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The Role of Regime Type in the Political Economy of Foreign Reserve Accumulation

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ABSTRACT

Authoritarian regimes have surpassed democracies in foreign reserve accumulation since the Asian Financial Crisis. Two prominent institutionalist theories could explain this diverging trend in reserves: First, the political business cycle theory, suggesting that reserves are reduced before an election. Second, the veto player theory, implying that a high number of veto players increases the de facto independence of central bankers, who are reluctant to invest in reserves. A time-series cross-sectional analysis for up to 182 countries over the period 1990–2013 shows that democratic governments tend to reduce their reserves before elections. While veto players do not affect reserves directly, a high number of veto players tends to limit a political business cycle before an election. Elections and veto players do not have an influence in authoritarian regimes. Election cycles tend to explain why democracies have relatively fallen behind in a period of massive reserve accumulation.

1. Introduction

The savings glut hypothesis has become a popular explanation for the global financial crisis and for persistent global imbalances. The former chair of the Federal Reserve, Ben Bernanke (2005), initially proposed the savings glut hypothesis in order to claim that the roots of the American current account deficit are external: Massive capital inflows from mostly developing countries fueled American capital markets with cheap credit, leading to declining real interest rates.

The fact that net capital flows from developing to developed countries is a "paradox" (Summers, 2006). Neoclassical theory suggests that capital should move from capital-abundant developed countries to emerging markets, where it is relatively scarce. Yet, the interaction of market demand and supply could not have caused this paradox exclusively. Foreign-exchange interventions by governments were a major driving force behind the savings glut (Wolf, 2008: 55–7). Fig. 1 shows that the world has witnessed a steady increase in foreign reserves held by governments since the mid-1990s, and a further accelerating trend in the first decade of the 21st century.

The literature highlights two explanations for the recent surge in reserves: self-insurance and mercantilist motives (Corden, 2009). First, accumulating a large pile of foreign reserves allows governments to support the financial system in a situation of financial distress. Holding a large war chest of reserves provides a self-insurance mechanism, which reduces the probability of suffering balance-of-payment or financial crises (Feldstein, 1999). Second, countries could acquire reserves to promote an export-led growth strategy. Without full sterilization, the national currency depreciates if governments sell their national currency for foreign

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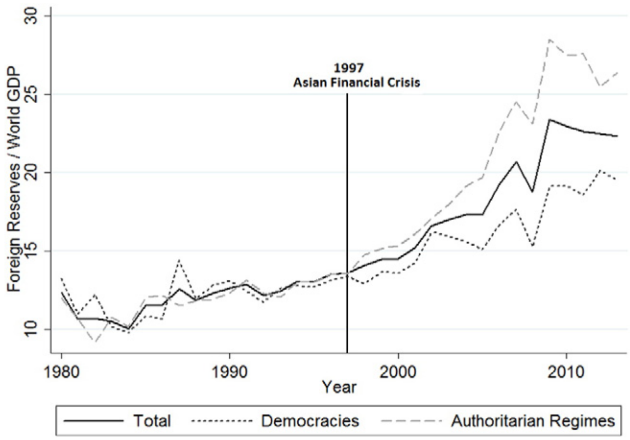

Fig. 1. Development of global foreign reserves, 1980–2013 Note: A country qualifies as democracy if Polity-IV score or the imputed score by Freedom House is 7 or above.

reserves in the foreign exchange market. In turn, the undervalued exchange rate bolsters the competitiveness of the export sector (Dooley et al., 2004).

Most research on the determinants of reserve accumulation focuses on macroeconomic variables to reveal whether the self-insurance or the mercantilist motive prevails (Aizenman et al., 2015; Aizenman and Lee, 2007, 2008; Bastourre et al., 2009; Cheung and Qian, 2009; Delatte and Fouquau, 2012; Jeanne, 2007; Lane and Burke, 2001; Mendoza, 2010; Obstfeld et al., 2010). But including only economic factors implicitly assumes that reserve accumulation is a choice variable regardless of the political environment. Political institutions, however, cannot be ignored because acquiring reserves is costly and has distinctive distributional effects. Hence, reserve accumulation is easier with an institutional framework that insulate policy-makers from bearing the political cost of reserve accumulation.

A fundamental institutional element of any polity is the regime type. Fig. 1 also shows that authoritarian governments have outperformed democracies in reserves accumulation since the 1997 Asian Financial Crisis. This article examines the role of regime type in explaining the surge in reserve accumulation and aims to answer the question:

Why were increases in foreign reserves smaller in democracies relative to authoritarian regimes?

The prominent political business cycle and the veto player theories could provide the causal mechanisms to explain why democracies have relatively fallen behind.

The political business cycle theory contends that incumbents have an incentive to use state resources, such as monetary or fiscal policies, before an election to manipulate short run economic outcomes in order to improve their chances of re-election (Nordhaus, 1975; Tufte, 1978). Reserves qualify for such a political business cycle, because they could be used in the short term for monetary expansion, to avoid a currency depreciation, or to distribute clientelistic goods (Aidt et al., 2015; Dreher and Vaubel, 2009; Walter, 2009; Walter and Willett, 2012). Thus, reserves should be negatively associated with an upcoming election.

Institutional constraints, however, could thwart the manipulation attempts by incumbents. Central banks are in charge of managing reserves, and they have increasingly become de jure independent to pursue low inflation rates (Arnone et al., 2007; Crowe and Meade, 2008). As an increase in reserves tends to induce inflationary pressures, independent central bankers should be reluctant to strongly invest in reserves (Shih and Steinberg, 2012).

But independent central banks do not operate in a political vacuum. Central bankers cannot completely ignore the demands of the government, because incumbents can influence the central bank through candidate selection and irregular dismissals. Keefer and Stasavage (2003) argue that the influence of elected politicians on central bankers is conditional on effective institutional checks and balances. The presence of multiple veto players makes it more difficult for incumbents to replace central bankers, which, in turn, enhances the capacity of central bankers to conduct an independent monetary policy. The number of veto players should constrain incumbents from initiating a political business cycle in reserves before an election, but veto players should also be associated with lower levels of reserves in non-election times because they ensure the de facto independence of inflation-averse central bankers.

Both political business cycle and veto player theories suggest that democracies will be associated with relatively lower foreign reserves. Yet, the recent literature on authoritarian institutions highlights that elections and parliaments are not distinctive characteristics of democracies anymore: A growing number of authoritarian regimes adopts quasi-democratic institutions that empirically foster regime survival (Boix and Svolik, 2013; Gandhi and Lust-Okar, 2009; Gandhi and Przeworski, 2007; Geddes, 1999; Gehlbach and Keefer, 2011; Jensen et al., 2014; Wright, 2008).