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Central banks' priorities and the left/right partisanship of exchange rates☆

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Abstract

This study argues that when central banks subordinate all policy goals to achieving price stability greater central bank independence encourages left-wing governments to seek greater exchange rate stability. Such central bank policy priorities make the Left's preferred distributive policies more dependent on the effectiveness of fiscal policy, which under high capital mobility increases with exchange rate stability. In contrast, right-wing governments put greater emphasis on market adjustments and price stability. Hypotheses are tested by estimating the sensitivity of exchange rate variation to partisanship, central bank independence, and the salience of price stability, using a Prais–Winsten estimator and Instrumented Variables, run on pooled cross-section time-series data from 22 OECD countries during 1990–2004.

JEL classification: E42; E58; E61; F31; F33; F41

Keywords: Exchange rates; Partisanship; Prais–Winsten estimator; Central bank independence; Price stability

1. Introduction

Ever since Hibbs's (1977) seminal contribution it has been argued that political agendas determine macroeconomic and, other scholars added, exchange rate policies. Right-wing parties are conventionally viewed as more inflation-averse than left-wing parties, and likelier to fix exchange

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rates and refrain from fiscal or monetary policies that attempt to redistribute market-allocated resources. Left-wing governments in contrast tend to focus their macroeconomic policies on job creation rather than on disinflation and thus suffer from low policy credibility and low investor confidence (Alesina & Sachs, 1988). Indeed, some empirical studies find that in industrial democracies left-wing governments are associated with more debt in attempt to cushion the effects of international trade, higher inflation (Alesina & Roubini, 1997), depreciation of the currency, and greater probability of speculative attacks on the exchange rate (Leblang, 2002).

However, left-wing governments may have a greater need for an exchange rate peg as a disciplining mechanism (policy anchor) precisely because they suffer from lower credibility in their macroeconomic polices. Thus, other empirical studies find that left-wing governments are actually associated with a lower rate of depreciation in the short term (Frieden, 2002), and greater efforts to defend a peg against speculative attacks (Leblang, 2003). In short, policy-makers, especially of the left wing, face a dilemma: to be effective a policy needs credibility, but efforts to earn this credibility restrict their ability to achieve other policy goals.

This dilemma is complicated by the interactions among various relevant institutions, such as central bank independence and official controls on capital mobility (capital controls). The choices with regard to central-bank independence and an exchange rate peg are interdependent (Bernhard, Broz, & Clark, 2002): choosing the former may obviate the government's need for the discipline of the latter. In contrast, according to the Mundell–Fleming model, under high capital mobility fiscal policy is more effective when exchange rates are fixed. Thus, as central bank independence increases, left-wing governments are likelier to fix exchange rate for the sake of distributive policies (O'Mahony, 2007).

This study argues that the level of the central bank's independence and its policy priorities affect the relationship between the government's partisan bias and the level of actual exchange rate stability in democratic market economies. All else equal, as central banks become more independent left-wing governments are associated with more volatile exchange rates than right-wing governments, because these are mostly alternative mechanisms for credibility. In addition, foreign exchange markets are more suspicious of left-wing governments and tend to be more volatile without a firm commitment by the government.

However, this study further argues that when central banks subordinate all policy goals to achieving price stability greater central bank independence encourages left-wing governments to seek greater exchange rate stability. Such policy priorities on the part of the central bank make distributive policies and macroeconomic activism more dependent on fiscal policy, the effectiveness of which under high capital mobility increases with exchange rate stability. This approach to exchange rates is less common among right-wing governments, which put greater emphasis on market mechanisms of adjustment in response to economic shocks.

To support its argument this study estimates the sensitivity of market-determined exchange rate variation to partisanship and central bank independence, while controlling for other political and economic determinants of exchange rate variation. The rest of the paper proceeds as follows. Section 2 develops the paper's theoretical argument and its hypotheses. Section 3 describes the sample used for testing the hypotheses, the estimation method, and the choice of dependent, independent and control variables. Section 4 tests the hypotheses with Instrumented Variables (IV) using a Prais–Winsten estimator based on pooled cross-section time-series data from 22 OECD countries during 1990–2004. Section 5 presents conclusions.