The effect of political transitions on market expectations of a currency’s value offers analysts a clear example of how domestic politics can impact international relations. Changes in government can lead to currency volatility that can spread to other countries not involved in the original crisis. This could necessitate exchange rate intervention and possibly a currency realignment, which would be negotiated among the finance ministers of the various Member States while currency market transactions in their respective countries are suspended. While currency crises may be domestic in origin, they can have ramifications for international politics as well.

Such volatility can emerge because markets are aware that the prospect of a change in government alters the government’s willingness and ability to maintain an exchange rate commitment. The government’s willingness can be compromised by its desire to lower interest rates, engage in inflationary spending and project a sense of economic growth and prosperity before an election. Economic fundamentals may thus deteriorate prior to an election as the government attempts to engineer preelectoral booms. These may or may not be interpreted as political manipulation, as governments may be expressing the preferences of its primary constituents.

However, even in the absence of policy changes market pressure can arise due to uncertainty surrounding the government’s policy preferences. Elections and government change would not be problematic if the outcome were easily predicted. When markets expect the incoming government’s exchange rate preferences to differ from its predecessor’s, markets will try to anticipate the change before the fact and move the
currency in that direction. If markets cannot discern the incoming government’s preferences, either because of a close election or uncertainty surrounding the composition of a coalition government, general instability may ensue as markets try to hedge their bets. If either of these two scenarios occurs, the exchange rate instability generated by markets will force governments to either defend the exchange rate or to devalue. Such crises are likely to end in devaluation when a new government takes office and can blame its predecessor for poor economic policies.

Currency Crises and Devaluations in the EMS

The EMS began in March 1979 as a fixed-but-adjustable exchange rate system in which the participating currencies were pegged to one another in bilateral exchange rates that could fluctuate within a narrow band. The original members of the ERM of the EMS were Belgium, Denmark, France, Germany, Ireland, Italy, and the Netherlands. In 1989 Spain joined the ERM, followed by Britain in 1990, and Portugal in 1992. In September 1992 both Britain and Italy left the ERM; Italy rejoined several years later, but Britain has yet to commit the pound. In 1995 Finland, Austria, and Sweden joined the EU and became participants of the ERM. All the aforementioned countries except Britain, Sweden, and Denmark have become members of EMU, the final stage of which began in 1999. Greece joined EMU in June 2000.

In joining the EMS, these countries made a commitment to defend the value of their exchange rate pegs; any changes in the official exchange rate values were to be made within the multilateral framework of the Monetary Committee. This makes exchange rate instability and devaluation easier to identify than in floating exchange rate systems as the government explicitly assumes responsibility for an announced exchange rate. Any deviation from the announced exchange rate value (and fluctuation band) clearly reflects a departure from this policy and can readily be observed by market participants as well as voters. This heightens the expectations placed on participating governments to adhere to policies that would support this exchange rate in both the long run as well as in the short run. When governments will not or cannot follow such policies, exchange rate instability ensues.

Are currency crises determined by a government’s unwillingness to maintain the parity? If this were the case, one would expect economic fundamentals to be decisive in determining the onset of currency crises. On the other hand, perhaps the government’s ability to maintain the exchange rate comes into jeopardy given a precarious political situation,