

Pegs and Politics¹

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September 29, 2005

Abstract: We study the political consequences of currency crises and the abandonment of a fixed exchange rate commitment. Theory and evidence suggests that democratically elected leaders face higher “audience costs” for reneging on a *de jure* fixed exchange rate commitment than do dictators. Within democracies we find that incumbent governments are heavily penalized in terms of their re-election chances if they abandon a *de jure* exchange rate peg. In contrast, abandoning a *de facto* actually improves an incumbent’s prospects. This implies that, conditional upon the selection of a *de facto* peg, democratically elected leaders will be less likely than their autocratic counterparts to announce a *de jure* exchange rate peg.

1. Introduction

Recent events across both industrialized and industrializing countries have made it abundantly clear that exchange rate policy is truly everyday politics. While financial crises swept across Europe, Latin American and Southeast Asia, countries in these regions also engaged in the dramatic experiment of abandoning their national currencies. The prospects and problems associated with domestic monetary policy were not lost on the public: voters in Denmark, Norway and Sweden turned out in great number to vote against joining the European Monetary System.

While the European referenda are likely unique events what is clear is that we live in an environment where exchange rate policies have wide ranging political implications. Regardless of whether monetary policy is shrouded in highly technical language the performance of a nation’s exchange rate has large and visible political consequences. Studies of Britain and France show that incumbents in these countries suffered large losses in the court of public opinion when their currencies

¹ I am grateful to William Bernhard, Steve Chan, Jennifer Fitzgerald, Jeff Frieden, and Jenny Wollak for comments on an earlier version of this paper. Jonathan Berohn, Ryan Biehle, Rand Blimes, Erica Chenowith, and Ryan Isaacson provided research assistance. Financial support from the University of Colorado’s SURE program and from the National Science Foundation is gratefully acknowledged.

experienced unanticipated depreciations (Bernhard and Leblang 2005; Bernhard 2001). In a recent update of Cooper's study of the consequences of devaluations, Frankel reported that a currency crash increases the probability that a leader will exit political office by 45% (Frankel 2004).²

In this paper we take a broader look at the political consequences of exchange rate policy and ask how incumbent governments fare electorally after they have abandoned an exchange rate peg and when their economies are hit by speculative currency attacks. While much research has examined the causes and consequences of financial crises³, the political consequences are far less understood.⁴

We contribute to the literature on exchange rate politics by examining the extent to which politicians are held accountable for changes in international economic policy. In developing the theoretical linkage between exchange rate policy and electoral support for an incumbent government we draw on several seemingly disparate literatures. Scholars interested in cross-national patterns of voting have focused on how economic conditions influence support for the incumbent. While we are aware of a few papers that focus on economic crises (e.g., Warwick 1992; Mainwaring and Scully 1995), only Remmer (1991) explicitly focuses on exchange rate behavior. A renewed examination of the role that exchange rates play is warranted as a growing literature recognizes that foreign economic factors – usually described under the rubric of 'globalization' – may constrain or limit a politician's room to maneuver when it comes to the implementation of domestic policy.⁵

² Leblang and Blimes (2005) reach similar conclusions regarding the consequences of an exchange rate crash based on a sample 143 countries from 1919-1998. There is also case study evidence suggesting that financial crises lead to the downfall of leaders. In his study of the Asian financial crisis Haggard observed that in Indonesia "...the causal arrows also work in reverse. Economic circumstances contributed to Suharto's fall..." (Haggard 2000).

³ For discussions and reviews of the economic and political variables related to currency crises see, respectively, Berg and Patillo (1999) and Leblang and Satyanath (2006).

⁴ See Gupta, Mishra and Sahay (2003) for a discussion of these issues and Bleaney (2005) for case study evidence.

⁵ See, for example, the contributions by Rodrik (2000) and by Hellwig and Samuels (2005).

Second, a burgeoning literature demonstrates that countries often exhibit a “fear of floating;” that they behave as if they have a fixed exchange rate while claiming that they are allowing the exchange rate to float.⁶ One explanation for this type of behavior is that governments do not want to be held accountable if and when it becomes necessary—either by choice or as a result of a speculative attack—to abandon what is a very public signal regarding monetary behavior.⁷ This argument assumes that politicians will be punished electorally for breaking a public promise. Deviating from an exchange rate policy that is not public, on the other hand, should not be as politically costly. This paper, in part, helps gauge the magnitude of these political costs.

Finally, a large body of theoretical and empirical literature on exchange rate policy treats domestic political phenomena – elections, leader change, etc – as exogenous in studies of speculative attacks, devaluations, and currency regime choice.⁸ In this paper we turn the causal arrow around and ask whether exchange rate behavior influences the survival of political leaders and the outcome of democratic elections. An understanding of the political advantages and disadvantages from exchange rate regime transitions, devaluations and speculative attacks may help us develop better theories when the causal arrow runs from political behavior to exchange rate policy.

⁶ The seminal contribution here is Calvo and Reinhart (2002). A number of other papers confirm Calvo and Reinhart’s finding and provide alternative measures of a country’s *de facto* exchange rate regime. These include Levy-Yeyati and Sturzenegger (2003), Reinhart and Rogoff (2003), and Shambaugh (2003).

⁷ Leblang (2005) argues that democratic governments are more likely to exhibit behavior consistent with fear of floating because elected politicians want to remove exchange rate policy from the political agenda come election time. Alesina and Wagner (2005) develop an explanation that has its roots in models of balance sheet effects.

⁸ Leblang and Bernhard (2000) and Leblang (2002b) develop models of cabinet and leader survival to generate measures of political uncertainty; these measures are then used to predict speculative attacks in OECD and non-OECD countries respectively. Frieden, Ghezzi and Stein (2001) argue that the electoral cycle can help explain both devaluations and the survival of exchange rate regimes; Leblang (2002a, 2003) examines patterns of successful and unsuccessful speculative attacks during the electoral cycle.

Specifically we argue that there are electoral consequences associated with deviating from an announced exchange rate peg; consequences that impact both politicians and their political parties. Given the strategic nature of policymaking, we then argue that politicians in democracies have an incentive to eschew public announcements of exchange rate fixity even if they are actively engaged in the maintenance of a fixed exchange rate. This strategy of announcing a floating regime while behaving as if the regime is fixed results in a lower probability that a currency crisis will occur.

The next section situates this argument in the literature and develops testable hypotheses. Section three discusses the data, sample and empirical model employed to test whether there are electoral consequences of exchange rate policy. Section four examines the factors leading to the choice of a *de jure* exchange rate peg and section five concludes.

2. Political Consequences of Exchange Rate Policy

The choice of exchange rate regime is fundamentally a political decision. Policymakers in Germany and France decided to break their countries away from the Bretton Woods system of fixed but adjustable exchange rate in an attempt to both increase domestic monetary policy autonomy and to avoid importing inflation from the United States. Likewise policymakers across Europe found the appeal of increased cross-border trade and investment to be convincing enough to create the European Monetary System. Understanding the political appeal of various exchange rate arrangements will help provide insight into the political costs and benefits of said arrangements.⁹

At its core the argument for a fixed exchange rate regime is fairly simple: by maintaining the value of its currency vis-à-vis the currency of another country a country's monetary authority stabilizes the external trading environment by decreasing the uncertainty surrounding movements of the exchange rate and by reducing transactions costs. The resulting increase in trade and investment, as recently

⁹ Reviews of the political economy literature on the choice of an exchange rate regime are contained in Frieden and Broz (2001) and Bernhard, Broz and Clark (2002).

documented in a series of papers by Rose, are substantial (Rose 2000). In addition to the aggregated macroeconomic benefits associated with increased trade and investment, fixed exchange rate regimes are beneficial in economies where domestic (nominal) shocks are far more pervasive than foreign (real) shocks.¹⁰

Even for countries that are not so trade dependent, fixed exchange rate regimes provide a useful solution to the problem of time-inconsistency by serving as a nominal anchor for domestic monetary policy. Fixing the exchange rate allows policymakers to visibly demonstrate to domestic and international audiences that there is a firm commitment to price and monetary stability. Fixing their currencies to the German mark allowed policymakers in various European countries to “import” the anti-inflationary credibility exhibited by the Bundesbank (Giavazzi and Giovannini 1989). Indeed, fixed exchange rate regimes have been part of stabilization programs in countries from Latin American to Asia to the Middle East. The signal sent by a fixed exchange rate regime is especially important in countries where domestic institutions are not strong and where even if a central bank does exist there are likely about its independence.

A policymaker’s success in using an exchange rate peg to signal a commitment to anti-inflationary and stable monetary policy, of course, depends on the credibility of that policymaker and on the perceived difficulty of maintaining the commitment (Drazen and Masson 1994). The credibility of an exchange rate commitment can be called into question when policymakers have an incentive to use monetary policy to achieve domestic policy objectives—often short term objectives—that are inconsistent with the maintenance of the exchange rate parity.

¹⁰ This is the argument advanced by scholars working in optimal currency area literature. See the seminal contributions of Mundell (1961) and McKinnon (1963). More recent variants of this literature examine the source of the shocks (e.g., Tavlas 1993; Frankel and Rose 1996).

Consider an incumbent politician who is facing the prospect of re-election at some point in the future. Three decades of research on the political business cycle show that politicians have an incentive to use expansionary monetary policy to stimulate the economy – increase employment and growth – in the run-up to an election.¹¹ The problem, of course, is that while lowering interest rates may stimulate domestic economic activity it may also lead to an exchange rate depreciation which, in turn, will lead monetary authorities will use foreign exchange reserves to maintain the exchange rate parity. This provides currency speculators with an opportunity to bet against the exchange rate peg and sell their holding of the domestic currency short, anticipating that the government will abandon the exchange rate peg. Not surprisingly a number of scholars have found that speculative behavior and currency devaluations increase in the period prior to an election (e.g., Lobo and Tufte (1998); Frieden, Ghezzi and Stein (2001); Leblang and Bernhard (2001); Leblang (2002, 2003)).

A devaluation or abandonment of an exchange rate peg has significant economic and political implications. Devaluing the domestic currency makes domestically produced import competing goods less expensive—at least in the short run—while at the same time stimulates foreign demand for domestic products. This privileges constituents working in import competing and export sectors – there is an increase in demand for their products and a likely increase in employment—while harming those working in the non-tradeables sector (Frieden 1991; 1999). In the longer run increasing domestic spending and abandoning the exchange rate results in inflation which increases domestic prices and increases the demand for imported products. This has predictable distributional

¹¹ Nordhaus (1975) and Alesina, Roubini and Cohen (1997) provide concise statements of the political business cycle hypothesis. The assumption that voters are retrospective and tie their evaluation of governmental policies to macroeconomic indicators of performance has been borne out in cross-national empirical literature. See Lewis-Beck and Stegmaier (2000) for a review and summary of this literature.

implications. How these broad sectoral effects are intermediated through the political process is likely to vary substantially from country to country and perhaps over time as well.¹²

Abandoning an exchange rate commitment has implications that reach across economic sectors. Politically different groups will blame the incumbent government for exchange rate changes that harm their economic futures. Consider the case of the British in the European Monetary System. Exchange rate stability within the EMS helped sectors involved in international trade and finance. But to maintain the pound's parity with the German mark, the government had to keep interest rates high. Since home-ownership is widespread in Britain and mortgages are tied to current interest rates, this policy hurt many home-owners, especially working-class home-owners who had just purchased their homes under Thatcher's privatization program (Clarke and Stewart 1995). Once grateful to the Conservative party for allowing them to purchase their own homes, these working class constituents soon turned against the Major government as high mortgage payments placed them in financial straits.

This is consequential especially to policymakers that initially adopted a fixed exchange rate regime to serve as a nominal anchor. The use of an exchange rate peg as a visible commitment device is a double edged sword. The same constituents that may have believe the government's commitment to low inflation and exchange rate stability may punish a government for breaking that promise. The visibility of a monetary commitment means that abandoning the parity can serve as a focal point for the public, causing people to re-evaluate their assessments of the government's economic performance and their future voting intentions (Bernhard 2001). Because a fixed exchange rate is a public and transparent statement with regard to monetary policy, abandoning the parity may be construed by constituents as a sign of weakness.

¹² And it will vary as a function of the ideology of the governing party/coalition. For a party of the left, for example, the effects of price increases on urban workers are likely to be much more salient than the effects on exporters' earnings, especially if the export industries tend to be capital and natural resource intensive. If a party of the right were in power, the reverse would be true.

Hypotheses

The simplest hypothesis is that we should observe greater political costs as a result of an exchange rate abandonment for politicians must face the electorate and ask to be re-elected. The hallmark of democratic institutions is that the electorate can hold an elected official responsible for actions it deems unacceptable. Political scientists have developed a large body of theory detailing the link between democracy and a commitment to an international policy regime (e.g. Gaubatz 1996; Martin 2000). Scholars have argued that democracies will be less likely to renege on an international policy agreement because voters will be more likely to punish them for that behavior (e.g. Fearon 1994). The idea that democratic leaders face large domestic audience costs for breaking international agreements has been applied in studies of conflict, international organization and trade.¹³

As applied to exchange rate politics, the audience cost literature would suggest that regardless of the potential benefits in terms of monetary autonomy realized by the shift from a fixed to a floating exchange rate, politicians in a democracy will suffer politically because of the stigma associated with a public and transparent deviation from stated policy.

H₁: Leaders in democracies face larger costs when abandoning an exchange rate peg as compared to leaders in autocracies.

This hypothesis, however, does not distinguish behavior within democracies. A basic assumption underlying models of voting behavior is adage that citizens vote based on their economic well-being. The economic voter hypothesis suggests that voters reward incumbents when the economy is good and punish the when the economy is bad.¹⁴ When considering economic factors most scholars account

¹³ See Fearon (1994), Smith (1996), Mansfield, Milner and Rosendorff (2002), and Tomz (2002).

¹⁴ The literature here is voluminous. See, for example, Fiorina (1981), Clarke and Stewart (1994), Nannestad and Paladam (1997), and Lewis-Beck and Paladam (2000).

for general economic conditions such as per capita wealth, inflation and/or unemployment.¹⁵ Why should exchange rate policy be salient? Aside from the signaling and distributional considerations discussed above there is a growing recognition that voters care about international economic factors when casting their ballots.

The distributional consequences of exchange rate policy mean that increasing economic ties among countries—increased globalization—should be politically salient.¹⁶ Lewis-Beck and Stegmaier (2000) recognize this when they write in their review of the literature on economic voting that globalization “may change the character of economic voting.” The specific impact of exchange rate changes on the prospects of policymakers has been highlighted by Cooper (1971), Frankel (2004) and Bernhard and Leblang (2005). Sachs and his colleagues summed up this hypothesized relationship between exchange rate policy and politicians’ political futures: “governments that commit to a peg and then renege on the promise typically face costs – loss of pride, voter disapproval, maybe even removal from office – that need not be proportional to the size of the devaluation” (Sachs, et al 1996).

H₂: Abandoning a public commitment to an exchange rate peg is costly to governments.

What, then, is a policymaker to do? Faced with the desire to maintain a peg as a vehicle towards increased trade and investment while at the same time wary of the consequences of breaking a public promise regarding exchange rate policy, policymakers have found a middle ground. As identified by Calvo and Reinhart (2002) many countries exhibit a “fear of floating;” a condition where policymakers declare that they are allowing the exchange rate to float yet behave as if they keeping the exchange rate fixed. Studies of the “fear of floating” phenomena argue that while a country’s stated—or *de jure*--

¹⁵ In a review of the literature Lewis-Beck and Stegmaier (2000) conclude that voters respond to national economic conditions and not to their own personal economic situation.

¹⁶ This is the conclusion reached by scholars studying various manifestations of globalization: Scheve and Slaughter (2001), Tomz (2004), and Hellwig and Samuels (2005).

exchange rate policy may be an important public signal, it does not accurately describe the country's actual—or *de facto*—exchange rate practice. And, because policymakers can maintain exchange rate stability without a public commitment, changing that policy may be less costly come election time.

H₃: Policymakers in democracies are more likely than those in autocracies to publicly state that the exchange rate is floating while behaving as if it is fixed.

The next section discussed the sample, data and empirical methodology used to test these hypotheses.

3. Sample, Data, Methods and Results

A. Political Costs in Democracies and Autocracies

The first hypothesis states that the consequences of renegeing on a *de jure* exchange rate commitment will be larger in democracies as compared with autocracies. To test this hypothesis we employ event history techniques and examine how an exchange rate abandonment impacts the length of time that a leader remains in office.¹⁷ The use of event history analysis allows us to focus on the length of time that a particular leader remains in office and permit us to see whether that duration differs as a consequence of the decision to abandon an exchange rate peg.

We use a parametric Weibull model to estimate the relationship between the abandonment of an *de jure* exchange rate regime and the likelihood that a leader will be removed from office. The use of a parametric duration model allows us to identify a specific distribution for time dependency, or the relationship between the likelihood that a leader will be removed from office and time. Specifically the Weibull model can be written as:

$$h(t | \mathbf{x}) = h_0 t^{\beta_0} \exp(\beta_1 x_{i1} + \beta_2 x_{i2} + \dots + \beta_j x_{ij})$$

¹⁷ See Leblang and Blimes (2005) for a review of the leader duration literature with specific reference to the implications that a financial crisis has for leaders.

where $h(t|\mathbf{x})$ is the hazard rate (the likelihood that a leader will be removed from office at time t , given that the leader has lasted until time t) at time t based on a set of covariates \mathbf{x} and the baseline hazard (h_0). Estimation of a Weibull model produces a shape parameter, p , that describes the shape of the relationship between the hazard rate and time, or the duration dependence. When $p>1$, the hazard rate is monotonically increasing with time, when $p<1$, the hazard rate is monotonically decreasing with time, and when $p=0$ there is no relationship between time and the hazard rate.

Rather than presenting hazard rates we provide coefficients in our results. These coefficients describe the relationship between the covariates and the hazard rate and can be interpreted as follows: positive parameter estimates mean that there is an increased hazard (risk) that a leader will be removed from office and, therefore, is associated with shorter duration times. The reverse is true for negative coefficients.

We exploit the data and model developed by Chiozza and Goemans (2004) in their study of international conflict and leader duration and we refer the interested reader to that paper for variable definitions and data sources. They argue that leader duration is a function of a number of variables: regime type (democracy v dictatorship), civil war, development (log of per capita gdp), change in development, change in trade openness, size of the population, age of the leader and the number of prior terms served by the leader in question. While their sample runs from 1919 – 1999 we only have exchange rate regime data from 1973-1999. This still leaves us with 3804 observations covering 711 leaders across 124 countries.

To Chiozza and Goemans' model we add a variable capturing whether a country has abandoned a *de jure* exchange rate peg. The International Monetary Fund's Annual Report on Exchange Arrangements and Exchange Restrictions provides data every year on a country's declared exchange rate arrangement. We code an abandonment of a *de jure* exchange rate peg equal to one if the country in question informed the IMF that it no longer following a *de jure* peg.

The results from estimating our Weibull model are contained in Table one. We note initially that the results are consistent with those of Chiozza and Goemans although we are using a shorter period of time. Our primary interest is in the variables Dictatorship, Abandon *de jure* peg and the interaction between these two variables (Dictatorship * Abandon). The variables for dictatorship and abandonment are individually significant and the combination of the three aforementioned variables are jointly significant ($p=0.0000$). Due to the inherent difficulty in interpreting coefficients from event history models, the bottom panel of table one contains predicted median survival times across our variables of interest.

Consider first the situation where a democratically elected politician is in office. All other things being equal, a democratic leader has a median time in office of a little over 1,000 days. If that same leader abandons a *de jure* exchange rate commitment their median time in office decreases by approximately 15% (845 days). This is consistent with a hypothesis derived from the audience cost literature: failure to uphold an international agreement – in this case a pledge to keep the exchange rate pegged – leads to a higher probability of removal from office.

We do not find a similar result when examine the impact of renegeing on a *de jure* exchange rate by a dictator. Abandoning a *de jure* fix, in fact, leads dictators to remain in office approximately 25% longer (2564 days v 2008 days), all things being equal. It may be the case that dictators – especially those that depend on a small segment of the population to remain in power – are able to consolidate their hold on political power by utilizing the monetary independence associated with a floating exchange rate regime. Monetary independence or autonomy allows leaders the ability to promise and deliver private economic goods to key constituencies.

This is consistent with an argument forwarded by Bueno de Mesquita, Morrow, Siverson and Smith (2003) suggesting economic crises (hyper inflation in their case) may not sway members of the dictator's power base because a potential challenger will likely not be able to credibly promise the

delivery of more private goods than the incumbent. It may also be the case that citizens in a dictatorship may not have sufficient information concerning the country's external economic situation to judge whether the leader has in fact reneged on an international commitment. The link from an abandonment to the removal of a leader depends on the availability of public information; something that is far from the hallmark of a dictatorial regime.

B. Political Costs in Democracies and Autocracies

The second hypothesis states that within democracies leaders will be punished if they abandon a *de jure* exchange rate peg. To test this hypothesis we exploit data on 378 democratic elections across 83 countries. The dependent variable dichotomous and measures whether the incumbent party – the party that holds either the presidency or the prime ministership in presidential and parliamentary systems respectively—is retains that office in the election is the change the share of the vote going to the incumbent party in any given election from 1972 through 2002.¹⁸ Golder (2005) has compiled a comprehensive set of elections for 174 countries from 1945 through 2002 and we rely on this coding to identify our universe of cases. Of these elections we drop those that occurred prior to 1972 and those that occurred under dictatorship.¹⁹ We drop the first election for each country (because we are working with differences) and could not identify the party of the incumbent for another 24 elections. Data limitations for our exogenous variables further limited our sample.

Independent Variables: For each presidential and legislative election we constructed a variable identifying the electoral term; a variable that uniquely identifies the period of time between the time t and time $t-1$ elections. This electoral term variable allowed us to generate our independent variables of interest.

¹⁸ We relied on numerous sources for this information. Details are contained in the appendix (to be completed) to this paper.

¹⁹ We use the classification devised by Przeworski et al and updated by Cheibub and Ghandi (2004).

De jure Exchange Rate Regime: This variable is as coded above.

De facto Exchange Rate Regime: We use the *de facto* indicator of a pegged exchange rate regime developed in Shambaugh (2003). Unlike other measures which focus on short term movements (Levy-Yeyati and Sturzenegger 2003) or longer moving window changes in (official and/or parallel) exchange rate and reserves (Reinhart and Rogoff 2003), Shambaugh focuses on the extent to which domestic interest rates follow that of the anchor country. This allows him to identify whether monetary authorities are able to follow a monetary policy that is independent from that of the anchor country. Using his annual data we construct measures of *de facto* abandonment that parallels that constructed for the *de jure* measure.

Control Variables

Because the dependent variable measures whether the incumbent party is re-elected at time t , we include the (log) of the incumbent's vote share at time $t-1$. This helps control for temporal dependence as well as specifying that the probability of a party being re-elected is a function of that party's political popularity.

As in Hellwig and Samuels we include two measures designed to control for the different dynamics associated with presidential and legislative elections: (1) presidential election is coded 1 for presidential and 0 for legislative elections and (2) incumbent running for re-election is coded 1 if a presidential incumbent is standing for re-election and 0 otherwise. To measure the strength of the economy we include two variables: the log of real per capital gross domestic product (gdp) and the log of trade openness which is measured as imports plus exports as a share of gdp. Both variables are averages over the electoral term.²⁰ Both variables were obtained from the World Bank's World Development Indicators.

²⁰ We tried a number of different specifications for these economic controls: converting them into growth rates for the electoral period; using levels or growth rates for the year prior to the election, and using changes from

Finally we include a dummy variable indicating whether this was the first electoral cycle for a democracy. This serves as a control for temporal heterogeneity and is based on the coding in Cheibub and Gandhi (1994).

Empirical Methodology

Estimation of a probit model asking whether the abandonment of an exchange rate peg impacts a party's chances at re-election is more complicated than it appears. A significant literature empirically demonstrates that exchange rate behavior – be it a devaluation, abandonment, crisis – is different around election time.²¹ This means that inclusion of a variable measuring an exchange rate abandonment is plausibly endogenous and standard probit results will be misleading. We deal with this problem through the use of instrumental variables and identify variables that are plausibly correlated with the probability of an exchange rate abandonment but not with the probability that the incumbent party will be re-elected and use these instruments in a first stage model.

We use three instruments in our first stage model: (1) Electoral cycle: the literature on devaluations and currency crises suggests that both of these phenomena will occur more frequently around an election (e.g., Frieden, Ghezzi and Stein 2001; Leblang 2002). We measure the electoral cycle as the number of years since the prior election. (2) Capital controls: the literature on currency crises and capital controls shows that there is an empirical relationship between these two variables (e.g., Leblang 1997, 2002) though there is no data at this point correlating controls with an exchange rate abandonment. (3) Central bank turnover: turnover of the central banker is an indicator of a lack of monetary instability and is likely associated with a government's decision to change exchange rate regimes. Data for these three variables are measured as electoral period averages. The raw data was

the prior electoral period. None of these changes resulted in substantive conclusions that are different from those reported below.

²¹ See the references in footnote 8.

obtained from Ghosh, Gulde and Wolf (2002). Following standard procedures for the estimation of instrumental variable models we also include all the control variables described above in our first stage model.

Results

The results from our instrumental-variable probit model are contained in table two. Cell entries in table two are maximum likelihood estimates with robust standard errors in parentheses. The columns differ in terms of the construction of the endogenous exchange rate regime variable.

Consider first the model in column 1. In this specification we examine the electoral consequences of abandoning a *de jure* exchange rate peg. Taking into account potential endogeneity we find that abandoning a *de jure* exchange rate peg decreases the probability that an incumbent government will be re-elected. This impact is statistically significant and its substantive impact is large. In the square brackets we report the marginal effect – or change in probability of re-election – as the endogenous variables changes from zero to one.

The baseline probability that an incumbent party will be re-elected –holding all variables at their means – is 57%. If there is no abandonment that probability increases to 66%. However, if the incumbent party abandons a *de jure* exchange rate peg the probability of re-election drops by 60%. While recognizing that this estimate is based on the estimates from a first stage model and that there are very few predictions from the first stage that are either zero or one, we also note that any adjustments do not substantively change the magnitude of this impact. The results show that incumbent parties that renege on an exchange rate commitment pay for it at the polls come re-election time.

But what about the potential benefits associated with monetary independence that accrues from abandoning an exchange rate peg? Certainly politicians are in a position to prime the pump prior to an election if they have the monetary autonomy associated with a floating exchange rate regime. To get at

this question we examine four additional specifications of the model in column one of table two. In column two we substitute the abandonment of a *de facto* peg for the abandonment of a *de jure* peg. Interestingly we find that abandoning a *de facto* peg is as harmful for an incumbent party's re-election fortunes as is the abandonment of a *de jure* peg – the estimated marginal effect for this parameter is -60%.

This finding for *de facto* pegs does not square with either the audience cost or economic voting arguments; those hypotheses suggest that politicians are punished because they have reneged on a public commitment. This evidence alone does not, however, constitute evidence against either hypothesis because more often than not *de facto* and *de jure* abandonments occur simultaneously. In column three of table two we include a dummy variable capturing just such a situation and find, unsurprisingly, that abandoning both types of pegged regimes simultaneously also negatively impacts the probability that an incumbent government will be re-elected.

The key test, however, is contained in columns four and five where we separate out the types of abandonments. In column four the endogenous variable is a situation where a policymaker reneges on a *de jure* exchange rate peg **but not** on a *de facto* peg. The estimated coefficient on this endogenous variable is statistically significant, negative, and substantively large with a marginal effect of -64%. This suggests that reneging on an exchange rate commitment sends a negative signal to voters; a signal that puts the prospects of re-election in jeopardy. What about abandoning a *de facto* **but not** a *de jure* peg? That situation is implemented in column five where this endogenous variable now has a positive and statistically significant coefficient.²² The increase in the probability of re-election for the incumbent party may be, as discussed above, a consequence of the incumbent party being able to use monetary policy in a way that privileges key constituents or that provides general increases economic fortunes at

²² It is important to note that this difference in sign is not a consequence of a different set of instruments; all models include an identical set of instrumental variables.

least in the short term. Given that our measure of a *de facto* exchange rate peg focuses on interest rate behavior, this interpretation is certainly more than a small possibility.

4. Public Exchange Rate Announcements

The previous results demonstrate (1) that leaders in democracies pay a higher political price for abandoning an exchange rate peg than leaders in autocracies and (2) that the price is higher when politicians renege on a *de jure* peg. This, as argued in hypothesis three, should lead policymakers in democracies to be less likely than their autocratic counterparts to adopt a *de jure* exchange rate peg. This should not, however, be taken to mean that democratic countries are more likely to allow their exchange rate to float; rather it means that they will be less likely to publicly announce a peg.

Why would policymakers in democracies claim to have a floating exchange rate regime and behave like they were managing a peg? As capital is increasingly mobile and information can flow instantly from one market to another a devaluation can have ramifications with both domestic constituents and international investors. For both audiences, devaluing a pegged or intermediate exchange rate may signal a lack of commitment on the part of the government. The consequences of which are likely not limited to a decrease in investment and may lead to the loss of political office. As elected officials are held more and more accountable for the management of macroeconomic policy, it is in their political best interests to remove exchange rate policy from the public eye. Publicly proclaiming that the currency is being allowed to float is a step in that direction.

Behaving as if the currency is pegged allows the policymaker to reap some of the benefits exchange rate stability. It allows internationally oriented domestic actors—traders and investors—to engage in longer term transactions in the event that forward markets do not exist. Exchange rate stability may also be seen by international markets as a signal that the government is maintaining a policy of sound macroeconomic management. Of course, the government does not gain the benefit of using the exchange rate as a nominal anchor. It may be the case that that countries with a fear of floating have

other domestic monetary rules (e.g., inflation targeting) that provides a degree of anti-inflationary credibility.

In table three we use a Heckman selection model to empirically test this argument. Since we are interested in whether policymakers in democracies are more likely to publicly announce a peg we estimate a two stage selection where the first stage models the determinants of a *de facto* peg and, for those countries that adopt a *de facto* peg, the second stage models the determinants of publicly announcing a pegged or a floating regime.

The literature on exchange rate determination has identified a large number of variables associated with the choice between fixing and floating and we draw on that research to identify determinants of *de facto* exchange rate regime choice.²³ Following Juhn and Mauro (2002) we use three variables that have been found to be robust across models of exchange rate determination: (1) trade openness: measured as the sum of imports and exports as a share of GDP; (2) trade concentration: measured as the percentage of a country's trade with its three largest trading partners; and (3) economic size: measured as a country's real GDP. These three variables are taken from the International Monetary Fund's Direction of Trade Statistics and International Financial Statistics on CD-Rom.

In addition to these three variables we also include a lagged dependent variable to account for temporal persistence in the choice of a *de facto* exchange rate peg. Given the arguments made above about the political incentives leading to the abandonment of an exchange rate peg we also include a dummy variable identifying whether an election occurred at time t , time $t-1$, and time $t+1$.

Conditional on the choice of a *de facto* peg we argue that a leader's decision to publicly announce this policy commitment is a function (1) the electoral variables described above; (2) whether they are held accountable via democratic institutions and (3) the existence of capital controls.

²³ See, for example, the discussion of and motivation for these variables in Eichengreen and Leblang (2003).

These data requirements allow us to utilize a sample 3,110 observations covering 140 countries from 1974-1999. Maximum likelihood estimates based on a Heckman selection model are contained in table three. The bottom panel of table three contains the selection equation where the dependent variable is coded one if the country has a *de facto* peg. In this model none of the election variables are individually or jointly significant at conventional levels. The economic determinants are a mixed bag: the two variables accounting for openness and reliance on international trade are both positive and statistically significant providing support for the argument that more open economies are more likely to fix the exchange rate as a mechanism to facilitate cross-national trade. The measure of economic size, a proxy for the economy's vulnerability to exogenous shocks, is not statistically significant.

The top panel of table three is the outcome equation: the choice between a *de jure* peg and *de jure* float given that the country has already selected a *de facto* peg; that is, the factors leading a politician to announce that the exchange rate is pegged. The parameter estimates in this model also square with the political story outlined above: policymakers in democracies are 10% less likely than those in dictatorships to announce a peg given that one is actually in place. It is also the case that public statements about exchange rate rigidity are lower both before and after an election – though it is surprising that the variable for an election at time t is not statistically significant. The results also suggest support for the argument that capital controls provide a mechanism whereby policymakers can drive a wedge between international and domestic prices; given a *de facto* peg the existence of capital controls make the announcement of a *de jure* peg more likely.²⁴

5. Conclusion

Exchange rate policy has domestic as well as international implications. Policymakers have to weigh traditional arguments in favor of a fixed exchange rate regime – that it increases cross border

²⁴ We thought that there may be an interaction between dictatorship and capital controls: that democratic policymakers shielded by capital controls would be more likely, given a *de facto* peg, to announce a *de jure* peg. There was no empirical support for this conjecture.

trade and investment and that it sends a signal an anti-inflationary signal to investors – against the consequences of having to renege on such a commitment. While an economy can recover from an exchange rate crisis the evidence in this paper suggests that it may be difficult for a politician’s political party to do likewise.

One solution to this political problem, of course, is for policymakers to abandon any responsibility for monetary policy joining a common currency area or by adopting the currency of another country (see Frieden 2003). This strategy allows policymakers to remove exchange rate policy from the political agenda and provides a degree of insulation from foreign economic shocks. Dollarization, of course, prevents policymakers from using domestic monetary policy to smooth economic fluctuations but it does make fiscal policy more effective.²⁵

Giving up all monetary autonomy, however, is not likely to be viable for all politicians. The balancing act performed by policymakers—especially those in emerging democracies—is to declare that the exchange rate is floating while at the same time engaging in active exchange rate management. Behaving as if the currency is pegged allows the policymaker to reap some of the benefits exchange rate stability. It allows internationally oriented domestic actors—traders and investors—to engage in longer term transactions in the event that forward markets do not exist. Exchange rate stability may also be seen by international markets as a signal that the government is maintaining a policy of sound macroeconomic management. Of course, the government does not gain the benefit of using the exchange rate as a nominal anchor.

The association between democratic practices and *de jure* floating exchange arrangements is also interesting in that there is a disconnect between what policymakers say they do and how they actually behave. It is likely that policymakers in democracies say that they are floating in an effort to

²⁵ Bernhard and Leblang (2002) argue that the loss of domestic monetary policy associated with a fixed exchange rate regime or an independent central bank in advanced industrial democracies may lead policymaker to restructure the electoral system.

depoliticize exchange rate policy; to decrease the likelihood that they will be blamed for appearing weak in the event the exchange rate loses a significant percentage of its value. What is interesting about this is that it appears that the exchange rate peg has lost some of its attraction as a nominal anchor. This may be because alternative monetary policy tools—inflation targeting rules, currency boards, or independent central banks—are becoming increasingly available and attractive. These considerations will play a central role as the international monetary system continues to evolve.

The questions and findings of this paper lay out a fruitful path for future research. The notion that policymakers often deviate in practice from their public announcements can help us develop better theoretical models of the causes of speculative attacks and exchange rate defenses. It also helps put into perspective that when modeling a policymakers choice of international economic policies – capital mobility, trade openness and exchange rate policy – it is important to be more explicit about the distinction between statement and practice.

Political scientists can also do a better job of mapping the political consequences of exchange rate behavior. Studies based on class or sectoral interests (e.g., Frieden 1999; Tomz 2004) can be carried out in environments where specific polling data exists on questions related to monetary policy (e.g., Sweden). More general models of leadership duration or party control can be enriched by taking into account the influence of international economic policies (e.g., Leblang and Blimes 2005). And there is much to learn if we consider banking and debt crises in addition to exchange rate crises. These are exciting avenues in need of further exploration.

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Table One
Exchange Rate Behavior and Leader Duration

	Abandonment
Dictatorship	-0.553** (0.155)
Civil War	0.463** (0.141)
Log(GDPPC)	0.020 (0.041)
Change in GDPPC	-0.003 (0.003)
Change in Trade Openness	0.013 (0.094)
Log(Population)	0.065 (0.041)
Log(Leader Age)	1.000** (0.258)
External War Involvement	0.103 (0.065)
Abandon <i>De jure</i> Peg	0.149* (0.079)
Dictatorship * Abandon	-0.348 (0.518)
Constant	-10.637** (1.133)
Ln(p)	-0.208** (0.041)
N	3804

Cell entries are maximum likelihood estimates from a Weibull survival model with robust standard errors in parentheses.

Expected Median Survival Time (Days)

	Abandon	Not Abandon
Dictatorship	2564.61	2008.60
Democracy	845.43	1016.17

**Table Two:
Exchange Rate Behavior and Incumbents**

	Abandon DJ Peg	Abandon DF Peg	Abandon Both	DJA but not DFA	DFA but not DJA
Endogenous Variable	[-60%] -2.100** (0.654)	[-65%] -2.405** (0.604)	[-63%] -4.238** (1.250)	[-64%] -3.152** (1.146)	[60%] 3.403** (0.538)
Log(Party Vote(t-1))	0.823** (0.322)	0.500 (0.430)	1.003** (0.273)	0.540 (0.558)	0.699 (0.618)
Presidential Election	-0.629** (0.310)	-0.502 (0.375)	-0.713** (0.294)	-0.571 (0.470)	-0.413 (0.560)
Incumbent Running	0.040 (0.446)	0.112 (0.447)	-0.038 (0.508)	-0.169 (0.435)	0.344 (0.409)
Log(Real GDPPC)	0.057* (0.029)	-0.001 (0.037)	0.031 (0.033)	0.067** (0.030)	0.048 (0.037)
Trade Openness	-0.000 (0.002)	-0.000 (0.002)	0.000 (0.002)	-0.001 (0.002)	0.001 (0.002)
New Democracy	-0.704* (0.399)	0.132 (0.463)	-0.658 (0.410)	-0.549 (0.413)	-1.095** (0.413)
Constant	-2.577** (1.193)	-1.229 (1.588)	-3.223** (1.030)	-1.612 (1.966)	-2.768 (2.034)

Endogenous refers to the endogenous covariate estimated in the first stage. The particular endogenous covariate is identified at the top of each column. Instrumental variables probit models. Instruments for the first stage include Log(Party Vote(t-1)), Presidential Election, Incumbent Running for Re-election Log(Real GDPPC), Trade Openness, New Democracy, Capital Controls, Electoral Cycle, and Central Bank Turnover.

Entries in square brackets are marginal effects based on changing endogenous variable from zero to one holding all other variables at their means.

**p<0.05

*p<0.10

Table Three:
Determinants of a *De jure* Peg

	Parameter Estimates	Marginal Effects
Outcome Equation : <i>De jure</i> Peg		
Dictatorship (t-1)	0.593** (0.205)	10%
Capital Controls (t-1)	0.559** (0.226)	10%
Election (t-1)	-0.176* (0.106)	-3.2%
Election	-0.035 (0.109)	-0.6%
Election (t+1)	-0.254** (0.101)	-4.7%
Constant	0.651** (0.279)	
Selection Equation <i>De facto</i> Peg		
<i>De facto</i> Peg (t-1)	2.841** (0.099)	
Log(Trade Concentration(t-1))	0.230** (0.093)	
Log(Trade Openness (t-1))	0.288** (0.068)	
Log(Economic Size (t-1))	0.008 (0.013)	
Election (t-1)	0.056 (0.085)	
Election	-0.068 (0.087)	
Election (t+1)	-0.005 (0.088)	
Constant	-2.208** (0.376)	
ρ	-0.867** (0.086)	
N	3212	

Parameter estimates are maximum likelihood estimates from a Heckman selection model with a probit second stage; robust standard errors in parentheses. Marginal effects estimated as the independent variable changes from zero to one holding the other variables at their means.

**p<0.05

*p<0.10

