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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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ABSTRACT

This paper examines the influence of government ideology, political institutions and globalization on the choice of exchange rate regime via panel multinomial logit approach using annual data over the period of 1974–2004 in a panel of 180 countries: 26 developed and 154 developing.

We provide evidence that government ideology, political institutions and globalization are important determinants of the choice of exchange rate regime. In particular, we find that left-wing governments, democratic institutions, central bank independence and financial development increase the likelihood of choosing a flexible regime, whereas more globalized countries have a higher probability of implementing a fixed regime. More importantly, we find that political economy factors have different effects on the choice of exchange rate regime in developed and developing countries. All our results are robust to panel ordered probit model.

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

* Corresponding author. Tel.: +886 7 6678888 5713; fax: +886 7 6679999.
E-mail address: cpchang@mail3.kh.usc.edu.tw (C.P. Chang).

[1] Benoit and Laver (2006) indicate that right-wing parties approve significantly more policies on deregulation, compared to left-wing governments.

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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

[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).