



Politically generated uncertainty and currency crises: Theory, tests, and forecasts

David Leblang^a, Shanker Satyanath^{b,*}

^a *Department of Politics, University of Virginia, P.O. Box 400787, Charlottesville, VA 22904, United States*

^b *Department of Politics, New York University, 726 Broadway, New York, NY, 10003, United States*

Abstract

While it is widely acknowledged that political factors contribute to currency crises there have been few efforts at using political variables to improve crisis forecasts. We discuss ways in which political factors can be incorporated into theoretical models of crises, and develop testable hypotheses relating variations in political variables to variations in the probability of a currency crisis. We show that the incorporation of political variables into diverse crisis models substantially improves their out-of-sample predictive performance.

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1. Introduction

In recent years emerging economies have been severely affected by currency crises. For instance, the currency turmoil that struck Asia in 1997 and 1998 caused Indonesia's gross domestic product to decline by 15% in a single year. Thailand and Malaysia suffered losses amounting to approximately 10% of GDP. These country experiences are far from unique:

* Corresponding author. Tel.: +1 212 998 8515; fax: +1 212 995 4184.

E-mail addresses: leblang@colorado.edu (D. Leblang), ss284@nyu.edu (S. Satyanath).

recent estimates by the IMF put average GDP contractions for emerging markets due to currency crises at 8%.¹

Given the high costs of currency crises it is of exceptional importance that the determinants of these catastrophes be well understood. Recognizing this, several scholars have recently responded by developing Early Warning Systems (EWSs) for currency crises. A wide array of EWS models focus on identifying a set of economic fundamentals that are correlated with crises and evaluating the usefulness of these variables in out-of-sample forecasts. What is surprising about the development of this literature is that political variables do not appear in EWS models, despite the fact that few would disagree that politics plays a major role in causing currency crises.²

In this paper we seek to fill this gap in a theoretically informed manner. We discuss ways in which political hypotheses can be drawn from the [Morris and Shin \(1998\)](#) model of currency crises. Specifically, we argue for the plausibility of a causal link between political variables that generate uncertainty, specifically divided government and recent government turnover, and currency crises. Using three previously published econometric models comprised of different economic control variables, different countries, and different conceptualizations/measures of currency crises, we find that the addition of these political variables robustly increases our ability to predict crises out-of-sample and, in some cases helps to reduce the proportion of false crisis warnings.

Our efforts to produce models that help forecast currency crises relate closely to previous efforts by [Frankel and Rose \(1996\)](#), [Sachs et al. \(1996\)](#), [Kaminski et al. \(1998\)](#), [Goldstein et al. \(2000\)](#), [Berg and Pattillo \(1999a,b\)](#), [Kamin et al. \(2001\)](#), and [Bussiere and Fratzscher \(2002\)](#). The distinctive feature of our approach is our focus on political variables.

The structure of the paper is as follows. In [Section 2](#), we discuss the implications that can be drawn from the [Morris and Shin](#) crisis model about the relationship between political variables and currency crises. [Section 3](#) contains a description of our data, and we report our main empirical results in [Section 4](#). In [Section 5](#), we address issues related to identification, collinearity, and robustness. [Section 6](#) concludes.

2. Causal relationship between political variables and currency crises

In this section we seek to develop testable hypotheses relating politics to crises that are solidly grounded in the logic of a formal model. Given that it is now widely accepted that currency crises have self-fulfilling features our choice was between using a so called “second generation” self-fulfilling features model with complete information on fundamentals, such as [Obstfeld’s](#), or using one with incomplete information, such as [Morris and Shin’s \(1998\)](#) model. As is now well known, in [Obstfeld’s \(1996\)](#) model there are three ranges of fundamental values. In the lowest range, fundamentals are so bad that the government will relinquish the peg even if there is no speculative attack. In the highest range, fundamentals are so strong that speculators do not find it worthwhile to launch an attack on the currency. However, in the intermediate range there are multiple equilibria. In one equilibrium speculators believe that the government

¹ [Goldstein et al. \(2000\)](#), 12.

² There are, to be sure, a number of papers that incorporate political variables into models of speculative attacks (e.g., [Eichengreen et al., 1995](#); [Bussiere and Mulder, 2000](#); [Leblang and Bernhard, 2001](#); [Leblang, 2002, 2003](#)). To our knowledge, however, none of these papers use political variables to help forecast crises out-of-sample.

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