Summary of Bernhard and Leblang, "Democratic Institutions and Exchange-Rate Commitments"

From the end of World War II until 1971, international exchange-rate practices were governed by the Bretton Woods system, in which all exchange rates were fixed and the dollar was the anchoring currency. Since 1971, countries have been able to choose between a fixed or a floating exchange rate as well as, in the case of Europe, multilateral exchange rate arrangements. In this article, Bernhard and Leblang seek to investigate what constraints domestic institutions place on countries' choice of exchange-rate policy. A fixed exchange rate helps to stabilize trade, but implies a certain loss of domestic autonomy in monetary policy. A floating exchange rate, on the other hand, gives politicians the opportunity to use monetary policy to cushion the effect of economic shocks on the domestic economy, and to use monetary policy for partisan advantage. Bernhard and Leblang examine politicians' incentives to choose one or the other system. They argue that "the configuration of domestic political institutions will influence politicians' need to maintain policy flexibility, which, in turn, shapes their preferences over the exchange-rate arrangement." (73).

Bernhard and Leblang assume that politicians have an interest in maintaining their place in office. They highlight the difference between two different factors in domestic government: a majoritarian or a proportional representation electoral system, and the costs of serving in the opposition. A majoritarian electoral system produces single-party majority governments in which incremental differences in the number of votes can produce large differences in power distribution between parties, and hence, policy outcome. Proportional representation results in coalition governments in which several parties have an influence over policy. The costs of serving in the opposition differ between systems in which opposition political parties are excluded from legislative policy-making, and systems in which legislative committee membership is spread across party lines, and which thus allows opposition politicians some role in the policy making process. This leads Bernhard and Leblang to draw a distinction between 3 different types of governments:

1. Majoritarian-low opposition influence: Bernhard and Leblang predict these governments will be unwilling to fix their exchange rates, since it limits their policy discretion, which could hurt their electoral popularity.
2. Proportional-low opposition influence: These are the middle-ground cases, in which coalition governments are common and politicians therefore more likely to fix the exchange rate as a focal point of agreement, but the opposition's policy influence is low. The party in power has an incentive not to risk its position in office, and will therefore be more unwilling to limit their policy options with a fixed exchange rate.
3. Proportional-high opposition influence: Bernhard and Leblang predict these types of governments will be most likely to fix their currencies, since the opposition will always have some power over policy and a fixed exchange rate may be the best form of agreement.

(Bernhard and Leblang do not find any significant examples of Majoritarian-high opposition influence systems). They contend that countries with exogenous electoral timing (election held at fixed dates) will be more inclined to float their currencies to ensure an economic boom at the time of the election. Those with endogenous electoral timing can time their elections to coincide with economic prosperity, so fixing the exchange rate becomes less of a problem. They include a variable for electoral timing in their analysis.

Bernhard and Leblang include several other variables for other international factors which are common in the literature seeking to explain exchange-rate commitments. There is a variable for trade dependence (countries that rely heavily on trade are assumed to prefer fixed rates), vulnerability to economic shocks (these countries are assumed to prefer floating rates to cushion the domestic economy), a variable to indicate the presence or absence of capital controls, and a variable to express the increased volume of international capital movement in the late 20th century. Likewise, they include a number of variables for domestic political factors: government partisanship (Left or Right), electoral cycle (whether governments float right before an election, only to fix just after it), and policy inertia (the fact that economic policies usually react to economic conditions that have already occurred, and therefore tend to lag).

They analyze the exchange rate regime choice of 20 industrial democracies between 1974-1995, between a fixed, floating, or multilateral system. (These last pertain to the European Exchange Agreement, called the Snake, or the European Monetary System). With respect to this last choice, Bernhard and Leblang seek to answer the question of whether geographic location or European Community membership had an outside influence on the adoption of multilateral currency agreements. That is, was it the case that European countries, because they were located in Europe, were pressured to join these agreements by their trading partners when otherwise they would have floated their currencies? Or conversely, were European countries all predisposed toward fixed currencies for other reasons and just decided to do it together?

Bernhard and Leblang found that the variables of the domestic political institutions were statistically significant. The proportional-high opposition systems are most likely to fix, while the majoritarian-low influence systems are most likely to float. Countries with exogenous electoral timing are also more likely to allow their currencies to float. Increased trade dependence and the presence of capital controls increases the probability of adopting a fixed exchange rate. No relationship was found to exist between increased capital mobility and the adoption of exchange-rate systems. Domestically, neither partisanship nor electoral cycles appeared to affect exchange-rate choices. Finally, two variables that describe geographic location and membership in the EC were analyzed. Geographic location was found to be insignificant, while membership in the EC did make the member states more likely to join a multilateral system than to fix unilaterally.

Bernhard and Leblang conclude from this that "in systems where the electoral system decisively determines the composition of government and the cost of electoral defeat is high, politicians will be unwilling to relinquish policy control with a fixed exchange rate. On the other hand, in system where coalition governments are common and the policy process is open, a fixed exchange rate can provide politicians with a focal point for policy agreement." (93). The structure of domestic institutions, in their analysis, does have a significant effect on exchange rate policies.