

CHAPTER ONE

The Political Economy of Exchange Rate Policy in Latin America: An Analytical Overview

Jeffry Frieden and Ernesto Stein¹

Exchange rates have been central to the course of economic development in Latin America for decades. From the heyday of import substitution in the 1960s to the rapid expansion of foreign debt in the 1970s, and from the debt crisis and its troubled aftermath to the rekindling of growth and borrowing in the 1990s, the exchange rate has been crucial to the mix of government policies that has shaped the region. Indeed, many analysts regard exchange rate policy as a major determinant of other economic outcomes, such as adjustment to the oil shocks of the 1970s and the debt crisis of the 1980s (Sachs, 1985). And currency policies have themselves been at the center of some of the region's most prominent economic processes and events, including liberalization in the Southern Cone between 1976 and 1982, the Mexican crises of 1982 and 1994, Argentina's adoption of a currency board in 1991, Brazil's 1999 currency crisis, and ongoing discussions of dollarization.

It is thus surprising that there is so little analysis of how political economy affects the exchange rate policies of Latin American governments. Currency policy is made by governments, and governments operate in a political environment, yet a *political economy* of exchange rate policy is barely in its infancy. There are no generally accepted theories that explain why governments choose certain currency policies, and no developed body of empirical work that shows the relationship of economic and political factors in the determination of currency policy. In contrast, scholars have long

¹ Jeffry Frieden is Professor of Government at Harvard University. Ernesto Stein is Senior Economist with the IDB Research Department.

worked with well-developed theories of the distributional implications of different trade policies,² and more recent work has focused on how electoral and other political institutions affect the making of trade policy.³

This book analyzes the political economy of exchange rate policy in Latin America. It brings together the work of economists and political scientists interested in the interaction of economic and political factors in the making of exchange rate policy. The basis of the book is a series of arguments about the potential determinants of currency choices by national governments. While purely economic factors are of course important—especially economic structure, trade patterns, and exogenous economic conditions—the focus here is on the political and political economy considerations that have typically been underrepresented in the literature. These include the role of interest groups, electoral competition, and the timing of elections. These considerations are evaluated both with statistical analyses and in-depth studies of important national experiences.

Analyzing the Political Economy of Exchange Rates

The contrast between the amount of literature on trade policy and that on the political economy of exchange rate policy is striking. Economists and political scientists have carried out rigorous analyses of the political economy of trade for over 60 years, and the large body of work on the subject has given rise to some more or less generally accepted principles. Analysts typically agree on the tradeoffs facing policymakers between the distributional and welfare effects of protection. There are powerful (if contending) theories about the distributional impact of different trade policies; well-developed models of the interaction of distributional, electoral, institutional and other factors; and a wealth of empirical studies evaluating these approaches. No such background is available for the study of the making of exchange rate policy.

This chapter presents a consensual view, drawn from what literature is available,⁴ on the crucial building blocks of the political economy of

² Indeed, there is a proliferation of such theories, including the Heckscher-Ohlin/Stolper-Samuelson approach, the specific-factors or Ricardo-Viner view, and more recent perspectives emphasizing imperfect competition.

³ Lohmann and O'Halloran (1994), Rogowski (1987), and Persson and Tabellini (2000).

⁴ See Bernhard and Leblang (1999), Clark and Reichert (1998), Collins (1996), Edison and Melvin (1990), Edwards (1996), Eichengreen (1995), Frieden (1994), Hefeker (1996), and Klein and Marion (1997).

exchange rate policy: the tradeoffs faced by governments, and the distributional, macroeconomic, institutional and other socioeconomic factors that affect the choices policymakers make as they address these tradeoffs.

Decisions on an exchange rate regime involve choosing the degree to which the currency is allowed to float freely or be fixed against some other currency. There is a wide spectrum of choices, ranging from a completely free float to a variety of managed floats, degrees of fixity ranging from a target zone to a peg, and a currency board or dollarization. The focus in this book on policies that address the level of the exchange rate is bound to raise eyebrows among economists. But theory and experience indicate that nominal exchange rate movements can have substantial real effects on relative prices, and that governments can and do affect their real exchange rates—within limits, of course. Although decisions on the exchange rate regime and level are closely linked, they can be thought of separately for purposes of analysis. In making these choices, policymakers have to consider the costs and benefits of their actions, and the tradeoffs they entail.

With regard to the exchange rate regime, the principal tradeoff is between *stability* and *flexibility*. Governments value two types of monetary stability. The most direct impact of the exchange rate regime is on *currency stability*, which is of value inasmuch as predictable exchange rates reduce the risk attached to cross-border economic activity.⁵ All else being equal, governments would prefer stable exchange rates, which tend to be associated with fixed regimes. Fixed exchange rates can also lead to *monetary stability*, i.e., low inflation, through two different channels. First, a fixed rate makes it difficult for tradables prices to rise without drawing in competing imports. Second, the choice of a fixed rate can serve as a visible signal of government intentions, as policymakers tie their own hands as a commitment device.

Yet this domestic and international monetary stability can only be attained at the cost of giving up national policy flexibility. A fixed currency regime makes it impossible, without abandoning the parity, to use the exchange rate as a policy instrument, and it also makes it difficult or impossible to use interest rates for macroeconomic policy purposes (the difficulty varies with the degree of capital mobility). This has two related implications for policymakers. First, it reduces maneuvering room for dealing with macroeconomic distress: they cannot devalue in the face of payments deficits, or lower interest rates in a recession. Second, it reduces their ability to

⁵ Certainly economic agents can hedge against these risks, but this possibility is especially limited in small developing countries where forward markets are often underdeveloped.

respond to distributional pressures for supportive policy: the government cannot devalue to satisfy complaints from importers or exporters about foreign competition, and it cannot lower interest rates to appease debtors. Obviously, this is not necessarily bad. In fact, policymakers may want to tie their own hands, removing inflation from the list of problems for which voters can blame them. However, this also means that they cannot use exchange rate policy to satisfy their constituents, which may be politically costly.

There is an analogous set of tradeoffs for the level of the exchange rate. A weaker real exchange rate stimulates demand for local tradable products, whether in domestic or foreign markets. It can therefore help reduce trade and payment deficits, and invigorate the tradable sectors of the economy. For exporters, it has the direct effect of raising the local currency earnings derived from foreign sales. On the other hand, a weaker real exchange rate reduces national purchasing power, making consumers worse off. The two desirable goals—stimulating local manufacturing, agricultural and raw materials sectors, and increasing local purchasing power—are mutually exclusive with regard to the level of the exchange rate. The benefit of increasing the competitiveness of national producers comes at the cost of reducing the real income of national consumers, and vice versa.

There are, then, two sets of tradeoffs. With regard to the regime (fixed or floating), the choice is either monetary stability or credibility versus monetary flexibility. And with regard to the level (depreciated or appreciated), the choice is competitiveness versus purchasing power. An even simpler setup could collapse the two into a choice between “credibility” and “competitiveness,” i.e., between a fixed currency with strong anti-inflationary effects but no ability to affect relative prices, and a more flexible currency with a tendency to depreciate in order to maintain local price competitiveness. Governments must weigh the costs and benefits of the various choices. The ways in which these choices are weighed depends on the structure of the national economy, and on the character of the domestic political economy.

Economic Structure

An economy with a greater need for an independent monetary policy, and a greater ability to pursue one, is more likely to choose a floating rate. As indicated by the longstanding literature on optimal currency areas, this implies that economies subjected to exogenous shocks uncorrelated with those faced by potential anchor countries, and with little mobility of factors between themselves and potential anchor countries, will be more likely to float. By the same token, extremely open economies will be more likely to

fix, for two reasons. First, highly open economies typically find the exchange rate less effective as a policy tool—the real impact of a nominal depreciation, for example, is rapidly eroded as import prices rise and are transmitted through the economy. Second, a very large proportion of economic agents in such economies are sensitive to exchange rate risk and will be sympathetic to attempts to reduce it. Empirical evidence indicates that these last considerations are especially relevant at very high levels of openness, typical of the small European countries or the small nations of the Caribbean, for which total trade is often in excess of 100 percent of GDP.

Macroeconomic Conditions

Countries with long histories of persistent high inflation might be especially tempted to use a fixed exchange rate to bring down inflation. However, this interest will be tempered by the fact that fixing the currency in conditions of high inflation typically leads to a real appreciation, with undesirable effects on tradables producers and the balance of payments. So the anti-inflationary advantages of a fixed exchange rate have to be weighed against the disadvantages of a transitional real appreciation. These last disadvantages may be moderated by a high degree of indexation, or by great wage and price flexibility, either of which substantially reduces the likelihood of a real appreciation. If, as has been the case in many episodes of hyperinflation in Latin America, wages, prices and contracts are indexed to the dollar, fixing against the dollar is unlikely to cause a substantial real appreciation. And since indexation tends to rise as inflation rises, typically becoming close to full in conditions of hyperinflation, it can be hypothesized that under hyperinflationary conditions, anti-inflationary motives predominate over concern about a real appreciation. Conversely, when inflation is moderate, avoiding a real appreciation tends to outweigh bringing inflation down, given the typically limited nature of indexation in these conditions. This would give the relationship between inflation and exchange rate regime choice a U-shape, with fixed rates most likely to be adopted in conditions of either very low or extremely high inflation.

Interest Groups

The exchange rate has powerful effects on relative prices, and thus on the interests of different groups. An appreciated currency raises the relative price of nontradables, while a depreciated currency raises the relative price of tradables, so preferences on the level of the real exchange rate are clear. With regard to the regime, tradables producers are likely to oppose a fixed

rate, for two reasons. First, as already discussed, the adoption of a fixed rate in conditions of high inflation, such as has characterized much of Latin America, usually leads to a transitional real appreciation, with detrimental effects on tradables producers. This is the common experience of most exchange rate-based stabilization programs. Second, a fixed rate eliminates the possibility of a depreciation to maintain or restore the competitiveness of tradables producers.⁶ Because these producers are often involved in cross-border transactions, they may also be concerned with the volatility that a floating rate can bring. They may thus prefer a regime such as a backward-looking crawling peg, which tends to both reduce volatility and maintain the competitiveness of the real exchange rate. The most prominent supporters of a fixed rate are likely to be those heavily committed to cross-border contracts that involve an intertemporal dimension, particularly in countries, such as many in Latin America, where forward markets are limited. These would typically include the commercial and financial sectors, and foreign currency debtors. The clearest predictions from interest group approaches, then, are that on distributional grounds tradables producers will prefer a depreciated, floating rate, while those heavily engaged in cross-border activities, such as finance, commerce, and foreign debtors, will prefer a fixed rate.

Political Institutions

A fixed exchange rate requires that the government respond to exogenous shocks with domestic adjustment measures, and rules out the use of active exchange rate policy or monetary policy to stimulate the national economy. It also requires that fiscal policy be under control. Therefore, relatively weak governments will be unlikely to be able to sustain a fixed rate. They will be less able to resist the fiscal demands of sectoral and other groups, as they will lack the political support necessary to impose adjustment. In addition, they may have strong motives to use the exchange rate to improve short-term macroeconomic conditions. Thus, minority or coalition governments, divided governments, and other governments in a weak political position may be less likely to opt for a fixed rate. On the other end of the political spectrum, dictatorships and other authoritarian regimes are likely to be better able to undertake the adjustment measures necessary to maintain a fixed rate.

⁶ It also eliminates the possibility of a nominal appreciation that would favor nontradables producers, but this is quite rare. The asymmetry, while of theoretical interest, is virtually universal and can simply be assumed to hold.

Electoral Considerations

There are a number of reasons why elections may have an effect on exchange rate policy. The income effect associated with depreciation reduces the purchasing power of the population. This can make depreciation unpopular, and therefore politicians may want to avoid it at election time. Devaluations may also be unpopular because they generate inflation.⁷ One specific possibility is that governments may be tempted to launch exchange rate-based stabilization programs during the period prior to an election. In addition to reducing inflation, these stabilization programs tend to generate an economic boom in the short run, followed by a recession.⁸ In high inflation economies, the combination of inflation reduction and economic boom may be appealing as an election approaches.⁹ These arguments point in the same direction: the rate of depreciation may be expected to decline prior to elections, and to accelerate once elections have taken place. In terms of the real exchange rate, a government facing elections may be expected to attempt to effect a real appreciation, perhaps by lagging (or fixing) the nominal exchange rate behind inflation, with an inevitable real depreciation to follow.

These, then, are the expectations regarding the analysis of the political economy of exchange rates in Latin America. The chapters that follow, which are summarized in the next section, subject the issue to close empirical investigation in the context of these analytical expectations.

⁷ Stein and Streb (1998) have developed a model in which devaluation acts as an inflation tax, and governments differ with regard to their competence. Competence is associated with the capacity of the incumbent to deliver a given bundle of public goods with less tax resources. Under an imperfect information setting, governments reduce the rate of devaluation (and thus the inflation tax rate) in the run-up to elections, in order to convey a signal about their competence and increase their chances of reelection.

⁸ See Kiguel and Liviatan (1991) and Calvo and Végh (1990).

⁹ Stein and Streb (1999) discuss several examples of such programs launched in the run-up to elections, and some of the country studies in this book provide additional examples. The chapter on Brazil presents an analytical framework in which politicians have a loss function defined in terms of the current account and inflation, but place different weights on these two objectives. Thus, the politicians tend to cater to two different groups in the population: workers, who place more weight on the inflation objective, and tradables producers, who care primarily about competitiveness. However, as elections approach, and in the presence of unobserved shocks, even those who favor the tradables sector have incentives to appear driven by inflation rather than competitiveness concerns, as workers outnumber tradables producers and can define the result of the election.

The Political Economy of Exchange Rates in Latin America

This book assesses the importance of factors that determine exchange rate policy in Latin America. Chapter Two is a cross-national statistical study that looks at a large number of Latin American and Caribbean nations over a 35-year period. The remaining chapters are case studies of Argentina, Brazil, Chile, Colombia and Peru. All the country studies include a descriptive analysis of the evolution of exchange rate policy since the 1960s, complemented by quantitative analysis. These analyses differ between countries in terms of the questions they ask, the methodology used to answer these questions and, of course, the results.

The five countries studied have gone through highly varied exchange rate experiences on several dimensions. While some countries have experienced few changes in their exchange rate regime during the period under study, others have had a variety of regimes, in some cases repeatedly. While some countries have shown great concern regarding the level of the exchange rate for competitiveness purposes, others have generally given more importance to macroeconomic stability in designing exchange rate policies. In several cases, the policy emphasis has swayed from macroeconomic stability to competitiveness and back, depending on external conditions, as well as on the country's economic and political developments.

This diversity of experiences naturally leads to different methodological choices in trying to learn about the political economy determinants of exchange rate policy. In Chile and Peru, where the exchange rate regime has undergone numerous changes over time, explaining the choice of regime and its level becomes an interesting experiment. For these two countries, as well as for the cross-country analysis, different models of qualitative dependent variables are used to study the political economy determinants of exchange rate regimes. In other countries where the regime has been constant for prolonged periods, it is more productive to focus not on the regime but rather on such exchange rate outcomes as the level of the real exchange rate or the degree of misalignment from equilibrium levels. This is the case in Brazil and Colombia, which have primarily been on backward-looking crawling peg regimes since 1967. The Argentine study takes a somewhat different methodological route, using various time series techniques to emphasize the change in the relevant tradeoffs underlying exchange rate policy, which have shifted from the politics of redistribution during the import-substitution industrialization (ISI) period to the politics of inflation.

Credibility vs. Competitiveness and Other Tradeoffs

Center stage throughout this book is the tradeoff in exchange rate policy between competitiveness (achieved through a depreciated real exchange rate) and macroeconomic stability (achieved through a fixed nominal and/or appreciating real exchange rate). In many instances, the nature of the tradeoff and the choices made along the way have changed over time. The chapter on Chile, for example, highlights shifts between pro-competitiveness and anti-inflationary stances. This was illustrated by the shift toward inflation fighting as the crawling peg was replaced by fixed exchange rates in 1979, only to go back to a pro-competitiveness stance (and a crawling peg regime) after the 1982 crisis.

The conflict between credibility and competitiveness was not always the main tradeoff in exchange rate policy. In Argentina, exchange rate policy evolved from being mostly a distributional issue during the height of the ISI period to being an issue dominated by conflicting concerns about macroeconomic stability and competitiveness. In the closed economy that characterized ISI, spells of appreciated real exchange rates were associated primarily with the goal of maintaining low prices for intermediate inputs, food, and capital goods. Given the heavily protected domestic market, the impact of the appreciated peso on local finished goods producers was essentially irrelevant. Although sometimes related to balance of payments constraints, devaluations were primarily associated with distributional conflict, and specifically with real wage reductions. In fact, before liberalization began in 1978, devaluations reduced real wages substantially. As the Argentine economy was liberalized during the 1980s, the competitiveness-credibility tradeoff emerged more strongly. Most particularly, the link between devaluations and inflation became much more direct, so that those concerned about inflation focused on the value of a real appreciation as an anti-inflationary tool. The Argentine study provides evidence, then, of a significant change in the very character of exchange rate politics as economies become more open, and as inflation becomes a more politically salient issue.

Economic Structure

The case studies in this book are not comparative, and as such they are not well suited to assess the impact of economic structure on exchange rate policy. In fact, the five countries studied are all of medium to large size by Latin American standards, have large manufacturing and primary exporting sectors, and went through long periods of import substitution followed by

substantial trade liberalization. The principal comparative evidence in this book, therefore, is in the cross-country chapter, where a strong finding is that a high degree of economic openness is in fact associated with a greater likelihood of a fixed rate. Although the result is due in part to the tendency of the very open economies in and around the Caribbean basin to fix their exchange rates, it is robust to the exclusion of these countries. Another comparative expectation was that national sensitivity to terms of trade shocks would be associated with a greater likelihood of floating. Surprisingly, the *opposite* relationship holds: countries whose terms of trade are particularly variable are in fact *less* likely to float their currencies. This is a puzzle not explained by the existing literature.

Macroeconomic Conditions

The country studies provide suggestive evidence about the impact of inflation on exchange rate policy. Conditions of moderate inflation typically were associated in all five countries with exchange rate regimes with some degree of flexibility—backward-looking crawling pegs, target zones, or managed floats. In almost all instances, hyperinflation led to the use of a fixed exchange rate to bring monetary conditions under control. This pattern appears to hold both across countries and over time. Argentina and Chile attempted exchange rate-based stabilization programs in the late 1970s to deal with high inflation. At the same time, countries with more moderate inflation, such as Colombia and Brazil, operated under crawling pegs. But as Brazil and Argentina ratcheted into hyperinflation during the 1980s, they turned to fixing the exchange rate to bring inflation down—this time, with substantial success. Chile, on the other hand, having essentially ended hyperinflation and settled into mild inflation, moved back to a more flexible currency.

There is a strong correlation between moderate inflation and flexibility, and hyperinflation and fixing.¹⁰ This tends to support the expectations of the U-shaped relationship mentioned above: regimes that allow some flexibility are more likely with moderate inflation, while fixing is more likely with very low inflation or hyperinflation. This is also in part borne out by the cross-national study: in particular, the statistical evidence

¹⁰ Peru, however, is an interesting counter-example. As shown in the chapter on Peru, hyperinflation was defeated without the active use of a nominal exchange rate anchor. This was probably out of necessity, as the country had essentially run out of reserves and could not credibly commit to a fixed rate. And once the program was successful, there was little reason to alter it. In any case, Peru does not fit the pattern described here.

is strong that, in times of hyperinflation, countries tend to adopt fixed exchange rate regimes.

Interest Groups

The impact of interest groups on exchange rate policy has evolved over time, primarily because of the trend toward trade liberalization in all the countries considered. In some cases financial liberalization seems to have played an important role as well. Because of the many specific tariffs and subsidies in place during the import substitution period, tradables producers tended to focus their demands on targeted measures that would affect their own profitability without directly implicating the exchange rate. These tariffs and subsidies made it possible for governments to respond to the demands of interest groups without affecting overall exchange rate policy, or to compensate those sectors otherwise hurt by changes in that policy. Indeed, given the prohibitive protection afforded many manufacturers, the level of the exchange rate was close to irrelevant—and an appreciated currency could even be favorable, as it kept input prices low. With the advent of trade liberalization and the dismantling of these specific measures the role of interest groups as a determinant of exchange rate policy became more important. And manufacturers, no longer protected by trade barriers, had much stronger incentives to push for a weaker real exchange rate.

The Colombian chapter illustrates the changes over time in the role of interest groups in exchange rate policy. The country's coffee sector was subject to export taxes (in the context of a stabilization fund) broadly related to international coffee prices and to the exchange rate. The relationship between prices paid to producers and the external price of coffee thus determined an implicit exchange rate applicable only to coffee. According to the authors, the sector was inclined to spend its lobbying efforts on the domestic support price, rather than on the general level of the exchange rate, which would have caused conflicts with other interest groups. In the 1990s, however, the availability of compensatory mechanisms declined and, in the midst of a substantial real appreciation, coffee growers became much more vocal about exchange rate policy. The manufacturing sector exhibited similar behavior: during the ISI period the industrialists' association sought protection through subsidies and trade barriers, but became very vocal on exchange rate policy issues as these measures were dismantled in the 1990s.

The changing policy preferences of interest groups are tackled empirically in the cross-national study, as well as in the Peru chapter. Both studies use dummy variables to indicate periods of trade liberalization and to explore how this affected the impact of the manufacturing sector on

exchange rate policy. In the cross-national study, a larger manufacturing sector is associated with the adoption of pro-competitiveness regimes, such as flexible regimes or backward-looking crawling pegs. However, these effects are much smaller during the ISI period compared to the period of liberalized trade. During the ISI period in Peru, a larger share of manufacturing was actually associated with a more appreciated rate and with the adoption of fixed or pre-announced crawling peg regimes. During the liberalization period, however, the effect of the manufacturing sector became significantly weaker. Therefore, although the manufacturing share variable has opposite effects under ISI in the two studies, in both the advent of trade liberalization affects the incentives of the manufacturing sector in the same way.

Other sectoral variables included in the studies are the share of agriculture and mining in GDP, as well as the share of exports over GDP. The presumption, in this last case, is that as the share of exports becomes larger, the group within an economy that would benefit from a depreciated exchange rate becomes larger and stronger. It would then presumably be in a better position to lobby in favor of exchange rate policies associated with a pro-competitiveness stance. While mining and agriculture did not appear to significantly affect exchange rate policy in any of the studies in which they were included, the share of exports in GDP in Chile appears to be associated with the adoption of more flexible regimes (crawling pegs and bands, rather than fixed exchange rates). In fact, the statistical analysis in the Chilean chapter implies that a 10 percentage point increase in exports as a share of GDP was associated with a reduction in the probability of a fixed exchange rate regime that was always significant, and ranged between 1.7 percent and 6 percent depending on the specification of the model. On the other hand, the likelihood of adopting a crawling peg increased between 1.9 percent and 7 percent in response to a 10 percentage point increase in export share, depending on the specification.

The presumption up until now has been that certain interest groups would exert influence on policymakers, and that their influence would be related to their share in GDP. However, there are other channels through which interest group considerations may have an effect on exchange rate policy. Exchange rate policy can be used as compensation to sectors that are hurt by other policies (such as trade liberalization). Perhaps more common, given the relatively broad effects of the exchange rate, is for governments to compensate specific sectors hit by exchange rate policy with countervailing measures. There are several examples of these compensation mechanisms in the country chapters.

The chapter on Chile develops the compensation issue most fully. In fact, the issue of compensation policies involving exchange rates is a

recurrent theme, whether depreciated exchange rates were used to compensate producers for the loss of protection, or whether subsidies were used to compensate dollar debtors for exchange rate changes. Regarding the relationship between trade and exchange rate policies, the chapter suggests that exchange rate regimes tended to be more flexible (which in the case of Chile means crawling pegs and bands, regimes associated with more depreciated real exchange rates) when the economy was more open, providing evidence in favor of the compensation hypothesis. The empirical evidence in this case, complemented by commentary from policymakers, leaves no doubt about the link between trade and exchange rate policies in Chile.

The Peru study suggests that export subsidies significantly reduced pressures for a depreciated exchange rate, thus providing more evidence regarding the importance of compensation mechanisms. More generally, the link between trade and exchange rate policies underlies the policy mix observed in most countries during the ISI period: appreciated exchange rates, which allowed for the import of cheap intermediate and capital goods products, coupled with high levels of protection for final goods.

The use of other policy measures to compensate for changes in exchange rate policy has been widespread in the countries studied, and has taken a variety of forms. After the exchange rate in Chile was floated in August 1982, a preferential exchange rate system was put in place, which was valid for payment of interest and principal of all existing debts denominated in foreign currency. Brazil in 1979 and Argentina in 1981 introduced variations of the same compensatory scheme following large devaluations. Other forms of compensation included the access of large conglomerates to newly privatized assets, and the introduction of special trade regimes such as that of the auto industry in Argentina following the adoption of the country's currency board.

Political Institutions

Several chapters in this book investigate the role of the political regime in exchange rate policy. Some studies explore whether the behavior of exchange rate policies under democratic governments differs from that under dictatorships, while others look at the role of partisanship, the existence of political competition, and divided government as potential determinants of exchange rate policy.

The cross-national study finds evidence that dictatorships were associated with fixed exchange rate regimes. The regressions include a time trend, so this result cannot simply be attributed to the coinciding trends

toward more flexibility and more democracy in Latin America. In the Brazilian study, the hypothesis is that democratic governments have a stronger incentive to cater to workers as opposed to tradables producers, since workers are more numerous and influence election results. Workers care about inflation and the purchasing power of their salaries. Although dictators may at times need political support, as a general rule they have fewer incentives to respond to popular demands, and thus are more likely than democratic rulers to respond to concentrated interests such as those of the tradables sector, which benefits from a depreciated exchange rate.

The evidence presented in the Brazil chapter, however, does not support this hypothesis. The authors use a Markov switching empirical model to characterize the behavior of the real exchange rate at any point in time as being in either an "overvalued" or "undervalued" state. Then they compute the effect of the political regime on the probability of remaining in each state, or switching from one state to the other. Contrary to the author's priors, dictatorship increases the probability of a switch to the overvalued state, and decreases the probability of a shift to the undervalued state, which should be the one favored by tradables producers. The authors attribute this unexpected result to the ISI pattern discussed above, in which highly protectionist trade policies during the military regime allowed tradables producers to benefit from an appreciated currency that would lower the price of capital goods and imported intermediate inputs.

The Colombian study looks at two different political-institutional variables. First, it finds that exchange rate policy has differed across political parties: the rate of nominal depreciation has been significantly higher when the Conservative party—which has a strong base of support in the coffee growing region—is in office. The difference is quite large in economic terms: the rate of quarterly nominal depreciation is nearly 4 percentage points higher under Conservative governments, although the partisan variable loses significance once the authors control for real exchange rate misalignments. Second, the chapter finds effects of the National Front, a power-sharing agreement between the two main parties that lasted from 1958 through 1974 and significantly reduced the degree of political competition. The National Front period is associated with lower rates of devaluation, suggesting that the absence of political competition reduced the incentives to pursue expansionary policies that might have compromised economic stability.

The cross-country study uses another variable related to the political regime: the proportion of government-controlled seats in the legislature. The expectation is that strong governments are more prone to adopt fixed exchange rate regimes, for they would be in a better position to implement the macroeconomic adjustments needed to sustain such a regime. The au-

thors indeed find that strong governments are more likely to adopt fixed exchange rate regimes. The same is true for governments that face a weak and fragmented opposition.

Electoral Considerations

The evidence in both the country studies and the cross-national study on the effects of elections on exchange rate policy is generally consistent with the arguments outlined in the previous section. The study on Brazil tackles the electoral issue most carefully. The Markov switching empirical model used in the chapter seems perfectly suited to gauge the effect of elections on the pattern of exchange rates, as it distinguishes between an "overvalued" and "undervalued" state and correlates these states with economic and political trends. The chapter finds that in periods that lead to elections, the probability of remaining in an overvalued state increases, as does the probability of switching from an undervalued to an overvalued state. Specifically, the results imply that, conditional on being "undervalued," the probability that the real exchange rate will switch to the overvalued state is 17 percent during the run-up to elections in the democratic period, up from just 2.2 percent during normal times. Likewise, the probability of switching from the overvalued to the undervalued state increases from 10 percent to 19 percent during the period after elections, although in this case the difference is not statistically significant.

By averaging more than 240 elections in Latin America, the cross-national study examines the behavior of nominal and real exchange rates within a 19-month window centered on these episodes. The authors find that the rate of nominal depreciation jumps upward two to four months after elections take place. The effects are particularly strong after presidential elections: the average rate of monthly depreciation jumps from around 2.5 percent in normal times, to around 6 percent in months two through four.¹¹ The real exchange rate, in turn, appreciates nearly 3.5 percent in the months leading to presidential elections, and depreciates on average 6 percent during the following four months. Interestingly, these results are even stronger when government changes are considered instead of elections, suggesting that the adjustment in exchange rates tends to be delayed until the new authorities take office. The authors also show how the probability of a large real depreciation (over 25 percent) is affected by the electoral cycle. The probability falls from 3.84 percent, in the case of the whole

¹¹ The authors use geometric averages rather than arithmetic averages in order to lessen the effects of outliers.

sample, to 2.66 percent in the run-up to an election (a reduction of over 40 percent), and jumps to 9.76 percent immediately after the new government is inaugurated.

Other studies that look at the election issue are those on Peru, Colombia and Argentina. The methodology used for Peru is similar to that of the cross-national study, and the results are similar as well. These results have to be viewed with caution, however, since they are based on a small number of elections. But the pattern of real exchange rate movements around elections is very clear, showing a sharp appreciation before elections, followed by a sharp depreciation once elections have taken place. The Colombian chapter compares the devaluation rate in presidential election years (10 between 1958 and 1994) to that of nonelection years. It finds that in the months leading up to an election, the behavior of the nominal exchange rate is similar to that in the same months of a nonelection year. The rate of devaluation seems to be lower between the election and the inauguration of the new government, and higher after the new government takes office. These results, however, do not appear to be very robust: the effect of elections on devaluation disappears completely when other variables are included in the analysis.

Both Brazil and Argentina experienced several episodes that illustrate the importance of the election effect. The Brazilian chapter discusses the 1986 Cruzado Plan in Brazil, when devaluation was delayed until one week after the elections, and the 1994 Real Plan, key to Fernando Henrique Cardoso's come-from-behind victory in the October 1994 elections. The chapter on Argentina stresses the political impact of the Austral Plan, based on a fixed exchange rate, on the 1985 Congressional elections, and the desperate (and failed) attempt to control inflation with the Primavera Plan during the run-up to the 1989 presidential elections. The study also presents evidence of the importance of the rate of inflation—which, the authors show, is very closely linked to depreciation—as a determinant of the electoral result.¹²

Conclusions

The studies in this book provide strong evidence that political economy is important in determining exchange rate policies in Latin America. Much of the politics of exchange rates revolves around the tradeoff between the

¹² Given the small sample of elections in Argentina, however, these results should be viewed with caution.

macroeconomic credibility that a fixed rate can provide, and the price competitiveness of local producers that a flexible rate can maintain. Where concern about real appreciation dominates, such as in countries with moderate inflation and little indexing, policymakers are more likely to maintain adjustable exchange rate regimes. Hyperinflation, however, makes fixing more likely, both as concern about inflation rises and as economy-wide indexing reduces the probability of a substantial real appreciation. Where exports are particularly important, currency policy tends toward flexibility, as exporters are particularly anxious to maintain relative prices favorable to them.

Special interests also appear to affect currency policy, particularly when the manufacturing sector promotes more flexible currency regimes to maintain the competitiveness of locally produced tradables. This is, not surprisingly, especially true in relatively open economies; and in fact it seems that in the closed economies of the ISI period this consideration was weaker or absent. Stronger governments are, generally speaking, more likely to choose and sustain fixed exchange rate regimes, as the macroeconomic adjustments involved are typically difficult for governments with weak political bases of support.

Elections, too, affect currency policy, especially inasmuch as a real appreciation can deliver an electorally popular reduction in inflation and increase in purchasing power. In line with this, governments show a strong tendency to allow or engineer a real appreciation in the run-up to elections, which is then reversed after the government changes hands.

The studies in this book, and others like them, indicate the centrality of political economy considerations to the determination of exchange rate policy. To be sure, the current state of understanding of the political economy of exchange rates is rudimentary. There is a great need for more rigorous and comprehensive theoretical and empirical studies of the problem, both in Latin America and beyond. Nonetheless, on the basis of the analysis and evidence presented here, it is clear that the evolution of Latin American currency policies cannot be understood without a firm grasp of the underlying political and political economy conditions in the countries of the region.

References

- Bernhard, W., and D. Leblang. 1999. Democratic Institutions and Exchange-Rate Commitments. *International Organization* 53(1): 71-97.
- Calvo, G., and C. Végh. 1990. *Credibility and the Dynamics of Stabilization Policy: A Basic Framework*. IMF Working Paper WP/90/110. International Monetary Fund, Washington, DC.
- Clark, W., and U. Reichert. 1998. International and Domestic Constraints on Political Business Cycles in OECD Economies. *International Organization* 52(1).
- Collins, S. 1996. On Becoming More Flexible: Exchange Rate Regimes in Latin America and the Caribbean. *Journal of Development Economics* 51: 117-38.
- Edison, H., and M. Melvin. 1990. The Determinants and Implications of the Choice of an Exchange Rate System. In W. Haraf and T. Willett (eds.), *Monetary Policy for a Volatile Global Economy*. Washington, DC: American Enterprise Institute.
- Edwards, S. 1996. *The Determinants of the Choice between Fixed and Flexible Exchange Rate Regimes*. NBER Working Paper 5576. National Bureau of Economic Research, Cambridge, MA.
- Eichengreen, B. 1995. The Endogeneity of Exchange Rate Regimes. In P. Kenen (ed.), *Understanding Interdependence: The Macroeconomics of the Open Economy*. Princeton: Princeton University Press.
- Frieden, J. 1994. Exchange Rate Politics: Contemporary Lessons from American History. *Review of International Political Economy* 1(1): 81-103.
- Hausmann, R., U. Panizza, and E. Stein. 2000. *Why Do Countries Float the Way They Float?* Inter-American Development Bank Research Department Working Paper 418, Washington, DC.
- Hefeker, C. 1996. The Political Choice and Collapse of Fixed Exchange Rates. *Journal of Institutional and Theoretical Economics* 152: 360-79.
- Kiguel, M., and N. Liviatan. 1991. The Business Cycle Associated with Exchange Rate-Based Stabilizations. *World Bank Economic Review* 6 (2): 279-305.
- Klein, M., and N. Marion. 1997. Explaining the Exchange-Rate Pegs. *Journal of Development Economics*. 54: 387-404.
- Lohmann, S., and S. O'Halloran. 1994. Divided Government and U.S. Trade Policy: Theory and Evidence. *International Organization* 48(4): 595-632.
- Persson, T., and G. Tabellini. 2000. *Political Economics and Economic Policy*. Cambridge, MA: MIT Press.

- Rogowski, R. 1987. Trade and the Variety of Democratic Institutions. *International Organization* 41(2): 203-24.
- Sachs, J. 1985. External Debt and Macroeconomic Performance in Latin America and East Asia. *Brookings Papers on Economic Activity* 2.
- Stein, E.H., and Streb, J.M. 1999. *Elections and the Timing of Devaluations*. Inter-American Development Bank Research Department Working Paper 396, Washington, DC.
- _____. 1998. Political Stabilization Cycles in High Inflation Economies. *Journal of Development Economics* 56(1): 159-80.