

I. Domestic Politics and Currency Crises: The European Experience

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With major currency crises affecting both developed and developing countries over the last decade, identifying the variables that affect a country's propensity to find its currency under attack has become a subject of interest for economists and political scientists alike. While economic fundamentals have played a large role in these crises, such explanations have proven unsatisfactory given the large discrepancies of economic conditions in the affected states. Disagreement over which economic conditions should be influential and the lack of correlation between economic conditions and the timing, size and duration of the crises indicate the need to look at additional factors.

The subject of devaluation has been studied less intently but is also critical to understanding the political economy of currency crises. Currency crises are not synonymous with devaluation; either can occur in the absence of the other. If a currency is under attack, what determines when and if a government will devalue? What incentives would a government have to change the exchange rate peg?

Elections and political institutions can provide at least a partial answer to both of these questions. The prospect of a change in government alters the government's willingness and ability to maintain an exchange rate commitment. The government's willingness can be compromised by its desire to lower interest rates, engage in inflationary spending and project a sense of economic growth and prosperity before an election. Economic fundamentals may thus deteriorate prior to an election as the government attempts to engineer pre-electoral booms.

However, uncertainty surrounding the government's ability to maintain the currency level can also lead to pressure on its willingness to do so. When a change in government is imminent, markets face three prospects regarding the incoming

government's preferences towards the exchange rate: 1.) the preferences remain stable 2.) the preferences change 3.) the preferences are unknown. In the first instance, neither the government's willingness nor ability to maintain the exchange rate should be affected, thus one should not expect the election to generate a currency crisis.

In the latter cases, however, either changing preferences or unknown preferences could cause markets to instigate speculative attacks against the currency, even in the absence of changing economic conditions or policy changes. If markets expect the incoming government's exchange rate preferences to differ from its predecessor's, markets will try to anticipate the change before the fact and move the currency in that direction. If markets cannot discern the incoming government's preferences, either because of a close election or uncertainty surrounding the composition of a coalition government, general instability may ensue. If either of these two scenarios occur, the exchange rate instability generated by markets will force governments to either defend the exchange rate or to devalue. The need to defend the exchange rate through higher interest rates or foreign exchange intervention could alter the government's willingness to maintain the peg and result in devaluation.

But is this necessarily the case? Government preferences at this time may still favor defense over devaluation despite the accompanying costs. The electoral dynamic that created the currency instability also affects the government's incentives to continue its currency policy and put off any major policy changes until after its consolidation of power and the solidification of the new government's preferences. Thus governments that do devalue will hold off such a policy until after the election has passed.

In order to demonstrate these propositions, the paper will be structured as follows. The first section reviews the economics and political science literature on the determinants of currency crises, explaining how the possibility of government change could result in market instability and what incentives a government has to devalue or defend the currency at this point. The second section tests the idea that political instability produces foreign exchange market changes by drawing on the economics literature of target zones. A type of target zone model called the “drift adjust” model is applied to the original European Monetary System countries in both pooled time series and individual time series to see whether and how politics affects exchange rates. The third section uses another target zone model for exchange rate devaluation in order to examine how electoral incentives and the consolidation of power affect a government’s preferences regarding the timing of any devaluation that may occur. The final section offers conclusions and suggestions for further research.

#### The Political Economy of Currency Crises and Devaluation

Economists have conducted the bulk of the work on exchange rate crises. The first-generation work has focused on economic fundamentals as the root cause of currency instability. As the government’s policies become inconsistent with the maintenance of a given exchange rate level, the defense of the currency depletes reserves until devaluation becomes necessary (Krugman 1979).

Though some argue that economic fundamentals continue to drive exchange rate crises (Bordo and Schwartz 1996), others counter that a single exchange rate equilibrium does not exist. Therefore, economic fundamentals can support a range of different exchange rate values provided that markets expect the government to support the rate.

But if the exchange rate becomes attacked, it may not be sustainable, even in the absence of appreciable differences in economic fundamentals (Obstfeld 1986; 1996). The idea of a self-fulfilling speculative attack implies that market expectations may be at least as important in explaining currency crises as economic fundamentals. Government *credibility* becomes critical.

Self-fulfilling speculative attacks were used to explain the 1992-3 European Monetary System crisis: given the changing expectations of the likelihood of monetary union in the wake of the Danish referendum, government credibility to maintain the exchange rate became questionable (Eichengreen and Wyplosz 1993). Rather than running out of reserves, as the balance-of-payments model predicts, the issue was one of government credibility rather than economic fundamentals or even policy changes.

While the Danish referendum was a one-time event, elections and changes in government can produce a similar process in causing markets to shift their expectations regarding future policy. Elections affect exchange rates because they alter a government's willingness and ability to maintain the exchange rate.

When a government change is possible, market expectations of the incoming government's preferences regarding the exchange rate can be divided into three probabilities: 1.) government preferences will be unchanged 2.) government preferences will change 3.) government preferences are unknown.

In the first case, there is no reason to expect a correlation between currency crises and political instability caused by the election or change in government. Any crises that occur in this instance should be attributed to other factors, most likely but not limited to economic conditions. The second and third instances, however, present markets with a

challenge as to how to protect investments and circumvent any losses that could be generated by policy changes that potentially could be implemented by the new government.

If the government expects the new government to have different preferences than the outgoing government, this provides forward-looking markets with the incentive to act on this information in advance of the actual change in government. The incoming government may represent a different constituency than its predecessor. This could alter either the level of the exchange rate or even lead to the abandonment of a fixed exchange rate system altogether, depending on how the existing system affects the interests of the politically favored sectors. Frieden (1991; 1994) has considered the different effects that fixed-versus flexible exchange rates have on various economic sectors in detail. The effect of these expectations can be either positive or negative in terms of the strength of the exchange rate. The expectation of a government committed to price stability and a strong currency, for example, could bolster the exchange rate as easily as the opposite expectation could lead to capital flight. Thus the direction of the exchange rate may vary depending on interests of the future government.

This process need not be limited to elections but can also apply to changes in government (Bernhard and Leblang 1998). A factional change in either the ruling coalition or party could result in exchange rate instability. Within a coalition government, the parties in the coalition could change or the relative strength of the parties could shift in a way that favors one type of economic (including monetary and exchange rate policy) over another. Even within a government comprised of similar parties in terms of left-right differences, substantial conflict can emerge over policy, and elections

and government changes have the effect of consolidating power in favor of one faction or another. Simple partisan labels may be unable to capture this dynamic.

Markets must also contend with the possibility of not knowing the incoming government's preferences. This could stem from uncertainty regarding the outcome of the election and/or the composition of a coalition government. This political instability creates a bias in forward exchange rates, indicating the shift in market expectations at this time as market actors try to make adjustments in anticipation of government changes (Bernhard and Leblang 1999).

Thus expectations of changing government preferences or uncertainty surrounding government preferences could cause changes in the exchange rate that are less related to economic conditions than early economic analyses have indicated. Universally accepted economic models of the determinants of exchange rates have not yet been constructed, and it is not certain when an exchange rate becomes unsustainable based on economic conditions. Even in the absence of changing economic conditions, forward-looking markets can drive currency fluctuations during politically uncertain times.

But do markets also drive devaluation? According to rational expectations theory, markets should be able to anticipate any opportunistic behavior on the part of governments and to neutralize their effect. For example, in the political business cycle literature, rational expectations prevent governments from successfully generating economic cycles to create a pre-election boom. The public would also be able to anticipate opportunistic behavior given past behavior (Cukierman and Meltzer 1986). If this were the case, one should not expect governments to engage in opportunistic

behavior regarding the timing of the devaluation either. If markets and the public were able to predict that a government would devalue after devaluation, the government would not be able to fool them otherwise, and the government would not have the discretion to try to time the devaluation to a more politically palatable period.

But the electoral process adds a considerable amount of noise to the development of rational expectations when the preferences of the incoming government are uncertain due to a close election or uncertainty surrounding the composition of the government. A government therefore may have some leeway in regards to the timing of the devaluation; after all, an election may make devaluation more likely but it does not make it a certainty. Governments may still be able to engage in some opportunism when it comes to devaluation.

Whether or not a government will do so depends on the audience a government targets. On the one hand, defending the exchange rate could involve rising interest rates and slower growth, neither of which would be popular before an election. On the other hand, changing a major policy shortly before an election could send negative signals regarding a government's competence in managing the economy. Why would a currency be under attack if the government were able to manage the economy so that the economic fundamentals supported the exchange rate?

This points to three possible audiences for government actions during periods of election and government change: markets, primary constituents, and voters. Which audience the government decides to target could yield different policy outcomes at different times. Why does a government devalue or not devalue, and under what circumstances?

In the first instance, the government could respond to exchange rate pressure as a challenge to currency markets. By defending the exchange rate vigorously, the government could try to signal that market estimations regarding either the government's unwillingness or inability to defend the exchange rate were mistaken, and that the government is indeed committed to seeing the continuation of current exchange rate policy. Much has been made of the power of global capital to influence policy and create incentives for governments to implement similar policies so as to attract or at least not drive off capital (Goodman and Pauly 1993). Thus if government responses were tailored to market expectations, a devaluation would not occur before an election because the government wants to make a case that the economic fundamentals are intact. If the government does not manipulate policy for electoral advantage, there should be no reason why devaluation should occur at election time more than any other time.

Next there is the issue of coalition costs. As Frieden (1991) has explained, fixed exchange rate systems impose different costs and benefits on different groups. Partisan differences may be the most appropriate indicator to capture the different interests that occur in a fixed exchange rate system. Exporters, particularly large businesses, have traditionally supported governments of the right while the more domestically oriented groups such as labor generally vote for the left. Thus if the primary constituents were the main target of government response, one would expect governments of the right to be less likely to devalue and thus disrupt exchange rate stability.

Finally, governments could target voters when responding to exchange rate crises. Devaluation so soon before an election could indicate to the electorate that the exchange rate policy was a mistake, or the government was incapable of carrying it through. A

government would be particularly vulnerable to such charges if the economy really was in a weak state and/or the reelection of the incumbent government was in jeopardy, for devaluation would confirm economic mismanagement. Governments may have stronger incentives to postpone devaluation until after election. That way the incoming government could try to shift blame for the devaluation on the previous administration.

The following section tests these ideas of the political sources of currency crises and devaluation by looking at the countries of the European Monetary System.

### Currency Crises and Devaluations in the EMS

The European Monetary System (EMS) began in March 1979 as a fixed-but-adjustable exchange rate system in which the participating currencies were pegged to one another in bilateral exchange rates that could fluctuate within a narrow band. The original members of the Exchange Rate Mechanism (ERM) of the EMS were Belgium, Denmark, France, Germany, Ireland, Italy, and the Netherlands. In 1989 Spain joined the ERM, followed by Britain in 1990 and Portugal in 1992. In September 1992 both Britain and Italy left the ERM; Italy rejoined several years later, but Britain has yet to once again commit the pound. In 1995 Finland, Austria and Sweden joined the European Union and became participants of the Exchange Rate Mechanism. All of the aforementioned countries except Britain, Sweden and Denmark have become charter members of European Monetary Union, the final stage of which began in 1999.

In joining the European Monetary System, these countries made a commitment to defend the value of their exchange rate pegs; any changes in the official exchange rate

values were to be made within the multilateral framework of the Monetary Committee.<sup>1</sup> This makes exchange rate instability and devaluation easier to identify than in floating exchange rate systems as the government explicitly assumes responsibility for an announced exchange rate. Any deviation from the announced exchange rate value (and fluctuation band) clearly reflects a departure from this policy and can readily be observed by market participants as well as voters. This heightens the expectations placed on participating governments to adhere to policies that would support this exchange rate in both the long run as well as in the short run. When governments will not or cannot follow such policies, exchange rate instability ensues.

Are currency crises determined by a government's unwillingness to maintain the parity? If this were the case, one would expect economic fundamentals to be decisive in determining the onset of currency crises. On the other hand, perhaps the government's ability to maintain the exchange rate comes into jeopardy given a precarious political situation, such as those found in elections and changes in government. In order to determine this I construct a political economy model of currency crises based on the drift adjust method of target zones. While previous political economy analyses of currency crises have largely focused on exchange rate fluctuations as the dependent variable (Bachman 1992; Blomberg and Hess 1997; Eichengreen, Rose et al. 1994; Bernhard and Leblang 1998) these studies examine currencies from a range of regimes from fixed to floating. This study looks only at the fixed currencies in the European Monetary System because exchange rate volatility demands a coherent government response in such systems, much more so than under floating systems. When a currency is in a floating rate

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<sup>1</sup> The only country to substantially deviate from this arrangement was Britain, which declared the value of the pound without consultation with its European partners when joining the ERM in 1990. In 1992 Britain

system, the government has the option of allowing the volatility to continue without a short-term policy response. Currencies in fixed rate systems demand either a response or a repudiation of the currency peg shortly after speculation occurs, lest the currency fall from its peg. This increases the stakes for both markets and governments and makes government credibility paramount. A focus on fixed currencies sharpens our awareness of the incentives of both governments and markets to diverge from the status quo.

The primary economic model for explaining currency devaluation for exchange rates that fluctuate within a band is the target zone model. (Krugman 1991). The “drift adjust” model (Svensson 1993) is a type of target zone model that has been used to measure the expectation of exchange rate realignment and thus serves as our proxy for market instability. This is done by subtracting the deviation of the currency’s spot rate from its central rate at time  $t$  and time  $t-1$ , taking the difference of this result, and subtracting it from the home country’s interest rate differential with Germany, the generally acknowledged anchor of the system. This number measures market expectations of realignment for currencies in a target zone. Thus:

$$\text{Expected rate of realignment} = (\text{domestic interest rate} - \text{German interest rate}) - [(\text{spot rate minus central rate}_{t+1}) - (\text{spot rate minus central rate}_t)].$$

The economic data are taken from the IMF’s *International Financial Statistics*. The exchange rates are the period average ECU rates. The monthly data covers the ERM I period before the target zone bands were widened from 2.25% up and down to 15% in August 1993. The economic variables included in this study have been widely thought to have an impact on exchange rate values and thus should be relevant to a study of expected exchange rate realignments. These economic variables are as follows:

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again made the unilateral decision to withdraw from the ERM.

- **inflation:** percent change in consumer price levels
- **real exchange rates**
- **reserves:** total reserves minus gold
- **output:** index of industrial production
- **trade balance:** exports over imports

With the exception of the inflation rate, these variables have been transformed by taking deviations of natural logarithms of domestic values from German values, following Rose and Svensson (1994).

In addition to the above economic variables, the following political variables were also considered:

- **Partisanship:** Left governments represent different constituencies than right governments, and they purportedly have different policy preferences. Left government are more likely to suffer currency crises because they are both more likely to favor loose monetary and fiscal policy and because they would be less willing to increase interest rates to defend the currency. This variable provides a more nuanced approach to evaluating the effect of partisan differences than traditional left-right distinctions. Taken from the *European Journal for Political Research*, dummy variables which distinguish between governments that are right-wing, right-center, balanced, left-center and left-wing were created. A right-wing government is defined as holding over 66 percent of the seats in government and parliament. A right-center government means that the right holds between 33.3-66.6 percent. The numbers for the left are the same. If a left-wing government is in power, the expectation of an exchange rate devaluation would be higher as it would

allow the government to follow a more lax fiscal and monetary policy which benefits its primary constituents. If a right wing government were in power, however, the expectation of devaluation would decrease because of the inflationary effects that are associated with devaluation. The closer either of these polar spectrums converges towards the middle through the inclusion of moderating influences in government, however, the less likely this variable will influence outcomes.

- **Elections:** The prospect of a new government coming to power could lead to a currency weakening if the incoming government were expected to either devalue the currency or pursue policies that would not support the existing exchange rate. Alternatively, the currency could strengthen if the incoming government were expected to implement policies that would strengthen the exchange rate. A dummy variable was constructed in which the value is 1 if an election occurs in that month, 0 if otherwise.
- **Type of government:** The type of government has previously been found to be significant in the reduction of interest rate differentials and nominal exchange rate stability (Oatley 1997). It stands to reason that a government's type may also affect market confidence regarding its ability to defend an exchange rate. Government type is operationalized as follows: 1=single party majority, 2=minimum winning coalition, 3=surplus coalition, 4=single party minority, 5=multiparty minority, 6=caretaker. There should be a negative correlation between government type and the expectation of exchange rate devaluation. The greater the number of parties involved, the more interests and constituencies the government must satisfy, making it difficult to rapidly respond to changing circumstances. Similarly, a government lacking a majority

would also find it difficult to craft a coherent response to rapid changes in economic policy given its need to maintain the support of parliament. Data was taken from the *European Journal of Political Research*, various issues.

- **Capital controls:** The use of capital controls makes it easier for a government to deal with capital flight, at least in the short run. Hence Quinn's index of openness was used, and a higher degree of financial openness should be associated with a lower expectation of devaluation.
- **Central bank independence:** An independent central bank removes the possibility that monetary policy will be pursued for short-term political objectives prior to an election, boosting a government's credibility to maintain an exchange rate. Hence central bank independence is associated with a reduced expectation of currency crises. An index constructed by Grilli et al. (1991) was used that measures the legal independence of central banks. Higher degrees of central bank independence should correspond with lower realignment expectations.
- **Devaluation:** Currency devaluations were also included in order to control for their effect on exchange rate expectations. Devaluations were marked as dummy variables, 1 when a devaluation of the currency's central rate occurs, 0 if otherwise.

Data from the following countries were studied: Belgium, Denmark, France, Ireland, Italy, and the Netherlands. Country dummy and year dummies were added in order to control for any fixed effects. Lags of the dependent variables were also added in order to correct for autocorrelation problems, and the lack of autocorrelation was verified through Durbin's m test.

[insert Table 1 here]

Consistent with economic studies of economic variables and exchange rate determination, economic variables were not the sole forces that drove the currency crises. Economic variables like inflation, output, and reserves were found significant, but the model also yielded the presence of elections as a significant variable. The prospect of changing government preferences and policies positively correlates with market expectations of devaluation and therefore hence currency crises.

Surprisingly, capital controls did not have a significant effect on the expectation of exchange rate devaluation, though the sign was correct. Central bank independence, however, did significantly reduce realignment expectations, reinforcing the significance of politics and specifically institutions in influencing market expectations. Neither government type nor partisanship, however, was significant.

While such pooled time series analyses provide a useful first cut for understanding currency crises, the EU provides a variety of countries that differ from one another to the extent that their aggregation could lead to a significant loss of information. For instance, elections may not have the same impact in a country with frequent turnover of government, like Italy, versus countries where elections are what precipitate the transfer of power. Political factors like elections, partisanship, and government type may not have the same effect in different countries, even in an area as integrated as Western Europe. Running the same variables as individual time series allows one to parse out how countries may respond differently to the aforementioned variables.

[insert Table 2 here]

The above regressions reveal that the economic and political variables differ in significance for the various European countries, differences that are lost in aggregation. Though the type of government was not significant for the group as a whole, it is significant for Denmark and France. In the case of France, for example, some of the problems the Socialist government had in maintaining the exchange rate concerned the demands of their Communist coalition partners. Once the role of the Communists in the government was reduced in 1983, the government was able to enact stabilization policies that reduced inflation and improved the strength and stability of the currency. Similarly, some of the problems the conservative government had in the early 1990s concerned the conflicting preferences over the desirability of monetary union between the RPR and UDF parties. This helped precipitate the currency crisis in the spring of 1993. Disagreements within government are more likely to occur with additional partners, reducing the government's ability to make decisive policies due to concern over their conflicting effect on partners' interests.

In the Danish case, it is not surprising that government type made a difference in market expectations given the relatively recent development of its multiple party system. Prior to 1973, four parties---the Social Democrats, the Radical Liberals, the Conservatives, and the Liberals dominated Danish politics. The 1973 elections stand as a watershed in Danish politics for its introduction of five new parties to the *Folketing* along with the losses sustained for the major parties. The proliferation of new parties made it difficult for any single party to muster a majority. Minority governments are common in Denmark, and this may have contributed to uncertainty surrounding government intentions. In Denmark from 1945-1987, the average duration of government for a

minimum winning coalition is almost twice that of a minority government (Laver and Schofield 1991: p152). This indicates that minority governments tended to be less stable and in a weaker position to pursue policies that could stabilize the exchange rate, hence the negative correlation between government type and devaluation expectations.

The partisanship variable was not significant for the EMS countries as a group, but it was for Belgium, Denmark and France. Once again drawing on the French example, the left government of the early 1980s attempted the famous Socialist experiment. These policies that included industry nationalizations, a reduced workweek and various public works programs led to a massive flight of capital and several devaluations of the currency. Though the Socialists improved their macroeconomic performance and credibility after the policy U-turn in 1983, the left continued to pursue some distinctive policies, such as the introduction of the 35-hour workweek in the late 1990s.

The Belgian case also indicates a positive relationship between governments of the left and the expectation of devaluation. Union participation in economic decision-making during this period remained high, and it was strongly associated with the participation of the left in government (Compston 1994). Belgium has thus been continually plagued by high levels of government debt despite the rigors that the Maastricht Treaty was designed to impose on profligate countries. Like France, this is the classic relationship hypothesized between left governments and currency instability: the participation of left governments and in particular unions in the formation of policy lead to capital flight because their preferred policies favor growth over price stability.

The Danish case is interesting as the sign of the partisanship variable is negative, contrary to the positive association between left governments and currency instability in the aforementioned countries. Partisan politics experienced a shift in Denmark during the 1980s, as the importance of unions declined and the system shifted from a centralized bargaining regime to one more decentralized, flexible, and reliant on market forces (Iversen 1996). This suggests that the link between parties and unions has shifted and can no longer account for economic conditions. Partisanship may need to be combined or replaced by another variable measuring union density and/or labor involvement in government policymaking in order to explain how markets consider partisanship from case to case. Partisanship may thus serve as an imperfect proxy for something else, hence the unexpected relationship between partisanship and currency crises. In cases where the hypothesized relationship between unions/labor and left governments does not hold, the partisan label no longer possesses the same meaning.

One can also question the meaning of partisanship in countries where this did not register as a significant variable. Unlike in countries like France and Germany, where the lines between left and right have traditionally been clearly drawn by parties, in Ireland the major cleavage has not been socioeconomic but rather nationalist. The two largest parties, the Fianna Fail and Fine Gael, are both considered right-of-center. Their primary difference has been the degree to which they support Irish autonomy, with the Fianna Fail being the more militant party and the Fine Gael more accommodating towards Britain. In the late 1980s the Progressive Democrats, a break-away faction of Fianna Fail, joined these parties of the right. Some analysts have concluded that the two major parties “provide no real alternative to Irish voters

on substantive issue” and that they both promote “pragmatic images...frequently not backed up by politics at all” (Sinnott 1987). It is therefore not surprising that partisanship was not significant in determining market expectations of devaluation in this case.

When elections were not found significant in Belgium, Denmark and Italy, an alternative variable of government change was used, with the information coming from the *European Journal of Political Research*. Only in Denmark was this alternative measure of political change found significant. Interestingly, though elections were found significant in France, Ireland and Denmark, the signs of the variables are different. In Ireland and France they are positive, indicating the expectation that markets anticipate the incoming government to either devalue the currency and/or the incoming government to pursue policies inconsistent with maintaining the current exchange rate. In France the national elections frequently served as a referendum on the state of the economy. The incumbent government consistently denied problems with the long-term maintenance of the exchange rate while challengers would question the competence of the government’s economic policy and would argue that devaluation was needed in order to correct the damage done to economic competitiveness under the current administration. Elections and the accompanying changes in administration hence heralded an upcoming devaluation.

The early 1980s were a tumultuous time politically and economically for Ireland. The country experienced three elections within a year and a half, and one of the primary issues concerned proposed austerity measures. The credibility of the government to carry out such measures given the general political instability at the time (exacerbated by issues

concerning the Northern Ireland question) was not very strong. Coupled with the non-membership in the ERM of Ireland's primary trading partner, Britain, the punt suffered as the government was unable to credibly commit to stabilization policies while confronted with a politically uncertain future. Even as the political situation steadied in Ireland during the later part of the decade, the Irish governments continued to find electoral periods a prime time for currency instability, as the elections often signaled a change in government and at times devaluation as well.

In the case of the Netherlands, however, elections lowered the expectation of realignment. This indicates that markets had more confidence in the willingness and ability of the expected incoming government to maintain the exchange rate. As previously noted, elections can have either a strengthening or weakening effect on the exchange rate, but pooled time series analysis may drown this out.

These results are broadly consistent with others who have found that either elections (Bachman 1992; Siklos and Tarajos 1996; Blomberg and Hess 1997) or cabinet instability (Simmons 1994; Leblang and Bernhard 2000) have affected devaluation expectations. The inclusion of variables to note government changes, whether or not such changes are directly linked to elections, strengthens the original insight that politics does affect market expectations and can have an important influence on the timing of currency crises. If markets react to political developments in addition to economic fundamentals, periods of government instability pose an added source of insecurity for governments in the form of currency speculation. Thus the government's ability to maintain exchange rate commitments can become weaker as the result of market expectations as well as economic conditions.

How governments react to such threats is the subject of the next section. Do these governments devalue their currency in the face of market speculation? Or do the same forces which incited market speculation also alter government incentives to devalue?

### *Explaining Exchange Rate Realignments*

A target zone model developed by Edin and Vredin (1993) uses both lagged interest rates and economic fundamentals to explain currency devaluations. They argue “a devaluation, which involves a change from one target zone to another, is related to ‘fundamentals’ (other than interest rate differentials), just like the change in the exchange rate within a target zone is determined by such ‘fundamentals.’” Specifically, there exists a “shadow rate” (determined by a set of economic indicators), which, if it diverges too far from the central parity, will lead to a change in the central parity itself. Devaluation occurs if:

$$\text{shadow rate}_{(t+1)} + \text{error}_{(t+1)} > \text{central parity}_{(t)} + \text{constant}$$

In other words, currency devaluations are driven by economic fundamentals. Unlike earlier versions of the target zone model, Edin and Vredin do not limit these fundamentals to studies of the money supply and interest rates but also include other economic indicators. Siklos and Tarajos extended this model to include political variables as well. The probit analysis below uses the same economic and political variables as well as the control variables discussed in the previous models of currency crises in addition to interest rate differentials with Germany.

[insert Table 3 here]

The economic model indicates that economic fundamentals may be less important in devaluation decisions than they are in determining realignment expectations. None of the economic variables found to be significant in the exchange rate crises models registered as significant in the devaluation model; interest rate differentials and real exchange rates were the only ones were found significant. While economic conditions are a motivating force in the onset of currency crises, the decision to devalue clearly reflects political motivations. Despite the rational expectations model's assumption that markets should be able to predict such decisions *ex ante*, it appears that elections provide sufficient noise and inject greater uncertainty in the process of trying to predict government interests and hence government policies.

Capital controls did enable governments to manipulate the timing of devaluation. Greater financial openness made devaluation a more likely possibility. Consistent with analyses that credit the relaxation of capital controls with greater exchange rate instability, the results shown here confirm that capital controls were an important tool in managing exchange rates in the 1980s and early 1990s.

Central bank independence also registered as a positive and significant influence on devaluation decisions. While capital controls enabled countries to skirt devaluation and market forces, the presence of independent central banks signaled less politically motivated, growth-oriented manipulation of monetary policy. Countries with higher levels of capital controls (like France and Italy) also tended to have politically dependent central banks, reinforcing the notion that governments try to assert greater control over monetary policy for political gain.

The type of government has a significant negative effect on the decision to devalue. This corresponds to the previous analysis of the role of government type in determining the onset of currency crises. The fewer interests that a government needs to concern itself with, the easier it is for the government to act decisively, particularly when pursuing a policy that diverges from the status quo. Minimum winning coalitions and single member governments are more likely to devalue a currency than surplus coalitions or minority governments. The latter group of governments needs to be concerned with pleasing the various members of the coalition and/or the supporting elements in the legislature that allow it to govern. Thus a clear policy break like an exchange rate devaluation may be difficult to make when a myriad of conflicting interests need to be satisfied.

So which audience does a government target when devaluing? The positive and significant coefficient of the post-electoral variable points to the general electorate, at least during electoral periods. If the government targeted markets, there should be no significant correlation between the political variables and devaluation as the emphasis would be on economic fundamentals.

The lack of significance of the partisan variables suggests that partisanship also does not come into play strongly during devaluation decisions. This makes sense intuitively, as the government already should be able to count on the support of its primary constituents. We can assume that the government has already enacted numerous policies to satisfy this constituency, and the exchange rate level and stability should already be satisfactory. Last-minute adjustments to policy could actually alienate these constituents and call into question the government's preferences in relation to their own.

Thus the status quo should be the optimal policy for a government when it faces exchange rate pressure, and there should be no correlation between elections and devaluation.

The significance of the post-election variable points to the electorate as the target audience. During an election time the government will try to appeal to as broad a range of voters as possible in order to secure re-election. Those voters who are not firm supporters of the government already are more likely to be swayed by last-minute policies that could negatively influence their perception of government competence and reliability. Therefore the government does not devalue before an election. The average voter would not perceive the government favorably after devaluation, and the government may also lack the needed support within the legislature to make such decisions so close to an election.

The government can also manipulate its participation in the EMS as a political symbol that reinforces its effort to sway votes based on its credibility. A government can use its EMS obligations to participate in two activities that Mayhew (1974) argues politicians engage in to enhance their prospects for reelection: credit-claiming and position-taking. The government can take credit for saving the currency from the evil speculators and preventing a humiliating devaluation. Credit can also be accrued from improving or at least not damaging the country's influence in the EU.

In addition, by not devaluing before an election, governments take a strong stance on their preferences for exchange rate and price stability. By demonstrating its willingness to spend foreign reserves and raise interest rates to defend the currency, the government signals to the market its commitment to a strong currency and lower

inflation. The public also perceives this commitment, and this enhances perceptions of government competence. According to Eichenberg and Dalton (1993), the decline in inflation rates is one of the primary reasons that public support for EC integration has increased over the last two decades. This indicates that public is aware of and concerned with inflation, and if it can affect their support of the Community it could also affect their support of the government responsible for the economy.

The fact that the defense of the currency takes place within the context of the government's obligation to uphold the European Monetary System also provides the government with a scapegoat for the unpopular consequences the defense of an exchange rate may require. This enables the government to implement policies that might otherwise be deemed too constrictive (Andrews 1993).

The period immediately after an election, however, is the best time to introduce new policies like a lower exchange rate or even switches in exchange rate regimes. The new government has likely consolidated its hold on power during the election and has a greater mandate to make policy changes. This is particularly true when, as mentioned previously, the new government is one that is strong and internally coherent and thus able to break with the previous exchange rate level.

### Conclusion

This paper illustrates the link between politics and economics when it comes to currency crises and devaluation. Economic fundamentals have traditionally been poor predictors of currency crises, making politics a natural explanatory variable to investigate. Both currency crises and devaluation tend to cluster around periods of political instability, specifically elections. Understanding this phenomenon requires not

only looking at market motivations for speculative attack but also government responses to them. While elections may cause markets to question a government's commitment to a fixed exchange rate, the timing of such attacks also influences how a government reacts. Despite the possibility of lowering interest rates via devaluation, governments prefer not to devalue so as to appeal to the maximum range of voters in the run-up to an election. After their power has been consolidated, however, the new government may decide to devalue in the months following an election.

These findings not only illuminate both government and market preferences during currency crises, they also point to the political nature of credibility and the autonomy that governments possess in determining the timing of devaluation, despite the power of markets in an age of high capital mobility. First of all, credibility is not easily quantifiable, it rests largely on perceptions and expectations of what governments are likely to do in the future. Governments can attempt institutional fixes like granting the central bank greater independence in order to signal its intentions, but it unclear how and why this signal has differed on the international stage versus the national stage. Why was the independent Bundesbank associated with a strong currency and low inflation but the even more independent European Central Bank with a weak currency? Why is central bank independence not associated with the same type of economic phenomena in developing economies as they are in developed economies? Influencing market expectations via enhanced credibility is complex task that requires taking stock of changing political circumstances in addition to structural factors like institutions.

But while governments try to sway the opinions of markets, this does not mean that markets have won the battle. Governments still play an important role in global

finance; they supply the environment of political and economic stability that is necessary for investments to prosper. They also retain some decision-making authority in the value of their currency, including the type of exchange rate regimes and the setting of the value of the currency itself. The relationship between governments and markets may have been altered by capital liberalization, but governments still play a vital role. And as long as governments matter, so will issues like credibility, authority and accountability. Politics not only complements economic explanations of exchange rate determination, they interact with one another to form the ideas and expectations generated by the market.

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Table 1 Expectation of Exchange Rate Realignment, 1979-1993

	coefficient (t-statistic)
Constant	3.156 (2.178)*
Lag real exchange rate	-3.005 (-1.322)
Lag inflation	-.238 (-4.675)**
Lag output	-3.370 (-3.061)**
Lag trade	.271 (.318)
Lag reserves	2.248 (5.153)**
Devaluation	2.947 (4.879)**
Capital controls	4.986E-02 (.455)
Central bank independence	-.773 (-5.916)**
Partisanship	6.553E-02 (.903)
Type	-.148 (-1.610)
Elections	1.690 (3.584)**
R	.728
N	

Not shown: lags of dependent variable, country dummies, year dummies  
 \*significant at .05 level \*\* significant at .01 level

Table 2 Expectation of Devaluation by Country, 1979-1993

	<b>Belgium</b>	<b>Denmark</b>	<b>France</b>	<b>Ireland</b>	<b>Italy</b>	<b>Neth.</b>
Constant	-7.678 (-2.043)*	-3.356 (-1.109)	-3.079 (-.495)	-21.663 (-4.040)**	4.512 (.456)	-6.428 (-2.436)*
Lag real exchange rate	-8.580 (-1.337)	10.638 (1.489)	-3.456 (-.474)	-13.831 (-2.614)**	20.908 (2.072)*	13.155 (3.404)**
Lag inflation	-.530 (-2.799)**	-.398 (-3.404)**	-.332 (-2.717)**	.161 (1.487)	-2.292E- 02 (-.136)	-.164 (-2.093)*
Lag output	1.176 (.181)	.114 (.039)*	-6.400 (-.659)	9.169 (2.568)*	12.807 (1.814)	-4.281E- 02 (-.030)
Lag trade	2.612 (1.227)	.560 (.466)	1.649 (.673)	1.210 (.600)	.455 (.217)	1.255 (2.203)
Lag reserves Type	2.728 (2.411)*	1.654 (2.565)*	3.722 (3.000)**	5.753 (3.788)**	3.123 (2.250)*	1.763 (4.292)**
Partisanship	-8.117E- 02 (-.368)	-.470 (-2.386)*	-.505 (-2.544)*	.411 (1.891)	-1.843 (-1.740)	3.998E-02 (.475)
Capital controls Election	.636 (2.356)*	-.653 (-3.687)**	.449 (3.457)**	-.690 (-1.113)	.712 (.298)	-.170 (-1.788)
Government change Devaluation	4.785E-02 (.293)	.288 (1.478)	7.963E-02 (.161)	.753 (2.138)*	8.152E-02 (.199)	.322 (1.924)
R square	1.124 (1.859)	.	5.737 (4.707)**	3.895 (3.235)**	-.921 (-1.178)	-.738 (-2.463)*
N	--	.737 (2.417)*	--	--	--	--
	.781 (.347)	1.589 (1.768)	9.355 (7.514)**	3.763 (2.468)*	.769 (.582)	Not applicable
	.642	.719	.771	.618	.656	.655
	169	171	170	170	160	171

Not shown: lags of dependent variable

\*significant at .05 level \*\* significant at .01 level

Table 3: Devaluation 1979-1993

	Coefficient (t-statistic)
Capital controls	-1.55154 (-2.38140)**
Central bank independence	4.73072 (2.42393)*
Pre-election period	-.39831 (-.63134)
Post-election period	1.27197 (2.92977)**
Type	-.91149 (-2.38709)*
Partisanship	-.26052 (-1.17105)
Lag inflation	-.04846 (-.39893)
Lag output	-5.44125 (-1.56788)
Lag real exchange rate	-12.08416 (-2.39191)*
Lag reserves	-.23035 (-.22129)
Lag trade	-.30741 (-.19894)
Interest rate differential	.11915 (3.67369)**

Not shown: country dummies, year dummies

\*significant at .05 level \*\* significant at .01 level