

# Policy Responses to Balance-of-Payments Crises: The Role of Elections

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# The Problem

- ▶ Governments facing balance of payments pressures have options
  - ▶ Draw down reserves
  - ▶ Impose capital controls
  - ▶ Raise interest rates
  - ▶ Impose trade barriers
  - ▶ Devalue the currency
- ▶ How do they choose among these options?

# The Argument

- ▶ Governments want lowest political cost. Thus
  - ▶ Try lower-cost options first; if they fail, move to higher-cost options
  - ▶ Delay higher-cost options until after elections
- ▶ Political cost a function of
  - ▶ Visibility: reserves and capital controls low, others high
  - ▶ Speed/intensity of effect: interest rate increases low, devaluation and trade protection high

# Empirical Expectations

- ▶ Governments will draw down reserves and impose capital controls before other options
- ▶ If these do not succeed, raise interest rates (impact is delayed)
- ▶ If further action is needed, delay until after election
  - ▶ Devaluation
  - ▶ Trade protection

# The Data

- ▶ Quarters in which one of five policies used by government, 1975-2010, 188 countries
- ▶ “Policy” defined as significant drawdown of reserves, increase in capital controls, rise in discount rate, depreciation; or GATT-WTO-permitted tariff surcharge
- ▶ “Significant” as defined by Forbes/Klein
- ▶ All national elections using National Elections Across Democracy and Autocracy Dataset

# The Model

- ▶ 5 logit models predicting policy use
- ▶ Independent variables: quarter before and after a national election
- ▶ Control for domestic and international economic environment

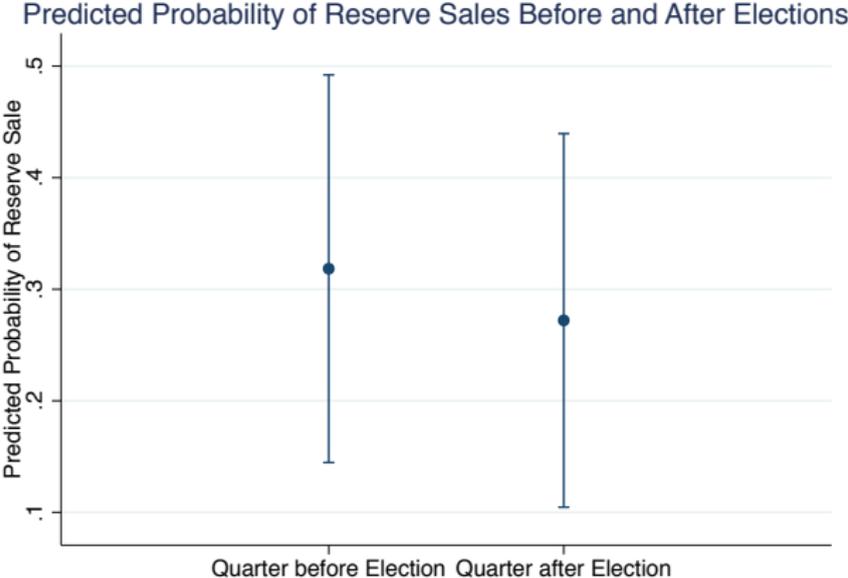
# Results

	(1) Reserves b/se	(2) Capital Controls b/se	(3) Discount Rates b/se	(4) Exchange Rate b/se	(5) Trade Protection b/se
Quarter before Election	0.419* (0.25)	-0.424 (0.57)	0.088 (0.25)	-0.635 (0.47)	-0.452 (0.71)
Quarter after Election	-0.538 (0.35)	0.278 (0.49)	0.175 (0.27)	0.739*** (0.26)	-0.571 (0.71)
Lag Change in Reserves	-1.174* (0.63)	0.302* (0.17)	0.099 (0.16)	-0.379 (0.44)	-1.788** (0.71)
Lag Change in Exchange Rates	-0.536 (0.70)	0.854 (0.89)	-2.771* (1.48)	4.261** (1.97)	1.007 (0.69)
Lag Change in Discount Rates	-0.003 (0.02)	-0.107** (0.05)	0.005 (0.01)	0.044*** (0.02)	-0.010 (0.03)
Lag Change in Capital Account Openness	-0.092 (0.37)	-0.184 (0.20)	0.391 (0.36)	-0.596 (0.50)	-0.747 (0.65)
Constant	-1.573*** (0.16)	-2.980*** (0.22)	1.034*** (0.13)	-2.354*** (0.15)	-3.303*** (0.22)
Observations	1065	1065	1065	1065	1065
Controls	YES	YES	YES	YES	YES
Pseudo R-squared	0.064	0.032	0.089	0.084	0.039

Notes: \* is significant at the 10% level, \*\* at the 5% level and \*\*\* at the 1% level. Errors are clustered at country level.

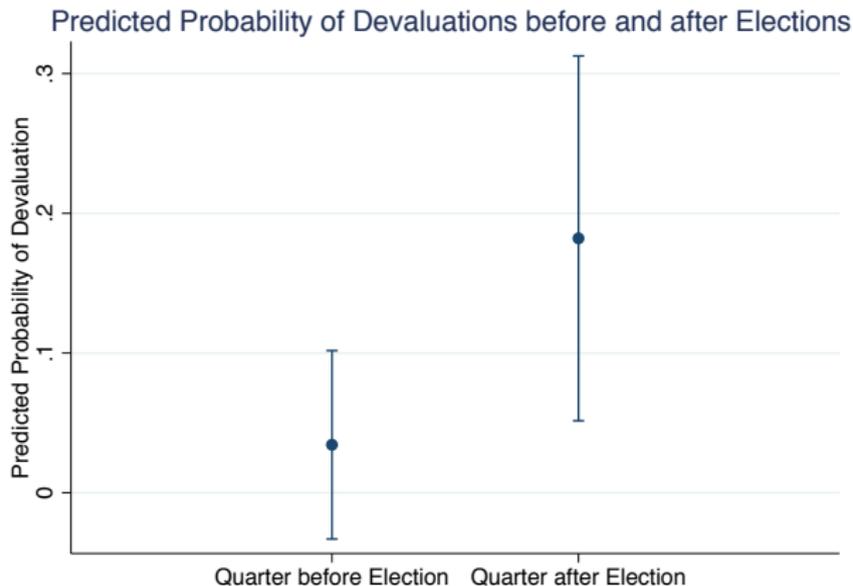
# Results: Reserves

**Predicted probability of selling reserves decreases 13% in the quarter following an election compared to the quarter before an election**



# Results: Devaluations

**Predicted probability of devaluing increases 12% in the quarter following an election compared to the quarter before the election**



# Results: Sequencing

- ▶ Policymakers will:
  - ▶ sell reserves and then impose capital controls if pressure persists
  - ▶ increase discount rates first and avoid subsequent capital control increases
  - ▶ try smaller devaluations and increases in discount rates first and wait to impose a large devaluation until after an election
  - ▶ sell reserves first to avoid imposing more visible and politically costly import surcharges

# Conclusion

- ▶ Governments faced with BoP difficulties choose policy options with political constraints in mind
- ▶ Adopt less transparent policies first, only move to more visible policies if necessary
- ▶ Delay more visible policies, and policies with more intense distributional effects, until after elections