European Journal of Political Economy 26 (2010) 248–264

Contents lists available at ScienceDirect

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpe

The political economy of fixed exchange rate regimes: The experience of post-communist countries

Cristina Bodea *

Department of Political Science, Michigan State University, USA

A R T I C L E   I N F O

Article history:
Received 10 November 2008
Received in revised form 19 November 2009
Accepted 13 December 2009
Available online 22 December 2009

JEL classification:
F31
F33
F41
P33
P26

Keywords:
Fixed exchange rate
Credibility
Realignment
Partisanship
Democratization
Post-communist

A B S T R A C T

Exchange rate policy changes are not only a function of economic conditions, but are also fundamentally related to political processes. This paper analyzes the propensity of policy makers to relax fixed exchange rate regimes by performing regular realignments. The argument is that when information is scarce as in transition countries in the 1990s, adherence to visible exchange rate commitments gives left wing politicians, the former communists, a useful mechanism to improve their reputation. Empirically, the paper uses a duration model to analyze monthly realignment data from former communist countries from 1990 to 1999 and assesses how a broad range of political and economic factors influence the duration of government fixed rate commitments. In particular, one of the robust findings is that left wing governments are associated with a lower risk of fixed rate realignment.

1. Introduction

Exchange rate fluctuations have important distributional implications and negative consequences for international trade and economic growth. In an attempt to limit fluctuation, governments in many developing countries announce currency arrangements that imply some form of anchoring of the exchange rate. A large majority of such commitments, however, prove to be short lived and the recent experience of developing countries provides numerous examples of devaluations, widening of fluctuation bands or leaving a pegged rate altogether. As the mechanisms used to limit exchange rate fluctuations are themselves unstable, the literature has investigated the factors that determine changes to exchange rate regimes. Thus, the extensive literature in international economics has focussed on disequilibria between currency parity and economic fundamentals, market expectations, panics and contagion. Research in political economy, however, suggests that interest groups, broad class constituencies, political institutions and the electoral calendar also affect exchange rate policy. The general argument in this recent research is that politics mediates the impact of macroeconomic factors on exchange rate developments, and, as such, a systematic account of the constraints and incentives of politicians can help anticipate better the timing and circumstances of devaluations, or other changes to exchange rate policy.

* 342 South Kedzie Hall, East Lansing MI 48823, USA. Tel.: +1 517 402 9585; fax: +1 517 432 1091.
E-mail address: bodeaana@msu.edu.

0176-2680/$ – see front matter
doi:10.1016/j.ejpoleco.2009.12.005

This paper is a theoretical and empirical investigation of the political economy of realignments to fixed exchange rates in post-communist countries. After 1989, several countries in Eastern Europe and the former Soviet Union announced and introduced currency arrangements that restricted the variability of their exchange rates — from pegged rates, to fluctuation bands and crawling rates.[1] In addition, these countries experienced a large variety of changes in exchange rate arrangements — small and large devaluations in pegged rates, changes in the width of fluctuation bands and changes in the devaluation rate of crawling pegs and crawling bands. The theoretical explanation in the paper highlights the public visibility of currency arrangements and the use of exchange rate policy by left wing parties as a mechanism to improve their reputation. Empirically, the paper analyzes monthly data from former communist countries from 1990 to 1999 and assesses how a broad range of political and economic factors influence the duration of government exchange rate commitments.

The theoretical explanation and the estimations in this paper are closely related to several areas of research in international economics. First, the paper relies heavily on the structural approach of the literature on the optimal choice of the exchange rate regime[2] and uses the results of the speculative attack literature.[3] Second, it adds to recent work which focuses on changes and devaluations to fixed exchange rates.[4] In particular, we investigate the causes of those exchange rate realignments which, in the terminology of Reinhart and Rogoff (2004), make de jure pegged rate arrangements become de facto floats or de facto bands. Finally, the paper improves the understanding of exchange rate policy in the developing world, not in the least by considering adjustments to the nominal exchange rate under various types of fixed regimes, by explicitly considering exchange rate decisions as political and by evaluating empirically credibility theories of exchange rate fixing.[5]

On the theoretical front the paper focuses on the dilemma of a partisan policymaker facing the choice of realigning a fixed exchange rate commitment. The policymaker trades off the advantage of maintaining a visible commitment mechanism which enhances the credibility of pursuing a low inflation policy with the costs incurred due to the lack of flexibility to react to downturns under a fixed rate as well as the political costs incurred should fixed rates be abandoned. The political economy literature commonly considers left wing parties to be less inflation averse than the right, and more likely to use inflation to promote job growth (e.g. Hibbs, 1977; Milesi-Ferretti, 1995; Alesina et al., 1997). Inflation, however, does not result in employment growth if the electoral incentives of the left are anticipated. In the medium to long run, inflation does not produce the growth that the left needs to satisfy its constituency. As such, the left is expected to have a greater need for the credibility that a fixed rate provides and be willing to pay the costs associated with fixed rates (e.g. Milesi-Ferretti, 1995).

Furthermore, the reality of developing countries is that fixed rates are adjusted frequently, even if the credibility and confidence building characteristics of a fixed exchange rate regime are undermined or lost if the rules governing the fix are regularly overridden. In this context the paper argues that left wing governments will refrain from actions that damage the credibility of the fixed rate instrument. In particular, the left will be identified with a fixed exchange rate regime in which realignments of the currency arrangement are infrequent, especially when markets are testing the resolve of the government.

Empirically, the paper uses the parametric Weibull duration model, which estimates the hazard rate of fixed rate realignments conditional both on time and time-varying covariates. The events considered here are all realignments to an announced fixed exchange rate that move towards a less constraining policy. Similar to other work (e.g. Klein and Marion, 1997) the events are not homogenous. However, the credibility story with respect to political parties and exchange rate policy gives a strong rationale for the use of all realignments as events that need to be explained. If policy maker's credibility and the credibility of the fixed rate is at stake, then even small defections from announced policy can be damaging. This should hold especially since small realignments can postpone or entirely eliminate the need to perform a large realignment.

The duration analysis yields a series of important results: Macro conditions affect commitment duration differently for pegged rates, fluctuation bands and crawling rates. For example, real exchange appreciation does not appear to influence realignments under a crawling regime, suggesting that much of inflation is already incorporated in the nominal exchange rate via the announced devaluations. Even so, currency crises appear to prompt realignments to crawling rates, but not to pegged rates. The analysis also shows that left wing governments have a lower expected probability of realigning a fixed rate, in particular in a currency crisis. The left's adherence to currency targets and especially adherence when markets are testing its resolve is supportive evidence that the left is searching to improve its credibility in macroeconomic policy. Finally, the estimations reveal that accounting for political events and institutions helps better predict particular realignments.

---

[1] For example, in January 1990 Poland fixed the Zloty to the US dollar, only to adopt the crawling peg with pre-announced daily devaluations in October 1991 and to give up the crawling peg in favor of the crawling band in 1995. Similarly, in July 1995, Russia tied the Ruble to the US dollar and allowed for a narrow fluctuation band until July 1996 when it introduced a sliding corridor regime with pre-announced monthly widening of the fluctuation band.

[2] The literature based on the early contribution of Mundell (1961) and McKinnon (1963).

[3] Work on developing countries includes Frankel and Rose (1996), Kaminski et al. (1998) and Edwards and Montiel (1989).

[4] E.g. Klein and Marion (1997), Von Hagen and Zhou (2002). For a discussion of de facto versus de jure fixed rates and the consequences of devaluations of fixed rates see Reinhart and Rogoff (2004), Levy-Yeyati and Sturzenegger (2003).

[5] Work in a similar vein includes Klein and Marion (1997), and Collins (1996). Also, there is little research on the political economy of exchange rates in transition countries despite evidence from other regions, including Bloomberg et al. (2005) (Latin America and the Caribbean, 1960 to 1999 — post elections there is an increased chance that pegs are abandoned); Frieden (2002) (Developed European countries, 1973 to 1994 — left wing governments are associated with less volatility but not with less depreciation of the currency); Simmons (1994) (Inter-war years — democracy, partisanship and cabinet instability affect capital flows, leaving the gold standard, and currency depreciation); Klein and Marion (1997) (Latin America and the Caribbean, 1956 to 1991 — changes in the executive increase the likelihood of devaluations within pegs). There is extensive economic research on exchange rate policy in transition countries, including Halpern and Wyplosz (1997), Von Hagen and Zhou (2002), Beblavy (2002), Hajnovic (2001) and Horvath and Jonas (1998).