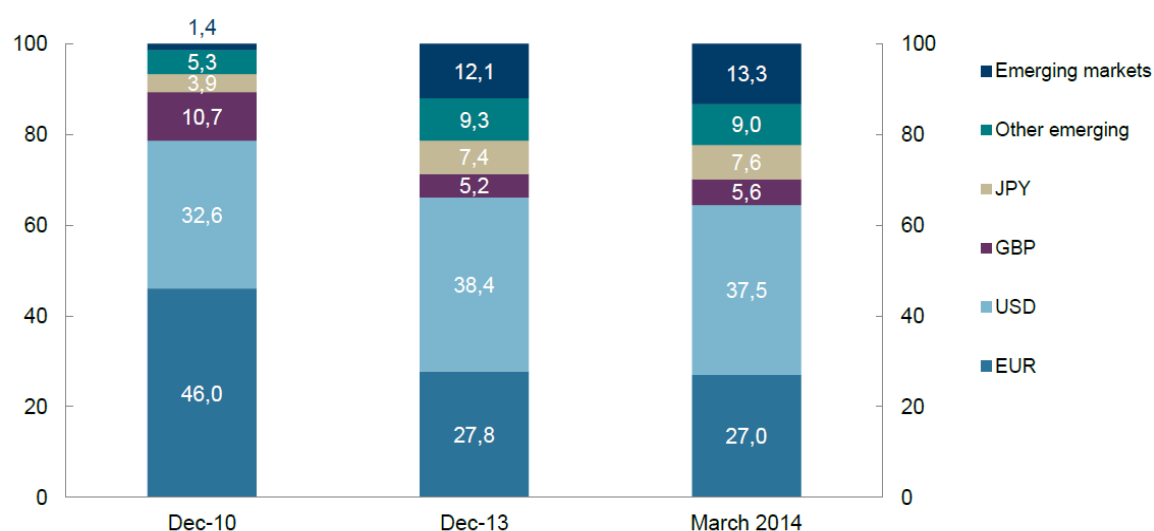


Figure 2 – Currency composition of foreign assets at the Government Pension Fund of Norway, in %
Source: (Bakker 2014)

fund, the well-known ‘Government Pension Fund of Norway’. The 863 billion dollar worth of assets allocated by the government’s fund have been distributed by 60% on high-yielding and liquid equities, by 35-40% on fixed income instruments and bonds, and by 5% on real estates²⁰. Europe and North America represent the 45% and 35% of total investment respectively, while the rest is distributed on the other continents, mostly in Asia. The currency composition shows an almost equal repartition, with about one third invested in euros, one third in US dollars and one third in other major currencies. Moreover, this composition has consistently changed through time following markets trends and big geopolitical events. For example, as shown in Figure 2, the euro was prevalent until 2010 due to the structural weakness of the dollar, but the greenback has significantly regained ground after the breakup of the sovereign debt crisis in the Eurozone. To give an idea for comparison, a conservative estimate of Saudi Arabia’s investment policy says the Arab kingdom concentrates at least 80% of its foreign assets in US Treasury bills and similar instruments denominated in US dollars (Institute of International Finance 2007; Samba Financial Group 2008; Setser 2008a).

²⁰ All data in the following pages are from (Bakker 2014)

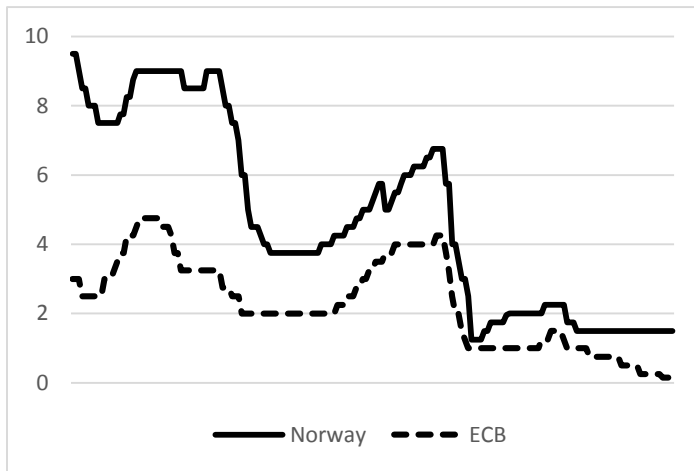


Figure 3 – Norges Bank's discount rate against ECB main policy rate (2000-2014; in % monthly)

Source: IMF – International Financial Statistics

The exchange rate and monetary policy of Norway have been adapted to the domestic exigencies of inflation control and to the necessity to maintain a stable flow of profits from the fund's foreign investments in terms of local currency. The Norwegian krone floats freely

against both the euro and US dollar, and is just occasionally managed against the euro to avoid damaging the country's tradable firms (in case of excessive appreciation) or the import bill (in case of excessive depreciation). Usually, currency fluctuations offset effectively the ebbs and flows of energy market prices, avoiding the overflow of local-currency liquidity in good times and a liquidity drought when oil and gas prices plunge. Monetary policy does not follow the compensation rule against either the Fed or the ECB. Despite the mounting current account surplus and the appreciating currency, the Norwegian authorities has constantly kept interest rates higher than the Eurozone, and recently, the *Norges Bank* has not followed Mario Draghi's hyper-expansive strategy to revive European economy, and kept interest rates fixed at 1.5% against the 0.05% reached in autumn 2014 by the ECB.

3.8 Monetary Neutrality though Investment Attractiveness

When countries want to be autonomous but have a political constraint in practicing surplus accumulation, or their economy is at a developmental stage requiring structural inflows of foreign capitals, the strategy of *investment attractiveness* can be a useful alternative allowing states to run larger and more extended current account deficits than would be usually permitted to indebted economies. Contrary to the ordinary weak-currency state, the capital attractive country exploits the exchange rate flexibility and a competitive and dynamic economic system to preserve a large extent of its policy

autonomy in spite of the necessity to appease international financial markets and get a continuous flow of financing to cover the excess of importations over exports.

The structural elements drawing foreign investors into the local economy pertain both economic fundamentals and the domestic institutional architecture. As to the firsts, economic soundness is characterised by a stable and low inflation, low public indebtedness, the ability to orient foreign investments in productive, long-term directions, and a substantial endowment of productive factors or natural resources. The level of development of capital markets is another primary feature of this strategy, as investors turn out attracted by liquid, complex and deep financial markets where they can enjoy a wide range of structured financial instruments and liquidate their positions quickly without generating substantial price variations. Obviously, a temporary trend of economic soundness is barely enough to appease market concerns on a country's capacity to pay back its foreign liabilities. Rather, a past record of reliable economic fundamentals, especially as far as inflation is concerned, is a starting to be complemented by an appropriate institutional structure that may assure financial investors that such policies will be followed in the future irrespective of governments' biases, economic cycle and other possible deviating factors.

Accordingly, some scholars argue that a liberal-democratic government with a strong system of check and balances, and especially, in this field, with an independent central bank, would be the real value added in countries' ability to withstand the balance of payment constraint from a deficit position (Schultz and Weingast 2003; Walter 2006). Their rationale is that the role of the national parliament and the central bank as permanent 'veto players' against inflationary surprises, and the development of the judicial protection of creditors' rights would convince domestic and international investors that it is worth lending to western-style liberal-democracies in spite of the possibly higher returns offered by alternative emerging markets.

Just like the strategy of surplus accumulation, also investment attractiveness present limits and underlying conditions if compared to monetary leadership. The first limit is that in order to preserve the country's policy autonomy the local exchange rate must be at least partially flexible against major world currencies, but in this way deficit countries are never really shielded from the consequences of policy autonomy. A bright example of how currency flexibility is able to loosen the pressure on long-term deficit

economies is that of Sweden during the 1992 currency devaluation. Before that date, the krone was fairly stable and largely overvalued against major European and world currencies while the country was experiencing a boom in foreign investments that lasted until the sudden stop of 1992, pushing the current account at its all-time low of 10 billion dollars in 1991. Flooded by the wave of

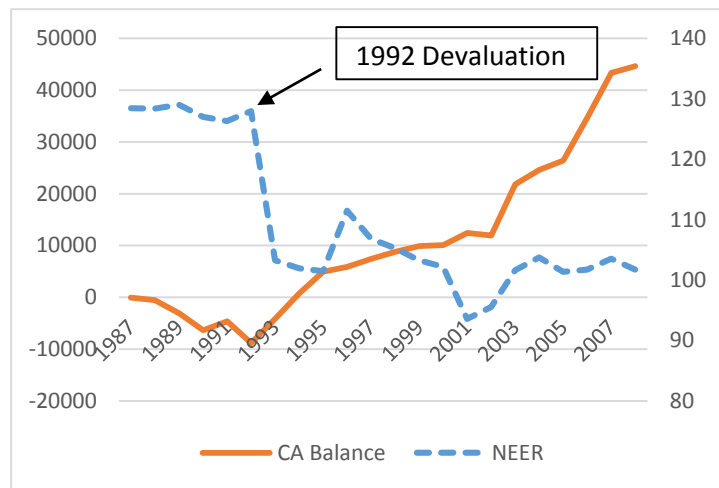


Figure 4 – Sweden nominal effective exchange rate (NEER, 2002=100) and Current Account Balance (yearly, in million US\$)
Source: IMF - IFS

depreciations hitting European currency markets in 1992 and by the rise of German interest rates, the small Scandinavian country, which was neither in the EMS nor a follower of the German Bundesbank, maintained an expansive monetary policy to address its own banking crisis and the stagnating growth while devaluing the krone by 30% against major trade partners to restore a positive current account by the end of 1994.

The second limit that ‘attractive’ states must accept when trying to run a persistent current account deficit is that, to some extent, their range of policy autonomy will be limited by their desire to appease financial markets. An exemplificative case of this problem is the 40-year long current deficit run by Australia in spite of a mounting nominal debt to foreign holders. This underpopulated country has so far exploited its large endowment of resources – like oil, coal and iron but also the abundant land and a continued flow of migrants – to increase its GDP year by year and offset the growing foreign-indebtedness. Meanwhile, it lets the Australian dollar fluctuate freely on foreign-exchange markets to allow for policy divergence between its monetary authorities and major world counterparts as well as to correct the NIIP through valuation changes whenever necessary. The main point to underline for this sub-type of investment attractive economies is that they obtain to run persistent trade deficits precisely by following a set of anti-inflationary, capital-friendly policies, and provided that the current deficit never gest as large as to make international investors doubtful

about the actor's ability to repay foreign liabilities. In other words, what 'investment attractiveness' gives to deficit counties in this case is not full autonomy – since it does not free these actors from the necessity to somewhat appease markets through 'sound' macroeconomic policies – but the mere possibility of running longer-than-usual current deficits.

Finally, the functioning of the whole strategy, and especially the role of exchange rate flexibility within it, is subject to two underlying conditions highlighted by economic theory: borrowing in one's own currency and realising the so-called Marshall-Lerner condition. The first condition is valid for both the private sector and the state. The practice to borrow from international markets in foreign currency, who Eichengreen et. al. have significantly called the '*original sin*' (Eichengreen, Hausmann, and Panizza 2002), has indeed the effect of nullifying the positive consequences of a currency devaluation on the country's net international investment position. Rather than reducing the value of debts (normally expressed in local currency) and increasing the value of foreign credits, the original sin makes the burden of liabilities skyrocket in nominal terms, and does not adjust its value net of foreign assets in case of currency devaluation. The second condition concerns the country's ability to restore a positive or balanced current account through an ordered exchange rate adjustment. In macroeconomics, this requirement is known as the Marshall-Lerner condition, and implies that both exports and imports react, in an opposite direction and with an elasticity greater than one, to currency movements. If, indeed, exports should rebound insufficiently to restore a positive ratio with national imports, the currency devaluation could even worsen the country's balance-of-payment problems by increasing the cost of imports and aggravating the shortage of foreign currency.

3.9 Three typologies of Monetary Followership between exchange rates and domestic policies

In this section, I move on to the less autonomous actors illustrating the different degrees of tightness in the relation between monetary leaders and their followers. According to three indicators – the way domestic policies follow the Compensation Rule, the rigidity

of the exchange rate peg to the core-currency, and the level of formalisation of the monetary arrangement – three sub-strategies of monetary followership can be identified: policy followership, exchange-rate followership and binding followership.

3.9.1 Policy Followership

In the first type, domestic policies are oriented to the leader's balance-of-payment exigencies, but the follower's currency is not necessarily fixed or strongly managed vis à vis the leader's core-currency. Since exchange-rate fluctuations, if not excessively large and prolonged, are not necessarily a taboo for the leader – what is important is their direction (depreciations are generally less desirable), and their pace (slow fluctuation are better than sharp ones) – monetary followers do not necessarily need a hard peg to stabilise the core currency. Every exchange rate regime other than hard pegs is equally eligible for policy followership, from intermediate solutions such as oscillation bands, crawling pegs and crawling bands, to more flexible solutions such as free floating, currency basket or soft-managed rates. Rather than using the exchange rate as a focal point, in policy followership central banks manage monetary variables to mitigate the fluctuations between the leader's money and the local currency unit, so as to favour a moderate and ordered adjustment of exchange rates and stabilise the core-currency against other major coinages. Changes in interest rates, money supply and foreign exchange reserves are more likely to play the lion's share in this weaker typology of monetary followership in that less politically sensitive compared to fiscal policy.

An exemplary case of this strategy is Japan's policy of constant support to the US balance of payment, mitigated by the possibility to let the yen float in response to specific trends of the Japanese economy. Indeed, especially since the beginning of the two-decade stagnation of the Japanese economy after the 1989 bubble, exchange rate devaluations have been used as a short-term relief valve to revive exports and preserve the country's international solvency vis à vis the plummeting national product. Nonetheless, monetary policy remains the real cornerstone of the Japanese strategy to support the dollar's role as an international key currency. In particular, interest rates show a visible application of the Compensation Rule, with a constantly expansive policy by the Bank of Japan aimed at encouraging the investment of the gigantic Japanese surplus in the United States' financial market. This trend is not simply a result of the

deflationary tendency of the Japanese economy, as a comparative approach suggests, but it started well before 1989 when the asset-price bubble was powerfully overheating the Japanese economy (Mastanduno 2009).

3.9.2 Exchange-rate Followership

Exchange-rate Followership denotes the case when both domestic policies and exchange rates are fully tied by the leader's moves. While both monetary and fiscal policies relax to offset the leader's indebtedness or get tighter to compensate the leader's surplus, the exchange rate is artificially maintained at implicit or explicit target vis à vis the core currency through recurrent and unilateral foreign exchange interventions. The main rationale behind this tightening form of monetary followership is to avoid speculative attacks and market pressure on the exchange rate by showing visibly to financial markets the country's commitment to the leader's currency stability. Examples of this policy are remarkably abundant, making this intermediate form of monetary followership de facto the most pervasive among the three categories. The Saudi Arabian Monetary Agency and the other central banks in the Persian Gulf play exactly this strategy, mimicking the Federal Reserve's moves in interest-rate setting and defending the established parity of their currency even from insignificant intra-day movements. Other examples are Malaysia from 1997 to 2005, China from 1995 to 2005 and Bangladesh in the last twenty years against the US dollar; Denmark, Croatia and the African countries members of the CFA²¹ towards the euro.

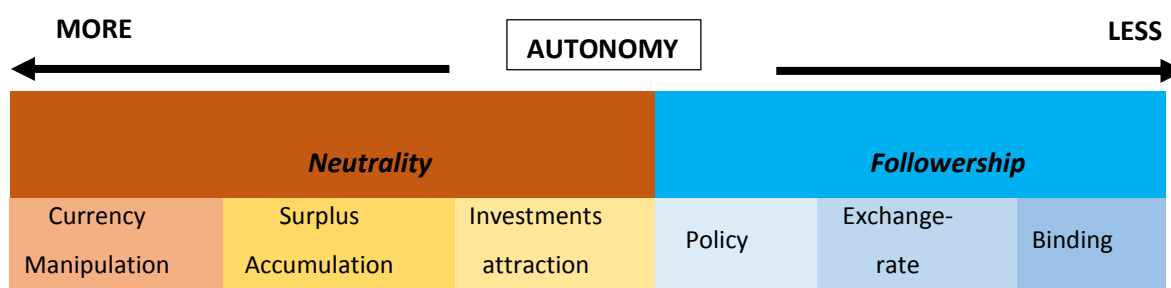
3.9.3 Binding followership

This last case is equal to exchange-rate followership in practical terms, but contrary to the former, comprises just those official, formalised, and institutionalised structures of monetary coordination. Empirical cases range from ad-hoc agreements such as the Louvre or Plaza accords of the 1980s', to those arrangements when currency parity are lawfully established, and macroeconomic adjustments are handled within the agreement's institutional framework. The variable making this phenomenon the tighter form of monetary followership is the network of institutional controls which guarantees follower's behaviour in presence of surveillance procedures and periodic feedbacks. On

²¹ *Communautés Financières d'Afrique*

the one hand, external institutional structures like international organizations can be entitled to obtain from national authorities data and reports on their financial situation, and are provided with the necessary prerogatives to punish violators by either concrete sanctions or by blame-and-shame statements. Similarly, currency boards and dollarization²² represent the unilateral version of this stringent monetary cage, more frequently observed in small countries and underdeveloped economies. Historical cases embrace such global currency agreements as Bretton Woods and the decennial experiment with fixed exchange rate and institutionalised coordination among western European countries, especially after the establishment of the single-currency in 1999. As to currency boards and dollarization, some paramount examples are Ecuador and Panama in their unilateral adoption of the US dollar as legal tender, Montenegro and Kosovo's adoption of the euro, and currency boards in Hong Kong and Argentina (1990-2001).

To summarise the multifaceted policy range of small and middle counties in international monetary affairs, the scheme below puts the five policy positions illustrated in this section on a graphical continuum based on the level of policy autonomy expressed by the different strategies.



The overview given so far to the strategies for managing external monetary relations is a mere a taxonomy of possible options. Therefore, they show which strategies small and medium countries can follow to remain autonomous against the pressures of would-be monetary leaders, hegemonic currencies and market forces. No insight, however, has

²² Currency boards are autonomous governmental agencies, which manage a country's monetary policy in order to maintain a rigid ratio between foreign reserves and domestic money supply (usually 100%). It is completely independent from both the executive and the central banks, and acts under a strict juridical mandate. Dollarization indicate the unilateral and passive adoption of a foreign currency by a sovereign states which renounces to all the privileges of seigniorage and to the autonomous management of its own money supply.

been yet given on the reasons why states select neutral or follower positions given this baseline range of alternatives. In the next chapter, I provide a cogent review on how scholars have explained monetary followership through different levels of analysis, with a particular focus on existing explanations for *the choice between surplus accumulation and the three forms of followership* in surplus states. Contextually, I illustrate the persisting theoretical gap about monetary followership in these countries, which I previously divided in small holders and major holders.

CHAPTER IV

The causes of Monetary Followership and the 'puzzle' of Surplus Countries.

4.1 Why do states follow in monetary affairs? Theories and Hypotheses on monetary followership

The choice to focus scholarly research on the political and economic reasons behind the choice of monetary followership emerges out of at least two considerations. The first is the relevance of this behaviour for the very existence of monetary leadership and hegemony. If all countries managed their official reserves, exchange rates and monetary policies looking exclusively at domestic indicators, no major actor would enjoy the privilege of full autonomy from the balance-of-payment constraint. The second reason is that monetary followership embraces all the most important prerogatives of national governments, such as the value of the currency, the cost of credit and the levels of taxes and public spending. That is to say that monetary followership can be economically, politically and ideologically costly for the ruling elite, and it is precisely for this reason that it deserves an explanation much more than alternative behaviours like challenge or neutrality. Especially, this is true in an anarchical arena of self-reliant actors such as the Westphalian international system, where I argued that autonomy emerges as the top priority as well for great powers as for minor states. Theories of monetary followership have been developed to detect those factors which contribute to *coerce*, *induce*, or *convince* central banks and governments in medium and small countries to give up policy autonomy and bear asymmetrically the burden of macroeconomic adjustments in an interdependent economic system.

According to Walter (2006), monetary followership can be explained by means of two alternative approaches. On the one hand, the *rationalist approach* assumes that minor states, although intentioned to preserve their autonomy other things being equal, follow when their cost-benefit assessment shifts due to economic incentives or the threat of induced costs by the leader. On the other hand, in the *constructivist approach* followers would rally around the core-currency and its policies because of the «normative socialisation» of political and academic elites in minor countries. For example, past literature has put in the spotlight the cases of relatively small countries, with fragile institutions and a history of hyperinflation as the more prone to use monetary followership as a safeguard mechanism against domestic financial instability and a precondition for economic development. Such a choice, however – lacking a

precise and shared understanding on the desirability of low inflation and the link between exchange rates and domestic prices (Kirshner 2001) – would be essentially political, driven by the anti-inflationary mentality and the supposed causal chains that has pervaded the epistemic community and public servants since the early 1980's (Calvo and Reinhart 2002; Fischer 2001; Giavazzi and Pagano 1988; McNamara 1998).

Other scholars have expanded the realm of material incentives dividing it further into negative or positive incentives. For Malamud (2011), the ways in which major powers can pressure minor states to bandwagon with their political objectives are essentially three: the *coercive-military way*, the *material-economic way* (bribes and cooperative incentives), and the *ideological-normative way*. Another author on the same path is Destradi (2010), who wrote of three sub-types of hegemonial control: hard, intermediate and soft. In hard control systems, the followers' compliance is obtained mainly through negative sanctions, threats and political pressures. The intermediate control is based on exclusively positive and material incentives: side-payments, bribes to political elites and perspectives of future economic or political rewards such as military protection, membership to international organizations and preferential treatment in trade and foreign investments. Finally, in the soft-control case, leaders modify and reshape norms and values of the followers through normative persuasion. The concrete instruments of this 'ideational entrepreneurship', generally, include privileged diplomatic contacts, incentives to cultural and academic exchanges, and the diffusion of the leader's scientific orthodoxy through think tanks and global media (Ikenberry and Kupchan 1990).

Another interpretation have proposed a similar distinction increasing further the number of potential levers fostering a state's will to adapt unilaterally its monetary and currency policies. Jesse et. al. (2012) list up to five explanatory factors that could determine a followership behaviour. The first is reciprocity, namely the fact that leaders and potential followers can coordinate in search of a fair exchange of mutual benefits. The second, similarly to constructivist scholars, stress the cases where «the leader transforms the interests, priorities and expectations of would-be followers». Likewise, in the third hypothesis, «followers might follow because of the perceived legitimacy of the leader and its leadership ability». However, the more interesting and original factors are the last two: one considers the international system and its characteristics,

especially the necessity to use an external leader for balancing a local threat that is perceived as more damaging and riskier. The other considers domestic politics, and particularly the party affiliation of the follower's top officials, in determining the likelihood of minor countries' followership in fields as diverse as military and economic cooperation.

Among the few general hypotheses described in previous pages at least two models can be identified. On the one hand, followership can be thought as essentially a by-product of the leader's capabilities to punish, bribe or persuade minor actors. This is not wrong in principle, of course, and most of the hypotheses that in this section and the next chapter will be reviewed are essentially linked to the leader's ability to increase the follower's costs of non-compliance, to increase its benefits in some area of economic or political concern, or to modify the way decision-makers and their advisors perceive and predict the costs and benefits of a possible followership. Nevertheless, the proposal by Jesse et. al. explores originally, although in a preliminary way, the other factors intervening between the leader's attempt to attract followers and the minor actors' expectable aspiration to maintain its autonomy and enjoy the advantages of an open international economy. At least two variables mentioned by these authors, the presence of international threats, and the follower's domestic politics are indeed independent from the leader's ability to modify the cost-benefit structure of minor states. In this research, I design the two main hypotheses precisely on these premises, guided by the intuition that *not all followers are equal*, and *not all international systems are equal*. Accordingly, on the one hand the same material or immaterial incentives provided by leaders are thought to have a different impact on small states with respect to middle powers. On the other hand, international systems characterised by thick interactions at the regional level show a greater tendency of small holders to follow despite baseline disincentives.

In this chapter, I review the main theoretical contributions concerning the general phenomenon of monetary followership, focusing then on those branches that seem to explain better the behaviour of surplus economies. Indeed, monetary followership by surplus actors represent an objective conundrum for most of the current literature, and so far, few hypothesis, coming mostly from realist IPE, have been developed to cope with this situation. As an illustrative criterion, theoretical hypotheses

are grouped in with the level of analysis to which they belong. Firstly, at the *agent-based level* I analyse the constructivist hypothesis and the approach of Comparative Political Economy. Secondly, at the *international-structural level* of analysis I considered exogenous variables such as the states' hierarchical position, the link between security issues and the politics of money, and the web of economic dependencies characterising international economic relations. The traditional divide between positive or negative material incentives is deemed unimportant in this context, as well as quite difficult to assess in numerous situations (for example, economic bonds or military links can be seen as both negative and positive at the same time). It is more intuitive, conversely, to explore all the incentives provided by the leader with a classification based on the level of analysis and the kind of interaction promoting followership (economic, military, or institutional).

4.2 Constructivist approach: cognitive and cultural variables

Hypotheses from constructivist IPE rely on the cultural and cognitive biases of epistemic communities and decision-makers to explain state choices and systemic outcomes. On the one hand, cultural variables connect monetary issues with the symbolic aspects of politics such as legitimacy, national pride, self-perception of state leaders and bureaucracies. Many studies, for example, have stressed the aversion of finance ministers and executives for currency devaluations and downward realignments of the exchange rate (Eichengreen 1992, 2008). Indeed, a sense of defeat, shame and outrage seems to have historically accompanied what, in principle, should be nothing more than a neutral price adjustment. Helleiner (2003) and Abdelal (2003) explain monetary choices led by nationalism and identity made against the rationality of economic incentives. On the other hand, the phenomenon of cognitive biases affects an actor's perception on the desirability of policies and outcomes in the monetary system, not on the base of values and sentiments, but on rational beliefs on the cause-effect mechanisms governing currency markets and economic phenomena in general.

It is widely recognised that economic ideas shape the decision makers' behaviour just because they frame the interpretation of the political and economic incentives of

any policy decision (Adler and Haas 1992; Eichengreen 2011b; Gavin 2003; P. M. Haas 1992; Kirshner 2003a, 2003b; Moschella 2011; Widmaier 2003, 2004). Undoubtedly, the phenomenon that is most studied through the lens of constructivist IPE is the decade-long experience of monetary cooperation in Western Europe. In that context, the followership by European powers such as France, Italy and Spain – which anchored their monetary policies to the anti-inflationary orthodoxy of the German Bundesbank – has been explained through the sharp decline of post-Keynesianism in economic theory, and the parallel rise of Friedmanian monetarism in the aftermath of the two Oil Crisis (Kirshner 1999; McNamara 1998). According to this interpretation, interest-rate compensation and currency stability vis à vis the German benchmark would be the result of a convergence of analyses, objectives and prescriptions by national monetary authorities, coordinated by the new technical orthodoxy about the priorities and strategies of central banking, both at the national and the supranational level.

The constructivist approach has been undoubtedly an innovative and insightful research path for the last twenty years, as well in International Relations as in IPE. In the context of this research, though, it may not be the most fitting perspective from which to analyse monetary followership and the divide between major and small holders. The example of western Europe, on which most of this literature is in fact tailored, is particularly illustrative of the limits of ideational convergence in explaining the timing and the magnitude of specific choices of unilateral policy coordination. Although the whole continent had absorbed, as early as the 1980's, the German deflationary orthodoxy, many other factors like political-electoral pressure for expansive policies, the exigency to refinance sovereign debts and the calls from the United States for a more accommodative monetary policy, contributed to weaken, and frequently to delay, minor countries' efforts to respect their commitments inside the European Monetary System (Bearce 2007; Clark and Hallerberg 2000; Webb 1995). As other studies from realist IPE put in evidence (Abdelal 1998; Andrews 1994a; Kaelberer 2001), for the Germans to be successful in export their deflationary model, some extent of side-payments and the sanctioning mechanism provided by currency markets turned out as fundamental as the ideological complicity of practitioners and economists in other countries. Without this material incentive, even the most rooted consensus within political elites and the

broader public support towards economic orthodoxy can be accompanied by delays and reticence by supposed followers in applying symmetrical adjustments.

The other puzzling weak point of this approach is related to the consequences of selection-bias on the models proposed by the constructivist framework. All the best works on the ideological contagion of neo-liberal ideas and its consequences on exchange rate policy in minor countries, if not looking at the European case, draw on the recent experiences of Latin America and East-Asia between the 1980's and the late 1990's (Grabel 2003; Hirayama and Woo 1996; McKinnon and Schnabl 2004; Schamis 2003). In each of these scenarios, small underdeveloped countries in search of credibility to attract financial resources abandoned the idea of a discretionary management of economic cycles invested by the new academic consensus on the efficiency gains of less universalistic welfare benefits, FDI inflows and market deregulation, especially in the financial sector. As far as effective this narrative might be for these instances, it is sufficient imaging the same scheme applied to a developed country, possibly with a positive net external position, to make the whole causality mechanism much less explicative.

A surplus country, averagely, does not need to appease financial markets with a monetary orthodoxy made of currency stability, liberalisation of capital markets and low inflation to avoid incurring in a balance of payment crisis. If anything, problems may arise when this actor faces the pressures of a deficit leader to do exactly the converse, namely a fiscal and monetary expansion or an ordered revaluation of the local currency. In this case, a Keynesian like-mindedness between the deficit leader and its minor followers would be of much greater help in generating a coordinative attitude in the minor country²³. Nevertheless, although cases of this kind are not rare in the history of the monetary system, empirical evidence do not seem as convincing about the role of ideas as neo-liberal consensus was for weak-currency countries. Even in an age of widespread post-Keynesian consensus like the post-war 'Glorious Thirties', the numerous disputes between the United States and Britain on the one side, and surplus countries such as France, Japan and Germany on the other, show surplus states

²³ Drawing on Keynes' proposals at Bretton Woods, the so-called 'Bancor Project', the Keynesian doctrine on international macroeconomic adjustments would be based on a symmetric correction of payment imbalances, necessary to induce both surplus and deficit countries to reach full-employment by state-led stimulus to the aggregate demand.

systematically unprepared to reflate their domestic economy and promote full-employment in other markets. On the contrary, whenever the attempt by monetary leaders turned out successful, the common scientific background framework focused on full-employment and financial repression played almost no role, leaving rather the stage to material variables such as economic coercion (Henning 2006; Kirshner 1995; Sterling-Folker 2002), financial entrapment (Kirshner 1995), or issue-linkages with security affairs (Gavin 2003; Hanrieder 1989; Hudson 1972; Mastanduno 1998; Zimmerman 2002).

4.3 Comparative approach: domestic institutions, economic systems and interest groups

The second group of agent-based theories looks at the *institutional architecture*, the *interest-group dynamics*, the *economic characteristics* and the *party-politics forces* of a country's domestic arena. Here, frankly, most of the literature has focused exclusively on the exchange rate regime, while the distribution of domestic adjustments has received a limited and insufficient attention. Nonetheless, the conclusions reached by this vast research program can be of great help also to interpret minor states' behaviour in the broader issue of monetary followership, and fulfil the objectives of this research as regards exploring the differences among followers and their impact on monetary policy coordination. To make the comparative argument clearer, the main hypotheses can be gathered into five groups.

Firstly, numerous researches on the institutional architecture of sovereign states has focused on the *democracy-autocracy divide* and the role of an *independent monetary authority*. Some studies, in particular, have tested econometrically the effect of political institutions on the exchange rate regime on a vast panel of countries, and concluded that autocratic governments are more likely to peg their currency to an external anchor compared with established democracies. The same results are observed for the role of independent central banks, whose presence reduces sensibly the likelihood of adopting a hard peg or any other fixed exchange rate regime (Bernhard, Broz, and Clark 2002; Broz 2002; Leblang 1999; Steinberg and Walter 2012). If anything, different interpretations emerge when it comes to formulate an explanation for this

robust regularity. Here, while the mainstream interpretation advocates for an endogenous role of domestic institutions – that is, non-transparent institutions (i.e. central bank and budget policy controlled by politicians) would generate the need for a visible currency peg as an alternative source of credibility vis à vis international markets (Bernhard, Broz, and Clark 2002; Broz and Frieden 2001; Broz 2002) – another hypothesis considers the autocratic regime and a government-controlled monetary authority just as more efficient transmitters of external pressures coming from monetary leaders (Leblang 1999; Li 2003).

The second strand of research is the *party-politics hypothesis*, developed in IPE by David Bearce (2007) after many studies, in previous decades, had denied any role for this variable in the decision-making process on monetary issues. This author performed a longitudinal test on 23 OECD countries since from 1973 to 1997, and found a significant relation between the presence of same-coloured parliamentary majorities in two countries (e.g. both leftist or both right-wing), and the degree of policy convergence between by the country's authorities. Particularly, left-wing governments would be more inclined to couple fiscal expansion with a restrictive monetary policy and flexible exchange rates, whereas rightist executives would apply fiscal austerity coupled with a relaxed monetary policy and a strong commitment to exchange rate stability. As carefully documented by the author with a series of qualitative case-studies, in many cases the substantive coordination of monetary policies would emerge out of a fortuitous convergence of political preferences instead of a strategic will to adjust national policies towards a shared goal.

The third research path in the comparative approach is *interest-group politics*. This set of hypotheses, also known as policy-demanders approach, has identified which economic sectors could have a stake in the choice of a country's exchange rate regime. Bernhard, Broz, and Clark (2002) identified two policy cleavages on which economic sectors, interest groups and electoral coalitions tend to conflict with one another. The first opposes pro- and anti-inflation actors, i.e. those who tolerate or even prefer a moderate inflation and those preferring prices to grow slowly and close to zero. Anti-inflationists tend to prefer currency stability and tight monetary policies, and vice versa for the pro-inflationists. The second cleavage lies between fixed and flexible exchange rates. In the end, the two factions almost overlap, as the pro-inflation, pro-flexibility

group includes non-tradable producers, debtors, low-skilled workers, small businesses, the agricultural sector and all the economic sectors driven by domestic and public investments. The second coalition, anti-inflation and pro-currency stability, encompasses the banking and financial sector, bondholders, pensioners, tradable producers, import-export intermediaries, and generally, the public opinion in countries with a history of high inflation (Broz, Frieden, and Weymouth 2008; Frieden 1991; Hefeker 1997; Steinberg and Shih 2012). The transmission of these actors' preferences to the actual policy-making is expected to follow the interest-groups' capacity to capture regulators and politicians in the domestic arena, mostly given by their economic strength in the national productive system and other path-dependent connections between politics and economic sectors.

Fourthly, a deeply rooted tradition in economics and political economy tries to predict political choices with the characteristics of a country's domestic economy. The most robust of this links connects the size of the actor's domestic market with its exchange-rate policy. Specifically, small and open economies are expected to peg their local currency to a major trade partner with a much greater likelihood than large states with a low trade-on-GDP ratio (Broz and Frieden 2001, 2012; Calvo and Reinhart 2002; S. Cooper 2007; Fischer 2001; Meissner 2002; Plümper and Neumayer 2011). When the attention is moved from trade to finance, many authors have hypothesised a negative relation between the development and efficiency of a country's financial markets and its proneness to give up a large share of policy autonomy by renouncing to exchange rate flexibility (Bordo and Flandreau 2003; Bordo 2003; Lin and Ye 2011). Open, large and developed financial markets, conversely, would enhance a country's credibility at the eyes of cross-border investors, making less essential the need to block the exchange rate against major currencies.

4.4 The limits of the Comparative approach against surplus countries and systemic outcomes

The research path investigating the role of domestic institutions, sectorial interests, national politics and the characteristics of the local economy is undoubtedly one the

widest and more developed inside comparative political economy. Its insights and findings will be of paramount importance in this research when the final case study will be deeply illustrated, especially by contributing to exclude country-specific effects when testing the major hypothesis of the fundamental divide between small and middle actors in the international system. However, the explanatory power of the comparative approach in the specific research question of this work is limited in at least three dimensions that are common to all the aforementioned theories and hypotheses.

The first is that they rarely, if ever, investigate the determinants of monetary and fiscal policy according to the Compensation Rule, focusing instead on the simple dichotomy or trichotomy between fixed, floating or intermediate currency regimes. Yet, observing a fixed exchange-rate between two countries can say almost nothing on how those actors have distributed the burdens of the system's maintenance among themselves. The second limit is an epistemological one, and relates to the scarce predictive power of the comparative approach on the distributive outcomes of multiplayer bargaining. If the analysis is limited to the strict logics of comparative political economy indeed, the outcome of a distributive conflict at the systemic level can be determined almost exclusively by the phenomenon known as harmony. Harmony is the name given by Keohane to a systemic condition where substantive coordination is not the result of a strategic and willing adjustment of national policies, whether cooperative or not, but simply of the accidental fitness of independent and uncoordinated actions (Keohane 1984). The different countries, in other terms, would manage economic policies according to their own domestic preferences, and the fact that this policies, every so often, turn out substantively coordinated with the balance-of-payment conditions of a leader state would be the mere result of the fortuitous fitness of the others' macroeconomic policies. Finally, the comparative approach suffers from an overvaluation and excessive generalisation of the experience of small deficit countries. Here below, I provide some examples of this tendency, which makes the comparative approach a useful but limited tool for the objectives of this research.

Firstly, the democracy-autocracy hypothesis is a clear example of difficulties in dealing with surplus countries. As mentioned before, democratic countries with a solid central bank independence would be more credible against capital markets, and therefore less incentivised to fix their exchange rate. However, most of the problems with foreign financial markets arise when a country's current account balance falls into deficit. Conversely, in numerous developing countries autocratic regimes have avoided the distrust of western-led financial markets for the ostentatious patrimonialism of their economic governance precisely by running extensive and permanent trade surpluses. Usually, their currency policy leans towards managed-floating exchange rates, while the fixed exchange rate against the dollar or other core-currencies has often taken the form of what in previous chapter I defined opportunistic followership.

Another evidence of pro-deficit bias comes from policy-demanders theories, linking currency choices to the politics of interest groups and economic sectors. For example, it has been argued that tradable producers, importers and the financial sector prefer stable exchange rates in order to avoid that currency volatility refrains their foreign counterparts to transact with them. However, this attitude could conflict with the expected direction of currency movements in case some extent of flexibility is guaranteed to the exchange rates. In a deficit country, for example, tradable producers could feel lamed by an overvalued currency, and would rather bear the price of a depreciation to regain competitiveness than preserve stability at all costs, especially considering how far hedging instruments have gone in financial markets to protect trade operators from short-term exchange-rate risks. Likewise, exporters and financial firms in a surplus country would be irremovable on currency stability simply because the expected change in exchange rates is going to damage their activities while advantaging

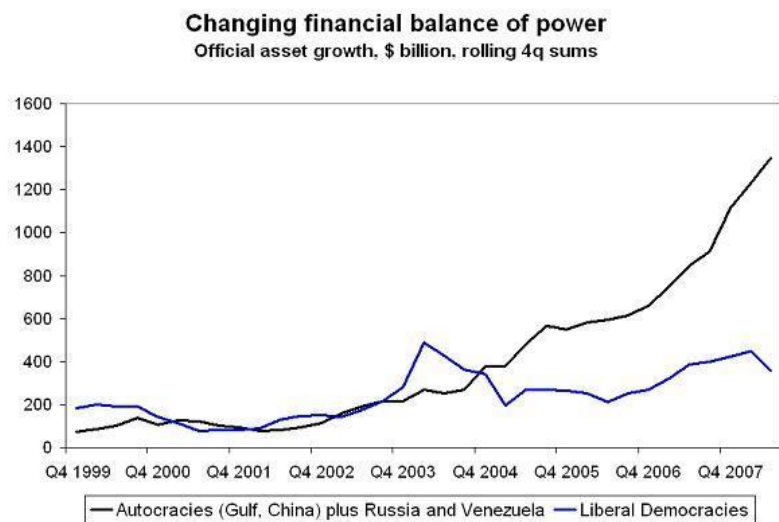


Figure 5 – Accumulation of official reserves assets in autocracies and liberal democracies (1999-2008). Image from (Setser 2008b)

foreign competitors and debtors. Recent direct surveys on economic actors have confirmed indeed as the direction of change, and not necessarily the change *per se*, is much more important in the stance of economic sectors towards a country's exchange-rate policy (Broz, Frieden, and Weymouth 2008).

To conclude, the comparative approach has demonstrated itself as an efficient hypothesis in accounting for cross-country variance in interest-rate and exchange-rate policy. However, it shows various deficiencies in explaining why those divergences disappear, with the practice of monetary followership, also among countries with different domestic characteristics. To explain a recurrent outcome such as monetary followership, which is a systemic phenomenon emerging from both actors' preferences and their strategic interaction, the analysis must take into account also those structural variables defining a players' bargaining power, the leader's potential for influencing others' policy-making and the characteristics of the international system in both the economic and security field.

4.5 International-structural approach: interstate politics, security issues and monetary followership

The international-structural approach is the approach generally adopted by realist IPE to explain minor actor's behaviour vis à vis monetary hegemons and would-be currency leaders. Structural theories imply that the interactions among units in a political system produce, without any intentional move or coordination by major actors, a series of 'scope conditions' defining constraints and opportunities for the countries operating within that system by means of an automatic and impersonal mechanism of punishments and rewards. Accordingly, changes in the structure of the international monetary system – such as the number of potential leaders (polarity), the flows of trade and investments, the existence of hegemonic currencies, and the extent of capital mobility – foster changes also in the opportunities for autonomy of smaller states. In some systems, an autonomous economic policy brings more easily to negative consequences for minor states, while in other structural configurations they would have more opportunities to enjoy open markets while retaining control on domestic

economic policies. According to the structural view on monetary relations, the international structure of the monetary system, analogously to the broader political system, would be characterised by an anarchical order and undifferentiated functions among units, further complicated by the presence of autonomous financial flows. In addition, as in Waltz's structure, the distribution of (monetary) power in the system, defining the position of any state within the systemic hierarchy, determines the actors' possibility to advance their own interests in the monetary arena. 'Monetary powerful' states enjoy greater room for neutrality or extort concessions to reluctant great powers, while monetary weak states surrender their autonomy to stronger states for governing macroeconomic imbalances in their place.

In giving a brief overview of structural theories of monetary followership, the main variables will be grouped into five core hypotheses. First, minor states would be more prone to currency followership when affected by structural bargaining asymmetries related to the specific realm of financial markets. Here, on the one hand, the *passive leadership hypothesis* impinges on the different reaction of international markets towards weak and strong currencies in case of economic distress. On the other hand, Kirshner's *entrapment theory* analyses the same mechanism from the point of view of surplus and creditor countries 'forced' to follow their leader's policies to preserve the nominal worth of their financial wealth. Secondly, followers' behaviour is explained by their *commercial dependency* on an external actor – especially regarding export destinations – which is associated to their choices about the exchange-rate regime and the anchor currency. Thirdly, in the '*precautionary surplus accumulation*' hypothesis, states' followership is seen as a preferential way to gain foreign exchange reserves given a crisis-prone and financially unstable global economy. Lastly, the *monetary-security nexus* investigates the relation of monetary policy, reserves and exchange rates with the broader scenarios of international security.

Among these five proposals, solely the passive leadership hypothesis can be seen as still excessively biased on deficit states, while the other core hypotheses are actually the more suitable to deal with the case of monetary followership in surplus countries. Partly, this is true because some of them has been explicitly conceived to explain long-term patterns of surplus accumulation (the precautionary and the export dependence hypotheses) or to describe the specific bargaining environment of creditor countries

(entrapment). Partly, because they imply a level of abstraction that makes irrelevant a country's balance of payment position, like the military-monetary nexus.

4.6 Polarity, capital mobility and asymmetries in monetary power

Monetary power has been defined as an actor's capacity to delay or deflect an undesired macroeconomic adjustment via a set of strategic interactions based on a country's bargaining chips. According to structural theories, a minor country's proneness to subordinate its economic policy to an external leader can be affected by the structure of the international monetary system, and especially by the role played by financial markets in the bargaining environment. In this section, I explain specifically how the structure of the monetary system is defined by the literature on passive leadership, how it affects the phenomenon of monetary followership, and what are the limits of this approach when applied to surplus economies.

Following the argument of passive leadership theorists, in a context characterised by a high level of cross-border mobility of financial capitals, the uneven distribution of monetary power among states is essentially a function of the *preferences of market actors* for using one or more core-currencies as safe haven for their own financial wealth²⁴. The consequence of this systemic picture is the creation of a hierarchy of national currencies, which given the instantaneous, indirect and automatic sanction of financial markets, represents *per se* the most effective instrument of major states for charging onto other actors the consequences of uncoordinated policy moves. Moreover, alternative measures to cope with systemic imbalances such as external policies (restrictions and currency realignments) and symptom-management policies (short-term loans and open market interventions), result more difficult and more costly than in systems characterised by relatively low financial interactions. To the extent that market actors tend naturally to pressure the lowest layers of the currency pyramid (deficit countries and fragile financial markets) for inducing an undue depreciation of their moneys, they also fly to international creditors as a safe haven attracted by low

²⁴ Essentially, this hierarchy of market preferences would be based on the solvency position of issuing states, with few exceptions

inflation performances, 'credible' financial markets and the tendency of their currencies to appreciate. Hence, strong-currency actors are able to shift the negative consequences of currency instability and capital flights onto their weaker neighbours, and simply by means of this 'implicit threat', to extort their acquiescence to bear the burdens of macroeconomic adjustments in their place, whether to postpone or undertake a painful domestic deflation (Andrews 2006; Cohen 2006).

The passive leadership approach is certainly one of the most remarkable innovations in structural theories of monetary IPE. However, the unequal and indirect distributive mechanism put under its spotlight presents at least two faults as concerns the focus of this research – followers with a positive and persistent current account surplus. The first is the condition assumed by the model: a system characterised by a predominant surplus leader and multiple weak-currency followers. This assumption is patently tailored on the actual case of monetary followership observed in the European Monetary System, where the implicit bargaining between Germany on the one side, as surplus leader, and the rest of European countries on the other, as deficit followers, fits perfectly the causal chain exposed by the passive leadership framework. However, when the same causal mechanism is applied to surplus followers, both theoretically and empirically, the outcome proves much less favourable to the leader as widely documented in previous chapters. Firstly, because the risk of abrupt depreciation of the national currency in case of large imbalances regards indebted and deficit countries. Secondly, because the capital flight that is supposed to trigger the run on weak currencies and the dry up of credit in weak-currency states hits creditor economies in the opposite way. Thirdly, because appreciating currencies are easier to stabilise than depreciating ones for the absence of the reserve constraint.

Therefore, this structural perspective on the causes of monetary followership, oversizing the role of the solvency position in the broader equation of monetary power, seems excessively tied to a specific shape of the same system characterised by the dichotomy surplus leader/ deficit follower. In any other systemic configuration, especially in the one analysed in this research (deficit leader/surplus follower) capital mobility and unipolarity are not sufficient, by themselves, to determine the behaviour of minor countries. Surplus followers, both if confronted by surplus leaders or deficit leaders, would in any case hold a greater bargaining advantage. Moreover, passive

leadership models exclude the possibility to investigate the behaviour of an actor which is of paramount importance in monetary systems dominated by deficit leaders: middle powers with a net creditor position. As next sections clarify, these states play the key role of accumulating and protracting the system's imbalances, allowing monetary leaders to pursue a debt-financed model of economic growth. These countries are as exposed to hot money flows as deficit followers. However, their vulnerability does not lie in capital flights and depreciation, but in capital inflows and appreciation. Financial flows come from weak currency countries attracted by the creditors' healthy external position, and by appreciating the local currency, would seriously damage the nominal value of these countries' financial wealth, which sounds as a powerful incentive to followership. In view of that, in the next section I outline the *Entrapment* hypothesis by Jonathan Kishner, who resort to this mechanism as a valuable alternative to explain the conundrum of monetary followership by surplus countries.

4.7 The accumulation of foreign assets and the entrapment hypothesis

Entrapment is perhaps the most peculiar form of coercion related to the politics of international monetary relations. According to Johnathan Kirshner, who first coined this definition in his *'Currency and Coercion'* (1995), entrapment is a structural condition emerging when follower states with persistent current account surpluses start accumulating foreign assets and foreign reserves denominated, for a large part, in the leader's core currency. After this first step indeed, most of the 'entrapped' country's financial wealth ends up to depend on the exchange rate between the two countries, with a depreciation of the core currency affecting negatively the balance sheets of the central bank as well as of households, banks and firms throughout the follower country. As a result, entrapped surplus followers could do nothing but to apply the Compensation Rule in monetary and currency policy in order to minimise the exchange-rate fluctuations between the national coinage and the leader's money.

Just like the passive leadership theory, this hypothesis is based on a form of power that is deeply rooted in asymmetries within the monetary system, as it impinges prevalently on the immaterial value of financial assets and the constraining effect of financial markets' decisions. According to Kirshner, there are essentially two channels

to rearticulate priorities and preferences of the follower's decision-makers towards the support of the leader's core-currency. The first is the engagement of sub-national economic actors.

«Entrapment is the transformation of interests that results from participation in a currency system. Entrapment takes place at two levels: at the level of the firm (or, more accurately, the sector) and the level of the governments [...] sectors will respond to external economic incentives and [...] will form political coalitions to advance their interests [...] “these regions and industries will exert a powerful influence in favour of a “friendly” attitude toward the state to the imports of which they owe their existence”» (Kirshner 1995)

But the strength of entrapment, as highlighted by Kirshner, is precisely to put its implicit pressure also on governments in case they hold a large amounts of foreign exchange reserves:

«In contrast to most trade transactions, the member government is likely to have a stake in monetary affairs. It will also usually come to hold significant balances of the core currency. The government of the member state therefore has a direct interest in the fortunes of that currency. For example, in order to preserve the value of its assets, such as reserves, it does not want to see the value if that currency decline. This will also give member governments an interest in the more general political fortunes of the core state itself, which will, especially in the case of war, importantly affect the future value of the core currency» (Kirshner 1995)

Intuitively, this causal hypothesis is one of the most suitable to surplus followers, as a persistently positive current account implies a structural accumulation of foreign assets, and brings more easily to the entrapment mechanism highlighted by Kirshner.

In recent times, the entrapment hypothesis has been used to interpret one the most discussed monetary relations of the last decade, that between China and the United States. China has become one of the world's major buyers of US securities, focusing its holdings on Treasury bonds and other risk-free assets. Whenever the perspectives of the Sino-American relations are analysed in the military or economic context, scholars raise the issue of the enormous holdings of dollar reserves stored by China, and of the most likely effect that this might have on Beijing's will to challenge the United States for regional hegemony. On the one hand, some argue, possessing around

fifteen percent of the overall US dollar liabilities places the Chinese government in the enviable position of triggering a collapse of the greenback by selling off all of its reserves on international markets. On the other hand, many argue instead that precisely the overload of dollar assets compared to the country's income prevents China from using its holdings as a credible 'nuclear option' against the US hegemonic presence in East Asia (Bowles and Wang 2008; Drezner 2009; Layne 2009; McKinnon 2007; Vermeiren 2013a). Should China try to dump its dollar reserves to jeopardise Washington's immunity to the balance of payment constraint, it would probably suffer more damages than it causes for the exorbitant capital losses on its dollar-denominated assets. Notably, during the recent post-crisis expansionary policy of the Federal Reserve, a top banker from the China Banking Regulatory Commission complained about this no-way-out situation with a Financial Times journalist: «except for US Treasuries, what can we hold? [...] Once you start issuing \$1 trillion-\$2 trillion [...] we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do» (Cit. in Stokes 2013).

Nonetheless, the entrapment hypothesis can also be indecisive in at least two dimensions. On a theoretical dimension, the entrapment perspective suffers from an evident problem of redundancy. Indeed, the accumulation of net financial wealth denominated in the core-currency constraints the follower to adjust its domestic policies to the leader, but it remains unexplained in any case why rational self-interested actors should tie their hands so strictly instead of undertaking a wise diversification of foreign assets. Eventually, if small and medium powers know what the stockpiling of single-currency securities implies, they must have other and compelling reasons to bring it forward at the expenses of their future policy autonomy. Historical records propose at least three hypotheses. The first is the structural advantage of monetary hegemony, that is, those countries issuing an international key currency. The strengths of monetary leaders in this position is that of enjoying a set of relations, customs and informal institutions which oblige minor countries, whether friends or foes, to have a partial stake in the functioning and the survival of the system built around the hegemon's currency. Today's hegemonic role of the US dollar is a privileged seat to observe how the universal acceptability of this currency by central banks, market actors and even transnational criminal organisations de facto obliges all countries in the world, included the US's worst

enemies, to accumulate a part of their financial wealth in dollars for financing external actions.

The second possibility is the one reported by Kirshner in its preferred case study: Germany's monetary leadership in the 1930's. According to the author, the shortcut to push minor countries in southern and eastern Europe to hoard the unconvertible reichsmark was the German availability to pay imports from these countries more than their prices on international markets (Kirshner 1995). Hence, generally speaking, a weapon of potential leaders to modify the minor country's cost-benefit calculus is to bear temporary economic losses in view of a future gain on autonomy by the time the entrapment mechanism is in place. Lastly, the over-accumulation of foreign assets in a single currency can be linked to political relations and alliance patterns. Since countries tend to trade and invest more with their own military allies, and given the prominent role of currency stability in a leader's military power, it sounds plausible that the accumulation of core-currency liabilities be a product of the dilemmas of alliances.

As regards the theory's faults on the empirical dimension, a cogent review of cases shows that supposedly entrapped actors have sometimes missed scholars' expectations and defected on leaders despite possible capital losses on their foreign assets. Recently, such behaviour has been observed in some of the Persian Gulf monarchies and in many Asian surplus economies such as Philippines, Malaysia, and Taiwan, which despite their financial exposure to the dollar, and the underlying action of their security ties with the United States, in the past decade maintained a monetary and exchange rate policy steadily focused on domestic needs, allowed currency appreciation and disregarded the Compensation Rule in interest rates policy. For these and other cases, evidently, other forms of political or economic constraints must complement the mechanism highlighted by the entrapment hypothesis.

4.8 'Bretton Woods II'. The Neo-Mercantilist explanations of currency followership in surplus economies

One of the most developed field of analysis about the external determinants of monetary followership is undoubtedly the link between economic asymmetries and

minor countries' exchange rate policy. Contrary to comparative studies on currency regimes, the main question of these research strand embraces both the choice of the exchange-rate regime (fixed, floating or some intermediate solution) and the choice of the anchor currency to which followers decide to peg their coinages. On the one hand, studies on large and generalizable samples have stressed the effect of import patterns for the exchange-rate decisions of potential followers. Plümper and Neumayer (2011) have tested econometrically states' choice of the currency anchor as a dichotomous alternative between pegging to the euro or the US dollar. Their results indicate that imports flows from both the leader country and its currency area are strong predictors of a follower's monetary anchor, together with the symmetry in output shocks with the leader's economy. Likewise, Meissner and Oomes (2008) performed a similar test on a panel of 100 countries from 1980 to 1998. Their results confirm «that a key factor explaining anchor currency choice is the existence of trade network externalities» and reiterate the positive effects of co-movement with the anchor's GDP. When the same currency is taken as reference in a circumscribed geographical area, trade network effect and output shocks multiply, facilitating the emergence of geographically concentrated patterns of monetary or exchange rate coordination.

On the other hand, theories of export dependency – also known in the scholarly debate as 'Bretton Woods II' or 'mercantilist hypothesis' (Aizenman and Lee 2007) – posit that surplus follower countries peg their currencies to an external anchor in order to develop a 'mercantilist' export-led growth strategy. This research path dates back to 2004, when Dooley, Folkerts-Landau, and Garber published an article that was destined to frame a decade of scientific inquiry, public debate and diplomatic actions about the relation between the United States and the fast-growing economies of East Asia (Dooley, Folkerts-Landau, and Garber 2004). In their paper, the three authors draw an explicit parallel between the first thirty years of the Bretton-Woods system, characterised by fixed exchange rates, accumulation of current surpluses in the European and Asian periphery (Germany, France, Japan), and the 'Dollar Standard' which emerged at the end of the XX century. In the revived 'Bretton Woods II' «East Asian economies – especially China – and oil exporting countries behave today like Japan and Western Europe did under the Bretton Woods system. They peg or soft-peg their currencies to the dollar in order to develop a 'mercantilist' export-led growth strategy»

(Otero-Iglesias and Steinberg 2013). The argument by Dooley et. al. was little more than a suggestion for further research, yet affected a generation of American politicians in their repetitive calls to China for letting a nominal appreciation of the Renminbi, in the hope of reviving the US tradable manufactures and create new high-productivity jobs on the American soil (Spiro 2012).

Besides the paradigmatic case of China and its neighbours, other cases can be brought to attention where countries with a positive external position, solid financial markets and highly competitive products have given up monetary autonomy in order to preserve their share of exports in leading destination markets. In Europe, Sweden and Switzerland have abandoned the domestic-oriented monetary policy followed until recently to shadow the ECB's expansive moves decided after the breakup of the Eurozone crisis in 2011. In a speech to the Chamber of Commerce and Industry of Southern Sweden, in Malmö, the Swedish central bank governor Karolina Ekholm explained to an audience of local businesspersons the bank's early-2014 choice to follow the ECB on an increasingly lax monetary policy. In her words, «If the market expects the policy rate in Sweden to be significantly higher than policy rates abroad, this can lead to an increase in the demand for assets in kronor as a higher Swedish rate, all else being equal, increases the return on investments in Swedish currency. This normally contributes to a strengthening of the krona exchange rate in the short term. [but] a stronger krona has a negative effect on net exports as it means that goods and services produced in Sweden become relatively more expensive. This in turn has a negative effect on GDP growth and resource utilisation» (Ekholm 2011). In the same period, the Swiss National Bank stepped in to stem the sheer rise of the franc by widening the negative rate differential vis à vis the ECB rates, and since early 2012, also by declaring an explicit floor at 1.20 francs against the euro. Despite having a balanced and diversified investment portfolio indeed, both the Swiss economy and the central bank are exposed to losses on euro-denominated assets and, above all, dependent on the vast Eurozone market as the main destination of national exports. Since mid 2011, over 200 billion Swiss francs in foreign assets have been accumulated by the SNB in order to stop the local currency's appreciation at the established threshold, and interest rates, already close to zero due to the traditional low inflation, has reached a thirty-year low in summer 2011 at 0.25.

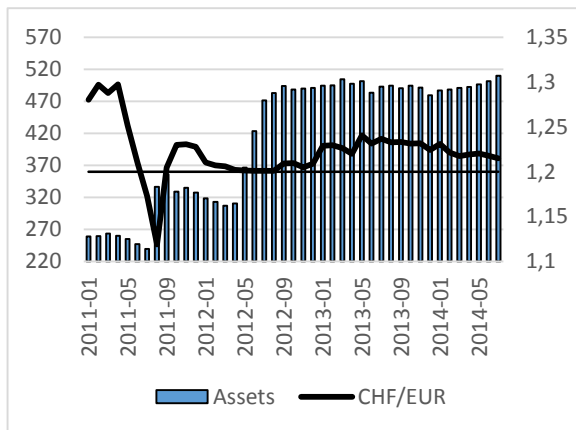


Figure 6 – SNB holdings of foreign assets (in billions francs) and franc/eur exchange rate (flat line at 1.20)
Source: IMF - IFS

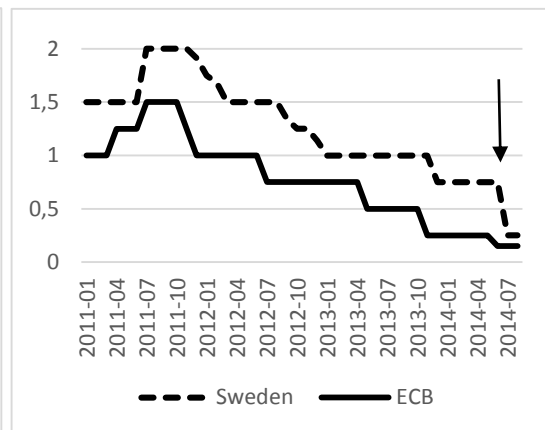


Figure 7 – Convergence of policy interest rates of European Central Bank and the Sveriges Riksbank (in %)

But the ‘mercantilist’ explanation has not been simply a useful interpretation for the public debate. The argument has been subject to severe scientific scrutiny, which, however, expressed documented doubts on the robustness of its causal chain as a universal explanation for currency followership. In 2007, Aizenman and Lee performed an econometric test on a 20-year panel of developed and developing countries, finding that «variables associated with mercantilist concerns are statistically significant, but economically insignificant in accounting for the patterns of hoarding reserves» (Aizenman and Lee 2007). Levy-Yeyati et. al., in their ‘Fear of Appreciation’, tested the relation between the mercantilist hypothesis and economic growth. Eventually, their «results [...] cast doubts on the channel of import substitution cum export stimulus often highlighted by [the mercantilist hypothesis]. Instead, [...] tests suggest that the mechanism [of economic growth] is associated with an increase in aggregate savings and investment and decline in labor income relative to capital compensation» (Levy-Yeyati, Sturzenegger, and Gluzmann 2013). In other words, currency undervaluation would be beneficial to economic growth, when this is the case, not because of a heightened performance of exporting firms, but because it reduces the purchasing power of national workers, and thus increases their propensity to save and reinvest domestically. Vermeiren (2012) analysed in detail the case of China, whose export-led pattern was taken as prime example by the advocates of the mercantilist hypothesis. He found that the country’s capital controls and the pro-US dollar investment strategy were certainly functional to keep an undervalued exchange rates, however, this serves to push Chinese nationals to save most of their earnings and deposit those savings in government-led banks. These, in turn, finance the country’s spectacular growth through

domestic investments in the so-called SOEs²⁵, having no better alternative because of the strict control on cross-border capital flows. A similar work was carried out by Moschella (2015) on the Swiss case, where she highlighted that the SNB's decision to peg the franc was as much driven by the need to discourage speculative capital inflows to Switzerland as it was to preserve the country's market share in the Eurozone. The January 2015 surprise by the SNB, which de-pegged its currency and let it float despite vibrant protests from the industrial sector, sounds as a powerful ex-post confirmation of this interpretation. Recently, Cruz (2014) confirmed the uncertain empirical consistency of the export hypothesis, verifying a positive and significant relation between the accumulation of foreign exchanges and the rise of real exchange rates. That is to say, the nominal currency stability would be the by-product of a strategy of forex intervention, which was designed for other reasons, but certainly did not contribute to make the price of national products more competitive on foreign markets.

Overall, the mercantilist hypothesis pays its excessive focus on trade relations and export-dependent constituencies as opposed to the governance of the banking and financial sector. That makes it a valuable, but incomplete tool to analyse the currency and monetary policy of surplus countries, despite the intuitive link between export performances and the current account. Certainly, as the Swedish central banker explicitly admitted, the importance of an accessible export market is paramount for economies that, for a reason of the other, suffer the smallness of their domestic market and need foreign buyers to lift aggregate demand for tradable products. However, as successive researches reveal, this might be one among many reasons to peg one's coinage to the core-currency leader, but as empirical tests, both qualitative and quantitative, demonstrate, not the most important for practicing a compensatory monetary or reserve policy. Indeed, opportunistic followership still allows neutral surplus states to maintain a currency peg without necessarily following another countries monetary policy or avoid diversification on foreign assets. The alternative view, as expressed in particular by Aizenman and Lee, is that trade surplus was not the purpose, but the instrument, of peripheral countries to accumulate official reserves to defend themselves against future balance-of-payment crisis. This hypothesis, known as the 'precautionary' reserve accumulation, will be the object of the next section.

²⁵ State Owned Enterprises

4.9 'Precautionary' foreign exchange accumulation: surplus countries' followership after a currency crisis

On the motives why several states, different by area, culture, economic development and even external position have decided to accumulate larger-than-usual foreign exchange reserves in the last twenty years (see figure 8), dozens of empirical and theoretical

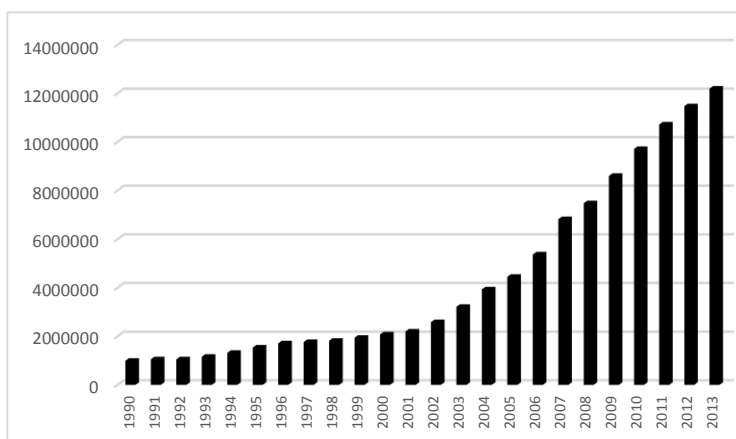


Figure 8 – Official foreign exchange reserves – world total (yearly data 1990-2013), in billion US dollars
Source: IMF – IFS

studies have speculated. Giving a complete account of this debate is an effort that goes beyond the purpose (and the space) of this research. Nonetheless, the reason why this practice, and the explanations that have been given to it, is important also for this research is the fact that forex accumulation, purposely or not, can be a form of compensatory monetary policy for surplus countries. As already mentioned indeed, while some monetary authorities use to let their economic actors choose how to allocate foreign investments, but manage interest rates so as to make more palatable to invest in the leader's market, others prefer to handle the country's foreign assets directly. If the leader is deficit, however, the effect on its balance of payment is practically the same, with a surplus on the financial account thanks to official investors that compensate the country's steady outflow on the current account. Understanding the causes of exchange accumulation, therefore, may contribute in a substantial way to understand a possible root of monetary followership. Especially, and this is the most challenging hypothesis, it might be shown that this practice is not a willing action of support to the leader, but simply a manifestation of farsighted self-interested actors that try to safeguard their financial systems from a future liquidity crisis.

According to the many works which proposed an interpretation for this phenomenon, at least three explanations can be drawn. The first is the manipulation of the exchange rate in order to protect the take-off in the tradable sector by avoiding a real currency appreciation. The theoretical underpinnings of this mechanism have already been discussed in the previous section. Here, it has to be noted that the empirical link between exchange rate stability and reserves accumulation has received a mixed empirical confirmation by the numerous works published on the issue. On the one hand, for some scholars a floating exchange-rate would correctly cause reserves to drop, but fixed or highly managed currencies would present no specular effects (Bastourre, Carrera, and Ibarlucia 2009). For others, reserve assets would be positively related to fixed exchange rates, especially in the form of managed or soft peg (Obstfeld, Shambaugh, and Taylor 2010; Vujanovic 2011). For another study, the effect of the exchange-rate channel on reserves would be completely absent (Steiner 2013). The second explanation for the massive hoarding of reserves around the world is rooted in the structural drivers of a country's propensity to save, that is its demographic and economic structure. Bagnai (2009) explained China's tendency to consume below its means in terms of a sluggish domestic demand due to the large share of poor agricultural workers in the Chinese productive structure. Likewise, countries with an ageing population would be naturally more prone to reduce consumptions and investments. Consequently, the mass of savings generated by retired people could hardly find enough investment opportunities domestically, and goes to fill the vaults of the country's foreign assets. Other things being equal, this phenomenon alone would have no effect on reserves. However, when the country's authorities want to use part of that money to oversize domestic investments, they will induce national savers to sell foreign exchange to the government and assume the monopoly of the country's foreign assets (Bussiere et al. 2013; Obstfeld 2012). Lastly, the tendency of an increasing number of state actors to hoard an unprecedented quantity of official reserves (and especially foreign exchange) has been explained through the vulnerability of emerging and developed actors to balance-of-payment crisis.

Among the three given explanations, this first is simply another face of what has been already discussed in previous sections. It maintains here the same strongpoints and limits I already illustrated, since the accumulation of foreign assets has no

autonomous role if not as an instrument to stabilise the real exchange rate. On the contrary, the second and the third explanation reverse this conclusion – since they consider the nominal undervaluation as the unintended by-product of the reserves build-up – and are much more interesting therefore as independent variables to understand monetary followership. However, the first is not exactly applicable to all the actors of the international system – because many of the newly emerging countries that hold most of the world’s currency reserves are neither ageing (Brazil, Saudi Arabia), nor necessarily poor in terms of per-capita income (Switzerland, Norway, Persian Gulf monarchies, Singapore, Hong Kong). Secondly, structural causes of reserve accumulation can explain just a little extent of a monetary followership policy. Indeed, as demonstrated by the case of Norway illustrated above, when a country hoards current surpluses because of the over-savings of retired persons, it does not necessarily give up its monetary autonomy, nor accumulate reserves or foreign assets necessarily in one single currency. All these are political choices on how to manage a structural surplus, and cannot be explained through demographic trends. Eventually, the hypothesis of reserves build-up as a ‘precautionary’ measure to hedge domestic banking systems from sudden stops of external financing remains the most promising. For the rest of the section I will focus on this explanation.

The ‘precautionary’ hypothesis, also according to econometric tests (Aizenman and Lee 2007), is the most suitable alternative to trade mercantilism for explaining the rapid amassment of foreign exchanges by central banks in the last decade. It comes as no surprise, however, that both the phenomenon *per se* and the mass of studies produced to explain it were geographically focused on East Asia and emerging markets in general. As early as the 1990’s, a great wave of capital markets liberalisation was carried out by ruling elites in a large number of emerging economies (Eichengreen 2004; Frenkel 2008, 2012; Hellmann 2007; Schamis 2003). The euphoria that this generated in international financial markets, coupled with the diffuse adoption of rigid pegs to the dollar, brought foreign investors to invest such small economies with an overflow of portfolio and foreign direct investments. As a result, their current account slid into deficit, while financial markets were growing increasingly sceptical on developing countries’ possibility to repay the external debt that they had rapidly accumulating in a few years. When this suspicion became diffuse, it occurred the so-called *sudden stop*,

that is, foreign investors stopped financing short-term loans that made sustainable the repayment of existing debts. With no capital inflows nor trade-driven demand, also the currency stability against the dollar fall in serious jeopardy.

Nevertheless, the worst had yet to come. In order to have back their loaned money in hard currency, and not in a devalued national coinage, developed countries pushed on local governments to ask for an IMF-backed bailout. The Fund accepted to cover the short-term liquidity needs of emerging markets in order to support the local currencies and restructure the external debt, but asked for draconian austerity programs and further reforms in exchange. As soon as these plans, due to the sacrifices imposed through domestic deflation and unemployment, proved equally unsustainable both economically and politically, the overindebtedness of deficit countries broke out into catastrophic depreciations and generalised credit crunch due to capital flights. The Mexican peso fell by 50% during the 1994 Tequila crisis, during the 1997 Asian crisis the Thai Baht lost 120% of its value, the Malaysian ringgit about 88%, up to 160% for the Indonesian rupiah. In 1998, the Russian rouble gave up the 320% in less than a year, while the peso fell by another 250% during the 2001 Argentinian Crisis. Many other currencies lose ground against the dollar during these episodes, causing painful effects to the local populations and refraining international markets from lending to emerging markets any longer after these undesirable records.

The grim experience of the 1990's affected policy choices for the years ahead, even for those countries that had not been directly invested by a currency crisis such as China. Most of emerging markets recovered their solvency by running several years of trade surpluses, and even those with a balanced or deficit trade account, or especially for this reason, started amassing foreign reserves as an emergency self-controlled fund on which drawing when external financing stops and capitals flow out of the country. Unlike multilateral schemes like the IMF programs indeed, this strategy guarantees to each country its own financial 'war chest', on which it decides *autonomously* about the conditions to use it. In respect to financial vulnerability, a high level of official reserves serves at least three objectives, one related to signalling the country's solvency to international markets, and the other two related to fill the needs of banks and firms for foreign currency liquidity, and of the whole country with respect to import essential commodities.

Obstfeld et al. (2010) described carefully the kind of threat that central banks have in mind – the so-called ‘*double drain*’ – when accumulating foreign exchanges for precautionary purpose. The double drain is the combined run on the national currency by both foreign investors and national investors as well. These last, in particular, would hit the credibility of the local currency in two ways. First, by withdrawing their money from national banks to convert it into foreign currency deposits. Secondly, they could even take their own balances of hard currency out of national banks to face immediate liquidity needs or avoid being dispossessed of it by the state under emergency rule. This perspective is particularly useful to disentangle a challenging puzzle for the ‘precautionary’ hypothesis, namely the oversize of reserve assets relative to the most established rules of adequacy²⁶. Empirical tests confirm that the accumulation of reserves is not solely related to the currency account surplus, but also to capital inflows (Bussiere et al. 2013; Obstfeld, Shambaugh, and Taylor 2010; Steiner 2013), highlighting the obsession of national decision-makers for the potential reverse of short-term liquidity flows in both surplus and deficit countries.

To conclude, a useful implication of the ‘precautionary’ explanation for this research is the following: if countries accumulate foreign exchange to avoid and escape the consequences of a balance-of-payment crisis, they are more likely to achieve this objective via current account surplus. In turn, to preserve the surplus notwithstanding mercantilist biases or the interests of the tradable sector, they will apply a compensatory monetary policy that preserves the tendency of national savers to invest their money abroad instead of increasing the country’s domestic investments. Similarly, in those countries when the accumulation is not driven by private actors monetary authority control directly the process of reserves build-up.

However, at least three loopholes cast doubts on the ‘precautionary’ explanation as the main driver of monetary followership. The first is its historical contingency. Indeed, while the practice itself, as widely pointed out in previous chapters, is as old as interstate relations as a toll to gain autonomy from the external constraint, its use to hedge against

²⁶ In this field, the simplest reference is the so-called Guidotti-Greenspan Rule, prescribing a one-to-one ratio between foreign reserves and short-term external liabilities with maturity of one year or less. While almost all emerging countries would abundantly overcome the adequacy criterion set by Guidotti and Greenspan, a double-drain approach would explain the oversize of their official reserves by accounting not just for the potential shortage of foreign loans, but also for the potential flight of domestic capitals.

financial crisis originated by cross-border capitals emerges out of a recent historical path. Hence, although this policy may have played a role in the choices of Asian and Latin American countries in the aftermath of their own currency crisis, it can hardly explain structural forms of monetary followership that took place out of this narrative, both temporarily and geographically. The second problem depends on the limited applicability of this hypothesis to developed countries with a solid financial system. In 2014, for example, among the first ten countries by holdings of foreign exchange reserves, just four were developing or emerging actors (China, Brazil, India and Russia). Among the others, one is Saudi Arabia, with its underdeveloped financial markets but also with no past problems of external indebtedness, and the other five are some among the richest nations in the world, comprising Taiwan, Singapore, Switzerland, Japan, Hong Kong and South Korea. For these countries, as well the model taking into account the threat of 'double drain' (Obstfeld, Shambaugh, and Taylor 2010), as the one estimating reserve adequacy on the base of external liabilities and import necessities (Vujanovic 2011) find a systematic excess of foreign reserves on the optimal level prescribed by adequacy rules. Finally, the third limit of the theory of precautionary accumulation, when used to explain monetary followership, is its imperfect account of why reserve 'accumulators' choose to focus on a single monetary leader instead of diversifying their assets into many currencies. The same argument can be made for interest-rate policy, where a minor country could follow a multiplicity of potential leaders and hoarding a balanced amount of hard currencies instead of focusing on one currency and foreign central bank. Precautionary strategies can be equally effective (or perhaps even more effective) when the accumulation follows a wise diversification, and monetary policy avoids fostering new crisis with an unfitting policy imported from the leader's authorities.

4.10 Money and security. Military alliances, alignments and the conflict on macroeconomic adjustments

The realist thinking has ranged across a wide range of positions about the influence of security issues on economic policies. Generally, the theoretical reflection oscillates

between the marked pessimism of neorealists, for which economic relations, entailing a mutual dependency, magnify the endemic mistrust among self-reliant actors (Waltz 1979), and the moderate optimism of realist IPE, which has more often focused on how good security relations provide adequate incentives to improve economic interactions (Abdelal and Kirshner 1999; Kirshner 2009; Mastanduno 1998). Empirical studies have provided a striking statistical evidence of this effect for any significant sector of economic exchange: trade (Baroncelli 2010; Gowa and Mansfield 1993; Gowa 1994; Keshk, Pollins, and Reuveny 2004; Mansfield and Bronson 1997; Pollins 1989), exchange rates (Li 2003) and financial investments, both portfolio and FDI (Gupta and Yu 2007; Rosecrance and Thompson 2003). However, the realist research program has focused also on a second, perhaps more important, research question. Since economic transactions produce distributive effects in terms of wealth flows and policy autonomy that do not disappear within military alliances and alignments, the most recent research has tried to link asymmetric vulnerabilities in the security field with distributive outcomes in economic relations. In this respect, the general hypothesis is that countries with shared security interests should be more prone to adjust their monetary and fiscal policies to guarantee the partner's power to delay the system's macroeconomic adjustments. However, those who need more the ally's contribution will be also more prepared to sacrifice macroeconomic autonomy to *convince or enable* the partner to play its part inside the alliance.

The idea of realist IPE is that the burden sharing conflict, characterising the debate on alliance politics since the 1960's (Christensen and Snyder 1990; Clementi and Carati 2010; Duke 1993; Olson and Zeckhauser 1966), could spill over into the field of monetary politics because of the constraint imposed by the balance of payment to the military efforts of a monetary leader. This undeniable link between the two dimensions allows alliance leaders to get their followers adjust unilaterally the system's imbalances in order to preserve its military effectiveness against the common enemy. Johnathan Kirshner defined the expected causality between security issues and macroeconomic adjustments as follows:

«to resolve disequilibria as they arise in the international economy, states must accommodate their macroeconomic policies. Cooperation can be sustained only if there is agreement about how such adjustments are to take place, and, most important, about who will bear the burdens

of monetary retrenchment and deflation [...] Security concerns can help overcome this problem. When national security is perceived to be at stake, the costs of monetary cooperation (the adjustment burden) remain the same, while the benefits are increased to the extent that monetary cooperation supports valued allies or facilitates and enhances overall political cooperation» (Kirshner 2003a)

In International Relations, the way to measure the asymmetrical demand of states for the military assistance or protection by another actor are the so-called dilemmas of alliances. The *dilemmas of alliances* have been devised by G. H. Snyder to define the countries' bargaining power within a military arrangement (Snyder 1984). Originally, Snyder's model comprised two dilemmas. On the one hand, the *dilemma of abandonment* indicates the possibility of an ally's defection on its original commitments to the shared goals. According to Snyder, the risk of being abandoned by an ally when its assistance is most needed persuades the most vulnerable part to reinforce its commitment to the partner, until the extreme of "chain-ganging" itself to the ally's decision, good or bad they might be. On the other hand, the *dilemma of entrapment* implies, for the 'entrapped' actor, the risk of being dragged into a conflict over an ally's interest that do not fit its own security concerns. Contrary to the danger of abandonment, entrapment induces a country to distance itself from the ally's strategy, for example by defecting on its commitments, or even appeasing the enemy, to de-escalate a crisis that could potentially turn into a full-scale undesired war.

Even though Snyder's dilemmas have been the keystone of alliance theory for almost three decades, the range of trade-offs states may come across in military alliances has been recently widened by Cesa with the *dilemma of weakening* and the *dilemma of strengthening* (Cesa 2010). His argument resembles Snyder's framework, but instead of referring to willing inducements by one of the two players, it posits that allies abandon or entrap due to impersonal forces related to the unequal growth rates of their economic, technological and military capabilities. The strategic response to an ally's strengthening usually entails throwing a spanner into its works, so as to keep power relations as equal as possible and avoid becoming a minor partner. On the contrary, a weakening ally is expected to be rescued by its partners, both economically and militarily, in order to preserve as intact as possible its contribution to the alliance's common objectives. It has to be noted, to conclude, that what is true for permanent and

official military aggregations is valid as well for occasional security cooperation and temporary alignments that could take place in a self-defence system as testified by the ambiguous relation between china and the US in the last decade (Maass, Norrlof, and Drezner 2014).

Monetary followership would be nothing but the economic side of a multi-faced response to both Snyder’s abandonment dilemma and Cesa’s weakening dilemma, aimed at safeguarding the leader’s effectiveness and will to play as security provider. Obviously, the scheme may work the other way round too, pushing minor states to safeguard their policy autonomy when they risk to be entrapped by an unduly assertive partner or being marginalised by a leader which is growing too strong in relative terms. In the scheme below, I hypothesise the causal relations between dilemmas of alliances and macroeconomic policies following the typologies outlined in chapter three.

DILEMMA	FOLLOWER’S REACTION
ABANDONMENT/WEAKENING	<ul style="list-style-type: none"> • Policy followership • Exchange-rate followership • Institutional binding
ENTRAPMENT/STRENGTHENING	<ul style="list-style-type: none"> • Monetary Neutrality (diversification, floating exchange rate, domestic-oriented monetary policy) • Strategic Disruption (boatrocking)

The scheme is intended to work notwithstanding the leader’s balance of payment position, even though the case of a weakening ally is intuitively more related to an excessive external deficit, while the second occasion happens more often with surplus leaders. At any rate, it has to be noted that monetary policy can be an instrument to placate the dilemmas of alliances even if the leader does not show evidence of balance-of-payment problems, as testified by some instances of strategic disruption.

The empirical evidence on the link between alliances, alignments and monetary followership is presently dominated by a case-study qualitative approach. Especially, historical cases on the first two dilemmas (weakening and abandonment) are abundant and clearly illustrative of the strategies and moves adopted by leaders and followers in

this situation. As a first instance, for example, Murphy (2006) describes the interaction between Japan and the Bank of England during the Classical Gold Standard as an emblematic trade-off between the Japanese support to the British monetary leadership and London's military cooperation against Japan's regional threats such as the Russian eastward expansionism. Mastanduno (1998) supposes that Tokyo's pro-cyclical monetary expansion of the late 1980's was ultimately intended to upkeep the price of US securities in response to warring Soviet manoeuvres in East Asia, while the same argument is presented by Stokes (2014) relative to East-Asian minor partners in the age of a rising China. Similarly, Hanrieder (1989), Zimmerman (2002) and Gavin (2003) reported the facts of the 1960's, when the US government, threatening explicitly the German Federal Republic to withdraw American troops from Germany's eastern borders, obtained the ally's commitment to correct the US trade deficit through military imports and to withhold their outstanding dollar claims instead of diversifying for gold and other currencies.

In the next chapter, I illustrate how the divide between major and minor followers, that is, between middle and small states in monetary relations, impacts on the structural elements traditionally associated to monetary followership in the realist paradigm (structural asymmetries in trade, military or financial vulnerability). Counterintuitively, I suggest that small states gain more autonomy when enjoying a structural current account surplus than middle powers, because of their irrelevance for price movements in the currency market. Conversely, major followers would be the genuine supporters of the leader's balance of payments, because since their contribution is much more valuable to the leader's grand strategy, their defection will also be much more costly both economically (capital losses) and politically (dilemma of abandonment). Subsequently, I argue why I expect material and immaterial inducements fostering the followership of small holders to be more likely to come from major holders than from monetary leaders, and why I expect this dynamics to induce effectively small actors to take part to the governance of asymmetrical monetary systems.

CHAPTER V

The divide between Small and Middle Powers in the Monetary System.
Implications for Autonomy and Followership of Small Holders

5.1 *The major-holder bias of the literature and the followership of small holders*

This chapter represents the theoretical core of this research. In its pages, I delineate the different strategic environment faced by small and middle powers respectively vis à vis the moves of the monetary leaders and powerful hegemonic actors. A narrower focus will be applied, as anticipated, to countries marked by a significant record of current account surplus. These actors are assumed to address a recurrent strategic dilemma between using their stronger solvency position to gain autonomy, namely, putting their own interests before the necessity to govern the system's imbalances (monetary neutrality) or sacrificing their autonomy to guarantee the stability of the core-currency on international markets (via the three forms of followership). The empirical elements to measure the followership policy of surplus countries are those already illustrated in previous chapters: a stabilising exchange-rate policy and the compliance with the Compensation Rule as regards either interest rates or official reserves.

The first conclusion of this analysis, which will be tested in the next chapter with a detailed case study, is that *small countries characterised by a significant current account surplus enjoy, other things being equal, a greater policy autonomy than middle powers*. They are supposed, in particular, to be more likely to diversify their foreign assets and escape the mechanism of entrapment, to govern interest-rates and money supply in accordance with domestic conditions about inflation and production and to choose fixed exchange-rate opportunistically when this accrues tangible benefits to the country's economy. On the contrary, their visible systemic irrelevance reduces also the power of non-financial means to coerce or induce small holders to coordinate with the leader, included the implications of monetary policy for the politico-military sphere.

The second conclusion concerns the causes of monetary followership rather the causes of defection. To identify the factors pushing small surplus states to follow a monetary leadership, I resort to the instruments of the decennial theoretical reflection on collective action dilemmas and the burden sharing problem in military alliances. Eventually, my conclusion is that there are essentially two ways for small holders to find followership more convenient than autonomy on the base of a rational cost-benefit calculation. The first is the presence of so-called *joint goods*, namely, goods whose benefits go to the shared goal of currency stability while generating relevant private gains for its producer as well. In other words, joint goods encompass the domestic

variables stressed by Comparative Political Economy and any country-specific gain from monetary followership that is not generalizable to all actors. The second way to favour small countries' followership is the action of neighbouring major holders through specific issue-linkages with relevant aspects of regional politics, such as economic cooperation and local military balancing.

On the contrary, the existing literature on the causes of monetary followership in surplus countries, as far as scarce and difficult to generalise, is strongly biased on the case of middle powers and their capacity to influence the core-currency. In the first place, mercantilist theory considers all countries as equally vulnerable to trade dependence. Instead, small countries, while on average more dependent on foreign trade than larger states, are better placed to exploit opportunities for diversification. Moreover, the lower systemic impact of their financial wealth implies a greater viability of opportunistic followership, where exchange-rate stability is oriented to the purpose of export promotion while domestic policies and reserves management are oriented to self-interested objectives.

In the second place, the connection of monetary issues with military affairs assumes the coincidence of monetary and military leader in an asymmetric alliance, and implies that followers' actions are able to increase or decrease, by affecting the strength of the leader's currency, also the effectiveness of a great power's military instrument within the security arrangement. However, this hypothesis suffers from the same complications affecting the burden-sharing bargaining on countries' contribution to military alliances. Indeed, in early studies on this topic military deterrence was considered as a public good²⁷ (Olson and Zeckhauser 1966; Olson 1965), which suffered precisely from the tendency of small countries to under-produce it given the scarce effectiveness of their conventional forces on the overall balance of power with rival great powers. Analogously, if the influence of small holders on the price of the core-currency is null or scarcely significant, the fact that balance-of-payment difficulties of a monetary leader may spill over on its efficiency as security provider does not provide any incentive whatsoever to small holder for sharing the costs of the system's maintenance.

²⁷ A public good may be consumed without reducing the amount available for others (non-rivalry in consumption), and cannot be denied to those who do not pay for it (non-excludability).

Lastly, the tendency to address the problem from the perspective of major holders is evident above all in game-theoretical works dealing with the effects of financial entrapment on the strategies of major Asian countries managing a huge amount of US-dollar reserves. In this context, scholars have taken for granted that, notwithstanding the size of a country's financial wealth, the accumulation of foreign assets had eventually turned any actor into a stakeholder of the core-currency on international markets. The idea that a financial wealth denominated in US dollars is conducive for the political mechanism described by Kirshner is supposed to lead to a standoff among follower countries that has been frequently represented as a static Prisoner's Dilemma (Ciorciari 2013; Drezner 2010). In his writing, Drezner outlines a clear definition of this strategic game. As he puts it,

«Collectively, [followers have] an incentive to hold on to their dollars, so as to maintain its value on world currency markets. Individually, each central bank [has] an incentive to sell dollars and diversify its holdings into other hard currencies. This fear of defection [leads] to a classic prisoner's dilemma and the risk that these central banks will simultaneously try to diversify their currency portfolios poses the greatest threat toward a run on the dollar»

Evidently, in these models all actors play equally as market movers of the core-currency, and the defection of even one of the dollar holders is deemed able to cause a collapse of the system of which only the first defector could escape the consequences.

However, this model faces some striking theoretical and empirical inconstancies. First, because the Prisoner's Dilemma is famous for predicting a single Pareto-inefficient Nash equilibrium of mutual defection, but this is not what we observe in the real world. Countries in the so-called Dollar Standard, the implicit worldwide monetary arrangement based on the greenback, have continued to accumulate dollar reserves in the last fifteen years, and have been willing to absorb the overhang of dollars created by the Federal Reserves in the aftermath of the 2008 financial crisis as widely documented in recent articles (Norrlof 2014; Stokes 2014). Second, not all the creditor countries, both presently and historically, have behaved as responsible stakeholders of the core-currency on international markets. For instance, France attempted at systemic destruction many times in the past from the position of major holder of gold (Accominotti 2009; Kirshner 1995), and many actors defected the US leadership during

the 2008 crisis all across East-Asia, the Persian Gulf and Latin America (Drezner 2009; Mehrotra and Koźluk 2008; Taylor 2013a, 2013b). These inconsistencies suggest the presence of a significant area of unexplained variance that is particularly strong for small holders, but invests also the motives behind the unwavering support given by major holders to the prostrated US economy and the declining dollar before and immediately after the last global crisis.

In the next chapter, I illustrate the baseline scenario of the bargaining between minor and major holders for the distribution of the burdens of adjustment in a system characterised by a deficit leader. Especially, I draw a parallel between this conflict and the burden sharing debate in military alliances addressed by the early literature on collective choice and its evolution in the last decades. In accordance with the 'small-exploit-the-large' hypothesis of this first writings, I first give a game-theoretical representation of the bargaining, and successively I discuss the elements that may shift the outcome out of the baseline scenario into cases of monetary followership by small surplus countries.

5.2 Modelling the baseline scenario of intra-follower relations

The theoretical reflection that is closer to the study of the conflict on macroeconomic adjustments, in terms of strategic dilemmas and bargaining problems, is that of burden sharing in military alliances. In the literature, this last issue has been analysed through a rational-choice approach drawing on the theory of collective choice. The actual problem, in the context of military alliances such as the 1960's NATO or the Triple Entente in the run up to the First World War, is that of distributing the economic costs of maintaining an effective nuclear or conventional force so that member states 'gain' a share of the common security which is proportional to their contribution in its production.

The first studies on the issue, which substantially equate security with deterrence (nuclear or conventional) between opposite blocks, are acutely sensitive to the choices of small states. Indeed, they get to the conclusion that countries with a minor economic and military potential are the most advantaged in the distribution of the burdens of common defence. As clearly stated in one of the seminal works on this topic, «There will [...] be a tendency for the "larger" members - those that place a higher absolute value

on the public good - to bear a disproportionate share of the burden» (Olson and Zeckhauser 1966). The main reason behind this outcome is precisely that «small nations, which find that even large sacrifices on their part have little effect on the global balance, would often be attracted to neutral or passive foreign policies, [while] large nations which know that their efforts can decisively influence world events [...] emphasize the urgency of the struggle in which they are engaged» (Olson and Zeckhauser 1966).

The analogy with monetary relation strikes as evident at this point. In particular, because both military deterrence and monetary stability are classifiable as non-rival and non-excludable public goods, and because the enhanced autonomy of small countries and the obliged contribution of major states are determined by the same circumstance: the influence of states on the system. However, there is also a fundamental difference in the way the scholarly literature has approached the hierarchical aspect of military burden sharing compared to relations in the monetary system. In the first context, the free-riding behaviour of small countries is intended to damage above all the alliance leader, while the contribution, role and behaviour of intermediate actors is scarcely considered if not completely ignored. In the second context, addressed by the literature of International Political Economy, the relation between leaders and followers has more frequently implied the point of view of middle powers. Conversely, the approach of this research has unveiled the fact that in asymmetrical monetary relations characterised by a deficit leader, the actual public goods producers are not great powers, but major holders. Accordingly, the main field of the macroeconomic conflict is not solely between minor states as a whole and deficit leaders, where the second wins by definition, but above all between major holders and small holders.

To the extent that the relation between small and middle powers differs from the analogous bargaining between producers and consumers of military deterrence, two significant differences emerge from this comparison. Firstly, the contribution of middle powers to currency stability, contrary to that of military leaders, may be the result of coordination among more than one actor with an equal capacity to influence the monetary system. For instance, the pivotal role of the sterling in the former British colonies in the years 1945-1960 was made possible by the implicit agreement among major holders of sterling balances, while the US dollar has passed successfully through its recurrent downward cycles on currency markets thanks to the coordination of a few

major creditors such as Saudi Arabia, China, Japan, Germany, South Korea or Hong Kong. Nonetheless, this simply means that current modelizations based on the Prisoner's Dilemma provide a rather imprecise representation of the so-called 'reserves game'. The strategic interaction among major holders is rather closer to a coordination game than to a mixed-motives situation. This is the case for mainly one reason: the rapidity and strength with which financial markets react to the defection of a major holder makes very difficult imagining that the first country to defect has any possibility to escape the heavy capital losses caused to its neighbours by this move²⁸.

Secondly, the producer of public goods, which in early models of the economic theory of alliances was a great power with interests, ambitions and concerns on a global scale, becomes in the monetary-system model a lower-ranked power with prevalently regional interests. This substantial dissimilarity makes these actors much more prone to suffer from the free-riding of small states, even considering the little marginal gains that these actors can provide to the production of the public good. A complete overview of how this fundamental difference affects the choices of followership in small surplus countries will be provided in next sections as part of the second core hypothesis of this research. Instead, to conclude this section I ignore this point and I provide a revision of the baseline game-theoretical modelization of both schemes of interaction about the conflict on macroeconomic policy autonomy among minor states – the one within major holders and the one between major holders and small holders.

The conundrum of major holders' coordination is still believed improbable by current theories predicting a beggar-thy-neighbour run on the core-currency. Contrarily, I suggest that the rapidity and strength of the reaction of financial markets can hardly allow any big player to escape the drawbacks of its single defection on its own financial assets, and that this simple fact is sufficient to turn the game into one of coordination. The case of South Korea in 2005 still resounds as the most evident example of such mechanism and an evidence of how the expected behaviour of major holders does not conform to the Prisoner's Dilemma expectations. South Korea was then the third major

²⁸ This characteristic of the game is sufficient to also confirm the unsuitability of iterative or dynamic games to represent the current strategic posture of main actors. Indeed, once the coordination in support of the core-currency fails for the defection of one player, the system leans toward collapse too rapidly and radically for leaving any space to retaliation, punishment and signalling typical of dynamic games situations.

holder of dollar assets in East Asia after Japan and China. In February 2005, the central bank discussed with the parliament about strategies to diversify its reserves away from the dollar into other currencies such as the Canadian and the Australian dollar that were more coherent with the country's trade pattern. Although the real plan did not imply a complete abandonment of the dollar by South Korea, at worst a slight diversification, in a single day the greenback fell so much against the Asian currencies that the spokespersons of every central bank in major creditor countries, from the Middle East to East Asia, spent the rest of the week running around to reaffirm their commitment to accumulate US dollars as receipt of their huge trade surpluses (Dougherty 2005). What is surprising in this affair is not simply the implicit and immediate coordination of major central banks, but above all the fact that the supposedly advantaged fist-defector, South Korea, had to renounce to diversify its foreign reserves as well.

Proceeding from these scope conditions, I propose a new the game-theoretical scheme describing the interaction among major holders as a static coordination game. In this first model, the leader is assumed to play autonomously as nature move, and small followers are kept momentarily out of the picture. Major holders hold the following utility functions:

$$U_i = S - F_i - k_i C_{INS} + \gamma_j F_j$$

$$U_j = S - F_j - k_j C_{INS} + \gamma_i F_i$$

Where i, j are two major holders in a deficit-leader system. $S = \gamma_j F_j + \gamma_i F_i$ is the payoff for currency stability, assumed to be beneficial to all actors in any case. As widely discussed in previous pages, it results from the joint effort of major holders' coordinating their policies through monetary followership. Indeed, $F_{i,j}$ represents the binary policy move of each actor, valued 1 if states follow the leader and zero if they remain neutral. Since autonomy is deemed to be a priority of economic statecraft, monetary followership ($F=1$) is considered a disutility in the actors' utility function, while neutrality implies no costs on autonomy ($F=0$). On the contrary, $\gamma_{i,j} F_{i,j}$ describes the utility, for each player, of the other actor's cooperation in the system maintenance, which is of course positive (i.e. states prefer at any rate to share the burden). The parameter $0 \leq \gamma \leq 1$ measures the actor's market power on international financial markets, whose most effective proxy is a country's share of the total core-currency

liabilities held by foreign actors. As the leader's external indebtedness is a finite quantity, in the model I assume that $\gamma_i + \gamma_j = 1$, and I set $\gamma_{i,j} = \frac{1}{2}$ since both states are major holders and thus are both necessary to the complete stabilisation of the core-currency through cooperative coordination. As regards the variable C_{INS} , it measures the disutility (i.e. the cost) of systemic instability following a scarce provision of monetary coordination by one or both major holders. By assumption, $C_{INS} = 0$ if $S \approx 1$, otherwise $C_{INS} = 1$. The parameter $0 \leq k \leq 1$ describes the importance attached by the two players to systemic stability. Although generally related to the variables described in chapter four, in this model I assume $k_{i,j} = 1$ for both players. That is, either major holders have a strong political, economic or country-specific interest in maintaining the stability of the core currency and the survival of the asymmetrical monetary arrangement. When actual policy moves are inputted into the functions, this is the resulting payoff matrix for the game between major holders.

		MAJOR HOLDER (2)	
		FOLLOWERSHIP	NEUTRALITY
MAJOR HOLDER (1)	FOLLOWERSHIP	(0.5,0.5)	(-1.5,0)
	NEUTRALITY	(0,-1.5)	(-1,-1)

Nash equilibria in (F,F; N,N)

This game represents the interactions among major holders in systems characterised by a multiplicity of surplus middle powers necessary to support the leader's coinage on international markets. However, there are two pure strategy Nash equilibria as none of the two players holds a dominant strategy in either neutrality or followership. Followership is convenient if players consider the other part to be reliably committed to play followership as well. Otherwise, neutrality is the less risky strategy if the other player's will to support the core currency is uncertain in the near future. In technical

words, (F,F) *payoff dominates* (N,N) being the pareto efficient solution of the game. However, (N,N) is said to be *weakly risk-dominant* over (F,F) since the product of the difference between the two players' payoffs in their last- and third-best scenarios, respectively -1.5 and -1, is equal to the product of the difference between their payoffs in the second- and first-best situations, respectively 0 and 0.5, as long as there is uncertainty on other players' will to cooperate²⁹. In practical terms, this means that states have no evident incentives in playing either a prudent, but less rewarding strategy like neutrality, or a risk-taking but potentially more fruitful strategy like followership. In this kind of symmetric games, a pure strategy solution is impossible unless players are able to assess other actors' intentions.

In this case, for (F,F) to be the Nash equilibrium of the game, like we observe, for example, in the Dollar Standard among major holders of dollar securities, it is sufficient for major holder (1) that $p(F, F) + (1 - p)(F, N) > p(N, F) + (1 - p)(N, N)$, where p is the probability that major holder (2) plays followership simultaneously. The equation must hold equally for major holder (2) with inverted moves³⁰ and p equalled to the expected probability that major holder (1) plays F. As long as p is greater than $\frac{1}{2}$ for either players – that is, other major holders are deemed more likely to follow the leader than to remain neutral – playing followership accrues higher payoffs with lower risks, and becomes the pure dominant strategy for both players. As regards the factors affecting the value of p , at least three variables can be identified under conditions of common knowledge of rationality. First, a bad economic health of other major holders can cast doubts on their ability, notwithstanding their political will, to support the leader in the near future. Second, a very troubled, hopeless situation of the core-currency, due to excessive imbalances and extreme market pressures can waver the trust of other major holders in their own possibility to avoid a collapse. Third, an assessment of other player's political relations with the leader can reveal increasing hostility due to geopolitical and military rivalry, reducing the possibility that a rising major holder supports the leader in the long run.

The second model is relative to the bargaining between small countries and intermediate actors in a deficit-leader monetary arrangement. As in the previous model,

²⁹ $(-1.5 + 1)(-1.5 + 1) \geq (0 - 0.5)(0 - 0.5) \implies -0.5 * -0.5 \geq -0.5 * -0.5 \implies 0.25 \geq 0.25$

³⁰ $p(F, F) + (1 - p)(N, F) > p(F, N) + (1 - p)(N, N)$

the leader is assumed to defect by nature, supposing that it is always willing and able to maximise its own policy autonomy at the expenses of other actors. Conversely, minor states are prepared to bear unilaterally the burden of adjustments to preserve the value of the core-currency, providing their contribution impacts significantly on international markets. The formalisation of utility functions is the same as the previous one, but with a significant change in the feedback effect of F on systemic stability given by an asymmetric value of the parameter γ .

$$U_i = S - F_i - k_i C_{INS} + \gamma_j F_j$$

$$U_j = S - F_j - k_j C_{INS} + \gamma_i F_i$$

In this model, i is a small holder while j is a major holder. As before, $S = \gamma_j F_j + \gamma_i F_i$, representing the payoff for currency stability. $F_{i,j}$ represents the policy move of each actor valued 1 if states follow the leader and zero if they remain neutral. Contrary to the previous model, $\gamma_j F_j$ describes the utility of small holders for the followership of major holders, while $\gamma_i F_i$ describes the utility of major holders given by the coordination of small holders. However, in this model the parameter $0 \leq \gamma \leq 1$ with $\gamma_i + \gamma_j = 1$ is not assumed equal for both players, but dissimilar mirroring the extensively larger influence of major holders on currency markets. Numerically, I assume $\gamma_j \approx 1$ since the core-currency stability is guaranteed solely with the unilateral coordination of major holders. Conversely, $\gamma_i \approx 0$ in small holders, since their effect on market prices, by definition, is slightly positive or null. This change has a big influence both on states' contribution to stability (S depends almost exclusively on F_j) and to the utility assigned by any actor to its counterpart's cooperation ($\gamma_i F_i \approx 0$ for major holders) As before, the variable C_{INS} measures the cost of systemic instability following a scarce provision of monetary coordination by major holders. Practically, in this case $C_{INS} = 0$ if $F_j = 1$, otherwise $C_{INS} = 1$. The parameter $0 \leq k \leq 1$ is assumed $k_{i,j} = 1$ for both players. That is, both the major holder and the small holder have a political, economic or country-specific interest in maintaining the stability of the core currency and the survival of the asymmetrical monetary arrangement. When actual policy moves are inputted into the functions, the resulting payoff scheme is the following:

		SMALL HOLDER	
		FOLLOWERSHIP	NEUTRALITY
MAJOR HOLDER	FOLLOWERSHIP	(0,1)	(0,2)
	NEUTRALITY	(-1,-2)	(-1,-1)

Pure Nash Equilibrium in (F,N)

Remarkably, the game between middle and small powers implies a largely different result with respect to the previous model. Indeed, given the lower value of γ for small holders, on the one hand these actors have a dominant strategy in N, forcing the major holder to a dichotomous choice between provoking a systemic collapse (N,N) or bearing the burden of adjustments alone (F,N). On the other hand, the major holder attaches a very small, perhaps negligible, utility to small holders' coordination per se ($\gamma_i F_i \approx 0$). However, the existence of a dominant strategy for one of the two players is sufficient to compute a pure strategy equilibrium even without specifying that for major holders, since y_i is slightly greater than zero when small holders follow, $(F,F) > (F,N)$ and $(N,F) > (N,N)$, while their values have been approximated in the payoff matrix.

Apparently, these two schemes cover the whole set of conflictual interactions between the two categories of potential followers. Now, just the question of monetary followership in small countries remains unanswered. The problem arises in a similar fashion for military alliances, where after decades of observation on the behaviour of the small NATO members, scholars have concluded that free-riding behaviours are rarer than is commonly predicted by the baseline scenario of collective choice theories. Rather, small allies' contribution in terms of military spending and conventional forces has been found disproportionately greater compared to the security gains of their alliance membership. Hence, the search for new variables determining a different burden distribution in military alliances has brought scholars on two parallel routes. On the one hand, they coined the categories of joint goods and 'impurely public goods' to identify those situations where the development of one's military instrument can

provide both public and private goods. On the other hand, recent studies have explored the potential of issue-linkages as a possible rebalancing factor in the bargaining between small and big players. In next sections, both hypotheses will be analysed and adapted to explain the distributive outcomes of monetary relations.

5.3 Joint Goods and Issue Linkages: the causes of monetary followership in small holders

In the field of military burden sharing, the main theoretical innovation reconciling the empirical evidence (small states do contribute as well as or more than major states) with the theory of public goods (which expects them to free-ride) is related to the concept of joint goods or joint products (Coneybeare and Sandler 1990; Cornes and Sandler 1984; Murdoch and Sandler 1984; Sandler 1993). This intuitive idea entails that conventional military capabilities developed by small states generate benefits that go beyond the pure public good of deterrence, supplying the contributing state with other two categories of benefits known as private goods and 'impurely public goods'.

With the first instance, scholars allude to the compresence of specific national exigencies, beside the general scenario, which could be benefited by additional investments in the military sector (Sandler 1993). Such concept encompasses country-specific security threats but also domestic interests related to the industrial complex or the conflict for resources among burocratic bodies. A crystal-clear example of this phenomenon is the trend of military spending in Greece and Turkey, which regularly exceeds their equal-contribution quotas inside the NATO thanks to their reciprocal territorial disputes over the islands of the Aegeus and Mediterranean Sea. Paradoxically, this inter-allies rivalry enhances the overall production of deterrence within the Atlantic Alliance by overcoming the underproduction problem of small countries. Differently, the concept of 'impurely public goods' concerns the damage limitation in case of actual enemy invasion, attack or other military moves. Indeed, in this case the advantage given by an already strong military is both beneficial to the producer and partially sharable with other countries at a declining rate depending on distance and length of the battlefield. Major examples come from countries very close to the border between the

two blocks during the Cold War, like the former Czechoslovakia or Baltic countries in the post-Cold War NATO.

A first idea to reconcile theory and empirical evidence in monetary relations can be the adaptation of these aspects of the theory of alliances to the conflict on policy autonomy. However, on the one hand it is doubtful that any 'impurely public good' may be related to the monetary followership of small holders. Those phenomena that enhance the general systemic welfare indeed, such as economic growth or financial stability, are more easily associated to domestic-oriented policies and a careful asset diversification, that is, they cannot imply followership. On the other hand, the literature review in the previous chapter has given a cogent account of the country-specific factors (private goods) that may bring to the fortuitous coordination of monetary policies: domestic institutional structure, economic and demographic trends, party politics and interest-group dynamics. Pairwise, all the numerous shortcomings of this approach have been stressed with regard to small surplus countries, to conclude that domestic-based hypotheses can be largely used as control variables in the empirical parts of this study, but do not represent the priority of its research design for their strong limits in dealing with the case of small holders.

Rather, to understand the peculiar fact of monetary followership in small holders it is more useful looking at those structural variables that the academic reflection has put under the spotlight as alternative to public-goods models of international economic relations (Axelrod and Keohane 1985; Keohane 1984; Kindleberger 1986; Oye 1985). Realist and liberal institutionalist scholars have elaborated at least four factors increasing the possibility to overcome collective action dilemmas – a low number of players, the presence of international institutions, the density of linkable issues and the opportunity to play iterative games. A further analysis of recent findings in the theory of alliances and the direct observation of monetary relations suggest identifying regional major holders as the most likely actors to exploit the opportunities granted by these structural factors. In particular, I advance the hypothesis that middle powers are the *most likely* and *most effective* subjects to connect the followership of small countries with issues and tables at the regional level, allowing these actors to privatize some of the benefits of currency and monetary coordination that would be otherwise dispersed by their scarce systemic influence.

The four elements usually emphasised in the literature on international coordination are not equally applicable to the debate on macroeconomic adjustments. Firstly, scholars argue that the lower the number of actors in a system, the greater the probability that countries coordinate for the production of public goods. However, the core question in the conflict between major and minor holders in hierarchical monetary systems is not about favouring cooperation among multiple equally-seized actors. Rather, the production of public goods is assured unilaterally by middle powers, which may cope with the free riding of small holders on a bilateral base vanishing the usefulness of this approach. Secondly, the possibility to provide coordination through the iteration of the game is limited by the unusual payoff structure of strategic interactions in asymmetric monetary systems. As shown in previous sections, the game between major and minor holders is solved by a Pareto optimal Nash equilibrium representing the first-best of small surplus powers. Consequently, the applicability of two strategies that have demonstrated their efficacy with the Prisoner's Dilemma – such as the Grim Trigger and the Tit-for-Tat – is severely limited by the fact that the payoff of the major holder is higher when it accepts the free-riding of small holders than when it tries to 'punish' them by playing defection. If anything, these strategies might work in presence of valuable assets external to the monetary game to use as a punish-reward mechanism to induce small countries to follow the leader's priorities.

Following this suggestion, the other two variables highlighted by past studies result quite more promising. The first pertains the role of international governmental institutions. In the rational-choice reflection, formal institutions contribute to the ritualization of interactions among the actors through periodic meeting, issue-to-issue connections in multiple negotiating tables and supposedly unbiased flows of information about the payoffs and the actual behaviours of other member states (Keohane and Martin 1995; Keohane 1984). Although the realist critique to this hypothesis argues that the institutional context, by itself, is hardly sufficient to guarantee the cooperative coordination among participant states (Grieco 1988; Mearsheimer 1994), it remains the uncontested importance of this variables in favouring the link between separate issues. It is indeed this last point to play the lion's share in the attempt to identify those structural variables that may push supposedly autonomous actors to give up their freedom in the macroeconomic field. Accordingly,

small holders will be more likely to participate in the support of the core-currency when major holders are willing and able to exploit regional issue-linkages to modify the cost-benefit calculus of their reluctant neighbours³¹.

The study of issue-linkages has been deep and extensive in past years, both in the liberal and the realist-minded literature. Overall, the theoretical reflection in the field of rational-choice theories has identified many different typologies of issue linkage. Haas (1980) proposes a tree-fold partition distinguishing among *tactical linkage*, which exchanges a partner's concession with an element that has no intellectual or technical link with the issue at stake; *Fragmented Linkage*, which establishes a link between the partner's cooperation and a side-payment which is not presented as a quid quo pro but as technically necessary; *Substantive Linkage*, which refers to cases where the linkage is pursued with a shared and substantial knowledge on the interdependency of two issue-areas. According to McGinnis (1986), «Two different types of linkage strategies are shown to allow for cooperation in different circumstances; one is a simple extension of tit-for-tat, the other entails a quid-pro-quo arrangement in which each player sacrifices on some issues in order to gain more on others». Likewise, Oye (1985) considers issue-linkages essentially as a tool for increasing the opportunities of game iteration and for providing punishing moves for a tit-for-tat scheme.

Axelrod and Keohane identify three typologies of issue-linkages denominated *backscratching*, *blackmailing* or *contextual* (Axelrod and Keohane 1985). The first two are the faces of a same coin based once again on the known mechanism of tit-for-tat. In backscratching scenarios, a state A modifies the cost-benefit ratio of state B acting on the benefits side, that is, with a promise of remuneration in case of conformity with the requests of state A. A clear example is that of a country exchanging the settlement of a monetary agreement with the promise to open its domestic market or promoting the membership of its partner to an international organisation. In the case of blackmailing, a state A threatens a retaliation on state B in case of non-conformity to its desired policies, therefore acting on the cost side. A clear example is represent by Eichengreen's game-theoretical model of Hegemonic Stability Theory applied to currency relations

³¹ This process is naturally passible to work the other way round. Namely, the number of small surplus followers may be decreasing when a regional major holder has a political or economic interest in not sharing the burden of followership with its regional neighbours.

(Eichengreen 1989). In that context, the leader punishes the cases of exchange-rate devaluation by small countries with a specular move on its own currency coupled with commercial restrictions. Lastly, in a situation of "contextual" issue-linkage, «a given bargain is placed within the context of a more important long-term relationship in such a way that the long-term relationship affects the outcome of the particular bargaining process» (Axelrod and Keohane 1985).

Among the many proposed typizations, both the so-called tactical linkages (whether negative or positive) and the contextual link of two issues within a regional political and economic framework, may be useful tools to coerce or induce small surplus states to follow in monetary affairs despite the lack of baseline incentives. In next sections, I explain why regional major holders, and not monetary leaders as commonly assumed by rational-choice theories, are more likely to resort to issue linkages and successfully induce small states *in the same regional system* to monetary followership towards the leader.

5.4 Systemic stakeholders or regional leaders? Major holders as mediators between monetary leaders and small countries

The impact of spatial variables on political relations in the monetary system, especially the different weight of regional and global issues for minor states, has received so far scarce attention in the IPE literature. Obviously, a notable exception is the vast group of studies on the cases of regional leadership, like the European monetary integration or the analyses on the regionalisation of economic relations (S. Cooper 2007; Hellmann 2007; Kenen and Meade 2008). However, theoretical studies have usually assumed global and unified monetary systems in their elaboration, mainly due to the peculiar nature of financial transactions, almost unaffected by space distances compared to trade and military relations. Yet, there are issues in international monetary relations where the spatial dimension, namely the geographical scale of state-to-state interactions, is frequently a more influencing factor than is commonly thought. In particular, with the progressive reduction on a regional scale of the web of diplomatic, economic and military relations among states in the post-Cold War, the number

opportunities to link issues on multiple regional negotiations has risen as well, opening new windows for states to advance their interests in the monetary arena.

In the theory of International Relations, the post-Cold War reflection has given a great thrust to innovate on the geopolitical complications of the concept of power, especially considering the increased weight of '*regional security complexes*' (Buzan 2004; Lake and Morgan 1997) in the strategic calculus of major actors. In other words, scholars have detected a widespread tendency by all the relevant systemic actors (excluded perhaps the American superpower) to prioritise threats, conflicts and opportunities within their immediate neighbourhood when pondering about the nodes of their strategic planning, including military, financial and commercial issues (Colombo 2010). About this, it is worth mentioning the great effort by Barry Buzan to reframe the concept of international hierarchy, incorporating a geopolitical criterion in the traditional scheme devised by Keohane and based on each actor's capacity to exert a significant influence on the system. In brief, Buzan's hierarchy includes three major actors: a) *superpowers*, characterised by top-ranked economic and military capabilities with a genuinely global presence; b) *great powers*, connoted by the possibility to exert influence in a few regional contexts other than their own; c) *regional powers*, including all those states which exert a significant influence on interstate relations, define a system's polarity and are considered important by other major actors, but solely *within their own regional system* (Buzan 2004).

This new conception of the relation between space and state power can be usefully employed to grasp the relative importance of regional issues when observing states' behaviour in monetary relations. On the one hand, great powers and regional powers, if not playing as monetary leaders, are able to play the role of major holders (or big debtor, more in general) in a regional or global monetary system. On the other hand, if major actors are currently re-orienting their interests from global issues to regional scenarios, this process is likely to be even stronger for small states, which in the previous bipolar global system had already shown a remarkable tendency to prioritise conflicts, relations and equilibria within their relevant strategic area. This widespread roll-back to regional politics, together with the greater priority attached to regional issues by small and middle powers, has also opened a wide potential for influence to those actors, like major holders of financial assets, that are willing and able to exploit their stakes in

regional politics as a bargaining weapon to induce small states to participate in the governance of an international monetary system.

For instance, the theory of alliances has already noticed some of the most evident consequences of this epochal change on the bargaining for the distribution of the burdens in military cooperation. Carati and Clementi (2010) have identified one of these processes in a study on the new-entered NATO members after the Cold War. They noticed that the contribution of the small countries, formerly members of the Warsaw Pact, to the out-of-area missions of the Alliance (Balkans, Iraq, Afghanistan) is not simply disproportioned with respect to their gains in terms of deterrence (so denying the expectations of the economic theory of alliances), but also that the hypotheses of joint goods and impurely-public goods are insufficient to explain this pattern. Their conclusion is that the countries of the former soviet bloc were deeply convinced that their remarkable contribution to all NATO-led missions, notwithstanding the scarce connection to the common security threats (e.g. Russia), would have been sooner or later remunerated by major European powers with the inclusion in the dense institutional structure characterising western Europe, and especially with a rapid accession to the European Union.

Analogously, the observation of the patterns of international monetary relations reveals that great powers or regional powers characterised by a creditor position towards the leader have frequently exploited their political, economic or military power, within their own region, to obtain from small states the surrender of policy autonomy, functional to the preservation of currency stability against the system's inevitable imbalances. In these cases, the major holder play the role of 'intermediaries' between the monetary leadership – which may be an extra-regional superpower as well as a local great power such as Germany – and small states within their regional neighbourhood. This position, however, may be exploited in another way, which is less relevant to this research but is worth a mention to avoid theoretical misunderstandings. Major holders can monopolise the support to the core-currency while promoting a detachment of smaller states' economic relations with the monetary leader when they are politically interested in weakening the ties between regional small states and an external power.

These two paradigmatic cases are well represented by the opposite strategies followed by Saudi Arabia on the one side and China on the other during the recent

monetary shock conveyed by the Federal Reserve after the burst of the housing bubble in the American market. The first behaved as the chain of transmission of the American hegemony on its reluctant small neighbours in the Persian Gulf. The second played exactly the opposite, with Beijing's authorities accepting their role of major holder of dollar securities, but also maintaining an autonomous monetary policy thanks to capital controls. This policy stance, accompanied by a widespread action of economic diplomacy by Beijing, has gradually driven many regional small holders out of a strict followership to the dollar. For example, econometric tests reveal that regional developing states, since the breakup of the crisis, have started weighting the renminbi more than the dollar in basket-pegged exchange rate regimes (Girardin 2011; Henning 2012), have used more frequently the Chinese currency to settle cross-border trade transactions (Campanella 2014), or have stopped tracking the Fed to follow the People's Bank of China in the monetary tightness of 2011 (Ciorciari 2013; Johansson 2012; Mehrotra and Koźluk 2008). China's project is indeed a long-term one, which accepts the US hegemony for the moment but works to replace it in the future as a regional monetary leader.

The action of middle powers in the monetary system is thus a major determinant of monetary followership in small holders. On the one hand, middle powers have a *greater interest* in the followership of small actors compared to the monetary leader. Indeed, while the leader's unique interest is the preservation of its autonomy vis à vis the balance-of-payment constraint, regardless of how followers distribute the burden of currency stability among themselves, major holder have two motives to want a more cooperative distribution of that burden with small holders. Firstly, for not incurring the risk of being considered the losers of the economic conflict by their public opinions. As shown by numerous case-studies indeed, even autocratic rulers cannot be completely isolated from regional news on the main economic and financial events, thus generating legitimate claims for policy reversal by interest groups and political factions damaged by the possible consequences of monetary followership when neutral choices are taken by similar neighbouring economies. Secondly, major holders are more interested in small country's choices because the geographical proximity of financial centres in small countries increases the burden of monetary followership on the major holder's monetary authorities. Indeed, if neighbouring countries present comparable financial

markets offering higher yields than the leader's market, the middle power would also have to avoid its residents' capitals to be invested in these alternative markets rather than being channels to support the core-currency.

On the other hand, middle powers are not solely more interested than the monetary leader in small countries' behaviour, but are also *better endowed with bargaining chips* for the greater density of issue-linkages potentially controllable inside and outside the monetary-financial arena. Trade networks, the military balance, the stability of domestic political regimes in small states are much more affected by regional major actors than by the action of external powers distracted by compelling global interests. The bargaining weapons in the hands of major holders are essentially a subset of those previously enlisted with regard to monetary leaders, but with a greater opportunity for small countries to privatise some of the gains from their contribution to the stability of the core currency.

The first is the link between external security and monetary issues. In this context, the geographic proximity of the major holder and its prominent stake in the regional power balancing allows it to exchange monetary followership in small states with a damage-limiting strategy in case of a hostile invasion. This good may be extremely valuable to small holders even if the regional security is ultimately guaranteed by an external superpower. The second bargaining chip is the link with small countries' *internal security and domestic consent*, where the major holder can provide military assistance in case of actual or probable overthrowing of the government in charge, or a declaratory support with ideological coverage for friendly governments. In all these policies regional powers would be more reliable and more likely to be effective given their greater interest in regional stability, the aversion to (hostile) ideological contagion and the greater affinity of political or religious language with their neighbours. Thirdly, *economic relations* are tighter and less subject to diversification among countries sharing a common border or belonging to the same region. Overall, regional schemes for economic cooperation, whether concerning trade, money or other fields (like cartels of raw material producers) offer a wider range of opportunities for tit-for-tat strategies as well as for 'contextual' issue-linkages given the greater connection among economic sectors. Fourthly, regional major holders can exert a greater *control over regional*

intergovernmental institutions, and use this power to exchange its preferred policies for the enhanced role of small states within these institutional arenas.

In the next chapter, I compare the different policy responses of the six members of the Gulf Cooperation Council to the decline of the dollar in the 2000's and the monetary shock of 2007-2009. Through a detailed analysis of their decision-making process, I highlight the functioning of the strategic mechanisms illustrated in previous chapters, first about the great monetary-power divide between small and large holders and second about the causes for monetary followership in small actors. Data, documental evidence and historical records show the undeniable autonomy gap between the medium-sized country, Saudi Arabia, and the minor monarchies vis à vis the United States, while confirming that small states' followership has been mostly induced by Saudi Arabia's mediation through linkages with relevant regional issues regarding economic and security cooperation.

CHAPTER VI

The GCC monarchies and the 2008 financial crisis: the small/major holder divide and the role of Saudi Arabia

6.1 Case selection and methodology

In this chapter I illustrate the results of an original case study carried out between 2013 and 2014 on the exchange-rate and monetary policy of the six member countries of the Gulf Cooperation Council: Saudi Arabia, Kuwait, Qatar, Bahrain, United Arab Emirates (UAE) and Oman. The key purpose of this work is to test the two major hypotheses of this research – the greater autonomy of small holder versus major holders and the leading role of regional powers in causing the followership of small holders – on a significant sample of state actors. The selection of the case is grounded on three methodological considerations.

On the one hand, the strong homogeneity of the six countries as regards the main variables that, according to the most recent literature, affect the proneness to monetary followership in small and middle powers. Other conditions being equal indeed, the observation of a different behaviour between small and major holders appears much more robust. Hence, in the first place, all the six countries have enjoyed a wide and persistent current account surplus from the late 1990's to the outbreak of the global financial crisis in 2008. This turned them into net creditors vis à vis the rest of the world economy and primary protagonists of the international financial system through their huge stocks of reserves and the actions of sovereign wealth funds. In the second place, all the relevant countries are characterised by strong and symbiotic relation with the United States in the field of security and military cooperation. From this alliance, all actors gain protection against Iran and other regional threats, while minor states see it also as a guarantee against the danger of a Saudi regional hegemony. In the third place, all countries share a great number of economic characteristics that may potentially impinge on monetary-policy decisions. Their commercial exchanges take place prevalently with the European Union and East Asia, while none of them has been subject to financial or balance-of-payment crisis in the last thirty years. Overall, their economic development is based on a classical rentier-state model dominated by the production and the sale of energy products (mainly crude oil and gas) and of related activities in the service sector. In the last place, the perspective on political systems shows a homogeneous model characterised by monarchic, autocratic and strongly centralised governments, whose grip extends to monetary authorities that are completely subordinated to the political power.

On the other hand, the second reason making this instance particularly suitable for a study on the burden sharing of macroeconomic adjustments is the historical moment considered in the analysis. The six countries of the GCC have indeed tightened their link to the dollar in a particularly unpropitious moment of the so-called dollar cycles, characterised by a deep crisis of the key currency that led its value to depreciate by about 50% against major world currencies from 2002 to 2008. The monetary policy of Saudi Arabia and other GCC states has significantly contributed to moderate this plunge, especially through the great mass of liquidity channelled towards the US market to recycle the huge inflow of 'petrodollars' that flooded to oil-producers in those years. However, the overflow of investments in the United States played also a big role in causing the boom and the bust of the housing bubble in 2007-2008, with all its painful consequences for the American and the global economy. Consequently, the US authorities tried to shift as much as possible of the costs of deleveraging on peripheral creditor economies such as Asian developing countries and oil producers. On their part, the GCC actors addressed the misalignment between policy priorities in the leader and the followers' market differently: on the one hand, Saudi Arabia, Bahrain and the United Arab Emirates followed the Fed's hyper-expansion of the money supply despite their booming domestic markets required a strong tightening of monetary conditions. On the contrary, Kuwait, Qatar and Oman managed their exchange rate, their interest rates or both disregarding the US policy and in accordance with the urgent domestic problems such as a rampant inflation on asset prices and base commodities. In a nutshell, the GCC case-study presents a clear instance of macroeconomic conflict, originated by a genuine divergence of policy priorities between leaders and followers, where the seconds had to face the dilemma between prioritising their own policy autonomy or preserving that of the leader country.

Eventually, a general element making this case particularly useful to the research on the politics of money and exchange rates is its originality. So far, the temporal nearness of main events had prevented a genuine political-economy analysis of monetary decision-making in the GCC during the subprime mortgage crisis. On the contrary, this study represents the first documented account of the decision-making process in the six Arab monarchies as regards monetary and exchange-rate policies, and

gives a further contribution to the large number of case-studies relative to the macroeconomic conflict in asymmetric monetary systems.

The purpose of this analysis is to demonstrate that the bargaining divide between small and middle states –namely, between the small monarchies and Saudi Arabia – has been the main determinant of the choices of defector countries. Contrarily, the small holders which did not exploit their position to gain autonomy (UAE, Bahrain and to a limited extent Qatar) have been constrained by an effective intermediation by the regional major holder, Saudi Arabia. Empirical evidence of these two processes will be given by a comparative analysis of economic data aimed at excluding the influence of other domestic or international variables that may have conditioned decision-makers in their macroeconomic choices. In addition, press articles, insider-analyses of practitioners and specialists and diplomatic cables from US authorities will be used to reconstruct the political, economic and ideational origins of public policies in the six countries³².

6.2 Background of the crisis: macroeconomic imbalances, the subprime mortgage bubble and the repercussions on the GCC countries

The onset of the 21st century has shown a remarkable shift in the international economic position of the Persian Gulf's Arab monarchies. Due to the soaring price of the crude oil, these countries have enjoyed a steady and large current account surplus, developed a net creditor position *vis à vis* the major world economies, and improved sharply their public budgets. At the beginning of the 2000's decade, their currencies had been officially pegged at a fixed rate to the US dollar, as an intermediate step towards the creation of a single currency for the six members of the Gulf Cooperation Council (GCC). However, the healthy situation of the state budgets fostered, all across the region, the implementation of massive infrastructural spending programs that overloaded the small local economies with a sudden liquidity shock. Expectedly, inflation soared, supported by the constant depreciation of the US dollar and a pro-cyclical monetary policy

³² Diplomatic cables come from American embassies and consulates in the countries under scrutiny. They are mostly classified as 'confidential' and therefore should have been kept unavailable for a period of at least ten years. However, the recent release by the organization known as 'Wikileaks' has made possible to consult them until 2010.

imported from Washington. Indeed, since fall 2007, as the first signs of the subprime crisis hit the banking sector in the United States, the Fed started an open-ended program of monetary expansion that conveyed low interest rates to the whole dollar area. Helped by this unfitting credit policy, an asset-price bubble developed in the Persian Gulf, which persisted until the last months of 2008. Concretely, inflationary pressure touched the highest in the spring and summer of the same year, reaching an average peak of 11% monthly rise in the official statistics, and climbing higher than 20% according to independent observers. The cost of fundamental commodities such as rice, flour, vegetables and fuel followed the same trend, rising from twenty to sixty percent of their initial price in less than a year. Eventually, in fall 2008, as soon as oil prices froze also the oil bubble burst, and the following financial chaos unveiled the contradictions of such a pro-cyclical policy stance. Deflation, bankruptcies and state-backed bailouts spread throughout the region. At the peak of the crisis, all the countries tried, unsuccessfully, to cure the problem with subsidies and wage augmentations. However, Saudi Arabia, Bahrain and the Emirates did not take any further step such as tightening monetary policy or revalue the local currency. Contrariwise, Qatar stopped tracking the Fed's rate in late 2007, Oman kept high interest rates for the entire period, and Kuwait dropped the dollar peg and revalued its dinar.

Country	Exchange-rate	Monetary Policy	Policy Outcome
Kuwait	Flexible	Tightening	Neutrality
Qatar	Peg	Tightening	Opportunistic Followership
Oman	Peg	Tightening	Opportunistic Followership
Saudi Arabia	Peg	Expansive	Exchange-rate Followership
UAE	Peg	Expansive	Exchange-rate Followership
Bahrain	Peg	Expansive	Exchange-rate Followership

The aim of this chapter is to explain how the interplay of traditional theories and new insights on the small/major holder divide shape the currency and monetary policy of the six countries along the two dimensions: the establishment and defence of a fixed exchange rate to the US dollar, and the monetary policy divergence in dealing with the external shock.

In economic sciences, the empirical indicator marking the run up to financial crisis is the accumulation of excessive indebtedness accompanied by inflating price bubbles. Normally, different paradigms of economics show no accord on the very sources of this undesirable outcome, and the case of the subprime mortgage crisis does not make an exception. On the one hand, endogenous explanations have largely focused on the role of deregulation and financial innovation in creating the bubble and the web of interconnections that expanded its effects well beyond Wall Street (Bhidé 2011; Calabria 2009; Crotty 2009). Alternatively, domestic-based hypotheses have blamed expansive macroeconomic policies in the US – especially Greenspan’s low interest-rate policy in the early 2000’s – for causing an excess of loanable capitals, which ended up in practices like asset-price inflation and subprime lending in a desperate rush to produce fruitful investment opportunities (Smith and Gjerstad 2011; Taylor 2009). On the other hand, external explanations link the excessive liquidity created by banks and financial firms in the United States to the huge inflow of foreign capitals that in those years flooded the American market to fill the gap of its persistent current account deficit³³ (Bernanke 2005; Chinn 2005; Frenkel 2008; McKinnon 2009; Obstfeld and Rogoff 2005; Setser and Roubini 2005). Considering this ‘external’ side of the problem, it is worth noting that during the run-up and the breakup of the financial meltdown of 2007-2008, the GCC financial systems were actually among the main providers of the cheap credit to the American economy that according to ‘external explanations’ played a significant share in causing the subprime mortgage crisis. They did it basically by means of three moves: the peg of national currencies to the US dollar, the systematic shrinking of their interest-

³³ In reality, this explanation is in fact a tale of two. It encompasses both the so-called ‘savings deficiency’ hypothesis – for which the root cause of the American current account deficit lies in a lax fiscal and monetary policy (Chinn 2005; McKinnon 2009; Obstfeld and Rogoff 2005; Setser and Roubini 2005) – and the so-called ‘savings glut’ hypothesis, blaming rather the structural propensity of emerging economies to save and reinvest in the dollar-based market due to precautionary motives, high prices of internationally-traded commodities, underdeveloped local financial intermediaries and demographic trends (Bernanke 2005; Frenkel 2008)

rate differential with the Federal Reserve (see Figure 9) and in the case of Saudi Arabia, with the accumulation of huge foreign exchange reserves denominated almost exclusively in US dollars.

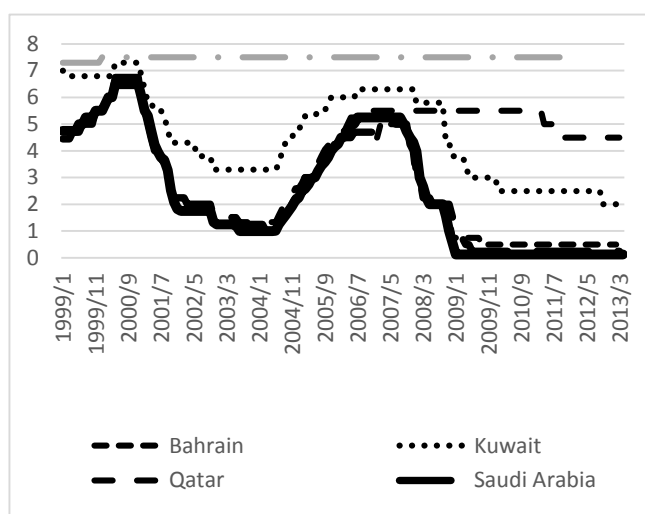


Figure 9 - Central Bank policy interest rate in GCC countries (except UAE) plus US Fed, in % (monthly data). Monthly data for UAE not available.

Nevertheless, as long as the business cycle in the leader economy was in tune with the periphery, the exchange between global creditors and the big American debtor did not generate a genuine political conflict on the distribution of costs and burdens of debt deleveraging. Surplus economies, included the GCC monarchies, exported their capitals

to fill the gap between savings and investments of the US economy, contributed to lift global growth, and boosted their exports to earn new profits to be rolled over again in the US capital market. The consequent build-up of symmetric piles of international assets and liabilities generated the widely discussed phenomenon of excessive global macroeconomic imbalances. However, even this great exchange between global debtors and creditors in the Dollar Area eventually came to a showdown with the 2008 financial shock. The subprime crisis caused a vertical fall in the import absorption of the US domestic market, and thus a significant reduction of its external indebtedness rate. While this process generally implies a painful shock for deficit economies, in this case the Fed (and the Government) had the rare privilege to cushion the adjustment with a combined fiscal and monetary stimulus. The main goal of such concerted effort was to support firms' profits through state-led aggregate demand and prop up the prices of financial assets through the central bank's rounds of quantitative easing coupled with near-zero interest rates. Moreover, QEs and low interest rates devalued the dollar *vis à vis* major world currencies. This had a double benefit for the US economy: on the real-

economy side, the aggregate demand generated by deficit spending was absorbed by domestic producers rather than increasing imports. On the financial side, the value of foreign assets held by American residents rose in relative terms, facilitating the reimbursement of existing overseas debts (Vermeiren 2013b). For the GCC countries though, the US monetary stimulus meant above all a surge in worldwide dollar liabilities, which pushed the price of raw materials to a record level, and, combined with

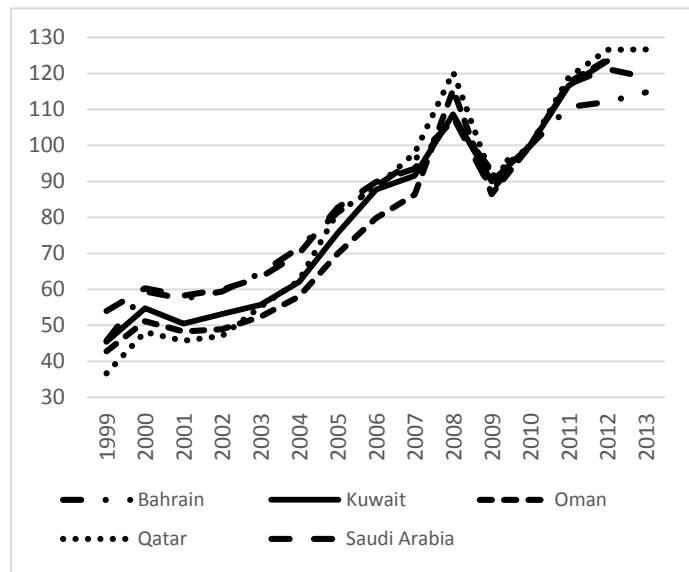


Figure 10 – GDP deflator index (2010=100)
Source: IMF – International Financial Statistics

their structural supply bottlenecks, hard-press inflation in local markets (see Figure 10). However, by following the Fed on its expansive policy and refusing to revalue their currencies to counteract inflationary pressures, loyal GCC followers paid a good part of the measures decided in Washington to mitigate the effects of the crisis through lower real yields on financial assets and lower real wages. This process of deleveraging between international debtors and creditors is the core of the asymmetric distributive conflict known as macroeconomic adjustment, and at this round, the burden fell conspicuously on follower countries.

To sum up the terms of the conflict, on the one hand the US were reducing their overindebtedness with an appreciation of foreign assets and a reorientation of consumptions towards the domestic market, while a ‘normal’ country would have suffered a massive capital flight and had to compress import flows with austerity measures. On the other hand, the sharp rise of domestic prices in foreign economies, and the GCC monarchies were not alone in experiencing that, is the way Washington made other countries pay the adjustment through the lower real value of their financial assets, salaries and wages. Indeed, to allow the Federal Reserve to print as much dollars as necessary to prop up the US economy – without making the dollar collapse together with its key currency role and the US global power – followers had to track the hyper-expansive Fed’s stance even though it was patently ill-designed for their booming

national markets. Domestic prices simply reacted consequently, with the effect of a real exchange rate depreciation of the greenback that went on far beyond its nominal recovery as of fall 2008.

In the next sections, I first analyse separately the six countries' decisions on the exchange rate regime and the nominal peg to the dollar, and successively I try to identify the determinants of their monetary policy. The assessment of current theories will be outlined according to their level of analysis, discussing first the domestic-based explanations of monetary and currency policy and then, in a separate section, the international-structural ones. The scheme will be the same for the two issues. Initially, I propose a brief review of the theoretical reasons that are supposed to affect the regime choice, the anchor currency and interest-rate policy. Then, I compare current theories with the actual policy of GCC countries, trying to assess the limits of traditional explanations and the room for new insights about the difference between small and middle-sized powers. To conclude, I analyse those situations where the small/minor holder divide seems apparently ineffective to assess the role of regional dynamics as illustrated in chapter five. Indeed, all the region's small countries except Kuwait have maintained a fixed exchange rate with the dollar, while Bahrain and the United Arab Emirates did not even change their monetary policy despite the limited influence of their decisions on the weakening dollar. For these instances, I provide evidence that the ongoing path towards the creation of the GCC single currency and the leading role of Saudi Arabia within that process played as unexpected and stronger constraints compared to societal pressures and rational incentives to defection.

6.2 The domestic political economy of the exchange-rate regime in GCC countries

In chapter four, I reviewed how the main approaches from Comparative Political Economy and the constructivist paradigm explain choices about the currency regime and the cross-country coordination of interest rates. For constructivist scholars, the convergence of governments and central banks on exchange-rate stability is contingent on a prior ideational convergence among central bankers, academics and politicians on the economic desirability of these policy stances. For comparative political economists,

there are four within-country dimensions affecting policy outcomes. First, autocratic governments would be more prone to adopt hard-pegs than democracies and hybrid regimes. Second, right-wing governments are more easily attracted by currency stability and monetary expansion than leftist ones. Third, the prevalence of anti-inflationary economic sectors in the domestic politics of interest-groups leads to fixed exchange rates as a bulwark against inflation. Fourth, small, open and financially underdeveloped countries are more apt to exchange-rate followership in order to attract foreign investments and stabilising trade flows. When applied to the current cases, characterised by countries with a strong record of current account surplus and a peculiar resource-based economic system, the abovementioned traditional explanations show a series of limits and inefficiencies.

Firstly, cognitive and ideological biases among the GCC's central bankers and academics are very difficult to assess and, whenever present, do not show any unanimous theory-driven consensus on the viability and desirability of the dollar peg. Central banks' statutes in the six countries are indeed very similar to one another, and put an equally strong emphasis on price stability, output management and exchange-rate stability. As to actual beliefs and analyses during the crisis, in their meetings with top US officials and diplomats GCC central bank governors revealed very different readings on the desirability of the dollar peg and its link with the impressive rise of inflation. Kuwaiti monetary officials, who decided to detach from the dollar in May 2007 and let the dinar appreciate by 15 percent in the following months, emphasised the «detrimental effects of the pegging system to the national economy», and defined the decision to drop it as «a move that "had to be done" to address rising inflation» (U.S. Department of State 2007b, 2007e). Contrarily, in a conversation with the US Secretary of Treasury Paulson, Qatari minister of finance Kamal argued that currency flexibility was unimportant on inflation statistics (U.S. Department of State 2008d). Nevertheless, the frequent calls to Washington, by all countries, to revive the declining dollar (U.S. Department of State 2007d, 2008d, 2008e, 2008g) demonstrate that the peg was perhaps not the main driver of the price overheating, but it was neither a completely non-influential element of the economic mess and a huge factor of concern for local policy-makers. Presumably, in absence of other constraints to a radical change in the currency regime, revaluation could have been a more efficient option than subsidies and

wage increases to relieve the inflationary pressure on imported goods and distribute a greater extent of purchasing power to low-income workers.

Secondly, GCC countries' policy of rigid dollar peg comes as no surprise looking data on the transparency and accountability of public institutions. The most used dataset for the classification of political regimes, the so-called Polity IV, grades all the GCC members below -6, which is the minimum threshold to be considered even partially democratic. Central Bank Independence, although there is room for a slight cross-country difference, is generally low if compared to developed countries, and the management of exchange rate and credit policy takes place entirely under the control of the executive power. Following the argument of the autocracy/democracy divide hypothesis, the exigency of the poorly legitimised GCC governments to enhance their credibility against international markets and their own citizens plays the greatest role in their adamant decision not to move away from the dollar in the last decades. Historically, after the troubled years of the first oil crisis and the breakup of Bretton Woods, Kuwait maintained the dinar anchored to a basket of major currencies until 2002 and Oman pegged the Rial to the US dollar as early as 1975. Bahrain, Qatar and the United Arab Emirates made the same decision around 1981, while Saudi Arabia was the last to join the club, in 1986, after having managed the Riyal's floating for almost fifteen years. Small monarchies switched their exchange-rate regime in a period characterised by a strong dollar, because of high-interest rates in the United States, and falling oil prices after the politically-driven peak of the late 1970's. Luciani (2011) reconstructed that milieu in a cogent historical analysis, pointing out that the newly established national currencies were being challenged by instable oil prices, domestic inflation and exchange-rate volatility. In such context, implicit pegs were adopted as a bulwark against currency substitution³⁴, which had become an immediate and concrete threat as early as the Second Oil Crisis.

A third strand of comparative literature looks at party-politics dynamics on a left-right scale. However, this can hardly explain anything relevant in neo-patrimonial absolute monarchies like the ones analysed here.

³⁴ This phenomenon occurs when citizens start using hard currency for their daily transactions instead of the local money

The fourth causal process highlighted by the literature is the power of domestic interest groups in influencing decision-making during the crisis. In this respect, two problems arise when the politics of exchange rate in GCC monarchies is observed from this perspective. On the one hand, powerful societal interests have strongly voiced their opinion on currency issues during the crisis. Nonetheless, their requests were partially different from the theory's predictions. On the other hand, despite the thick web of connections with the political power and the continuous pressure, their requests went largely unheeded. The peculiar nature of the GCC crisis indeed split the link between currency volatility and inflation underpinning most of the current analysis based on this hypothesis. The interests of the banking and financial sector, for instance, was strongly anti-inflationary as expected³⁵, but contrary to the typical situation taken for granted by the literature, top bankers and investors hard-pressed politicians for a revaluation of local currencies and a tighter monetary policy (Andrew and Khalaf 2008; Arabnews.com 2008; Al Asoomi 2011; Drummond 2008; Garnham 2007; Ghafour 2007, 2008; Karam 2008; Mezarban 2007). In Saudi Arabia, press reports talk of societal pressures coming from a group of prominent clerics, who blamed the royal family for the rising prices. In December 2007, Bahraini central bank governor Al-Maraj said to US diplomats that «Bahrain's political authorities were feeling the heat of public pressure to de-peg from the dollar» (U.S. Department of State 2007c, 2008b). In Doha, Qatar, a widespread Arab newspaper wrote furious comments on the inability of the government to tackle the situation, even calling for the resignation of the people in charge (U.S. Department of State 2007g). Similar scenes could be found all through the Gulf, but little or no results are observed on the actual governmental policy except from Kuwait.

Finally, agent-based theories stress the role of economic characteristics in guiding a country's exchange-rate policy. Trade openness and financial backwardness are two main factors highlighted by current theories as determinant for the adoption of rigid pegs, and apparently, they have both a strong influence on the GCC economies (AlKather 2012; Bourland 2007; Khan 2009; Looney 2009). On the one hand, recent research findings on newly available data (Naceur and Ghazouani 2007) show that the six countries score far below the average of high-income OECD economies in terms of

³⁵ Inflation in fact reduces the real yield of securities and other fixed-income assets, and the declining dollar hit particularly their large US-based investments

depth, liquidity and efficiency of financial markets (Figure 11). On the other hand, dependency on trade, both in regard to exports and imports, is also very high across the region, justifying, at a first glance the firm position in defence of the dollar peg (Figure 12).

However, the debate among economics professionals has also raised serious doubts on the desirability of the fixed peg solution for the peculiar case of countries that are open to international trade, but strongly dependent on commodity exports. Many well-renowned economists claim that precisely the unstable nature of energy markets, for example, would rather recommend the adoption of managed flexible currency

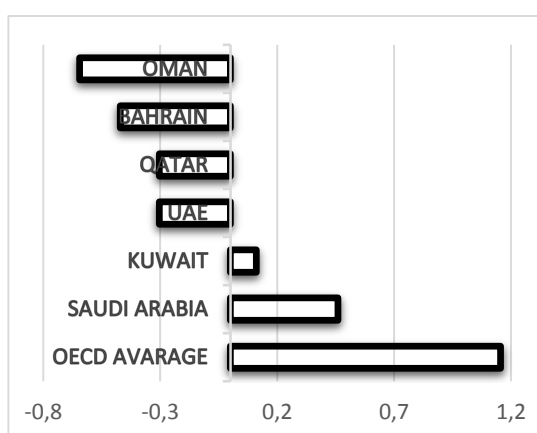


Figure 11 – Index of financial market development (average 2007-2009).

Source: World Bank – Global Development Index,

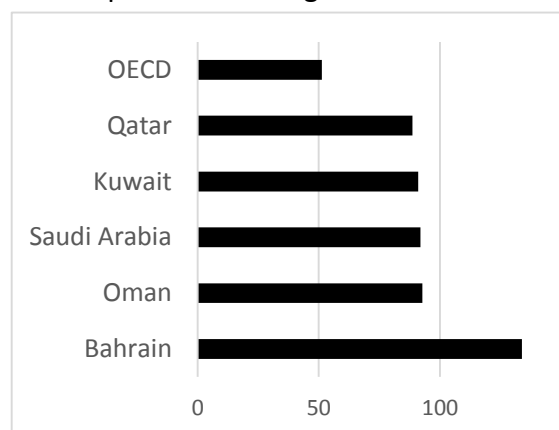


Figure 12 – Volume of Imports and Exports on GDP (average 2007-2009).

Source: World Bank – Global Development Index

regimes (Feldstein 2008; Frankel 2008; Saab, Roula, and Ayoub 2011; Setser 2008a). Accordingly, mainstream economics suggests to oil-exporting countries to peg their coinage to a basket including both their major trading partners and the price of oil (Frankel and Saiki 2002; Saab, Roula, and Ayoub 2011; Setser 2008). On purely economic grounds, this system proves much more efficient than the present one. On the one hand, the need to shield local economies from the ebbs and flows of energy market nominal prices would be achieved with a predictable and stable system. On the other hand, the enhanced flexibility would allow both a more autonomous monetary policy and a smoother adjustment of the external accounts via exchange rate instead of fuelling inflation (when oil prices are high) or deflation (when oil prices are low). The inclusion of the oil price in the basket is a key element, for it allows local governments to sterilise the flow of oil revenues whereas, in the current system, they are forced to tighten the budget excessively when oil prices stagnates and overspend when revenues expand. It is not a coincidence, in this respect, that practically all the other oil and gas exporters

except the five GCC countries did opt for a flexible basket-peg instead of focusing on a single currency.

To conclude, domestic-side predictors for the hard-peg regime offer mixed results in explaining the currency policy of GCC countries in the first decade of the XXI century. On the one hand, hypotheses on the institutional system, the openness of trade and the development of capital markets show accordance with empirical data. On the other hand, societal pressure (advocating for revaluation) seems to push policy-makers in the opposite direction, while a deeper analysis of the trade pattern of GCC markets suggests that exchange-rate instability is an actual problem, but also that adopting an excessively rigid peg to address it may create more problems than it solves. An oil-currency basket solution, through predictable and moderate exchange rate fluctuations, would preserve local currencies' purchasing power from the instability of international commodity prices much better than the actual system. Similar doubts and perplexities on the desirability of the dollar peg emerge also by approaching the question from the perspective of international theories on economic dependency, assessing not simply the GCC countries' incentives to fix their exchange rate, but also the reasons to choose precisely the dollar as nominal anchor. The next section assesses the problem from this point of view.

6.3 International economic relations and the dollar peg

As widely illustrated in previous chapters, international-structural theories explain monetary followership in surplus countries by means of three different variables: first, economic dependencies relative to trade relations; second, the state of military cooperation between allies or aligned countries; third, the allocation of surplus countries' financial wealth and the entrapment mechanism. In this section, the role of economic dependencies will be assessed through data on commercial flows, showing that the impact of this factor is marginal if not contradictory. Conversely, in the next section data and documental evidence will be provided about the role of politico-military relations at both the regional and the global level and the financial trap highlighted by the entrapment hypothesis. In past theoretical reflections, the link between trade patterns and exchange-rate policy, with a special attention to the choice

of the currency anchor, has been related to either the direction of exports, the so-called 'mercantilist' hypothesis, or the direction of imports, the so-called 'network externalities' hypothesis.

As regards the first, the choice of GCC countries cannot be related to the mercantilist narrative mentioned in previous sections, which links currency choices to the necessity of fostering an export-led growth through the artificial undervaluation of the national money (Aizenman and Lee 2007; Dooley, Folkerts-Landau, and Garber 2004; Spiro 2012). This negative conclusion comes out of two main considerations relative to the peculiar model of growth of oil-producing countries, as well as to the observation of actual data on export patterns in GCC countries. The first element distinguishing GCC economies from the typical case of Asian manufacturing economies – often taken as prime examples of a mercantilist strategy – is that the main export products of the region – oil, gas and financial services – are not priced in local currency on international markets. Therefore, their demand is infinitely inelastic to changes in the exchange rate since their price is expressed directly in US dollars.

If anything, changes occur in the local-currency value of revenues from export proceedings, reducing gains for governments and state-owned enterprises in case of exchange-rate revaluation against the dollar. Actually, this issue has been repeatedly raised by experts, scholars and local politicians when discussing the GCC currency policy. For example, Saudi, Bahraini and Omani leaders have claimed the main reason to follow the dollar was that crude oil, on which they depend for government revenues, is priced in US dollars and any change in this relationship would cause uncertainties in the draft of the country's budget (U.S. Department of State 2008a, 2008c, 2009, 2010). This objection has been critically addressed by many well-renowned economists, who claim that precisely the unstable nature of the energy market prices would advocate for a flexible currency regime (Feldstein 2008; Frankel 2008). Setser (2008a), in particular, vibrantly rejects the claim that getting paid in dollars is a good reason to peg to the dollar. Many oil-exporting economies, he contends, «argue that they peg to the dollar because oil is priced in dollars. Linking their currency to the dollar eliminates the apparent mismatch between the government's dollar-denominated oil revenues and its local currency spending. This logic, however, fails to accurately diagnose the real fiscal problem of oil-exporting economies. Oil-exporting economies' fiscal difficulties stem

from large fluctuations in the dollar price of oil, not from a mismatch between dollar revenues and local currency spending».

A second sub-issue raised by advocates of the mercantilist thesis is based on the common economic phenomenon known as 'Dutch Disease'. The Dutch Disease occurs when rapid and large increases in the price of a preponderant export commodity encourage a real exchange rate appreciation which destroys the competitiveness of other tradable products and prevent productive diversification (Arezki and Hasanov 2013; Cevik 2006; Looney 2009; Lyons and Maratheftis 2007). In the Gulf region, the diversification of production away from oil-related activities has been considered a long-term priority of decision-makers for the last thirty years. However, this hypothesis shows significant gaps in at least two points. Firstly, real effective exchange rates have substantially depreciated during the plunge of the dollar between 2002 and 2006, favouring in principle the development of economic sectors alternative to oil and gas fields, refineries and related services. Yet, the peg to the dollar has been paid with huge inflationary consequences that have offset (not completely) the nominal devaluation as of 2007, when non-oil products lost some of the price competitiveness gained in previous years due to the soaring cost of basic inputs and fixed capital (land, dwellings, factories). Secondly, other economical instruments like the proposed oil-currency basket can deal with the Dutch Disease more efficiently and cover a wide range of situations like, for example, a nominal appreciation of the US dollar. It sounds puzzling indeed assuming GCC governments as deeply worried about the Dutch Disease when the dollar depreciates against major currencies, and surprisingly unconcerned about it when the dollar, in the past, strengthened so much to damage their competitiveness against the rest of the world economy.

Lastly, data on trade flows, and particularly of export destinations, can be observed to assess the extent of dependency GCC markets on dollar-related economies notwithstanding the peculiar nature of their economic systems. As shown in the graph below, I collected data on 37 major economies (plus the Eurozone) having either a

floating exchange rate or a nominal anchor other than the US dollar³⁶. The dollar-area countries comprise not simply the United States, but also all that countries using the dollar as legal tender, fixing their currency to it, or even practicing a managed floating against the greenback. For example, China, which represents a substantial portion of GCC imports and exports, is included in the dollar area despite having dropped the fixed peg in 2005. This precautionary enlargement of the dollar area, however, make results more robust in assessing the real direction of the Gulf monarchies' trade dependency. As shown in Figure 13, results indicate that dollar-based countries are not over-dominant in the GCC export basket, nearly equated by East Asian, European and the Middle Eastern countries whose currencies float against the greenback.

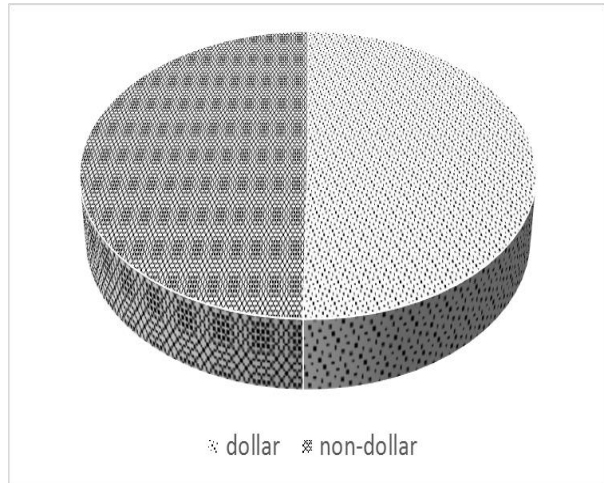


Figure 13 – Main export destination of GCC countries in 2007
Source: The Atlas of Economic Complexity - Centre for International Development (CID), Harvard University

However, the second strand of studies on the link between trade dependency and the currency anchor emphasises the greater importance of network externalities relative to imports rather than exports (Meissner and Oomes 2008; Plümper and Neumayer 2011). Notably, the oil-rent structure of local economies

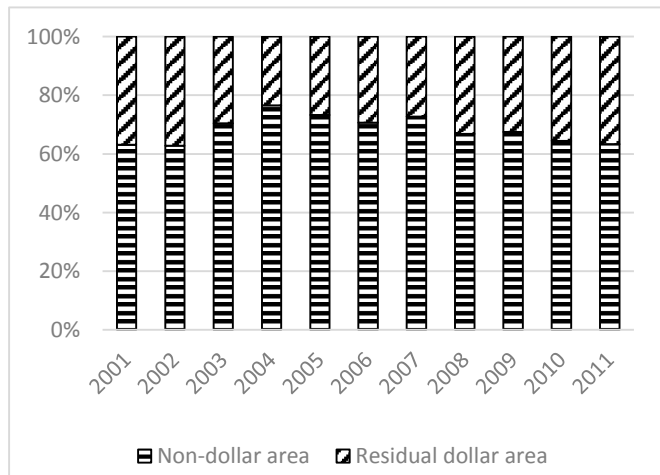


Figure 14 – Share of imports from non-dollar related countries on total GCC imports.

Source: IMF – Direction of Trade Statistics, author's calculations

³⁶ The complete list of countries comprises Argentina, Albania, Australia, Brazil, Canada, Chile, Colombia, Egypt, the Eurozone, India, Indonesia, Japan, South Korea, Malaysia, Mexico, New Zealand, Norway, Pakistan, Paraguay, Peru, Philippines, Poland, Russia, South Africa, Sweden, Thailand, Turkey, United Kingdom, Switzerland, Libya, Algeria, Iran, Croatia, Denmark, Czech Republic, Syria, Morocco and Uruguay. They have been selected listing the forty larger economies not tied to the US dollar. Data on their de-facto exchange rate regime are taken from IMF (2009). In order to infer robust conclusions from the analysis of data, China has been included in the dollar area despite having dropped the fixed peg in 2005 moving on to a gradual and controlled appreciation of the renminbi. According to calculations, the main source of imports in absolute terms is the Eurozone, and the main destination of exports is Japan.

may be more sensitive to import necessities than to exports because of the inelasticity of the world demand to local-currency fluctuations. Instead, a loss of purchasing power on the main import markets due to the mismanagement of nominal exchange rates may exert a greater influence on policy-making. In this respect, I collected and computed the value of imports of all the GCC countries for the same 37 major economies (plus the Eurozone) having either a flexible exchange rate or a nominal anchor other than the US dollar. I compared data on non-dollar imports with the total of GCC countries, with results clearly showing that the volume of goods and services imported from countries not tied to the American coinage are fairly greater than imports from those countries linked, more or less tightly, to the greenback. In conclusion, if network-effect theories had worked in this case, Gulf states should have adopted a peg to the euro or to a basket of currencies including their main sources of their imports, exactly as Kuwait did for most of its history as independent country.

The next section, I review the other two hypotheses of structural theories in light of data and documental evidence, concluding that military relations with the United States play the lion's share in the regional currency policy, especially as far as Saudi Arabia is concerned. Contrarily, to interpret minor countries' behaviour current theorists must be complemented with the insights from major/small holder approach as illustrated in previous chapters.

6.4 International political relations and the dollar peg

The scarce empirical support for hypotheses based on trade dependency begs alternative explanations for both the resilience of the fixed exchange rate and the anchorage to the US dollar. This paves the way to the role of security ties both at the regional and the global level and for the entrapment mechanism. Data and diplomatic documents confirm that all these three dimensions interplayed in determining the policy position of the five countries that preserved the dollar-peg during the crisis. Specifically, the positions of the UAE and Qatar are linked to regional political dynamics, Oman's decision-making seems to suffer the constraints of entrapment, and is tied to the peculiar nature of this country inside the regional scenario. Finally, a combination of

security concerns and entrapment mechanism had a greater influence on the choices of Bahrain and Saudi Arabia.

As previously discussed in the section on the institutional determinants of exchange-rate policy, in the monetary history of the region the six countries addressed differently the first decade after the generalised abandonment of fixed exchange rates in 1973. Kuwait maintained the dinar anchored to a basket of major currencies until 2002, Oman pegged the Rial to the US dollar as early as 1975, while Bahrain, Qatar and the United Arab Emirates made the same decision around 1981. Saudi Arabia adopted a hard-peg to the dollar after letting the Riyal float from 1973 to 1986. Therefore, while small monarchies' choice, at least initially, can be interpreted as economically rational due to the risk of depreciation (the dollar was soaring following the 'Volker Cure') and the negative perspective of oil prices, the case of Saudi Arabia, with its puzzling timing, gives the opportunity to observe an interplay of economic and political incentives that seem to have had an equal weight in determining its initial policy choice.

On the one hand, Riyadh's decision to imitate its neighbours came in coincidence with the so-called oil-collapse of the mid-1980's, when prices plummeted to an all-time low since 1973 threatening to drag the Riyal further into a depreciation that was ongoing since the early 1980's. On the other hand, as Figure 15 illustrates, the fluctuations of the Riyal stopped overnight on June 1986, about twenty days before President Reagan dispatched to the Congress an indispensable written statement to unlock essential

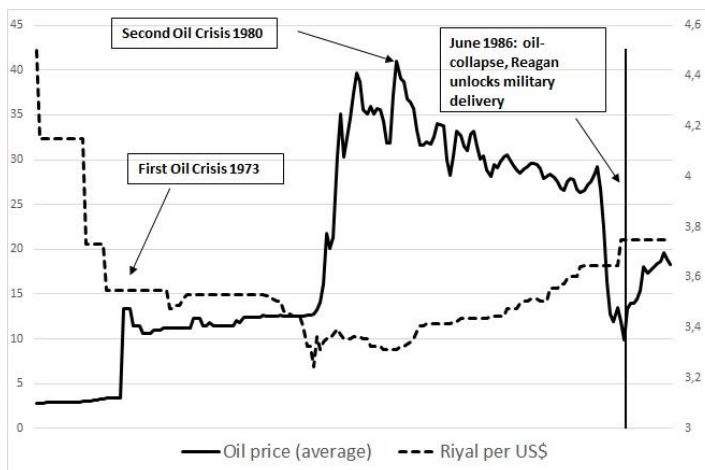


Figure 15 – Monthly Riyal/US\$ Exchange Rate (right scale) and price of Oil (left scale, monthly average current US\$)
Source: IMF – International Financial Statistics

military deliveries to the Saudi Air Force (Gwertzman 1986; Reagan 1986). Before the deal was finally settled, frictions on this weapons transfer – consisting, *inter alia*, in a series of 'AWACS' aircrafts equipped for airborne surveillance – had precipitated the Riyadh-Washington longstanding

alliance in one of its roughest moments since the First Oil Crisis (Bzostek and Robison 2008).

Even though GCC countries did have an economic rationale behind the choice to peg to the dollar thirty years ago, it is doubtful the same motives may have exerted an equal influence in 2007-2008 given the astonishing shift in the underlying economic conditions. During the recent crisis, the dollar was falling (while it was soaring in the early 1980's); oil prices were at their highest since 1979 (while they were plunging in 1981-1986) and the greenback was no longer a salvific anchorage, but rather the source of all problems thanks to imported inflation and an ill-suited monetary policy. If economic incentives shifted but policies did not, political variables may offer a better grasp for today's loyalty to the dollar for both small states and Saudi Arabia. In this respect, traditional theories highlight two influent processes: the nexus with security relations and the entrapment mechanism. The case of Saudi Arabia is perfect to illustrate a powerful interplay between these two variables, while among small holders, Oman's political and monetary authorities have explicitly mentioned entrapment on their official reserves as a key driver of their currency decisions. However, for the other small countries of the region this two explanations rise limits and contradictions that pave the way to the theoretical insights outlined in this research.

The Wahabite kingdom has been subject to impressive economic transformations in the first decade of the XXI century. The peg to the dollar, initially justifiable with the dangers of a riyal's devaluation (as well as by important military side-payments) could hardly be defended today from a purely economic perspective. Recent in-depth interviews with top Saudi officials and businessmen explicitly interpret Riyadh's dollar peg as a remuneration for the US security umbrella against the regional threat coming from Iran (Otero-Iglesias and Steinberg 2013). In fact, the history of the financial ties between Riyadh and Washington dates back to 1974, twelve years before the riyal's anchorage to the dollar was put in place. According to Spiro's documental reconstruction (Spiro 1999), after the First Oil Crisis and the end of the global system of fixed exchange rates in 1973, Washington exploited Saudi Arabia's security concerns to extort from its ally two precise concessions in exchange for its military commitment in the Gulf. The first was the recycling of the huge Saudi capital surpluses, inflated by the oil-price boom, in US Treasury Bills, and the second was Riyadh's pledge to induce OPEC countries to price their crude petroleum in dollars for the years ahead.

In recent times, there is considerable evidence that this policy has resurged with the explosion of the Saudi current account surplus in the 2000's, while the peculiarities of the current scenario relative to the 1970's magnify the importance of the exchange-rate link for both the US dollar and the preservation of Saudi Arabia's huge financial wealth. On the one hand, the dollar is in a much worse shape due to the twin-deficit³⁷

and the overindebtedness of the US economy. As widely explained in past chapters, a deficit leader with a great mismatch between international demand and supply of its national coinage

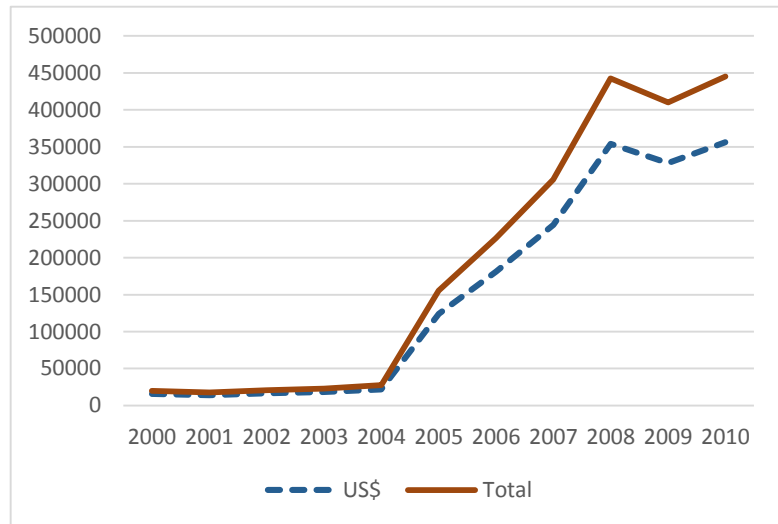


Figure 16 – Foreign exchange reserves in Saudi Arabia, in million US\$
Source: IMF – International Financial Statistics

necessitates the will of follower states to preserve as much as possible its purchasing power on currency markets. Knowingly, minor states can support the leader's coinage by propping up its value against major currencies through foreign exchange intervention, reserve accumulation and a compensatory interest-rate policy. All this factors are over-present in the Saudi monetary and exchange-rate management of the last decade. The rigid peg to the greenback determined the necessity to intervene heavily with dollar purchases to stop speculative upward moves towards the Saudi riyal. Foreign exchange reserves have been hugely amassed and denominated for at least the 80% in US dollars according to independent estimates (Samba Financial Group 2008; Setser and Ziemba 2007). Their size widely exceeds the precautionary liquidity holdings of crisis-prone countries, and no other economically-rational criterion could justify their steep rise as of 2004. Finally, as reported in the opening section, the SAMA has loyally tracked any interest-rate movement of the Federal Reserve, preserving a zero or negative differential as prescribed by the Compensation Rule.

³⁷ The twin deficit problem refers to the compresence of a chronic deficit condition on both the current account balance and the federal budget. Contrarily, in the 1970's the worldwide overhang of US dollars was caused by role of reserve currency in the previous Bretton Woods system, but the current account balance was in equilibrium or moderately positive.

On the other hand, the rigid peg to the dollar turns out even more necessary in the contemporary world economy because the reactivity of financial markets amplifies the consequences of decoupling monetary and exchange rate policy. From a systemic perspective, indeed, «[a] Saudi movement away from the dollar could trigger a panic, which could further undermine both the value of [its] overseas assets and the global economic system» (Looney 2009, 4). Suffice to remind, in this regard, the 2005 plunge of the greenback following South Korea's announcement of an imminent currency diversification to get an idea of what would be the consequence if a pivotal major holder such as Saudi Arabia signalled the same intention by de-pegging from the dollar. To conclude, from the Saudi perspective even the gradual reform of the exchange-rate regime towards a currency basket, given the unavoidable role of this country in that last-resort buyer of US securities, would result in recurrent capital losses as long as Riyadh lacks the possibility to diversify its foreign investments for political reasons. It is worth reminding indeed that a collapse of the dollar is likely to make unsustainable the global reach of the US military on which Saudi Arabia ultimately relies for its existential security needs (Cappella 2013b; Eichengreen 2011a; Kirshner 2008; Norrlof 2010, 2014; Stokes 2014).

Yet, once monetary followership has been cogently explained for Saudi Arabia, the same variables do not show the same effectiveness on small countries despite all of them, and especially security relations, are almost overlapping between Saudi Arabia and its neighbours. On the one hand, Kuwait ditched the dollar peg and practiced an autonomous monetary policy. On the other hand, Qatar and Oman undertook what I previously defined 'opportunistic followership', that is, maintained a fixed exchange rate to the dollar while weakening the position of the key currency through a tightening monetary policy. Therefore, in next sections I explore the potential of the major/small holder divide in explaining the deviant cases of small sectors, exploring both their exchange-rate and monetary policy vis à vis the monetary leader in light of their weaker dimensional constraint.

6.5 *The international political economy of the dollar peg in small holders*

In previous sections, Saudi Arabia's choice to remain tied to the dollar during the 2008 crisis has been explained financial entrapment and security cooperation with the United States. Within this picture, though, two puzzling phenomena have been temporarily put in the background. The first is the autonomous path undertaken by Kuwait, which responded to the misalignment between its own domestic exigencies, the trend of the dollar and the American monetary policy by de-pegging its currency and adopting higher interest rates than the Federal Reserve. The second is the partial defection of Qatar and Oman in the conduction of monetary policy. These two countries have indeed increased real interest rates and diversified the currency allocation of their foreign investments. They did it while opportunistically maintaining the fixed exchange rate with the dollar (which was convenient for them for other reasons), but under this apparent loyalty to the United States, they have actually worked to accelerate the decline of the dollar by raising the global demand for alternative investment assets such as gold, the euro or other hard currencies.

With the first hypothesis outlined in this research – the tendency of small countries to free-ride on larger public-good producers – I explain why these three countries followed economically-advantageous policies rather than politically-driven ones. Indeed, if the moves of a major holder like Saudi Arabia produce their effects instantaneously on the value of the core-currency, the mechanism does not work for the GCC small monarchies, which do not hold enough financial wealth to enjoy some market power on the international price of the US dollar. As widely documented in previous chapters, past research has rarely looked at the intra-follower bargaining differences to explain dissimilar policy patterns, and the study of GCC case does not make an exception saved for some sporadic and anecdotal mentions³⁸. For instance, according to Setser «[the] investment funds of some of the smaller Gulf economies do seem to have diversified away from the dollar. Consequently, this constraint is likely to be more severe for the large oil-exporting economies than for the smaller economies» (Setser 2008a). Data and documents provided in this research contribute to confirm

³⁸ For two noteworthy but incomplete exceptions (Steiner 2013) and (Setser 2008a)

empirically the hypothesis that the absence of market power in minor holders has been a powerful structural factor in the choices of the three defecting actors.

Contextually, the second hypothesis of this research – which expects more cases of small holders followership, despite baseline disincentives, when the regional major holder is a political stakeholder of the monetary leader – will be used explain the fact that other two, potential, free-riders such as Bahrain and the Emirates did not exploit their position to gain autonomy at the expenses of Saudi Arabia. Likewise, Qatar and Oman’s preservation of the peg must be explained through new theoretical insights given their autonomous stance on monetary policy. In the case of Abu Dhabi, and to a lesser extent also for Qatar, Riyadh was an unavoidable actor in the construction of the monetary union and for the establishment of the future common central bank in the territory of the UAE. Moreover, data on the allocation of foreign investments and reserves show that the Dubai Sovereign Wealth Fund is among the major worldwide holders of dollar-denominated securities, and the same entrapment mechanism seems to have had a huge impact on Oman’s choice. As regards Bahrain, instead, the military and economic patronage exerted by Saudi Arabia played the lion’s share in conditioning any policy choice that could have had a global or regional impact beyond its borders.

In previous sections, the strong support given by Saudi Arabia to the dollar has been detected in three main policy domains: exchange rate, reserves and interest-rate policy. Kuwait is the only actor which followed a different path in all these domains. In spring 2007 the Kuwaiti government ceded to months of insistent societal pressures reportedly coming from its advisory parliament, the banking sector and press campaign for the return to monetary autonomy. The central bank Governor Al-Sabah and the Minister of Finance Bader Al-Humaidhi had already expressed their misgivings about the decision to peg the dinar to the dollar during a January 2007 visit to Kuwait of U.S. Treasury and Federal Reserve officials (U.S. Department of State 2007e), and defined the return to currency basket as «a move that had to be done to address the rising inflation» (U.S. Department of State 2007b). Remarkably, Kuwaiti officials gave an involuntary confirmation to the argument about the greater autonomy of small countries when it came to justify the breakup of the dollar peg before American diplomats. As reported in US cables, «Central Bank Deputy Governor Dr. Nabil Al-

Mannanei maintains that *this decision will have a negligible impact on the dollar* while allowing Kuwait greater monetary policy control»³⁹ (U.S. Department of State 2007e).

Given this state of asymmetric possibilities, it sounds confusing that other small holders did not exploit the same window of opportunity. According to an analysis of data, press reports and diplomatic documents, the choice of small loyal countries seems to have been affected by two factors: the issue-linkage with regional cooperation and, limitedly to Oman, the entrapment mechanism.

The first thing to stress when analysing this historical moment is that the decade under scrutiny includes one of the most important events in the Persian Gulf politics: the establishment of a road map for the currency unification among GCC members. It would be pointless ignoring the effect that this big event had on the regional currency policy, especially considering that a cornerstone of this process was the adoption of the US dollar as the official monetary anchor by all the six states⁴⁰. Overall, the process took place within the institutional framework of the Gulf Cooperation Council, a scheme of regional integration established in 1981 among the six Arab monarchies overlooking the Persian Gulf following security concerns raised by the Iranian revolution and the successive eight-year war between Saddam Hussein's Iraq and Khomeini's Iran. The GCC has served through time as a framework for military coordination and commercial integration, with the intent of curtailing, through economic growth, the tensions between the vast Shiite communities of the Gulf and the Sunni ruling families of the Arab Peninsula (S. Cooper 2003; Momani 2008). However, the Council has also suffered, as many other schemes of regional integration, from an inevitable tension between centripetal and centrifugal forces. On the one hand, external security needs demand further integration in the form of policy coordination and sacrifices of sovereign prerogatives. On the other hand, a greater economic and political coordination opens up the Pandora box of the regional power hierarchy, and revives the omnipresent fears of small countries about the hegemonial designs of the locally preponderant actor, Saudi Arabia. With the GCC summit of 2001 in Muscat, the economic side of the organisation

³⁹ Emphasis mine.

⁴⁰ Previously, the dollar peg was informal in five out of six countries, and Kuwait pegged to a basket of major currencies. This choice emerged out of a negotiation at the GCC summit of Muscat in December 2001 (Buitter 2008; Khan 2009), and according to the Saudi monetary agency, «was based on the fact that [the dollar] is the intervention currency for all the GCC countries, and their foreign reserves for currency cover and balance of payments purposes are largely held in dollar» (SAMA 2003).

was decided to expand with the forthcoming adoption of a single currency unit for the six countries, to be established by January 2010, and implying as a first step the official link of all their exchange rates at the current immutable rate to the dollar. The peg to the dollar, and its stubborn preservation in the hottest days of the inflationary peg, were also, not exclusively, part of this history of regional integration.

Actually, the first country to withdraw from the project over concerns for its fiscal and monetary autonomy was Oman. This country, with Bahrain, is indeed the less dependent on energy-related exports for its revenues and GDP, and enjoys the lowest efficiency of monetary policy transmission compared to regional partners (Espinoza and Prasad 2012; Pattanaik 2008). Given the country's peculiar situation, the government decided to leave the common-currency project in late 2006, justifying its move with the reluctance to «relinquishing part of its sovereignty over monetary and budgetary policy» and the intention to pursue the «maximum flexibility» of macroeconomic governance (U.S. Department of State 2007d), as in fact it did. Meanwhile, it refused to drop the dollar peg despite «[voicing] concerns about the impact of the declining dollar on inflation» (U.S. Department of State 2007f). In private meeting with US officials, Omani authorities provided a two-fold justification for this choice, arguing that «the dollar peg was in Oman's best interests given that *most of the Sultanate's reserves were in dollars* and that the dollar is accepted virtually everywhere»⁴¹.

On the contrary, the GCC common currency project seems to have played a major role in the choices of Qatar and the United Arab Emirates. Reportedly, among small countries the UAE and Qatar shared the greatest ambitions about the opportunity to diversify their economies as global financial centres (Buitter 2008), and hope to use the single currency as an instrument to overcome their dimensional constraint and gain further autonomy in economic affairs *vis à vis* the United States and Saudi Arabia (AlKather 2012; Khan 2009). This idea is well summarised by a Qatari top banker⁴² during a meeting with US diplomatic officials: «under an eventual monetary union, [he contends], the GCC would have a more independent monetary policy that best suits the regional economic environment. The current peg to the U.S. dollar will be used to help

⁴¹ Italics mine.

⁴² Mohamad Moabi, Executive Manager of Qatar National Bank's Economics and Research department. R. Seetharaman, Deputy Chief Executive Officer of Doha Bank has expressed similar opinions in the same occasion.

standardize all the countries before the monetary union, but [afterwards, it will change] to include more of the GCC's economic partners (U.S. Department of State 2007h).

Given this ambitious project, the resilience of the currency peg emerge as a top priority of Doha's policy-makers. In a 2007 meeting with US diplomats, the head of Qatari central bank claimed: «while we cannot rule out a revaluation, it would almost certainly be done in concert with other Gulf states» (U.S. Department of State 2007g). One year later he reaffirmed that «Qatar is committed to the dollar peg at least until a common GCC currency is established» (U.S. Department of State 2008f). Similarly, diplomatic cables from the US embassy in Abu Dhabi report of a vivid debate inside the UAE during the crisis, highlighting the firm position of the government in favour of the dollar-peg against the central bank and powerful societal actors. In details, in a December 2006 cable, the UAE Central Bank's economic advisors told the US envoys that the government was not willing to change its policy on both interest rates and the exchange rate unless the shift was agreed by all GCC partners (U.S. Department of State 2006). More specifically, in November 2007 the US Econchief collected opinions from top financial managers in the country, concluding that the government was «reluctant to change its currency policy in the absence of similar steps by Saudi Arabia» (U.S. Department of State 2007a).

Finally, Bahrain's monetary and currency policy remains a conundrum for the major/minor holder divide. Despite presenting similar values as Qatar in many variables, the little kingdom consistently maintained the dollar peg and did not defect on monetary policy. Presumably, therefore, in this case the royal family's limited autonomy in foreign policy played a much greater role than any domestic-level characteristic or the security tie with Washington⁴³. The weakness of the isolated Sunni monarchs, under the constant threat of the country's Shiite majority, has made the dynasty a de-facto protectorate of Saudi Arabia, as testified by the pro-status-quo military intervention carried out during the spring 2011 uprisings. Furthermore, the strong economic and political links with Riyadh, combined with geographical proximity

⁴³ The little kingdom is the seat of the NSA Bahrain, the home base of the US Navy 5th fleet, by far the most important American military facility in the area, both from the numerical and strategic point of view. The US military personnel deployed in Bahrain ranges between 1500 (considering just permanent ground forces) and over six thousand people considering the whole NSA Bahrain program (ground plus afloat) [U.S. Department of Defense 2008]. Considering an overall population of 1.3 million inhabitants, the US presence in Bahrain is the more numerous among GCC allies, both in absolute and relative terms.

and the enormous size differential between the two countries, have favoured a wide circulation of Saudi riyals alongside the Bahraini dinar (U.S. Department of State 2008b). As a result, any disalignment between monetary and exchange-rate policy on the two sides of the King Fahd Bridge may result in unbearable hot-money flows in or out of Bahrain and significant losses on Riyals balances of ordinary citizens.

6.6 Monetary policy, reserves and sovereign wealth funds. Opportunistic followership in small holders

The same pattern favouring the neutral moves of small holders is observed for monetary policy, where states without regional constraints exploited their size advantage to diversify on foreign investments and practice a tighter monetary policy detached from an hyper-expansive Federal Reserve. While Saudi Arabia has started a massive purchase of dollars on international markets since 2004, small countries (except Bahrain) strove to diversify away from the plunging greenback investing in euros and gold. Indeed, although the small monarchies' share of dollars in foreign reserves is even higher than that of Saudi Arabia – it oscillates between 90% and 85% – the bulk of these countries' financial wealth has been largely allocated through sovereign wealth funds whose assets are managed in a more risk-averse and profitable portfolio allocation (Samba Financial Group 2008; Tétreault 2011).

On the one hand, the graph in Figure 17 shows that the major holder allocates almost all the exceeding revenues from oil exports in the central bank's official reserves. Contrarily, monetary authorities in small holders hold a minimal quota of these countries' financial wealth, which is mostly gathered in some of the largest sovereign wealth funds in the world economy. On the other hand, Figure 18 shows that the share of dollars in the currency composition of these funds, according to many independent estimates, is far from the 80-90% threshold observed in foreign reserves, with more than half of financial and real assets denominated in currencies other than the US dollar. The United Arab Emirates (especially the Dubai Investment Fund), probably for the greatest absolute size of their portfolio, is the only country distributing at least half of its investments to US-based securities.

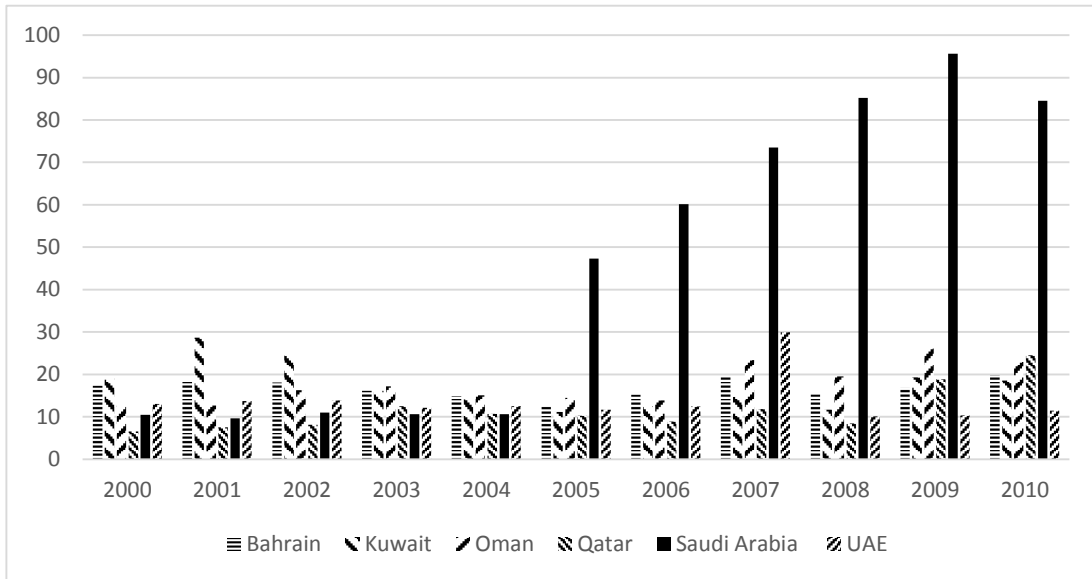


Figure 17 – Official Reserves/GDP ratio in GCC countries (yearly data, % on GDP at current US\$)
 Source: IMF- IFS & IMF-World Economic Outlook, author calculations

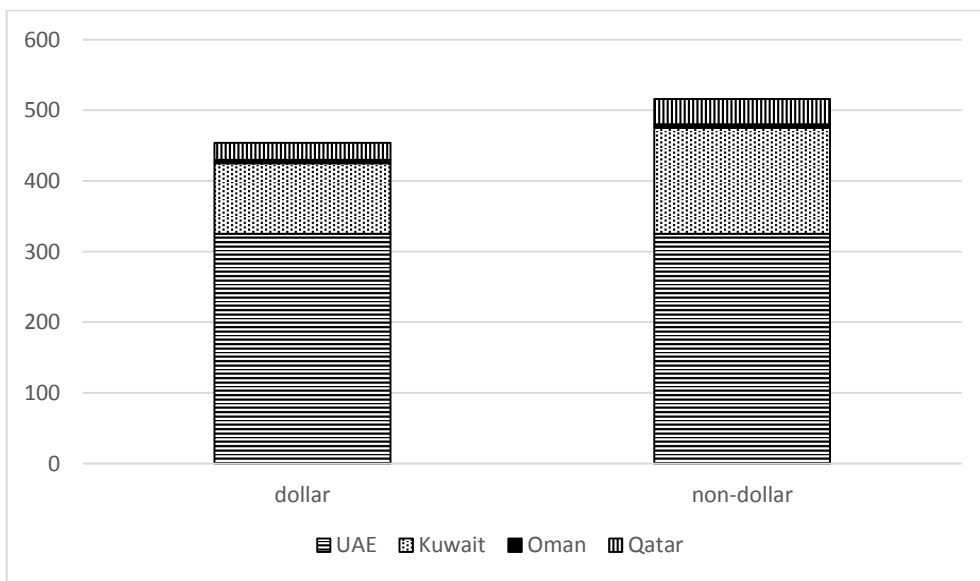


Figure 18 – Currency composition of SWFs in GCC minor monarchies (2007, in billion \$)
 Source:(Setser and Ziemba 2007), author calculations on IMF-IFS

The enhanced policy autonomy of small countries compared to the responsible behaviour of Saudi Arabia and its allies left traces also in diplomatic meetings held by US representatives in the period of greater divergence between the Gulf Countries and the American monetary policy. On the one hand, central bankers from loyal countries have repeatedly exposed their concerns for the misalignment of the Fed's expansive stance with the local economic cycle. For instance, in late 2007 the Central Bank governor of Bahrain told to the US Treasury Secretary Kimmitt that the Fed's monetary policy «was contraindicated for Bahrain's current economic conditions and deprived him of a useful tool for fighting inflation», then adding, «"Our economy is very strong. I should be raising rates"» (U.S. Department of State 2007c). By contrast, defector countries avoid complaints and tend to focus on how to justify their choices relative to the allocation of reserves and interests rates. In Oman, local officials communicated that «the Central Bank has increased commercial bank reserve requirements from 3% to 5% and has issued more certificates of deposit in an efforts to mop up excess liquidity». This caused capital inflows from the US to the local market that Omani officials related during another meeting in early 2008: «[there] has been a lot of money coming into the country, and with the recent tumbling of world financial markets, more Omanis are bringing their money home» (U.S. Department of State 2008c).

In Qatar, central bank officials «urged the US government to "do something" quickly to reverse the dollar's decline» reporting that «the Central Bank is doing its job with monetary policy, particularly with respect to open market operations to absorb excess liquidity, including issuing CDs⁴⁴ and increasing reserve requirements» (U.S. Department of State 2008d). In two occasions in 2008 Doha's decision-makers describe to the US Treasury Secretary what, in fact, is definable as a fruitful speculation against the greenback. Around 20% of the country's dollar holdings, according to Qatari officials, have been swapped for euro-denominated assets during 2007 and early 2008, and bought back in late 2008 when the American currency was expected to rebound against major currencies (U.S. Department of State 2008d, 2008h). Despite the pressure exerted

⁴⁴ Certificates of Credit, equivalent to a sovereign bond or bill

by capital inflows on the exchange rate, Qatar and Oman had other and well-documented reasons to avoid appreciation and maintain the dollar peg. Consequently, they took advantage of the short-term benefit of surplus countries and kept their currencies in line with the dollar through sterilised foreign-exchange intervention.

6.7 Conclusions

The present case-study aims at testing the two key hypotheses of this research looking at a regional scenario which provides insightful and original data on the behaviour of small and middle powers enjoying a structural current account surplus. The results of this vast analysis confirm the interaction between the major/small holder divide, regional politics dynamics and the traditional variables that are deemed to influence the monetary and exchange rate policy of minor states.

In the first place, the findings show the value added and the contribution of the major/small holder hypothesis in particular, and the international-structural approach in general, against the unsatisfactory and incomplete account given by domestic-based theories. Against conventional wisdom, in the case of GCC countries domestic drivers of exchange rate policy (i.e. political regime, GDP size and trade openness, financial development, and interest-group politics) do not give a clear indication on the desirability of the rigid peg, calling for a further consideration of the international-structural explanas. Moreover, a further analysis into the economic desirability of fixed exchange rates for oil- and gas-exporters revealed that the alleged mission of this currency regime, stabilising the internal and external purchasing power of national currencies, was patently failed when applied to this kind of actors. Eventually, domestic incentives seem to have had little impact on how the six countries reacted to the consequences of the global crisis between 2007 and 2009, with the only exception of Kuwait where they might have had a role given the complete lack of structural counterweights. On the contrary, data and documental evidence emphasise the role of external dependencies – such as financial entrapment and security ties – and regional political dynamics in the GCC countries' choice to defend the stability of their exchange rates during the crisis.

In the second place, the study of the three deviant cases of Kuwait, Qatar and Oman provided a clear evidence of the greater autonomy of small holders. The major/small holder distinction turns out fundamental to reconcile empirical outcomes with previous considerations on the web of external incentives tying Saudi Arabia, and in principle all the GCC countries, to the United States and the dollar. Indeed, although all the six actors are equally engaged in security cooperation with Washington and hold dollar-denominated securities as reserve assets, smaller countries actually enjoy a greater room for policy manoeuvring given the negligible impact of their moves on the global demand for dollars. This is particularly visible in the allocation of SWFs financial stocks, which in every country except Saudi Arabia the US dollar do not represent more than 50% of the fund's portfolio.

Nonetheless, it has been observed that exchange-rate policy remained anchored to the US dollar in all countries except Kuwait, and that two actors, Bahrain and the Emirates even refused to adapt their monetary policy to counteract the mounting inflationary pressures. In all this cases, the hypothesis of regional power intermediation provides the clue to bridge the gap between theory and empirical evidence explaining monetary followership in small holders. On the one hand, Bahrain is a de-facto protectorate of Saudi Arabia, where Riyadh plays as the benchmark for Manama's policy choices in every economic, political or military decision that may have an impact on regional or global issues. On the other hand, Qatar and the UAE were probably the most interested actor in the proposed monetary union, and diplomatic communications indicate that both countries felt restrained to free-ride on Saudi Arabia given the risk to jeopardise the whole project.

In this sense, both the importance of the monetary union *per se*, and the web of connections with other regional issues inside the GCC justifies the definition of this situation as a 'contextual linkage' (Axelrod and Keohane 1985). In other words, for small countries abandoning the peg could have been detrimental to this and other issues on the table within the GCC institutional arena, regardless of the regional key power's will to punish their choice. The dollar-GCC link was, so to say, 'embedded' in regional politics and the UAE and Qatar had too much stakes in the currency-union project to sacrifice it for short-term autonomy. It went differently, of course, for countries like Oman and Kuwait which place much less importance on this regional development due to less

ambitious geopolitical objectives and a different economic structure. As a further confirmation of the two major hypotheses of this research, it is worth noting that all the five small holders, according to their own words in diplomatic meetings, were fully aware of their lesser vulnerability to the leader's (i.e. the United States) bargaining chips in the monetary game. However, when they decided not to exploit this advantage, regional issues and the pivotal role of the Saudis have been explicitly mentioned as main policy-drivers.

Conclusively, the present case-study suggests that currency issues remain deeply dependent on international dynamics such as alliance dilemmas and regional cooperation both with respect to the exchange rate policy and the management of macroeconomic policies. The ruinous failure of the GCC currency union, which was expected to get started in 2010, but will not see the light in the near future, is perhaps the most famed victim of this troubled period. Indeed, once they realized that regional monetary cooperation was not enhancing their autonomy over economic policy, but simply expanding Saudi Arabia's grip on regional affairs, small monarchies decided to abandon the project one after the other. Oman left the project in late 2006 over concerns for its fiscal and monetary autonomy. Kuwait dropped the exchange rate harmonisation to revalue the dinar and tighten monetary policy against the mounting inflation. Finally, even the United Arab Emirates announced its withdrawal from the project in early 2009 after disagreement with Saudi Arabia over the location of the future central bank, probably the most important issue at stake for the Emirati leadership.

Conclusions

The purpose of this research was to improve the theoretical understanding on how the financial size of small and middle-sized states affects their behaviour in the monetary system. In particular, against the tide of a literature focused on small economies and underdeveloped countries, I posited that within the sub-group of surplus states, characterised by a considerable buffer of foreign reserves and stocks of foreign assets, small states would be advantaged against middle powers in the bargaining over macroeconomic adjustments, which is assumed to emerge cyclically in heterogeneous monetary systems. Secondly, once the peculiar effect of the small/major holder divide among surplus countries was made clear, deviant cases of monetary followership in small holders, given a baseline incentive to free-ride, remained largely unexplained. Hence, the second hypothesis of this research states that, *ceteris paribus*, small holders cohabiting in the same region with a major holder will be more likely to be pressured by these actors for cooperating in the management of the international monetary system.

On the theoretical side, a careful assessment of states' preferences, given by the combination of both domestic and international pressures, reveals the greater priority assigned to policy-making autonomy and the protection from excessive exchange-rate fluctuations in a context of strong financial and trade interdependence. In other words, states manage their relations with other subjects of an international monetary system, included private actors, in order to reconcile as much as possible three usually incompatible elements such as economic interdependence, policy autonomy and exchange-rate stability. Small and middle-sized states are justifiably considered as concerned as great powers for avoiding this tradeoff as demonstrated by a careful assessment of their potential preferences and a brief overview of case studies.

After stressing the underlying bias of current theories for the case of small underdeveloped countries, among the deficit units, and that of major holders among surplus units, I drew the set of strategic interactions showing that small states can be more autonomous than large states when experiencing a significant record of current account surplus. Small holders are considered rational actors with full knowledge of their effect on the market and full awareness of the constraints of major holders. Given that state of things, the benefits of interacting in a system characterised by the stability

among major currencies and a growth-friendly environment with financial stability in larger states is hold constant and independent from their actions. Consequently, the cause of their policy decision between followership and neutrality falls entirely on the cost side, where the first opinion is undoubtedly the more expensive given the value attached to autonomy in all actors' utility function. At the same time, the greater protection from painful currency crisis given by the trend on the current account shields the small holder from the downsides of autonomy commonly experienced by its deficit counterparts.

Nevertheless, while this insight provides a convincing explanation for the cases of defection and autonomy in small countries, and significantly challenges the size-pessimism previously inherited from open macroeconomics, it inevitably opens another problem as regards the numerous cases of small followers. Indeed, in the old theoretical framework, based on the assumption of the equal influence of potential followers, it was plausible explaining followership in major holders and small holders with the same variables. On the contrary, if traditional variables are scarcely effective on small holders, the usual determinants of monetary followership must be at least complemented by a new approach. The strong proposal of this research is to consider the intermediation of major holders as both more likely and more effective than the action of monetary leaders, the only one taken into account so far. On the one hand, major holders are more likely to engage small holders in the same geographical region because of the domestic pressures from relevant constituencies and the public opinion, more concerned with intra-regional politics, and for the increased burden of policy divergence with neighbouring actors. On the other hand, they are also more effective for the more extended web of diplomatic, economic and military connections useful to exploit potential issue-linkages against small states. The first set of elements increases the benefits of coercion or inducement, the second lowers the costs and risks of such initiatives.

Eventually, the detailed analysis of historical and present policy choices of the six member countries of the Gulf Cooperation Council confirms the testable hypotheses outlined in the theoretical part of the research. On the one hand, despite an equal set of economic and political incentives to follow the Federal Reserve and the US dollar in one of the most troubled periods of their history, data show clearly that the major

holder (Saudi Arabia) behaved in a consistently loyal way compared to small monarchies, which defected repeatedly the US leadership with a documented awareness of their size advantage. On the other hand, whenever small countries did not exploit their bargaining power to remain autonomous against the pressures of financial interdependence, data, press reports and diplomatic documents provide a clear evidence that the regional major holder had in fact set up an explicit or implicit set of incentives to make cooperation convenient, even reluctantly and temporarily, to small holders.

In conclusion, the findings of this research hold a set of substantial strengths and some weakness, especially on the empirical side, which represent the privileged fields for future research on this issue. Firstly, the merit of this reflection is to shed light on the political mechanisms governing fundamental policy choices, such as those on money and exchange rates, by providing a universal tool with which assessing the monetary power of all non-leader states. Indeed, while theories on the influence of domestic factors (like party-politics interactions) or international dependencies (like the military-monetary nexus) might not be applicable to all states, the small/middle power divide acts as an underlying force filtering all the traditional causes of monetary followership. Every country that is not a monetary leader is either a small or a middle power, and this factor affects the efficacy of the overall set of bargaining weapons at its disposal. This innovation finally provides a convincing account for a consistently large unexplained variance in the behaviour of small countries in the group of surplus economies. Thanks to its contribution to the prediction of policy choices in a wide set of markets and countries, the model developed here is useful for a variety of potential applications besides the academia, in both policy-making and private-sector activities such as cross-border asset allocation and portfolio management.

Secondly, however, the findings on the small/major holder divide show some limitation related to the large extent of empirical evidence that has yet to be provided to make its theoretical predictions more robust. On the one hand, the design of the baseline distribution of monetary power between major and small holders, based on the free-riding expectations of Collective Choice Theory, is potentially testable through econometric techniques on a much larger panel of units than the six countries of the GCC. Admittedly, an ideal confirmation for this hypothesis would be made of a careful

combination of qualitative accounts, showing in detail the motivations and perceptions of actors, and a wider statistical evidence provided with a large longitudinal study. On the other hand, while the present case study has shown that the actual moves of the major holder, as well as the response of small holders, fit the theory's predictions, a wider cross-regional comparison is necessary also to stress the different effect on small holders of regional environments characterised by the absence of a major holder or the presence of a major holder which is not politically interested in cultivating the ties between small followers and the monetary leader.

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