The political economy of exchange rate regimes in developed and developing countries

Aziz N. Berdiev a, Yoonbai Kim b, Chun Ping Chang c,*

a Department of Economics, Bryant University, Smithfield, RI 02917, USA
b Department of Economics, University of Kentucky, Lexington, KY 40506, USA
c Department of Marketing Management, Shih Chien University at Kaohsiung, Kaohsiung, Taiwan

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1. Introduction

The economic and political science literature emphasizes that political parties promote and advance policies in conformity with their ideology (Hibbs, 1977). Pearce (2006) explains that “governments may begin with an ideology and part of that ideology translates into policy proposals (p. 155).” In this context, political parties favor the “inherent effects of their policies and that parties have different objectives and incentives (Alesina, 1987:652).” The influential work of Hibbs (1977) first documented that left-wing governments favor relatively low unemployment, and, in turn, tolerate high rates of inflation in order to maintain low rates of unemployment. In contrast, right-wing governments prefer moderately low inflation at the expense of high rates of unemployment. In this line, left-wing parties are more averse to unemployment and less averse to inflation than the right-wing parties (Alesina, 1987). Thus, a large strand of literature has been devoted into understanding the nature and significance of government ideology in economic policy.

The principal role of government in the economy is an underlying discord between right-wing and left-wing parties (Potrafke, 2010a). Right-wing governments favor protection of property rights and legal quality, while left-wing governments prefer government intervention in the economy (Bjørnskov, 2005a). Several papers, including the works of Bortolotti et al. (2003) and Potrafke (2010a), for example, explain that right-wing governments are associated with the privatization and deregulation processes to expand the support for market-oriented reforms.1 More explicitly, market-oriented and right-wing parties promote economic freedom and prefer minimum government involvement in the economy. The empirical works of
Duso (2002), Pitlik (2008), Bortolotti and Pinotti (2008), Bjørnskov and Potrafke (2011) and Potrafke (2010a) demonstrate
that market-oriented and right-wing governments promote and advance privatization, liberalization and deregulation
processes.

Recently, exchange rate regime determination has received noteworthy academic research and discussion. The type of
exchange rate regime provides essential consequences for price stability, international trade and monetary policy (Frieden et al.,
2010). Thus, an extensive literature provides considerable evidence that government ideology influences the exchange rate
policies. More precisely, government ideological differences across political parties create diverse attitudes in regards to policy,
and, in turn, play a critically important role in determining the choice of exchange rate regime. For instance, when right-wing
governments are assumed to favor low inflation, they may choose fixed exchange rate regime in order to create monetary stability;
and, in turn, generate low rates of inflation (Frieden and Stein, 2001; Broz and Frieden, 2001; Levy-Yeyati et al., 2010; Frieden et al.,
2010). In a similar notion, when left-wing governments are assumed to prefer relatively low unemployment and high output, they
may favor the flexible exchange rate regime to manage independent monetary policy in order to achieve its macroeconomic
objectives (Broz and Frieden, 2001; Frieden et al., 2010).

In addition, the theoretical consideration of Milesi-Ferretti (1995) illustrates that a right-wing government may abstain from
choosing a fixed exchange rate regime with the intention of benefiting from inflationary reputation policies of the left-wing
government. Bodea (2010), who expands on the work of Milesi-Ferretti (1995), suggests that right-wing governments are
typically more inclined to realign fixed exchange rates. The fundamental argument is that market-oriented governments (right-
wing) favor the fixed exchange rate regime in the choice of exchange rate system, while the intervened-oriented governments
(left-wing) prefer a flexible exchange rate regime. Yet, Klein and Schambaugh (2010) emphasize that the proposition that right-
wing parties advance and promote the fixed exchange rate regime is not supported by many empirical studies, and, therefore,
generated mixed results.

Despite the great deal of academic research and discussion, the influence of government ideology on exchange rate regime
choice is not straightforward, and empirical studies often produce contradictory findings.2 Earlier empirical literature has
generated inconsistent results regarding the effect of ideology on the exchange rate regime, which we believe are obscured by the
various econometric techniques, the choice of explanatory variables that impact exchange rate regime determination and further
mitigating factors such as the linkage of exchange rate regime choice to other policies. Hence, the goal of the present paper is to
examine the impact of government ideology, political institutions and globalization on the choice of exchange rate regime a
country implements.

The present paper contributes to the existing literature on the effects of government ideology, political institutions and
globalization on the choice of exchange rate regime along several dimensions. First, we ask, does government ideology influence
the choice of exchange rate regime? A review of the literature suggests that governments prefer a fixed exchange rate regime to
create monetary stability, which is generally associated with low rates of inflation (Frieden and Stein, 2001; Broz and Frieden,
2001; Levy-Yeyati et al., 2010; Frieden et al., 2010). Alternatively, the foremost benefit of a flexible exchange rate regime is to
allow the government to conduct independent monetary policy (Broz and Frieden, 2001). Given that policymakers have
systematically different preferences regarding macroeconomic objectives and differ in their valuation of growth, employment and
price stability, policymakers may choose the exchange rate regime that conforms to their political orientation. In the interest of
robustness, we use three measures of government ideology in our empirical analysis. In particular, we follow the methodology in
Dreher et al. (2010) and Bjørnskov (2005b, 2008) by employing the national election results characterized in the Beck et al. (2001)
Database of Political Institutions, which classifies the three largest government parties according to whether they have a left-wing,
centrist or right-wing ideological orientation.

Second, we examine the impact of political institutions, central bank independence and electoral motives on the type of
exchange rate regime a country implements. While government ideology is one factor that can influence the choice of exchange
rate policy, it may also be the case that political institutions impact the exchange rate regime determination.3 For example,
democratic institutions facilitate greater information and render credible signal about policy objectives to the public than non-
democracies (Fearon, 1994; Broz, 2002). Perhaps not surprisingly, politicians in democratic institutions incur demands to employ
more redistributive policies than politicians in authoritarian countries (Leblang, 1999). As such, democratic institutions may
implement a flexible exchange rate regime in order to allow the government to conduct monetary policy toward domestic
stabilization purposes.

Further, the work of Pissarides (1980) explains that governments may potentially strive to control the economy to make them
a more “popular party.” In a similar notion, Bernhard and Leblang (1999) emphasize that policymakers are disinclined to
relinquish any policy instruments that can facilitate them in gaining office. That is, policymakers may influence the exchange rate
regime before the elections to facilitate output growth in order to increase their probability of reelection. Thus, prior to elections,
policymakers may choose the flexible exchange rate regime to allow the government to conduct monetary policy to achieve
employment growth to facilitate their likelihood of reelection. Nevertheless, a credible independent central bank predictably has
the ability to oppose pressures from policymakers (Klein and Schambaugh, 2010). That is, a high level of central bank
independence considerably constrains the authority of policymakers to guide monetary policy for electoral intentions (Clark et al.,
1998). The purpose for appointing monetary policy to a credible independent central bank is to eliminate political conflict over

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2 For a detailed literature review, see Broz and Frieden (2001).

3 We construct our discussion on democracies and nondemocracies in the analysis of domestic political institutions. A similar body of research has examined
the effect of political strength on the choice of exchange rate regime (Frieden and Stein, 2001; Hossain, 2009; Levy-Yeyati et al., 2010).
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