



8TH JACQUES POLAK ANNUAL RESEARCH CONFERENCE

NOVEMBER 15-16, 2007

---

# **A Micro-Empirical Foundation for the Political Economy of Exchange Rate Populism**

Discussion by

Allan Drazen  
University of Maryland

Presentation given at the 8th Jacques Polak Annual Research Conference  
Hosted by the International Monetary Fund  
Washington, DC—November 15-16, 2007  
Please do not quote without the permission from the author(s).

**The views expressed in this presentation are those of the author(s) only, and the presence of them, or of links to them, on the IMF website does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the presentation.**

**Discussion of  
de Carvalho Filho and Chamon**

**A Micro-Empirical Foundation for the Political Economy  
of Exchange Rate Populism**

**Allan Drazen**  
University of Maryland

**8TH JACQUES POLAK ANNUAL RESEARCH CONFERENCE  
IMF  
NOVEMBER 15-16, 2007**

# Motivation

Conventional wisdom – Currency appreciation is politically popular because it increases consumers' purchasing power

This paper examines the basis for the supposed popularity of appreciations – namely, the effect of appreciations on real income and purchasing power

Poor households may on net be worse off – They benefit from effect of appreciation on consumer goods prices, but their income is adversely affected

# Political-Economic Questions

When looking at a policy whose economic effects are meant to gain political support, 3 basic questions:

- 1) Are the effects really there?**
- 2) Does it actually “buy” support?**
- 3) Do politicians actually use it?**

# Paper Concentrates on First Question

Some evidence on the third question

1. Prevalence of overvaluation in emerging market countries since 1980.
2. Currency appreciation before and depreciation after elections.  
(Consumption boom before an election via real exchange rate appreciation.)

# Economic Effects of Appreciation: Theory

## **Results make sense theoretically**

Appreciation reduces price of tradables, which are heavy in consumption basket of poor, benefiting poorer households more than proportionately.

Factor incomes of tradable producers is hurt

# Economic Effects of Appreciation: Empirics

## **a) Pass-through to consumer prices**

Results are broadly consistent with what others have found  
Gopinath, Itskhoki, and Rigobon (2007) on pass-through  
with local currency pricing  
(But, not with producer currency pricing)

## **b) Distributional effects on consumption**

Based on pass-through results combined with relative  
consumption baskets – seems reasonable  
The effect is fairly flat, with the distributional effects of a 10  
percent appreciation varying by less than 1/2 percent  
across the distribution.  
Level effect is large with large pass-through

# Economic Effects of Appreciation: Empirics (cont.)

## c) Factor income effects

I'm less able to judge

Real appreciations negatively affect the relative incomes of rural, the least educated, and the older headed households, while significantly increased the relative incomes of more educated heads of households



# **Economic Effects of Appreciation: Empirics (cont.)**

## **d) Net distribution effects**

Main result: bulk of distributional effects of nominal appreciations seem to work through factor incomes instead of consumption effects.

Poor (especially rural poor) on net are hurt  
Middle class enjoys the largest gains from appreciation

# Political Implications

What should we conclude about “Exchange Rate Populism” if it hurts the poor?

**Populism** – “Short-sighted” expansionary policies goal of redistribution towards poor

Why would a policy be used to gain political support if it harms its intended target?

# What is Political Value of Overvaluation?

1. According to these results it does benefit the middle class

But “overall, the net distributional effects tend to be small, and relatively well distributed across households”

2. Limited distributional effect means no group expresses strong discontent. Large average effect means appreciations may be popular across the board

3. Paper suggests that positive effect on lower prices is short-run effect, while income effect may be longer-term, so it may gain support of voters with short memories

# Are Voters Easily Manipulated?

Conventional wisdom is that voters respond to manipulation (especially poorer, less educated voters)

(Example – Expansionary Fiscal Policy)

But, the data don't give support to this view

Brender and Drazen (2007) – deficits are strongly punished at the polls in developed countries. No evidence they help in re-election in other groups of countries

# What is Voter Response to “Exchange Rate Populism”?

In short, conventional wisdom on voter response to fiscal and economic expansions is often incorrect

Is CW correct here? Similar to effect of appreciation on income, there is a dearth of hard evidence on this

It would be nice to see a careful study

# Overvaluation as a Political Tool

One response to question of whether it gains political support is that it is used

Evidence is stronger here, but a note of caution

Analogously, CW is that governments run higher deficits in election years to gain votes

Brender and Drazen (2005) – Political Deficit Cycle is phenomenon of new democracies, absent elsewhere

# What should we conclude?

1. Fiscal austerity is not an “election loser” in OECD countries. Are developing countries different?

But in more “normal times” tax increases, like devaluations, are postponed till after elections.

2. To what extent is creeping overvaluation before elections like FOMC “dead spot”?

**“I wish we had the luxury to sit back and do nothing until after the election, as is the conventional procedure of the Federal Open Market Committee.”**

Alan Greenspan, (*FOMC Transcripts*, October 6, 1992)

That is, are governments hesitant to take highly visible measures before elections??

# Concluding Comments

Paper makes a good case that effects of overvaluation does not benefit the poor

Less clear to me what to conclude about political value of overvaluation

- Is it “targeted” to a politically important constituency other than the poor?
- Do voters really respond positively to bad economic policies?
- Is Latin America different in that candidates can’t win on a market-friendly platform?

There is a conventional wisdom, but I think these are among questions that need to be re-examined