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# Playing with Fire: Pre-Electoral Fiscal Manipulation and the Risk of a Speculative Attack

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**When do developing countries engage  
in pre-electoral fiscal manipulation?**

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- Always
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  - Shi and Svensson (2006)



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  - Why?
    - High cost of losing office
    - Low levels of oversight
    - Retrospective voting
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But this ignores international economic ties

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# Pre-electoral fiscal manipulation when Low risk of a speculative attack

Speculative attacks:

- Belief governments will not maintain fixed exchange rate value
- Market actors sell domestic currency
  - ↓ Demand for currency
  - ↑ pressure to devalue

Abandoning exchange rate peg is costly,  
especially prior to an election

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# Pre-electoral fiscal manipulation when Low risk of a speculative attack

- ↑ Speculative attack risk:
  - Highly appreciated real exchange rate
    - ↓ sustainability of peg
    - ↑ cost of defense



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- ↑ Speculative attack risk:
    - Highly appreciated real exchange rate
      - ↓ sustainability of peg
      - ↑ cost of defense
    - Low foreign reserves
      - ↓ ability to stave off attack
      - ↓ commitment signal
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## Pre-electoral fiscal manipulation when Low risk of a speculative attack

Under a fixed exchange rate:

$H_1$ :  $\uparrow$  Real exchange rate appreciation  $\rightarrow$   $\downarrow$  PEFM

$H_2$ :  $\downarrow$  foreign exchange reserves  $\rightarrow$   $\downarrow$  PEFM

$H_3$ : PEFM most likely when real exchange rate is depreciated and reserves are high

Under a flexible exchange rate: no relationship  
between PEFM, reserves, exchange rate

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# Empirics

- 97 developing countries, 1975-2005 (N: 1521)
  - OLS with country and year controls
  - DV: *Government Balance*
    - central government fiscal balance as a % of GDP
    - ↑ PEFM → negative change
  - Controls: *lagged DV, GDP per capita, GDP growth, Trade, Population between 15 and 64, Population above 65*
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# Empirics

- *Election* (Hyde and Marinov 2010)
    - Was opposition allowed?
    - Was more than one party legal?
    - Was there a choice of candidates on the ballot?
  - *Fixed exchange rate* (Reinhart and Rogoff 2004)
    - Range: from 'no separate legal tender' to '*de facto* crawling'
  - *Real exchange rate* (Penn World Tables)
    - Measure of real exchange rate undervaluation
    - $\uparrow$  real exchange rate  $\rightarrow$   $\downarrow$  speculative attack risk
  - *Reserves* (World Bank)
    - Foreign exchange reserves/Money supply (M1)
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# Alt. $H_1$ : unconditional PEFM

Election	-0.52 ** (0.19)	

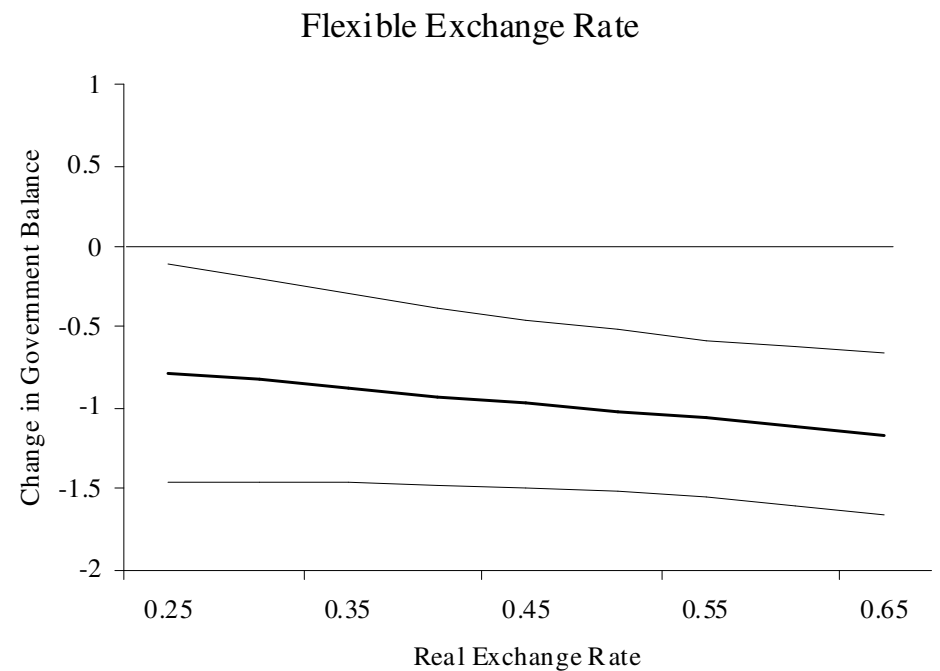
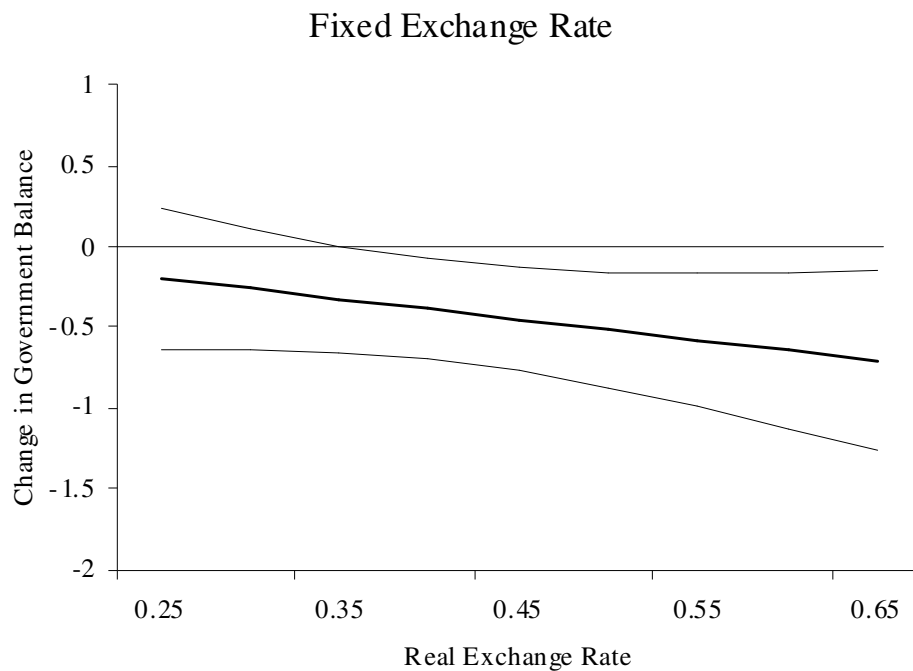
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Blunt implication:

↑PEFM under flexible exchange rate

Election	-0.52 ** (0.19)	
Election under Fixed Exchange Rate		-0.41 * (0.20)
Election under Flexible Exchange Rate		-1.01 ** (0.32)
Fixed Exchange Rate		-0.09 (0.46)

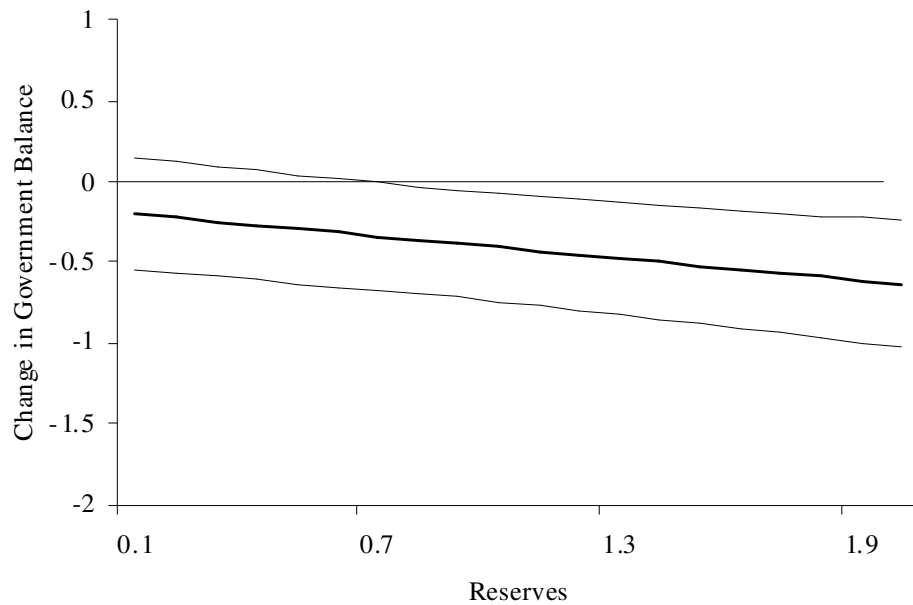
$H_1$ :  $\uparrow$  real exchange rate appreciation  $\rightarrow$   
 $\downarrow$  PEFM under fixed exchange rate



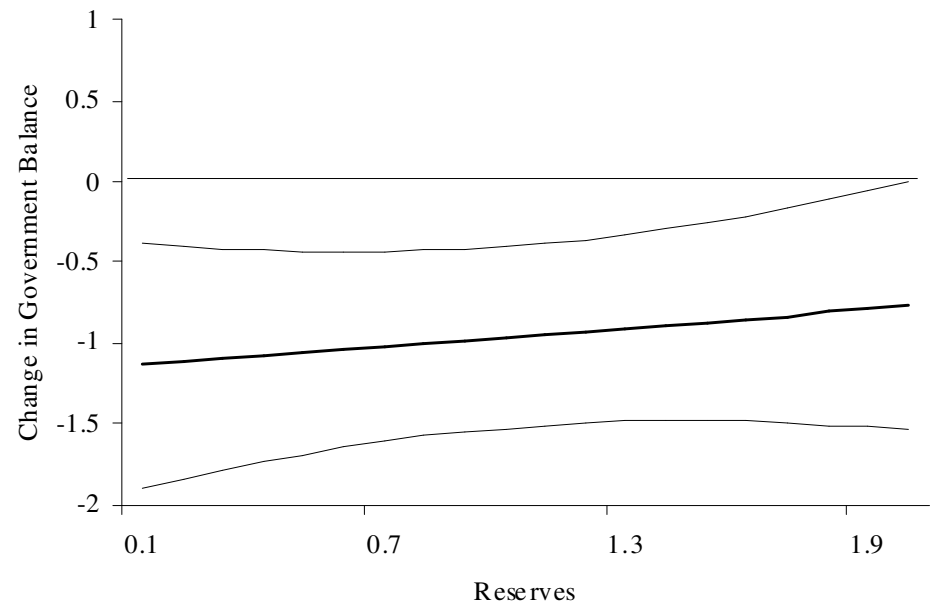
H<sub>2</sub>: ↓ reserves →

↓PEFM under fixed exchange rate

Fixed Exchange Rate

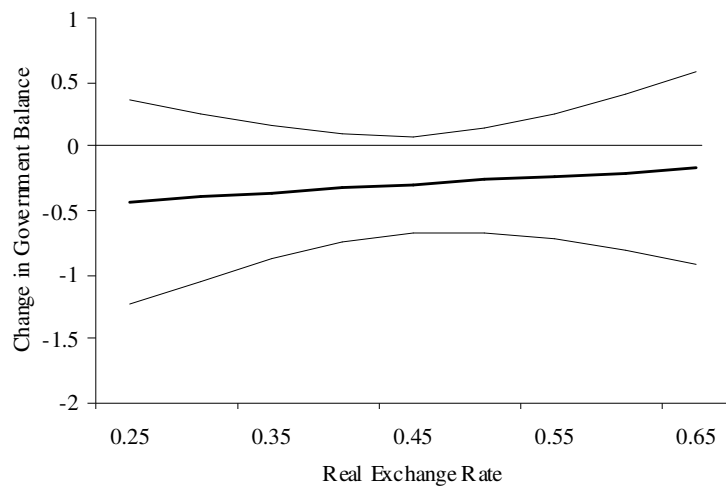


Flexible Exchange Rate

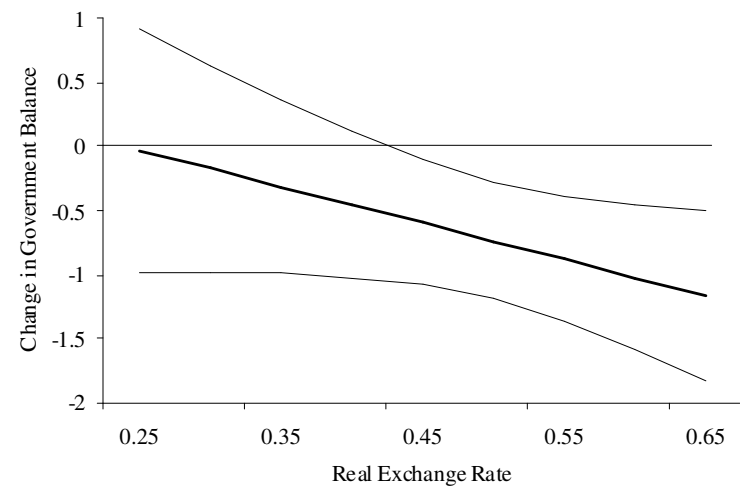


H<sub>3</sub>: ↑ reserves & ↑ exchange rate  
depreciation → ↑ PEFM under fixed rate

Real Exchange Rate varies, Reserves at 10<sup>th</sup> percentile



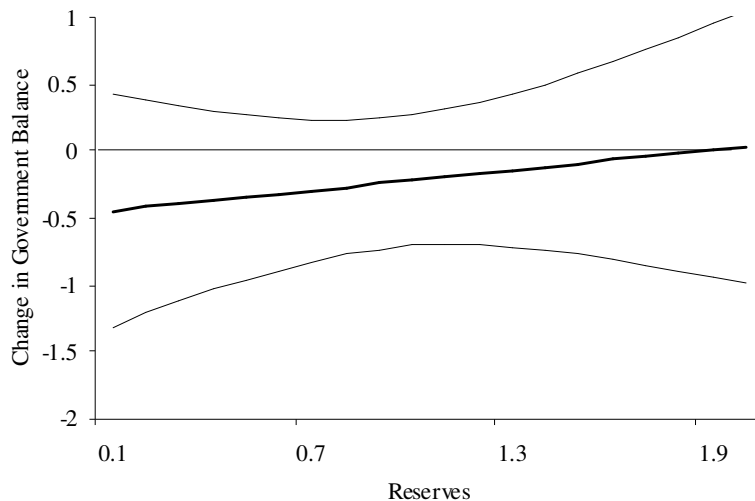
Real Exchange Rate varies, Reserves at 90<sup>th</sup> percentile



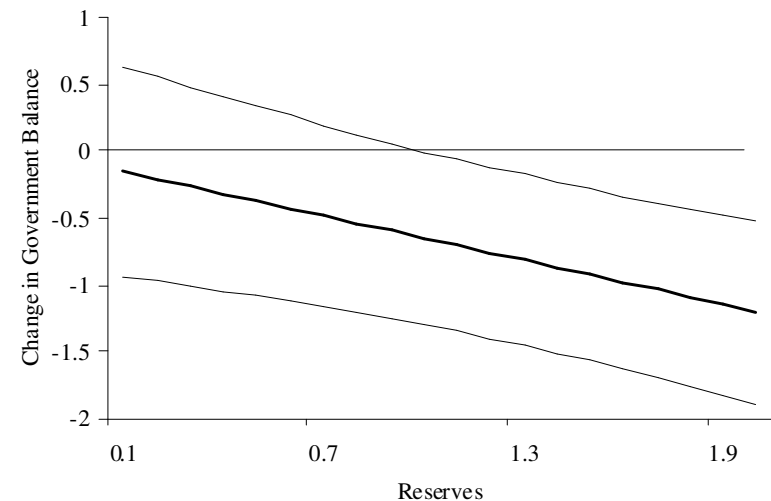


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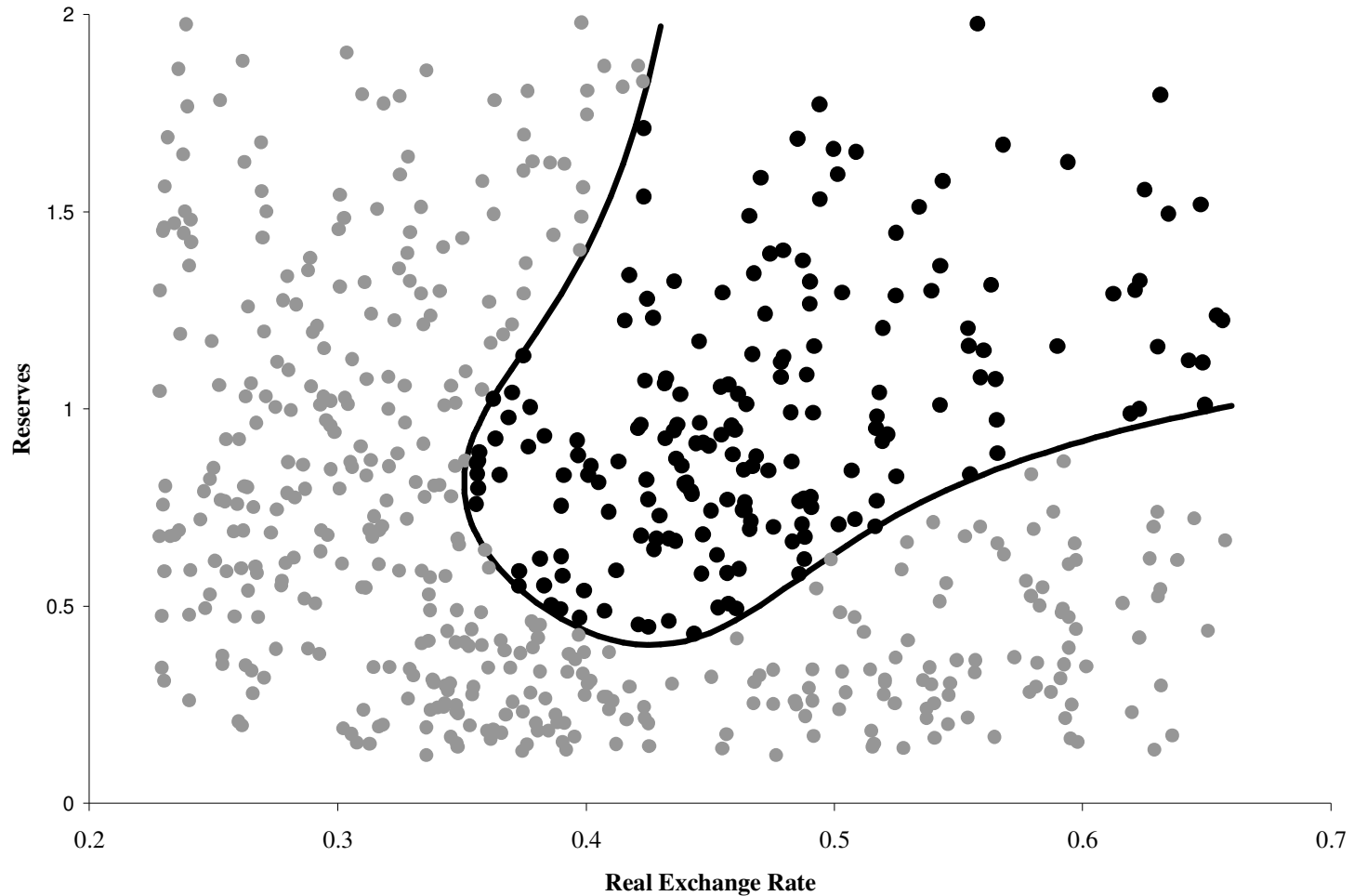
Reserves vary, Real Exchange Rate at 10<sup>th</sup> percentile



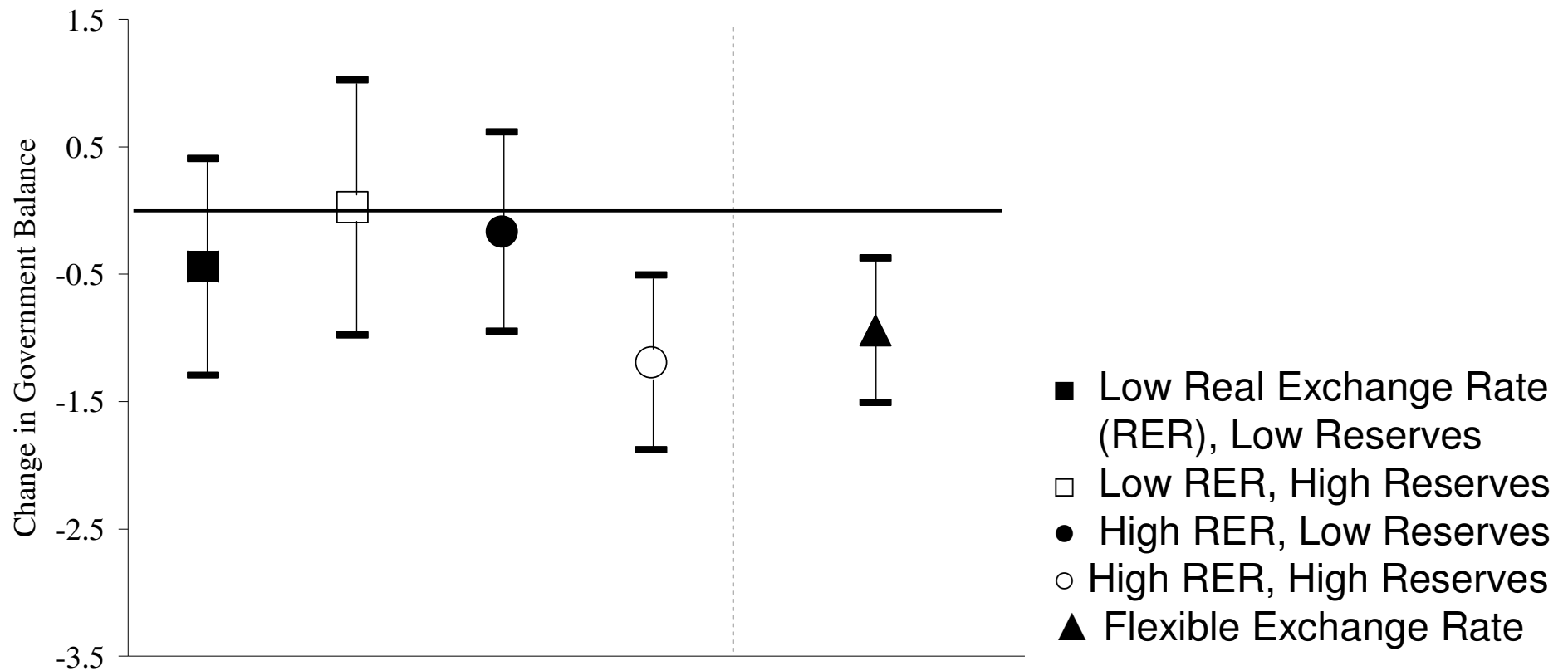
Reserves vary, Real Exchange Rate at 90<sup>th</sup> percentile



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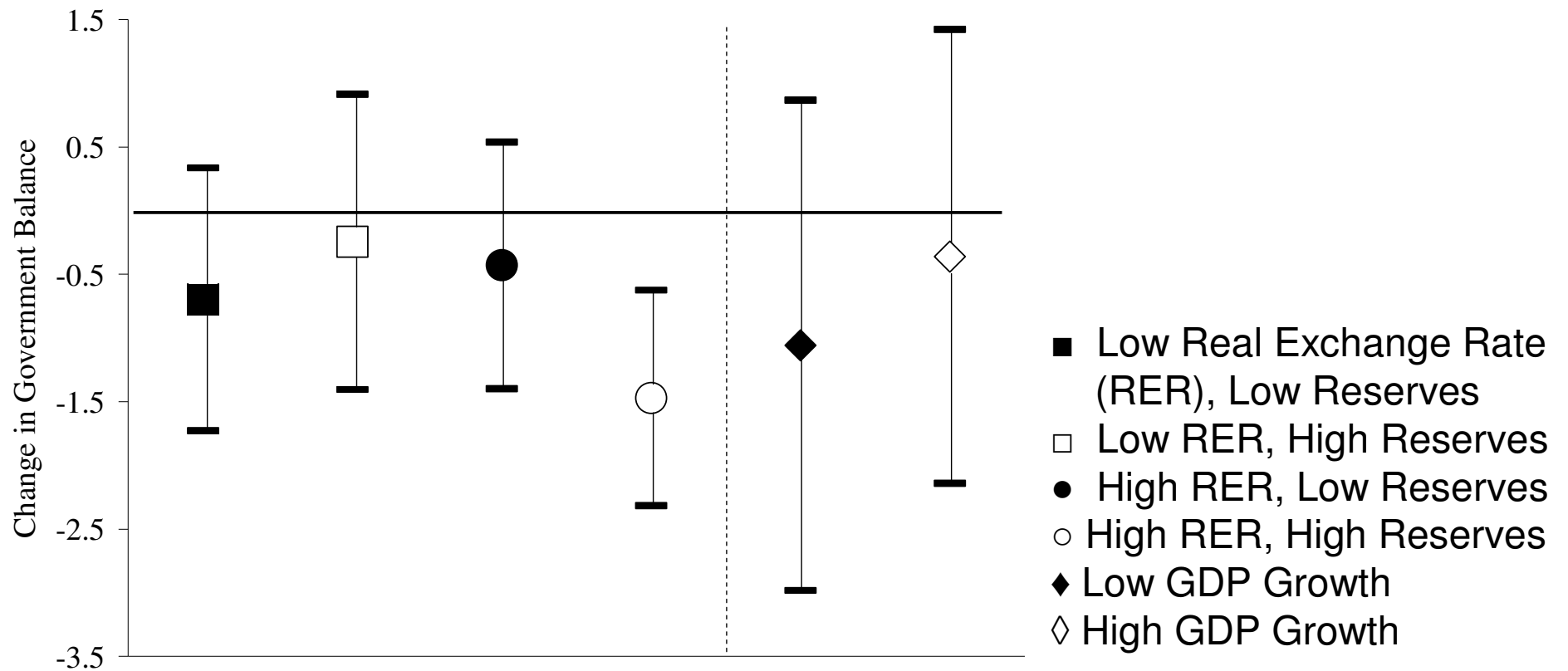
# Conclusion

- Governments' chances of reelection  $\uparrow$  when:
  - Engineer economic good times
  - Maintain exchange rate peg
- Governments forgo pre-electoral fiscal manipulation to stave off speculative attacks

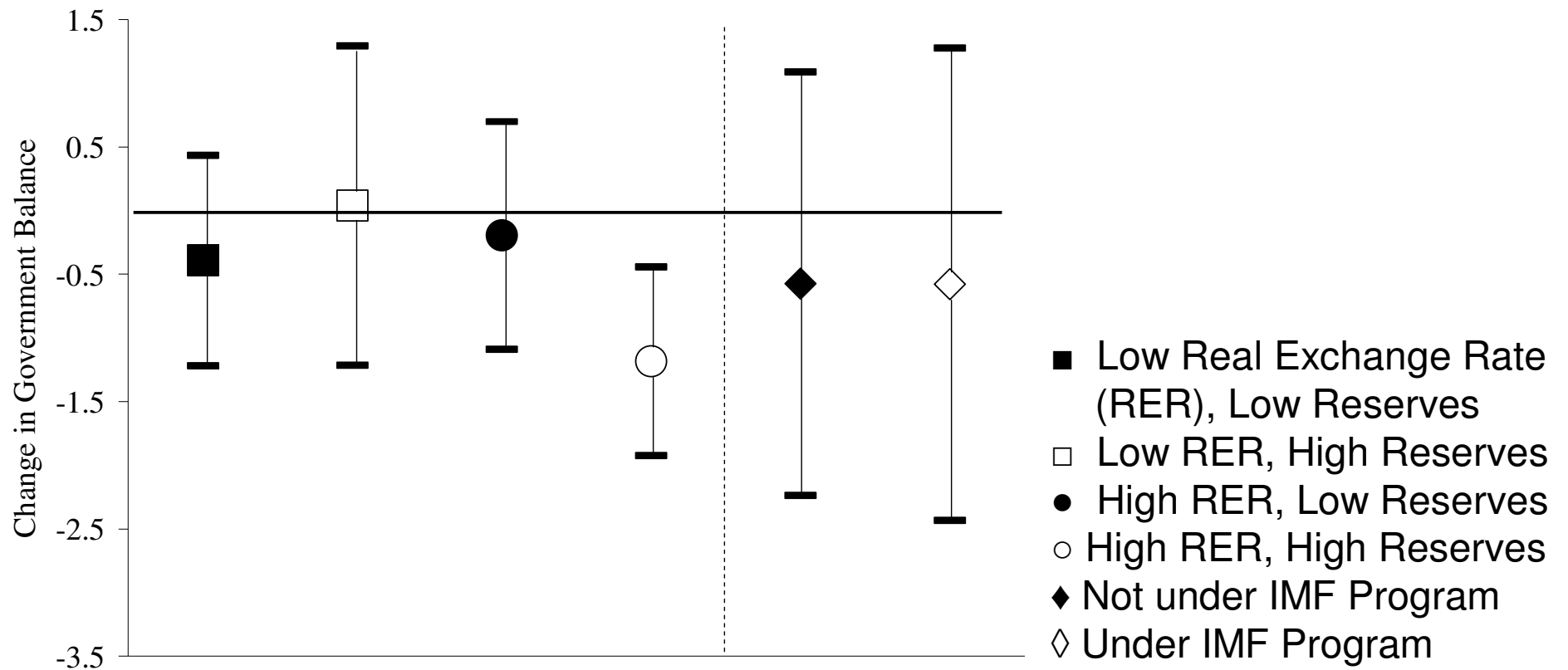
Under a fixed exchange rate, developing countries engage in greater pre-electoral fiscal manipulation when the risk of a speculative attack is low.

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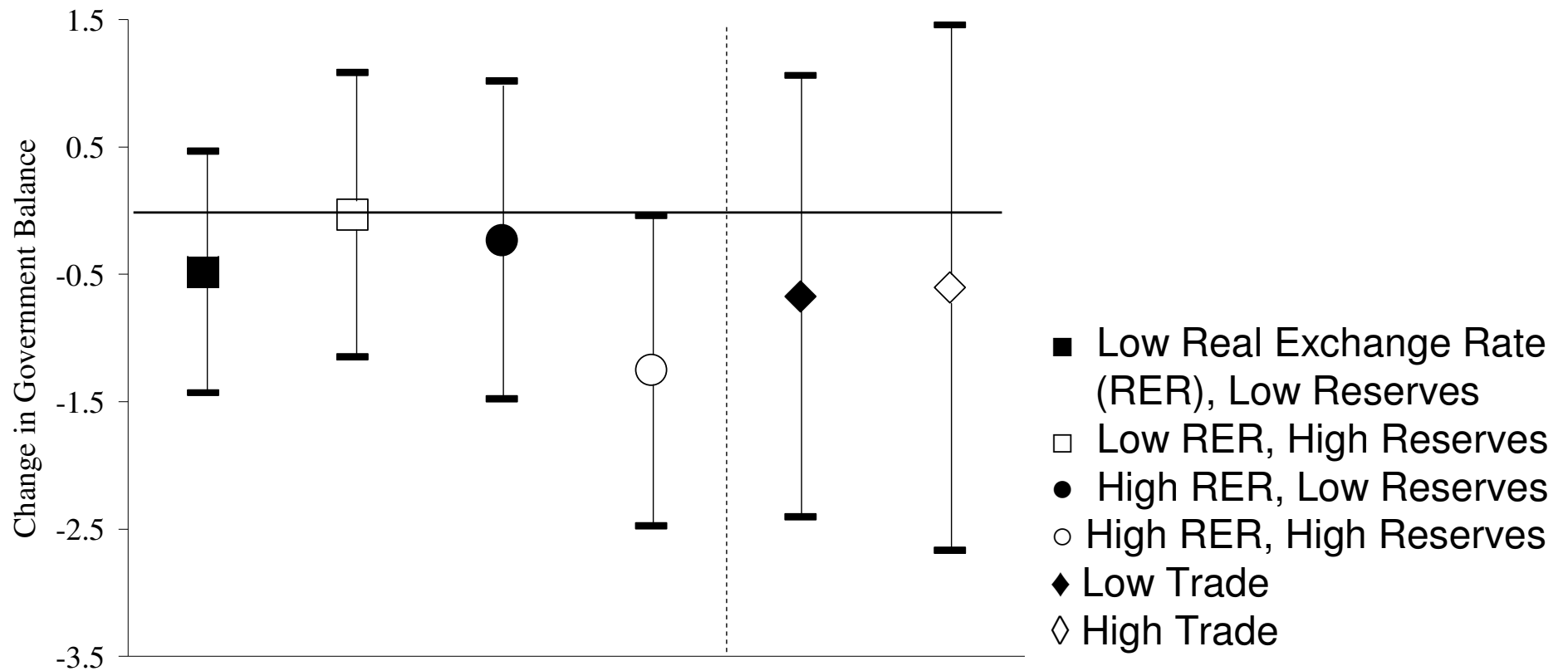
# Election \* GDP Growth



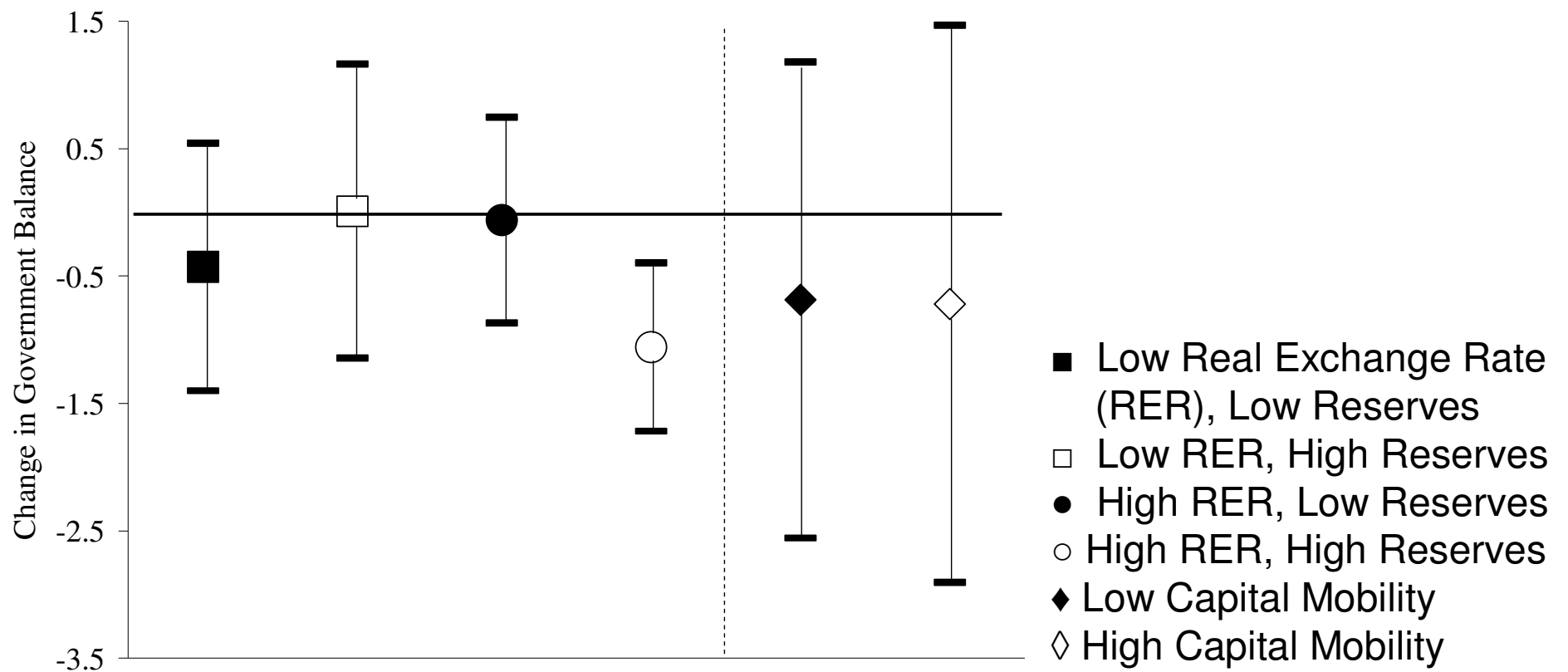
# Election \* IMF Program



# Election \* Trade

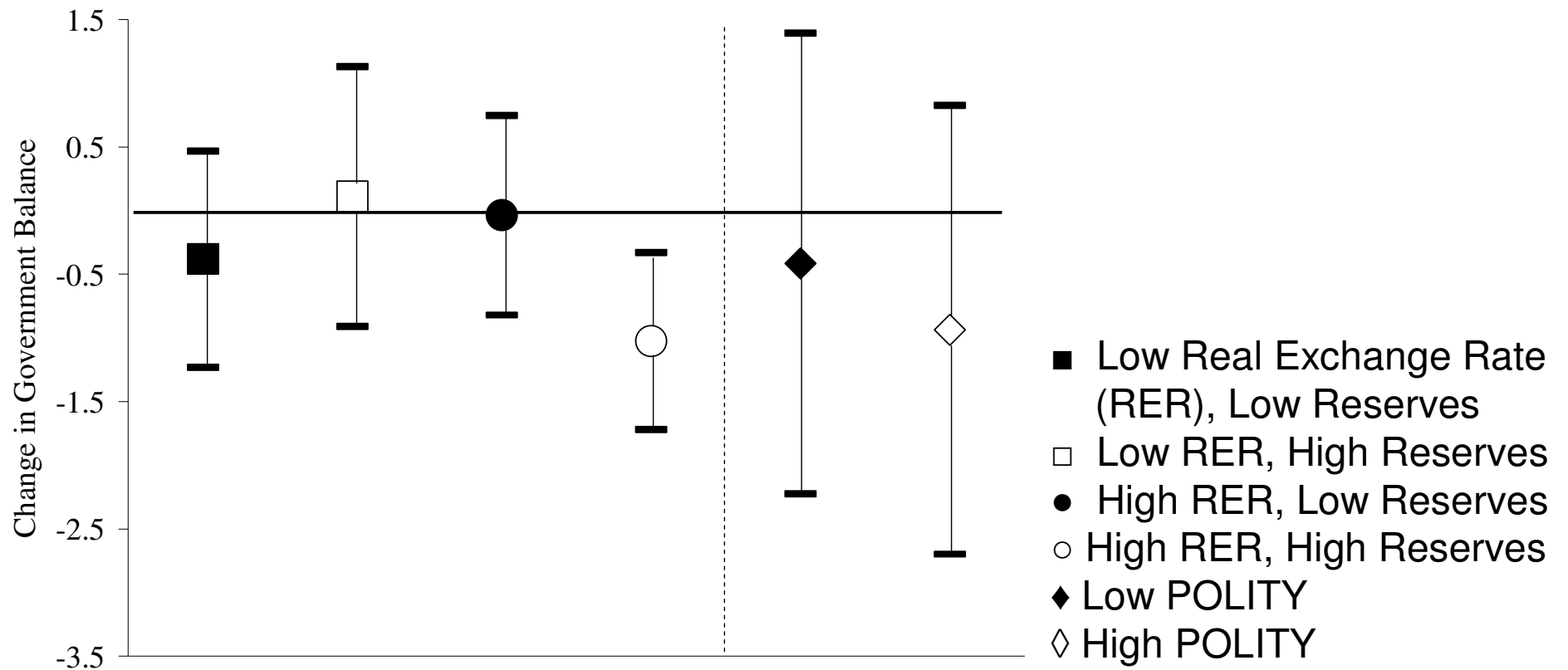


# Election \* International Capital Mobility





# Election \* POLITY



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Base Model

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Election	-0.52	(0.19)	**
Government Balance (lagged)	0.39	(0.10)	**
GDP Growth	0.06	(0.03)	*
GDP per capita	-0.41	(0.90)	
Trade	0.04	(0.01)	**
Population between 15 and 64	0.15	(0.10)	
Population 65 and above	-0.49	(0.30)	^
Constant	-6.73	(5.57)	
R2		0.52	
Observations		1850	

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## Exchange Rate

Election under Fixed ER	-0.41	(0.20)	*
Election under Flexible ER	-1.01	(0.32)	**
Fixed Exchange Rate (ER)	-0.09	(0.46)	
Change in Government Balance (lagged)	0.37	(0.11)	**
GDP Growth	0.05	(0.03)	^
GDP per capita	-0.19	(0.99)	
Trade	0.03	(0.01)	*
Population between 15 and 64	0.12	(0.11)	
Population 65 and above	-0.37	(0.32)	
Constant	-6.70	(6.29)	
R2		0.51	
Observations		1648	

Real Exchange Rate			
Election under Fixed ER	0.11	(0.51)	
Election under Fixed ER x RER	-1.26	(1.17)	
Election under Flexible ER	-0.54	(0.58)	
Election under Flexible ER x RER	-0.95	(0.87)	
Fixed Exchange Rate (ER)	1.31	(1.21)	
Real Exchange Rate (RER)	0.37	(0.49)	
Fixed ER x RER	-3.26	(2.72)	
Change in Government Balance (lagged)	0.37	(0.11)	**
GDP Growth	0.06	(0.03)	*
GDP per capita	-0.11	(0.98)	
Trade	0.03	(0.01)	*
Population between 15 and 64	0.13	(0.12)	
Population 65 and above	-0.21	(0.33)	
Constant	-7.60	(6.11)	
R2		0.51	
Observations		1647	

Reserves			
Election under Fixed ER	-0.18	(0.22)	
Election under Fixed ER x Reserves	-0.23	(0.10)	*
Election under Flexible ER	-1.16	(0.48)	*
Election under Flexible ER x Reserves	0.19	(0.33)	
Fixed Exchange Rate (ER)	-0.80	(0.57)	
Reserves	-0.37	(0.26)	
Fixed ER x Reserves	0.63	(0.24)	**
Change in Government Balance (lagged)	0.37	(0.11)	**
GDP Growth	0.04	(0.03)	
GDP per capita	0.07	(0.96)	
Trade	0.03	(0.01)	*
Population between 15 and 64	0.11	(0.11)	
Population 65 and above	-0.30	(0.31)	
Constant	-6.90	(6.52)	
R2		0.52	
Observations		1521	

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Reserves & Real Exchange Rate

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Election under Fixed ER	-0.67	(1.05)	
Election under Fixed ER x RER	0.86	(2.21)	
Election under Fixed ER x Reserves	0.68	(0.90)	
Election under Fixed ER x RER x Reserves	-1.86	(1.67)	
Election under Flexible ER	-0.94	(0.34)	**
Fixed Exchange Rate (ER)	1.65	(1.58)	
Real Exchange Rate (RER)	1.02	(1.39)	
Reserves	-0.23	(0.92)	
RER x Reserves	-0.24	(2.34)	
Fixed ER x RER	-5.66	(3.30)	^
Fixed ER x Reserves	-0.08	(1.05)	
Fixed ER x RER x Reserves	1.43	(2.36)	
R2		0.53	
Observations		1521	

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