Trade Integration and the Politics of Exchange Rate Regime Choice

José Fernández-Albertos

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Outline

1. The puzzle: trade integration and exchange rate regime choice
2. An institutional model of exchange rate regime preferences
3. Empirical evidence from OECD countries
4. Conclusions
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- Nominal anchor approach: Trade integration should amplify the anti-inflationary benefits of pegs
- Political-Economy arguments: Trade integration should empower those who benefit from ER stability.
### Exports (%GDP) and # of Regime Changes

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Trade and ER Regimes
But...

Extensive evidence for Latin America suggests that trade integration has been associated to preference for floating, not fixed, regimes (Frieden and Stein 2001, passim; Klein and Marion 1997; Brock Blomberg et al. 2005).

In some European countries, the exporting sector is amongst the most outspoken critics of monetary unification.
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In some European countries, the exporting sector is amongst the most outspoken critics of monetary unification.
But...

“The Italian politician in the left is happy for the introduction of the euro. The Chinese businessman in the right, even more.”
But...

- The empirical literature is anything but conclusive:
The empirical literature is anything but conclusive: Economic Openness, the most frequent analyzed variable, is found to be significantly associated with floating regimes by three studies, significantly associated with fixed exchange rates by three studies, and not significantly associated with any particular exchange rate regime by another five studies (Juhn and Mauro 2002).
An institutionally-informed political-economy approach

- Institutional Domestic Factors
- International sector’s preferences
- Internationalization
- Exchange Rate Regime Choices

Model (chapter 3)
The basic intuition
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- Three groups in society: Nontradables, Exporters, Import-Competitors
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- Monopoly unions in wage-bargaining units of size $c$ set wages in each sector, maximizing

\[ W_i = (1 - \gamma_i) (-1)^{1/2} U_i + \frac{1}{2} (w_i - \pi_i) - \gamma_i |\Delta e| \quad \text{for} \quad \gamma_{EX} > 0, \gamma_{IC} = 0, \gamma_{NT} = 0 \]
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\[ \gamma_{EX}, \gamma_{IC}, \gamma_{NT} \geq 0 \]

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\[ W_{CB} = -\nu \pi^2 - (1 - \nu)U^2 \]
Exchange Rate Regimes

Floating Exchange Rate Regime

Unions in all sectors behave equally
Exporters suffer from changes in the nominal exchange rate caused by deviation from international prices

Fixed Exchange Rate Regime

Central bank is additionally committed to keep prices in nontradables in line with international prices. It becomes completely non-accommodating towards tradables. Only nontradables can now exercise wage push. The more they do so, the greater the real wage loss for tradables.

Wage militancy in nontradables depend on wage bargaining centralization and central bank conservatism.
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Under guarantees of wage constraint
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Empirical implications

Hypothesis 1
Exporters' support for pegs will be contingent on the presence of domestic institutions that promote wage restraint in nontradables.

Hypothesis 2
Economic internationalization will be associated with:
- greater preference for pegs when the institutional environment encourages wage restraint: wage bargaining is coordinated, central banks are conservative (independent).
- greater preference for floats when the institutional environment encourages wage militancy in nontradables: wage bargaining is decentralized, central banks are accommodating.
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2 The model

3 Empirical Evidence

4 Conclusions
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- Control variables: exports, size (log GDP), past inflation, foreign liabilities to money, raw agricultural exports, regional GDP under fixed exchange rates (diffusion)
If the theory were correct...
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- Central bank conservatism: Legal independence (Cukierman index)
## Results. Logit coefficients with BKT controls

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Probability of peg. The mediating effect of CWB
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Probability of peg. Joint effect of CWB and CBI

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Trade and ER Regimes
## Robustness to different CWB measures

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<td>Exports*CWB</td>
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<td>0.636**</td>
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<td>Foreign Liab.</td>
<td>1.642**</td>
<td>0.970**</td>
<td>2.102**</td>
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<td>(0.619)</td>
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<td>Log GDP</td>
<td>-1.824**</td>
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<td>(0.065)</td>
<td>(0.104)</td>
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<tr>
<td>Diffusion</td>
<td>10.621*</td>
<td>7.446*</td>
<td>12.041**</td>
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<td></td>
<td>(5.423)</td>
<td>(4.508)</td>
<td>(5.371)</td>
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<tr>
<td>Federalism</td>
<td>-1.303</td>
<td>-1.031</td>
<td>-0.860</td>
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<tr>
<td></td>
<td>(1.256)</td>
<td>(0.688)</td>
<td>(0.776)</td>
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<tr>
<td>Multiparty govt</td>
<td>1.866**</td>
<td>0.533</td>
<td>1.155</td>
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<td>(0.906)</td>
<td>(0.595)</td>
<td>(0.744)</td>
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<table>
<thead>
<tr>
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<tr>
<td>Iversen</td>
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<tr>
<td>Kenworthy</td>
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<td>OECD</td>
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### Robustness to different definition of DV

<table>
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<tr>
<th>Dep variable:</th>
<th>Rogoff1</th>
<th>Rogoff3</th>
<th>IMF Fix</th>
<th>IMF Fix+Int</th>
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<tbody>
<tr>
<td>Exports</td>
<td>0.232</td>
<td>-0.620**</td>
<td>0.068</td>
<td>0.068</td>
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<tr>
<td>CWB</td>
<td>-0.669</td>
<td>-2.526*</td>
<td>0.361</td>
<td>-0.199</td>
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<tr>
<td>Exports*CBI</td>
<td>-0.021</td>
<td>0.057**</td>
<td>-0.007</td>
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<tr>
<td>CBI</td>
<td>21.381</td>
<td>-32.217**</td>
<td>2.478</td>
<td>0.294</td>
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<tr>
<td>Exports*CBI</td>
<td>-0.176</td>
<td>1.317**</td>
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<td>0.140</td>
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<td>Foreign Liab.</td>
<td>0.431</td>
<td>1.486**</td>
<td>0.318</td>
<td>-0.328</td>
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<tr>
<td>Log GDP</td>
<td>-0.394</td>
<td>-2.390**</td>
<td>0.181</td>
<td>0.762</td>
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<td>Lagged inflation</td>
<td>-54.726</td>
<td>27.574**</td>
<td>-22.127**</td>
<td>-2.881</td>
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<td>Raw Agg Exports</td>
<td>0.327*</td>
<td>-0.126</td>
<td>0.047</td>
<td>0.275**</td>
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<td>Diffusion</td>
<td>114.319**</td>
<td>17.537**</td>
<td>26.629**</td>
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<td>Multiparty govt</td>
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<td>2.334**</td>
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<td>1.057</td>
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<td>398</td>
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<td>.8838</td>
<td>.8781</td>
<td>.7958</td>
<td>.8099</td>
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Table of Contents

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2. The model
3. Empirical Evidence
4. Conclusions
In principle, the adoption of a fixed exchange rate regime benefits exporters by stabilizing the nominal value of the currency. But a fixed exchange rate regime implies a monetary policy rule that makes wage militancy very harmful for tradables. The support of the international sector for pegs will be contingent on the existence of institutional incentives for wage restraint.
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Evidence on ER regime preferences and ER regime choices seem to support these claims.
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