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Emerging Markets Review 4 (2003) 287–309

EMERGING MARKETS REVIEW

www.elsevier.com/locate/econbase

Political conditions and currency crises in emerging markets

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Received 13 March 2003; received in revised form 10 June 2003; accepted 19 June 2003

Abstract

This article demonstrates the impact of structural political conditions on the likelihood of currency crises in emerging markets. Controlling for a standard and parsimonious set of macroeconomic variables, I find that: right-wing government is less conducive to currency crises; 'strong' governments (those with larger legislative majorities and those which face more fragmented legislative opposition) are also less vulnerable. Democracy also reduced the likelihood of currency crises in emerging markets; yet, in contrast to previous studies, this article does not find a significant impact of elections on the likelihood of currency crises.

JEL classifications: D72; F31; F32; O23

Keywords: Currency crises; Politics; Emerging markets; Elections

1. Introduction

Since the publication of Krugman's seminal (1979) study of currency crises, at least 40 empirical articles on this subject have appeared in scholarly journals. The Asian crisis has stimulated a new wave of such studies. Yet, econometric models built to explain currency crises, in keeping with the predominant theories of speculative attacks, have relied almost exclusively on macroeconomic indicators as explanatory variables. Kaminsky, Lizondo and Reinhart's (Kaminsky et al., 1998)

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1566-0141/03/$ - see front matter
PII: S1566-0141(03)00041-4

extensive review of this literature identifies 60 explanatory variables that have appeared in various models of currency crises, the most commonly used indicators being the real exchange rate, international reserves, real GDP growth and the current account balance. Among those 60 explanatory variables, only four pertain directly to political events.

It is curious, however, that so many studies have relied exclusively on macroeconomic indicators, since, as Drazen (2000) notes, decisions to abandon fixed exchange rates may more often reflect a choice among competing policy objectives than a technical incompatibility of monetary and fiscal policy with fixed exchange rates. For instance, Obstfeld (1994) characterizes the government as facing an explicit trade-off between maintaining the fixed exchange rate and other objectives, such as limiting the growth of unemployment. A government's willingness to trade-off inflation for unemployment is inevitably a political decision. Indeed, second-generation currency crisis models typically give rise to the possibility of multiple equilibria in which the realized outcome is a function of market expectations.

This article proposes and tests the hypothesis that market expectations regarding a government's possible response to a speculative attack may be a function of political as well as economic conditions. Despite the considerable elegance of second-generation models in depicting optimal government behavior, such models open the door to political explanations of currency crises, but typically do not cross the threshold. While political factors have played a more central explanatory role in several qualitative studies of crises, particularly in Dornbusch et al. (1995), the theoretical and empirical literature has been largely silent on the subject. Drazen (2000) is among the first to address this gap in theory, though his article concentrates specifically on issue of contagion.

Part of the theoretical motivations for the present analysis lies specifically in combining second-generation currency crisis models (I take Obstfeld (1994) as the archtype) with insights from partisan political business cycle theory (Hibbs (1977) and Alesina (1987)). As described in Section 3, this combination of seemingly unrelated theories gives rise to the hypothesis that currency crises are less likely under right-wing governments. Related work (Frieden et al., 2000) suggests the further hypothesis that 'strong' governments may be less vulnerable to currency crises, which I confirm with two complementary indicators of strength. There is also reason in theory to hypothesize that the occurrence of elections might create uncertainties in expectations that could give rise to currency crises, and some previous empirical literature (Mishra, 1998; Mei, 1999; Leblang, 2001) has found such effects. In contrast, I do not find elections to increase the likelihood of currency crises. Democracy itself is also a potentially important political condition that may shape market expectations, and Section 3 describes that the direction of this effect a priori is ambiguous.

The article is organized as follows: Section 2 provides a brief review of the empirical literature on explaining and predicting currency crises, emphasizing the few studies that have highlighted political explanations. Section 3 outlines the theoretical motivation for considering the effect of political variables on the likelihood of currency crises and presents the hypotheses to be tested. Section 4