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.

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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...
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 policies. 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.
2. The argument

2.1. The partisan divide and the credibility of left-wing governments

The starting point for this discussion is that societal preferences over macroeconomic policy reflect a class cleavage: owners of capital, represented by right-wing parties, prefer low inflation and a non-accommodating policy, even if unemployment rises. Labor, represented by left-wing parties, is more concerned with full employment than with price stability, and prefers an accommodating policy, which attempts to prevent rising unemployment (O’Mahony, 2007). These preferences reflect both material and ideological bias.

Assuming that governments can surprise the public, unanticipated inflation has different material effects on the real incomes of labor and capital (Alesina & Roubini, 1997; Cukierman, 1992; Hibbs, 1977): although unexpected inflation erodes the real income of both, for labor it also increases the short-term probability of employment. If inflation is not too high, labor’s employment gain can outweigh the erosion of its real income. However, for capital an accommodating monetary policy mainly lowers the real return (O’Mahony, 2007). Of course, if employment rises some employers must be expecting to profit from it, at least in the short term. However, the benefits of an accommodating policy to capital are lower than those for labor because wealthy owners of capital may be more concerned than poorer workers with the policy’s expected negative consequences in the long-term, not least its consequence for their financial assets. In addition, greater employment may not always reflect greater business because many workers are employed in the public sector. Finally, changes in labor productivity and variation in the degree of structural rigidities in goods and labor markets may cause employment gains to exceed corporate profit gains and shift the income distribution in labor’s favor.

Ideologically, left-wing governments typically seek to avoid wage adjustments and do not favor flexibility in the labor market. In contrast, right-wing economic agenda tends to emphasize greater reliance on market mechanisms in effecting adjustment to shocks, and to emphasize the importance of price stability. Liberal economics prescribe price and wage flexibility as an alternative to fiscal or monetary activism. For example, economic liberals typically argue that lower wages or at least the freedom of employers to hire and fire workers at will, can end a recession without much need for higher public deficits or lower interest rates. An underlying suspicion of market mechanisms as well as the view that jobs are more important than low inflation (and that there exists a fundamental tradeoff between the two), are still defining features that distinguish the left from the right, at least in OECD countries.

Hence the relative reluctance of left-wing governments compared with right-wing ones to declare price stability as the main policy goal. Indeed, studies show that announcements of the death of partisanship have been premature (Keech, 1995) and that capital-market openness does not undermine key programs advocated by left-leaning governments, such as the welfare state and redistribution (Kite, 2002; Mosley, 2003).

Since left-leaning governments are expected to pursue accommodating policies more than right-leaning governments, they suffer from lower credibility among investors, which diminishes the effectiveness of macroeconomic policy because it makes it harder for left-wing governments to surprise the public. Thus, their policy preferences notwithstanding, left-wing governments are interested in acquiring credibility.

As Bernhard et al. (2002) argue the independence of central banks and the stability of exchange rates are alternative policy anchors, mechanisms through which a government can earn credibility. And since left-wing governments suffer from lower credibility than right-wing governments they...
are expected to be more prone to fix exchange rates on the one hand, but on the other hand to face
greater foreign-exchange market volatility if they opt for an independent central bank instead.
The following hypothesis summarizes the argument above:

**Hypothesis 1.** Under high capital mobility, as the central bank becomes more independent, left-
wing governments are associated with higher exchange rate variation compared with right-wing
governments.

### 2.2. Central bank independence and price stability

The level of central bank independence is not the only intervening variable between partisan preferences and partisan exchange rate policies. Other important factors are the extent to which the central bank’s statutes prioritize price stability and the level of capital mobility. It is worthwhile at this point to recall what central bank independence entails. Central bank independence most obviously means that representatives of the elected government do not direct the monetary policy, and do not set policy targets. Furthermore, a truly independent central bank elects its own governor, or at least the government cannot impose one on it. An independent central bank also retains the right to refuse to extend credit to the public sector on special terms that it would not receive from market agents such as private banks (Cukierman, 1992).

An independent central bank can manage monetary policy without political prejudice and especially without the short-sightedness and dependency on narrow interests that often characterize elected politicians. It can better avoid the time-inconsistency problem, from which many elected governments suffer.

However, the independence of central bank decision making from governmental oversight does not automatically imply any particular policy preference on the part of the bank. In past decades central bankers have followed a variety of economic paradigms to guide their policy decisions, without any relationship to their degree of decision-making autonomy. This is evident, among other central bank features, in the priority that central banks’ statutes accord to price stability compared with other policy goals. In some countries central bank’s statutes define a number of policy objectives, with equal weight being given to potentially conflicting goals such as supporting government policies on the one hand and preserving price stability on the other hand. Sometimes price stability is not mentioned at all and in yet other cases price stability is the only goal mentioned or is defined as the central bank’s top priority.

For example, during much of the 1980s and 1990s the job of the governor of Finland’s central bank depended on a few members of the executive, and there was no measure to prevent conflict of interest arising from other positions held by the governor. Therefore, the Finnish governor cannot be said to have been independent. Nevertheless, price stability was stipulated as the only policy objective of the Finnish central bank. A similar situation prevailed in the Netherlands, where in addition to the above there were no legal limits on securitized lending by the central bank to the government, the terms and the maturity of the credit extended were decided by the government, and the government was not obliged to pay any interest on the central bank’s loans.

In contrast, in Switzerland the central bank is prohibited from extending any credit to the government, the governor is appointed for a comparatively lengthy office term and is prohibited from holding any other office, and the bank has the final word whenever a conflict arises with the government over policy. And yet, in spite of this independence from the government price stability was never mentioned in the Swiss central bank’s statutes. Similarly, the Danish central bank has always had complete autonomy in deciding monetary policy, but again price stability
is not mentioned in its statutes. Canada’s central bank is also relatively independent, at least as far as its governor’s terms of office and limits on lending to the government are concerned, again without reference to price stability (Cukierman, 1992).

By choosing to allow a central bank to manage an independent monetary policy and to refrain from monetizing its debt a left-wing government can earn greater credibility, even if price stability is not defined as the bank’s ultimate goal. Under this institutional setup the government may still rely on the central bank to independently carry out a policy designed to cushion employment and wages from negative shocks that are exogenous to government policy, such as energy shocks or natural disasters.

However, the more focused the central bank is on price stability, the less can a left-wing government trust it to cushion labor. This does not mean that central banks that are committed above all to price stability do not ever consider unemployment in their decisions. However, by having to subordinate their policies to the greater cause of price stability their room for maneuver is obviously limited. In that case fighting unemployment from a left-wing point of view depends mostly on fiscal policy.

Under full capital mobility the effectiveness of fiscal policy in turn depends on exchange rate stability against a more accommodating external anchor (Kant, 2005). According to the standard Mundell–Fleming model fiscal policy becomes less effective when exchange rates are not fixed, and monetary policy becomes more effective (Moons, Garretsen, van Aarle, & Fornero, 2007). Thus, under full capital mobility, the more focused the central bank is on price stability, the greater the interest that a left-wing government has in stable exchange rates compared with a right-wing government. The following hypothesis summarizes the discussion above:

**Hypothesis 2.** Under high capital mobility, as the central bank becomes more independent and price stability becomes more prominent among its policy priorities, left-wing governments are associated with lower exchange rate variation compared with right-wing governments.

Building on O’Mahony’s (2007) framework, and assuming a high degree of capital mobility, domestic unanticipated inflation \( \pi_D \) can be modeled as an average of the government’s preferred level of inflation \( \pi_G \) and the central banks’ preferred level of inflation \( \pi_B \), weighted by the degree of central bank independence \( \eta \):

\[
\pi_D = (1 - \eta)\pi_G + \eta\pi_B \tag{1}
\]

Since:

\[
\pi_G = \gamma P \tag{2}
\]

where \( \gamma \) is the short-term employment gain from unexpected inflation and \( P \) is the left-wing bias of the government, and since actual unanticipated inflation \( \pi \) is an average of local and foreign levels of inflation \( \pi_D \) and \( \pi_W \), respectively, weighted by the degree exchange rate flexibility \( \alpha \), O’Mahony’s Equation (5) can be rewritten as:

\[
\pi = \alpha[(1 - \eta)\gamma P + \eta\pi_B] + (1 - \alpha)\pi_W \tag{3}
\]

The government’s loss function is:

\[
L_G = -(\pi - \pi_G)^2 \tag{4}
\]
and the degree of exchange rate flexibility that minimizes it is:

$$\alpha^* = \frac{\gamma P - \pi_W}{(1 - \eta)\gamma P - \pi_W + \eta \pi_B}$$  \hspace{1cm} (5)

The derivative of $\alpha^*$ by $\eta$ is therefore:

$$\frac{\Delta \alpha^*}{\Delta \eta} = -\frac{(\pi_B - \gamma P)(\gamma P - \pi_W)}{[(1 - \eta)\gamma P - \pi_W + \eta \pi_B]^2}$$  \hspace{1cm} (6)

This derivative is negative only when $\pi_B > \gamma P > \pi_W$, or when $\pi_W > \gamma P > \pi_B$, in other words, when the government’s preferences are located between the two anchors, and it can balance the preferences of both, one against the other. However, this is not likely in the case of left-wing governments, which tend to be less conservative than both potential anchors ($\gamma P > \pi_W$, and $\gamma P > \pi_B$). Hence a rise in central bank independence under a left-wing government is associated with greater exchange rate flexibility as Hypothesis 1 states. The derivative of $\alpha^*$ by $P$ is:

$$\frac{\Delta \alpha^*}{\Delta P} = -\frac{\gamma \eta (\pi_B - \pi_W)}{[(1 - \eta)\gamma P - \pi_W + \eta \pi_B]^2}$$  \hspace{1cm} (7)

This derivative is negative when $\pi_B < \pi_W$. Thus, the more conservative the national central bank is (lower $\pi_B$), the likelier a left-wing government (rising $P$) would be to stabilize exchange rates (reduce $\alpha$), as Hypothesis 2 suggests.

3. Research design

3.1. The sample

This study uses a pooled time-series cross-sectional dyadic data set. Among the 22 sample OECD countries (those that joined the OECD before 1990, excluding Luxembourg and Turkey) there are 126 dyadic observations. These include 15 dyads between each G-7 country (each being regarded as a potential anchor) and the other non-G-7 sample countries, as well as 21 dyads consisting of two G-7 countries. The choice of the sample countries and sample period – 1990–2004 – is constrained by the assumption of full capital mobility. The member states of the euro zone and Luxembourg are excluded from the sample because they have no independent exchange rate.

3.2. The method of estimation

In order to properly correct for two-way causality between political variables and exchange rate variation this study uses Instrumented Variables (IV) estimation using a Prais–Winsten estimator, which corrects for the first-order serially correlated residuals and cross-panel heteroskedasticity. First-order lagged dependant variables are included in all equations. IV estimation is a two-step procedure for estimating an equation (henceforth the structural equation) with endogenous explanatory variables. Endogenous variables are characterized by being correlated with the disturbance in the equation, thus making one-step estimators inefficient and inconsistent.

The IV procedure runs a first-step equation in which the dependent variable is an endogenous variable and the independent variables are the exogenous variables from the structural equation and the set of instruments. There is one first-step equation for each endogenous explanatory
Table 1
Descriptive statistics of dyadic values.

<table>
<thead>
<tr>
<th>Variable/instrument</th>
<th>Mean</th>
<th>Standard deviation</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Unit of measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent variables</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>VARIATION1&lt;sup&gt;a&lt;/sup&gt;</td>
<td>2.1</td>
<td>1.1</td>
<td>0.03</td>
<td>6.0</td>
<td>Percent</td>
</tr>
<tr>
<td>VARIATION2&lt;sup&gt;a&lt;/sup&gt;</td>
<td>3.4</td>
<td>2.1</td>
<td>0.02</td>
<td>12.3</td>
<td>Percent</td>
</tr>
<tr>
<td>Endogenous variables of the structural (second-step) equation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BANK</td>
<td>0.53</td>
<td>0.18</td>
<td>0.19</td>
<td>0.90</td>
<td>Index</td>
</tr>
<tr>
<td>CYCLE&lt;sup&gt;a&lt;/sup&gt;</td>
<td>9.2</td>
<td>4.3</td>
<td>1.0</td>
<td>30.9</td>
<td>Percent</td>
</tr>
<tr>
<td>OPEN&lt;sup&gt;b&lt;/sup&gt;</td>
<td>55.1</td>
<td>16.5</td>
<td>18.3</td>
<td>121.4</td>
<td>Percent</td>
</tr>
<tr>
<td>Exogenous variable of the structural (second-step) equation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PARTY</td>
<td>−0.12</td>
<td>0.60</td>
<td>−1</td>
<td>1</td>
<td>Index</td>
</tr>
<tr>
<td>PS</td>
<td>0.21</td>
<td>0.22</td>
<td>0</td>
<td>1</td>
<td>Index</td>
</tr>
<tr>
<td>ELECTIONS</td>
<td>0.69</td>
<td>0.36</td>
<td>0</td>
<td>1</td>
<td>Index</td>
</tr>
</tbody>
</table>

Notes: descriptive statistics for instruments and interactive variables are excluded for brevity’s sake but are available from the author. Statistics are based on all of the sample’s 1346 observations for all variables except CYCLE, for which there is data for only 1288 observations.

<sup>a</sup> For clarity of presentation values are 100 multiples of the exponential transformations of the variable.

<sup>b</sup> For clarity of presentation values are 100 multiples of the variable.

variable in the structural equation. In the second step the structural equation is run with first-step fitted values replacing the endogenous variables.

3.3. The dependent variable

Many of the studies of the politics of exchange rates analyze the effects of political and economic factors on policy decisions. However, this study adopts as its dependent variable the variation of actual nominal market exchange rates, which is the ultimate test for any commitment, so long as intervening political and economic factors are controlled for, such as market developments, informal government action and other (possibly inconsistent) policies pursued.

Two measures of exchange rate variation are used in this study. The first is VARIATION1. For each pair of countries in each year percent changes are calculated between each two successive monthly averaged nominal exchange rates (based on the IMF’s <i>rf</i> series). VARIATION1 is then calculated as the logarithmic transformation of the standard deviation among these monthly changes during the year. VARIATION2 is another measure of nominal exchange rate variation. In each observation the standard deviation of the monthly nominal exchange rates during the year is divided by its average and logarithmically transformed (see Table 1).

3.4. The independent variables

To test its hypotheses this study uses PARTY as a proxy index for partisanship based on an updated on-line version of Beck, Clarke, Groff, Keefer, and Walsh (2001). It records 1 for a left-wing government, −1 for a right-wing government and 0 for a center government. If there are more than one party in government the index is a simple average of the codes of all coalition partners. PARTY is treated as an exogenous variable in this model.

BANK is a proxy index for legal central bank independence, based on Cukierman’s (1992) method and on analysis of the legal documents in force during the sample period. Crucially, this index excludes the price stability component in Cukierman’s formula. For each dyad in each year
a maximum value of 1 is recorded if in both countries the central bank was fully independent, and a minimum value of 0 is recorded if in both countries the bank was fully dependent on the government. Variable PARTY\_BANK is an interaction of PARTY and BANK. A positive coefficient for this variable would support Hypothesis 1. BANK, PARTY\_BANK and all of the interactive variables that involve BANK (see below) are regarded as endogenous variables too.

PS is an index for the prominence of price stability among the central bank’s policy objectives based on Cukierman (1992) and on analysis of the legal documents in force during the sample period. For each dyad in each year a maximum value of 1 is recorded if in both countries price stability was indeed the top policy priority, and a minimum value of 0 is recorded if in both countries price stability is not mentioned at all in the banks’ statutes. PARTY\_BANK\_PS is an interaction of PS and PARTY\_BANK. A negative coefficient for this interactive variable would support Hypothesis 2. For the sake of methodological consistency the other products of these three variables are also specified as independent variables: PARTY\_PS and BANK\_PS.

3.5. Control variables and instruments

ELECTION is an exogenous variable that controls for the effect of elections on exchange rate variation. For each dyad it is the portion of each year that was either a pre- or a post-elections period (nine months either way from the elections’ month) in at least one of the two countries. Thus, a value of 1 stands for a year in which at any given month at least one of the countries was either ahead of or after elections, and a value of 0 signals a year in which none of the two countries was going through such periods (see Table 1). ELECTION is expected to be positively associated with exchange rate variation.

The less correlated the business cycle is among the partners, the greater the exchange rate variation between them is expected to be. According to the endogenous optimum currency area theory business cycles tend to get more correlated if enough intra-industry trade (i.e. trade motivated by economics of scale) develops between the partners (Frankel & Rose, 1998, 2002). CYCLE is an endogenous measure of business cycle correlation between any two countries. It is the logarithmic transformation of the standard deviation of the difference in their de-trended monthly industrial growth rates (in percent) during the sample period. Since high values of CYCLE represent low business cycle correlation it is expected to be positively associated with exchange rate variation.

The more open is an economy to international trade and investments, the less potent is its exchange rate as a policy tool. In a highly open economy exchange rate manipulation cannot reallocate resources between the tradable and non-tradable goods sectors, and mostly affects the price level. Thus, the government has little to lose from adopting a foreign currency (Grubel, 2005). The greater the openness the lower exchange rate variation is expected to be. OPEN is an endogenous measure of economic openness based on data taken from the IMF’s International Financial Statistics Yearbook. For each country the annual sum of exports and imports of goods and services is divided by GDP. OPEN is the dyadic average of these national ratios (see Table 1). OPEN is expressed in percent points and is expected to be negatively associated with exchange rate variation.

The set of instruments in this study consists of three social fragmentation indices accounting for linguistic, religious and ethnic cleavages, geographical distance, a dummy variable for adjacency,

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1 Data is taken from the IMF’s International Financial Statistics Yearbook. GDP or employment growth rates are used for countries with unavailable industrial production data. Hodrick–Prescott filter is used for de-trending of data.
Table 2
Second-step equations of exchange rate variation.

<table>
<thead>
<tr>
<th>Equation number</th>
<th>(8) VARIATION1</th>
<th>(9) VARIATION1</th>
<th>(10) VARIATION2</th>
<th>(11) VARIATION2</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PARTY</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>PARTY_BANK (+)</td>
<td>2.40** (0.97)</td>
<td>4.06* (2.24)</td>
<td>3.38*** (1.04)</td>
<td>5.21** (2.62)</td>
</tr>
<tr>
<td>PARTY_PS</td>
<td>4.56 (5.82)</td>
<td></td>
<td>4.64 (7.10)</td>
<td></td>
</tr>
<tr>
<td>PARTY_BANK_PS (-)</td>
<td></td>
<td>6.88 (8.21)</td>
<td>7.31 (10.0)</td>
<td></td>
</tr>
<tr>
<td>BANK</td>
<td>0.63 (0.48)</td>
<td>0.43 (0.55)</td>
<td>0.82** (0.41)</td>
<td>0.56 (0.43)</td>
</tr>
<tr>
<td>PS</td>
<td>0.87 (1.26)</td>
<td>0.96 (1.34)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BANK_PS</td>
<td></td>
<td>1.29 (1.45)</td>
<td>1.52 (1.73)</td>
<td></td>
</tr>
<tr>
<td>ELECTIONS (+)</td>
<td>0.15 (0.12)</td>
<td>0.16 (0.12)</td>
<td>0.15 (0.12)</td>
<td>0.16 (0.12)</td>
</tr>
<tr>
<td>CYCLE (+)</td>
<td>0.00 (0.05)</td>
<td>0.01 (0.06)</td>
<td>0.00 (0.07)</td>
<td>0.00 (0.07)</td>
</tr>
<tr>
<td>OPEN (-)</td>
<td>−0.17 (0.14)</td>
<td>−0.10 (0.15)</td>
<td>−0.25 (0.23)</td>
<td>−0.17 (0.18)</td>
</tr>
<tr>
<td>LAG</td>
<td>0.65** (0.11)</td>
<td>0.61*** (0.11)</td>
<td>0.57*** (0.12)</td>
<td>0.55*** (0.12)</td>
</tr>
<tr>
<td>$R^2$-square</td>
<td>0.59</td>
<td>0.59</td>
<td>0.50</td>
<td>0.51</td>
</tr>
<tr>
<td>Wald statistics</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General</td>
<td>138.22***</td>
<td>275.21***</td>
<td>91.73***</td>
<td>113.50***</td>
</tr>
<tr>
<td>Redundant variables (p &gt; .05) (p value)</td>
<td>5.69 (0.224)</td>
<td>23.90*** (0.008)</td>
<td>3.66 (0.301)</td>
<td>25.16*** (0.003)</td>
</tr>
<tr>
<td>Redundant PS variables (p value)</td>
<td>11.56*** (0.021)</td>
<td>10.73*** (0.030)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Durbin $h$ statistic (p value)</td>
<td>−0.360 (0.719)</td>
<td>−0.311 (0.756)</td>
<td>−0.188 (0.851)</td>
<td>−0.185 (0.853)</td>
</tr>
</tbody>
</table>

Notes: all equations in this table are based on 1178 dyadic annual observations and use a Prais–Winsten estimator, which corrects for first-order serially correlated residuals and for cross-panel heteroskedasticity. Column entries are parameter estimates, standard errors in parentheses. Signs by instruments’ names indicate their expected relationship with one of the dependent variables. All dependent variables as well as CYCLE are logarithmic transformations of the 100th fraction of their values that are analyzed in Table 1.

* .05 < $p$ ≤ .10.
** .01 < $p$ ≤ .05.
*** $p$ ≤ .01.

an index for language similarity, country area, population, the share of the agricultural sector in national employment and union density.

The social fragmentation indices are expected to explain central bank independence because fragmented societies tend to produce fragmented political systems with many veto-players, which increase the credibility gains for the government from independent central banks (Bernhard et al., 2002). Distance, adjacency and language similarity are expected to explain trade (Frankel & Rose, 2002), which explains business cycle correlation (Frankel & Rose, 1998). Area, population, the size of the agricultural sector and union density are expected to explain openness, the former two because small countries tend to have open economies, and the latter two because these interest groups are expected to resist globalization and openness. Using proxies for their strength as instruments, this study also controls for the effect of these interest groups on exchange rate variation.

4. Results

Table 2 details four second-step equations, two for each alternative dependent variable representing exchange rate variation.\(^2\) Eqs. (8) and (10) run a simple specification that excludes variable

\(^2\) First-step equations are not reported for brevity’s sake, but are available upon request.
PS and its interactive variables. All four equations feature very low Durbin $h$ statistics, which means autocorrelation is very weak. Three Wald tests are presented at the bottom of the table. The general one tests the null hypothesis that all coefficients are equal to zero, and the second tests for the null hypothesis that any coefficient with a significance level worse than 5 percent is equal to zero. These tests are important because of the low statistical significance of many coefficients in the equations. Strong results are obtained for Eqs. (9) and (11), which means that their estimates can be used for inferring conclusions even if they feature low statistical significance on an individual basis. In contrast, weak results are obtained for Eqs. (8) and (10), but none of the weak coefficients there are important for this study’s hypotheses. The last Wald test is for the null hypothesis that PS and its interactive variables are all equal to zero. This hypothesis is again strongly rejected in Eqs. (9) and (11).

The positive coefficients of PARTY_BANK support Hypothesis 1. They imply that the greater the level of central bank independence the larger is the increase in exchange rate variation due to a left-wing government. In Eqs. (8) and (10), when the effect of the central bank’s policy priorities (PS) is not controlled for, the total effect of partisanship on exchange rate variation is the sum of coefficients of PARTY and PARTY_BANK (1.07 in Eq. (8) and 1.49 in Eq. (10)).

Hypothesis 2 receives support from the coefficients of PARTY_BANK_PS in Eqs. (9) and (11). These coefficients are negative as expected, and as the strong redundancy tests for these equations show they are statistically significant as a group, although their individual levels of significance are weak. These coefficients imply that the greater the level of central bank independence among countries with price stability as a prime policy objective, the larger is the decrease in exchange rate variation due to a left-wing government. The sum of coefficients of all variables involving PARTY is $-0.58$ in Eq. (9) and $-0.39$ in Eq. (11).

ELECTION, the proxy for the political business cycle, returns positive coefficients as expected. This means that exchange rate variation is higher in a year in which every month is either a pre or post-election period. CYCLE’s coefficients indicate a mild rise in exchange rate variation in response to a decline in business cycle correlation. OPEN’s coefficients indicate a decline in exchange rate variation when the openness ratio rises.

5. Conclusions

Partisanship is an important causal source of exchange rate variation. However, its effect is intermediated by institutions such as capital mobility, central bank independence and policy orientation of the central bank. This study distinguishes mere independence in the bank’s decision making from its policy priorities. Experience shows that central banks can be highly independent in formulating their policies and refuse to print money to finance the government’s debt, with or without a commitment to price stability as the prime policy objective.

If the central bank’s policy priorities are not controlled for, the evidence in this study shows that under a fully dependent central bank, left-wing governments are associated with more stable exchange rates than are right-wing governments. In addition it is shown that the more central banks become independent the more volatile exchange rates become under a left-wing government, as some of the recent contributions to partisanship theory predict.

The evidence in this study further shows that when central banks are very independent in their decision-making, the more they emphasize price stability among other policy objectives, the more left-wing governments become associated with stable exchange rates. This was explained by the interest of such governments in the effectiveness of short-term fiscal measures for the benefit of employment and wages. If the central bank is focused on price stability it can provide only limited
assistance for labor. This leaves a left-wing government with fiscal policy as the major or only tool for carrying out their distributive policies. Under high capital mobility the effectiveness of fiscal policy in turn depends on stable exchange rates.

By the same token a government that has opted for fixed exchange rates as a mechanism for discipline under full capital mobility has already given up control of monetary policy because of the mechanics of the ‘ unholy triangle’ and would lose nothing by accepting greater central bank independence. A left-wing government would be expected to shed even fewer tears on the lost autonomy of the central bank the more it is committed to price stability, which is not known to be among the policy priorities of the left. It is even possible that a left-wing government chooses to make its central bank independent and price-stability oriented in order to impress investors, and at the same time neutralizes the bank’s ability to manage an autonomous policy by fixing the exchange rate. So again, prioritizing price stability and stabilizing exchange rates are associated policies from a left-wing point of view.

In contrast, independent central banks that pursue price stability do not pose such a policy dilemma for right-wing governments because price stability is anyway on their partisan agendas and because their preference for market mechanisms and labor market flexibility in effecting economic adjustments reduces their reliance on fiscal policy when facing economic shocks.

The findings of this study carry some interesting implications for the European Union’s (EU) single currency. The preference for stable exchange rates is expected to be shared by left-wing governments in all EU member states, whether they are part of the euro zone or not, because since 1999 all EU member states, with the exception of the UK, are required to make their central banks independent and adopt price stability as their prime policy objective. One possible implication of this study’s results is that the euro zone has a soft gravitational pull on left-wing governments outside it, but not on Britain’s Labor Party. Similarly, the inability to gain control over the central bank and change its policy priorities by withdrawing from the euro zone weakens the interest in leaving the euro zone for left-wing governments in participating countries. Thus, paradoxically a project that is considered by many to have institutionalized a right-wing agenda in the EU’s political-economy, ex post gains some support from the left as well.

Of course, the Stability and Growth Pact (SGP) limits budget deficits to no more than 3 percent of GDP, and this could be argued to reduce the interest of left-wing governments in EU member states in stabilizing exchange rates. However, that limit should still leave enough room for fiscal maneuver for left-wing governments to care about, if balanced budgets are maintained in the long run. Anyway, the SGP has always left ample legal room for political maneuvers.

Further development of the literature on partisan exchange rate politics could benefit from careful treatment of endogenous variables as well as more emphasis on actual exchange rate variation rather than declared policies. More important, the level of capital mobility should be controlled for, as well as the mediating role of various institutions between the partisan agenda of the government and observed reality.

References


