The Partisan Reversal:
Partisanship and Exchange Rate Policy in Closed and Open Economies

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Current version: November 10, 2020

Abstract

This paper shows that political parties strongly influence exchange rate policy, and that rising international capital mobility has reversed which parties maintain overvalued exchange rates and which maintain undervalued exchange rates. We model exchange rate policy decisions as a function of the partisan orientation of government and the degree of international capital mobility. At low levels of capital mobility, an overvalued exchange rate redistributes income from capital to labor. As capital mobility rises, overvalued exchange rates become costlier for workers but more attractive to firms. We therefore hypothesize that left-wing parties, whose core constituent is labor, are more likely to overvalue the exchange rate at low levels of international capital mobility. Right-wing parties, representing business interests, are more likely to overvalue the exchange rate at high levels of capital mobility. Analyses of time-series cross-sectional data for the period of 1975-2017 support these hypotheses. The results indicate that globalization can have transformative effects on the relationship between partisanship and economic policy.

1 Introduction

Many observers believe that globalization creates pressures on countries to converge on market-friendly economic policies (Cerny, 1995; Friedman, 1999; Ohmae, 1995; Rodrik, 1997). Consistent with this expectation, there is considerable evidence that economic globalization has reduced the differences in the economic policies of left and right governments (Milner and Judkins, 2004; Kastner and Rector, 2005; Steiner and Martin, 2012; Ward et al., 2015). But many other works find that left and right parties' policies have instead continued to diverge as globalization has unfolded (Allan and Scruggs, 2004; Bearce, 2007; Garrett, 1998; Korpi and Palme, 2003; Oatley, 1999; Pinto et al., 2010). We argue that rising international capital mobility—a central feature of economic globalization—can have even more dramatic effects on partisan politics than is typically recognized. Globalization does more than just change the *degree* to which party positions vary; it can *reverse* parties' positions on economic policy.

To develop this argument, we focus on one important economic policy issue: exchange rate policy. Specifically, we focus on whether countries maintain overvalued or undervalued real exchange rates—that is, whether countries have a "strong," appreciated, exchange rate that lowers the costs of foreign imports, or a "weak," depreciated, currency, which makes imports more expensive but also makes a country's exports more competitive internationally. The degree of exchange rate over- or undervaluation is essential to study because of its important economic and political consequences. Undervalued exchange rates are associated with faster and more sustained rates of economic growth (Rodrik, 2008; Berg et al., 2012); greater domestic financial stability (Frankel and Saravelos, 2012); and lower levels of unemployment (Frenkel and Ros, 2006; Levy-Yeyati, Sturzenegger, and Gluzmann, 2013). On the other hand, undervalued exchange rates can hamper other countries' growth prospects, exacerbate global economic imbalances, and therefore intensify international political tensions (Bernanke, 2010; Krugman, 2010).

Despite the importance of the issue, we still know little about the impact of partisanship on the real exchange rate.[1] In fact, the prevailing wisdom holds that political parties are largely

[1] A number of works explore how partisanship impacts (nominal) exchange rate stability (Simmons, 1994; Bearce, 2007; Frieden, 2002; Bodea, 2010; Sadeh, 2011). Closer to the present study, some studies find that right government are more likely to devalue when their fixed exchange rate is under attack from speculators (Bodea, 2015; Leblang, 2003;

irrelevant for this issue. One review of this literature asserts that a "class-based partisan approach is not much help" for understanding exchange rate valuation because "the distributional effects of the real exchange rate on profits and wages cut across sector (tradables vs nontradables) and not factor (labor vs capital) lines . . . There is thus little reason to believe that class-based political parties will find common ground on the preferred level of the exchange rate" (Broz and Frieden, 2001, 333). Echoing this sentiment, Singer (2010, 312) suggests that "there are no clear partisan divides over exchange rate policy."

The empirical record, however, suggests that these claims need to be re-examined. Figure 1 shows that there are often substantial differences between left and right parties when it comes to the real exchange rate. In the 1970s and 1980s, left parties had substantially more overvalued exchange rates than right (and centrist) parties. However, in more recent years, the left has maintained more undervalued exchange rates than their right-wing counterparts. These trends provide suggestive evidence that partisanship may be a more important driver of exchange rate policy than has been previously appreciated, and points to the plausibility of our partisan reversal hypothesis.

We argue that rising levels of international capital mobility explain this partisan reversal on exchange rate policy. An overvalued exchange rate increases real wages, and redistributes income from capital to labor. When capital mobility is low, firms cannot relocate production abroad to avoid this redistribution. Hence, in this context, left parties, whose core constituent is labor, are more likely to overvalue than right parties, who are more focused on promoting business interests. But, as capital mobility increases, overvaluation becomes less attractive to workers. The ability to shift investment overseas means that an overvalued exchange rate will lead firms to substitute away from high-wage production at home to lower-cost foreign production, and therefore increase unemployment at home. Financial globalization has also given firms greater access to foreign-currency loans, which increases their interests in an overvalued exchange rate. Right parties are therefore more likely to overvalue than left parties at high levels of international capital mobility. We verify that these predictions hold in a formal general equilibrium framework under modest

Sattler and Walter, 2010; Walter, 2009). Whether or not partisanship has a similar effect outside of the context of a speculative attack against a fixed exchange rate regime remains to be determined. We are not aware of any previous research focused on the general relationship between partisanship and real exchange rate valuation.

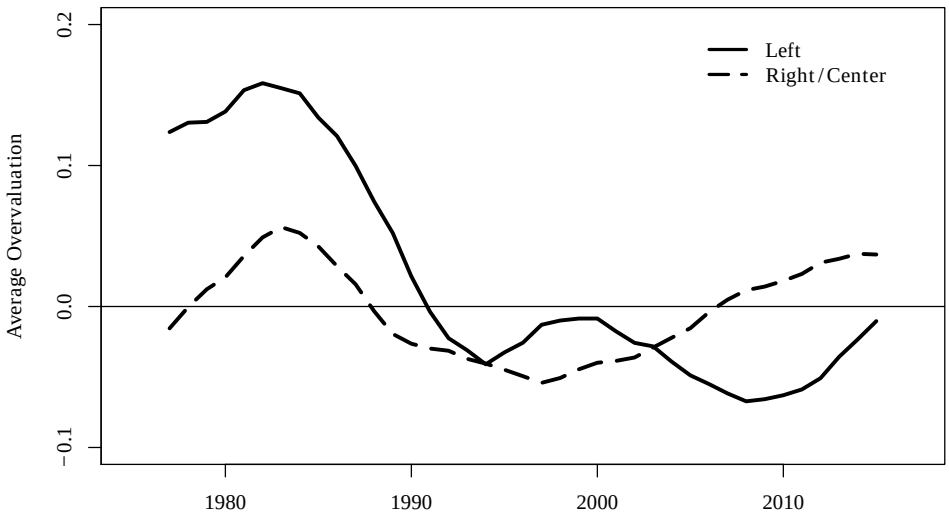

FIGURE 1: Partisanship and Real Exchange Rate Valuation. Lines display five-year moving average of exchange rate over/undervaluation for left parties and for center and right parties. Positive (negative) values indicate overvalued (undervalued) exchange rate. Sources: CEPII EQCHANGE and Database of Political Institutions.

assumptions.

Analyses of time-series cross-national data covering 124 countries from 1975 to 2017 provide empirical support for the main predictions of the model. Relative to right-wing parties, left-wing parties are associated with more overvalued exchange rates at low levels of international capital mobility, but they are associated with greater undervaluation when capital mobility is high. The results remain robust when using alternative measures of the real exchange rate and capital mobility; to different strategies of modeling trends in the data; and when using an instrumental-variables approach to address the possibility that capital mobility is endogenous.

This study makes several important contributions to scholarship on International Political Economy. Our results indicate that partisanship is one important factor shaping exchange rate policy decisions that deserves more attention in the future. Relatedly, while previous scholarship on exchange rate politics has focused predominantly on sector-based interests (e.g. Broz et al. (2008); Frieden (1991); Steinberg (2015); Walter (2013)), our theoretical and empirical analyses suggest that class-based interests can also play an important role in this issue area.

Our research also highlights a profound, but overlooked, way in which globalization can influence domestic politics. It is now widely recognized that rising global economic integration

can influence whether left and right parties adopt different economic policies. We show that globalization can also reverse the policy positions of left and right parties on issues over time. On one hand, our evidence that political parties continue to have a strong impact on economic policies in the era of globalized finance is consistent with the spirit of earlier "divergence" arguments, which emphasize the ongoing importance of partisanship. On the other hand, it would be wrong to conclude that globalization is irrelevant for partisan politics. We show that globalization can have far-reaching effects on the policy preferences of political parties without diminishing the importance of partisan politics for economic outcomes.

2 A Theory of Partisan Influence on Exchange Rates

Our central argument is that the partisan orientation of the government influences exchange rate policy, but the way in which it does so depends on the degree of international capital mobility. The real exchange rate, defined as the relative price of domestic and foreign goods, is our main outcome of interest. The executive branch impacts two components of the real exchange rate: the nominal exchange rate and domestic inflation rates.[2] Governments maintain a depreciated, or "undervalued," real exchange rate by intervening in the foreign exchange market with sterilized foreign currency purchases and by pursuing anti-inflationary fiscal and monetary policies. Conversely, macroeconomic and financial policies that increase inflation and limit currency depreciation produce an appreciated, or "overvalued," real exchange rate.

Following a large literature in political economy, we assume that left-wing parties represent the interests of labor and right-wing parties support the interests of capitalists (e.g. Garrett (1998); Hibbs (1977); Oatley (1999); Milner and Judkins (2004); Pinto et al. (2010); Pinto (2013)). The tendency of left (right) governments to overvalue or undervalue the exchange rate will therefore depend on which of these policies is more beneficial to workers (firms). However, the distributional effects of the real exchange rate are not static, but depend on the degree of international capital mobility. Under conditions of low international capital mobility, labor tends to benefit from an overvalued exchange rate and capital gains when the exchange rate is undervalued. High lev-

[2]Formally, the real exchange rate is defined as $q = E(P_F/P_D)$, where E is the nominal exchange rate (price of foreign currency in terms of domestic currency), P_D is the domestic price level, and P_F is the foreign price level. An increase in q thus represents a real depreciation.

els of international capital mobility reverse these preferences, shifting labor's preference towards a more undervalued exchange rate and firm owners preferred exchange rate in an overvalued direction. The remainder of this section elaborates on this logic.

2.1 Effects of the Real Exchange Rate on Workers

When barriers to cross-border investment are extensive, overvalued exchange rates are highly attractive to the working class as a whole. An appreciated real exchange rate lowers the relative prices of imported and other tradable goods, which tend to take up a large share of workers' consumption baskets. By lowering the consumer prices of essential items like food, clothing, oil, and other goods, overvaluation increase workers' real wage rates. This explains why left-wing populist governments in Latin America consistently overvalued their exchange rates during the 1970s and 1980s (Kaufman and Stallings, 1991; Sachs, 1990). Conversely, depreciation hurts the working class because it increases the domestic prices of consumer goods relative to their salaries, which are typically fixed in the short run, thus reducing their real wage rates (Cravino and Levchenko, 2017; Levy-Yeyati et al., 2013; Teimouri, 2015). Along these lines, Krugman and Taylor (1978, 450) posit that the effect of depreciation on wages explains the "traditional reluctance of leftist governments to devalue."

The benefits of overvaluation for workers decline as capital becomes more mobile internationally. Capital mobility expands employers' opportunities to substitute away from domestic workers. As Scheve and Slaughter (2004, 664) explain, "globalization of production within multinationals gives access to foreign factors of production ... This expands the set of factors firms can substitute towards in response to higher domestic wages." An overvalued exchange rate incentivizes firms to act upon this newfound ability to shift production overseas because overvaluation lowers the cost of foreign inputs relative to wages. As a result, an overvalued exchange rate is likely to increase unemployment (Frenkel and Ros, 2006; Levy-Yeyati et al., 2013; Lysenko, 2019). On the flip side, undervalued exchange rates encourage inward FDI (Klein and Rosengren, 1994; Xing and Wan, 2006), which can benefit workers by serving as a source of new jobs (Pinto, 2013; Pandya, 2010). In short, overvaluation benefits workers in closed economies because it increases their real wages but as economies become more open to international investment an overvalued

exchange rate is costlier to workers because it can raise the unemployment rate.

To illustrate the argument, consider the responses of an archetypal left party—Argentina's Peronists—in two different periods. In 1973, the government of Juan Perón revalued the peso-dollar exchange rate—a move that contributed to the massive overvaluation of the exchange rate—in response to pressure from organized labor to boost their workers' real wages (Steinberg, 2015, 137). This provides a stark contrast with the actions of another left-wing Peronist, Néstor Kirchner, who took over as President forty years later, at a time when Argentina was more dependent on international investment. Kirchner's coalition of support was "similar to the historic populist coalition. Nevertheless, the new populist coalition was based on an entirely different set of economic policies. Whereas previously, the populist alliance combined an overvalued exchange rate with industrial subsidies, the Kirchner alliance relied on an undervalued exchange rate" (Richardson, 2009, 239). The main goal of Kirchner's "export-oriented populism" (Richardson, 2009) was to promote employment, and his strategy received enthusiastic support from the country's powerful labor movement (Etchemendy and Collier, 2007).

2.2 Effects of the Real Exchange Rate on Business

The same feature that makes undervaluation problematic for workers in a closed economy makes it attractive for employers: an undervaluation reduces real wages and therefore fattens firms' profits (Clarida, 1997; Diaz Alejandro, 1965, 28; Ibarra, 2015; Krugman and Taylor, 1978, 449-450; Levy-Yeyati et al., 2013). However, the benefits that firms accrue from lower domestic wages decline as capital mobility increases. Profit margins for firms with production facilities abroad, or firms that have the opportunity to expand production overseas, are less sensitive to domestic wage rates.

For example, in Japan, a "clear majority of the private sector" favored an undervalued currency in the 1970s (Henning, 1994, 330). Accordingly, the ruling conservative Liberal Democratic Party strongly resisted the Carter administration's pressure to appreciate the Japanese Yen (Henning, 1994, 128). However, following the liberalization of the capital account in 1980, there was "an extraordinary transformation of exchange rate preferences": increased capital mobility

gave Japanese firms a "greater ability to contend with the higher yen, to be sure, through increased…foreign direct investment, and offshore outsourcing" (Henning, 1994, 167). Similarly, in Germany, the Federation of German Industries lobbied intensely against currency appreciation in the 1960s, but by the 1980s, when German firms' production processes had become more internationalized, they no longer advocated an undervalued currency (Kinderman, 2008).

The growth of cross-border debt has been another important component of capital mobility that has reshaped firms' exchange rate preferences. Increased financial globalization has given firms more opportunities to borrow from foreign financial institutions. Crucially, a large share of this debt is denominated in foreign currency (Bank for International Settlements, 2016; Du and Schreger, 2017; Corrales and Imam, 2019). Exchange rate depreciations are very costly to firms with foreign-currency-denominated debts because a depreciation increases the value of those debts in domestic-currency terms (Walter, 2013; Woodruff, 2005).[3] As a result, in financially-open economies, capital will tend to favor a more overvalued exchange rate, and right-wing parties will have a stronger incentive to overvalue.[4]

The overvaluation of the Mexican peso in the early 1990s exemplifies this logic. There was "strong support" for overvaluation "even among those industrial interests that traditionally stood to gain competitiveness through a devaluation" because Mexico's largest economic groups saw a doubling of their dollar-denominated debt between 1988 and 1991 (Kessler, 1998, 62). When President Salinas—a "neoliberal" reformer—decided to limit the degree of currency depreciation in 1991, the government "justified [this] action in large measure based on the benefits to large Mexican firms that had significant dollar debts" (Kessler, 1998, 62).

To summarize, the effects of exchange rate movements on workers and firms depend on the degree of international capital mobility. In economies that are closed to international investment, workers tend to benefit from an overvalued exchange rate while firms gain from an undervalued

[3]Individuals with foreign-currency debts also tend to oppose currency depreciation (Ahlquist et al., 2020; Rys, 2020). However, the share of the voting population with foreign-currency debts tends to be quite low: around 3% in Poland (Ahlquist et al., 2020, 910), and 6% in a sample of Eastern European countries (Rys, 2020). Foreign-currency borrowing is more prevalent in Eastern Europe than in other regions, so this likely provides something close to the upper bound of the share of the population that is directly affected by this consideration.

[4]Financial openness might also increase the attractiveness of an overvalued exchange rate for firm owners by helping them transfer their profits overseas at a more favorable rate. Describing the Russian experience, (Stiglitz, 2002, 146) observes that "for the new class of businessmen the overvalued exchange rate was a boon…it meant that they could get more dollars for their rubles, as they squirreled away their profits in foreign bank accounts."

exchange rate. Accordingly, left parties are more likely to overvalue than right parties when cross-border capital flows are restricted. However, when capital is mobile internationally, overvaluation is more beneficial to firms and less beneficial to workers. Under these conditions, we expect right-wing parties to have more overvalued exchange rates than their left-wing counterparts. The next section shows that these claims hold in a simple general equilibrium model.

3 A Stylized Model of Partisan Exchange Rate Policy

We develop a simple general equilibrium framework that formalizes the argument above and yields testable comparative statics.[5] As in the preceding argument, the two central features of the model are partisan differences and the degree of international capital mobility. We model partisanship via a policymaker who takes on one of two types: a "right-leaning" type who cares solely about capitalist utility, and a "left-leaning" type who cares solely about worker utility. We assume that capitalists face an exogenous constraint that limits their access to foreign direct and portfolio investment flows to a fraction of the total external supply of and demand for these flows, and we model increases in capital mobility as a relaxation of this constraint.

We focus on a single, composite "capitalist" that earns revenue from both nontradable and tradable goods and earns utility from its profit net of the costs of its factors of production. For the sake of tractability, we assume that the capitalist produces nontradable goods, but is endowed with an exogenous stock of tradable production goods.[6] Movements in the real exchange rate affect tradables and nontradables producers differently, such that the overall effect of a real depreciation on the business community at large will be ambiguous (Frieden, 1991). The composite approach we take here simply nests these differential effects of the real exchange rate in a single firm.

Consequently, a representative "worker" earns labor income by working in the nontradable production sector, but receives an exogenous endowment of tradable goods for consumption. The

[5]Though we present a static model for ease of exposition, the analysis could be generalized to a more complex dynamic model in which liberalization occurs gradually over time.

[6]This composite capitalist can thus be thought of as a nontradable firm with "tradable" characteristics. See, e.g. Benigno et al. (2020), for a similar example of this composite approach. Our composite capitalist also more realistically reflects the presence in developing economies of large conglomerates that undertake activities spanning multiple sectors (Schneider, 2004, 462).

restriction of endogenous productive activities to the nontradable sector within the composite capitalist implies that variation in the real exchange rate ultimately results from changes in employment in the nontradable sector.

Domestic labor market slack in the nontradable sector arises, in turn, as a consequence of the first of two ways in which agents engage with the international economy. First, we allow the capitalist to engage in outward FDI by employing foreign labor in the production process. We assume that foreign labor is an imperfect substitute for domestic labor and is paid in (exogenous) wages denominated in foreign currency. Second, we allow capitalists to borrow from international financial markets (i.e. via inward portfolio investment). We assume, as is common in many developing economies and emerging markets, that this borrowing is denominated in foreign currency. The extent to which capitalists can engage in FDI or borrow in foreign-currency is governed, in a way to be made explicit below, by the degree of capital mobility. Higher degrees of capital mobility allow greater FDI and foreign borrowing, thereby exposing both capitalists and—via the labor market—workers to the distributional effects of the real exchange rate.

Finally, for ease of exposition and to avoid introducing money into the model, we assume that the policymaker affects the real exchange rate by imposing a tax on nontradable consumption, as in Mendoza (2005). As we show below, this tax discourages the consumption, and thus production, of nontradable goods and increases the relative price of nontradables to tradables, thus producing a real appreciation.

3.1 Model Structure

Our starting point is a benchmark two-good, tradable-nontradable economy[7] populated by three agents: a representative firm, or "capitalist"; a representative household or "worker"; and a policymaker. The capitalist undertakes production of nontradable goods (Y_N) according to a constant-elasticity-of-substitution (CES) production function using domestic labor (L_N) or foreign labor (F) as imperfect substitutes, where the latter can be interpreted as following from outward

[7] See, e.g. Rodrik (2008), Korinek and Servén (2016), and Guzman, Ocampo, and Stiglitz (2018)

FDI. Output is thus defined by:

$$Y_N = (L_N^{\gamma} + F^{\gamma})^{1/\gamma} \tag{1}$$

where $\phi = \frac{1}{1-\gamma}$ is the elasticity of substitution between the domestic worker's labor and foreign labor.[8] The domestic-currency price of foreign labor (i.e. the foreign wage), denoted W_F, is given by $W_F = W_F^* \mathcal{E}$, where W_F^* is the (exogenous) foreign-currency denominated foreign wage and $\mathcal{E}$ is the nominal exchange rate, quoted as the price of the foreign-currency in terms of the domestic currency. Because we are not concerned with the capital stock, we suppress it here for ease of exposition and without loss of generality.

In addition to the nontradable production component, the capitalist also derives profit (and thus utility) from an exogenous endowment of tradable goods, which we denote $\bar{T}$. This endowment represents a component of revenue that varies negatively with the relative price of nontradable to tradable goods, so that the capitalist balances the competing preferences of both tradable and nontradable goods producers. Consistent with an open capital account, the capitalist can also increase her income by borrowing from abroad via one-period foreign-currency bonds, denoted D, at the beginning of the period. We assume that the firm contracts this debt at an exchange rate $\mathcal{E}_0 = 1$ and a zero interest rate, so that the repayment burden of the debt is given by $\mathcal{E}D$.

To capture variability in capital mobility as simply as possible, we assume that both foreign-currency borrowing and outward FDI are subject to an exogenous constraint, given by $\lambda \in [0, 1]$. Intuitively, λ is the fraction of the total supply of and demand for cross-border investment flows to which firms have access. $\lambda = 0$ implies that firms can neither borrow abroad nor engage in FDI. In turn, both the foreign labor supply and the demand for foreign-currency debt are assumed to be fixed and exogenous, given by $\bar{F}$ and $\bar{D}$, respectively.[9] For simplicity, we assume that the exogenous openness constraint always binds, so that

$$F = \lambda \bar{F} \tag{2}$$

$$D = \lambda \bar{D} \tag{3}$$

[8] An increase in γ corresponds to a greater degree of substitutability. $\gamma \to 1$ thus corresponds to the case where foreign and domestic labor are perfect substitutes.

[9] Note that the constraint on debt can also arise either because of an endogenous credit constraint as in Kiyotaki and Moore (1997), or government prudential policy, as in Korinek and Sandri (2016).

λ can thus be interpreted as a capital control applying to both foreign borrowing and outward FDI. We assume for simplicity that the level of restriction is the same for both types of flows.

Finally, we assume the capitalist's discount factor is equal to one,[10] that the price of tradables is governed by the law of one price,[11] and that the foreign price of tradables, P_T^* is normalized to one. The capitalist derives utility directly from its profits, but does not remit these profits to workers as is typical in standard real business-cycle models. The capitalist thus solves the following program in nominal terms:

$$\max_{L_N,F} P_N(L_N^\gamma + F^\gamma)^{1/\gamma} + \mathcal{E}\bar{T} - W_N L_N - W_F^* \mathcal{E} F + D - \mathcal{E} D$$

The representative worker derives utility from a Cobb-Douglas aggregate of tradable and nontradable consumption according to

$$U_w = \ln C_T^\sigma C_N^{1-\sigma} \tag{4}$$

where C_T and C_N are the worker's consumption of tradable and nontradable goods, respectively. The worker's consumption of nontradable goods is subject to a tax, denoted τ, imposed by the policymaker in order to affect the real exchange rate.[12] To fund her consumption, the worker earns labor income from her participation in nontradable production and receives an exogenous endowment of tradable goods, $\bar{y}_T$. We assume that the proceeds of the tax are rebated to the worker in a lump-sum fashion, with this transfer denoted T_W. The worker's budget constraint in terms of nontradable goods is thus:

$$\hat{p}_T C_T + C_N(1+\tau) = w_N L_N + \hat{p}_T \bar{y}_T + T_W \tag{5}$$

where $\hat{p}_T$ is the real exchange rate and w_N is the real (product) wage. For simplicity, let the gov-

[10] That is, the capitalist weights current and future utility equally.
[11] That is, $P_T = \mathcal{E} P_T^*$.
[12] See Mendoza (2005)

ernment's budget constraint be given by

$$T_W = \tau C_N \tag{6}$$

so that the government runs a balanced budget. In turn, so that the tax can affect the demand for nontradables, and thus the real exchange rate, we assume that the worker takes T_W as given. In other words, the worker does not internalize the government's budget constraint.[13]

The policymaker in this model may be one of two types: R, corresponding to "right-leaning," or L, corresponding to "left-leaning." As in Alesina and Tabellini (1989), R-policymakers choose τ to maximize the utility of the capitalist subject to (6) and optimal private-sector behavior. In contrast, L-policymakers choose τ to maximize the utility of the worker. The policymaker's preferences for different classes represents the fundamental political choice mechanism in this model: we do not model an electoral process but instead alternately examine the optimal choices of an R- and L-type policymaker.

To close the model, we stipulate that the market for nontradable goods clears,

$$C_N = Y_N, \tag{7}$$

and that the worker consumes her entire endowment of tradable goods,

$$C_T = \bar{y}_T. \tag{8}$$

3.2 Private Sector Equilibrium

We now characterize optimal private-sector behavior. The worker maximizes (4) subject to (5). This yields the following standard optimality condition:

$$\hat{p}_T = \frac{\sigma}{1-\sigma}\left(\frac{C_N(1+\tau)}{C_T}\right) \tag{9}$$

where $\hat{p}_T$ is the relative price of tradables to nontradables—that is, the real exchange rate.

[13] Put differently still, we assume deviations from Ricardian equivalence here.

To analyze the behavior of the capitalist, it will be helpful to write capitalist profit in terms of nontradable goods, setting $P_N = 1$, as

$$\hat{\pi}_C = (L_N^\gamma + F^\gamma)^{1/\gamma} + \hat{p}_T \bar{T} - w_F^* \hat{p}_T F - w_N L_N + \bar{d} - \hat{p}_T \bar{D} \tag{10}$$

where w_F^* is the real foreign (product) wage, w_N is the domestic real (product) wage, and $\bar{d}$ is the initial stock of foreign-currency debt, expressed in terms of nontradable goods. Note that we have also imposed the law of one price in tradable goods, $P_T = \mathcal{E} P_T^*$, and set $P_T^* = 1$.

The capitalist chooses domestic and foreign labor to maximize profit. The first-order conditions with respect to L_N and F are, respectively:

$$\frac{L_N^\gamma}{F^\gamma} = \frac{1}{w_N^{\frac{\gamma}{1-\gamma}} - 1} \tag{11}$$

$$\frac{L_N^\gamma}{F^\gamma} = \hat{p}_T^{\frac{\gamma}{1-\gamma}} - 1 \tag{12}$$

where we have normalized $w_F^* = 1$ in the second first-order condition. Note that (12) can be rearranged to yield an expression for the real exchange rate, $\hat{p}_T$:

$$\hat{p}_T = \frac{(L_N^\gamma + F^\gamma)^{\frac{1-\gamma}{\gamma}}}{F^{1-\gamma}} \tag{13}$$

In equilibrium, it must be the case that (9) and (13) are equal. Equating them, using the clearing conditions (7) and (8) and solving for L_N yields

$$L_N^* = \left(\frac{\bar{y}_T \left(\frac{1-\sigma}{\sigma}\right)}{(\lambda \bar{F})^{1-\gamma}(1+\tau)} - (\lambda \bar{F})^\gamma \right)^{1/\gamma} \tag{14}$$

We focus on the case in which employment is demand-determined (see, e.g. Uribe and Schmitt-Grohé (2017) and Huo and Ríos-Rull (2020)). Then, along with the assumption that FDI is fixed at $\bar{F}$ and constrained by the degree of capital openness λ, (14) defines equilibrium employment in the nontradable sector.

Note that equilibrium employment in the nontradable sector is decreasing in the foreign

labor supply, reflecting the substitutability of foreign and domestic labor, as well as in τ. To understand why domestic employment is decreasing in the tax on nontradable consumption, use (14) to substitute for L_N in (13), which gives an expression for the real exchange rate in terms of the tax:

$$\hat{p}_T^{\frac{\gamma}{1-\gamma}} = \frac{\bar{y}_T \left(\frac{1-\sigma}{\sigma}\right)}{\lambda \bar{F}(1+\tau)} \tag{15}$$

Thus, the tax on nontradable consumption brings about a real appreciation (i.e. a decline in $\hat{p}_T$). Intuitively, the tax on nontradable consumption reduces the consumption, and thus the production, of the nontradable good, raising its relative price. Next, combine the two first-order conditions (11) and (12) to derive an expression for the real wage:

$$w_N^{\frac{\gamma}{1-\gamma}} = \frac{1}{\hat{p}_T^{\frac{\gamma}{1-\gamma}} - 1} - 1 \tag{16}$$

We focus on the range of values for which $1 < \hat{p}_T < 2$, which ensures that the real wage is positive. Then, defining $\Gamma \equiv \frac{\bar{y}_T}{\lambda \bar{F}} \left(\frac{1-\sigma}{\sigma}\right)$ for convenience, so that $\hat{p}_T^{\frac{\gamma}{1-\gamma}} = \Gamma/(1+\tau)$, we can write the real wage as

$$w_N^{\frac{\gamma}{1-\gamma}} = \frac{(1+\tau)}{\Gamma - (1+\tau)} - 1 \tag{17}$$

which shows that the real wage is increasing in the tax—and thus with real appreciation as well. Hence, a real appreciation, effected via an increase in the tax on nontradable consumption, raises the real wage and lowers equilibrium employment in the domestic nontradables sector.

3.3 Optimal Exchange Rate Policy

As we show in equation (15), the policymaker affects the real exchange rate by choosing the nontradable consumption tax, τ. What is the optimal level of τ for each type of policymaker? We begin with the *R*-type policymaker. The first-degree homogeneity of the CES production technology in (10) implies that when a capitalist is behaving optimally, its profit will be given by

$$\tilde{\pi}_C = \hat{p}_T \bar{T} + \lambda \bar{d} - \hat{p}_T \lambda \bar{D} \tag{18}$$

Differentiating this function with respect to $\hat{p}_T$ yields a knife-edge first-order condition:

$$\bar{T} - \lambda \bar{D} = 0. \tag{19}$$

This condition yields the core intuition for our argument about right-leaning parties. When $T > \lambda \bar{D}$, the R-type policymaker maximizes the capitalist's profit by intervening to make $\hat{p}_T$ as large as possible—that is, to deliver undervaluation by setting τ as low as possible (i.e., $\tau = 0$).[14] The preceding condition will be increasingly likely to hold as λ falls—that is, as the economy is increasingly closed to financial flows. Intuitively, the benefit the capitalist receives from the increase in tradable good revenues outweighs the additional debt burden she faces as the real exchange rate depreciates. When the capital account is fully closed ($\lambda = 0$), the capitalist clearly prefers undervaluation, as she carries no foreign-currency debt.

Conversely, when $T < \lambda \bar{D}$, the R policymaker will prefer to deliver an overvalued exchange rate by setting τ as high as possible, as the capitalist's debt costs rise by more than its tradable endowment in response to a real appreciation. This condition is more likely to hold for high values of λ. Note that this condition will also hold for sufficiently high values of $\bar{D}$, reflecting that the benefit to the capitalist of real appreciation depends not solely on openness as such, but also on whether there exists sufficient external demand for domestic debt instruments.

We thus have the following result:

Proposition 3.1. As international capital mobility (λ, $\bar{D}$, $\bar{F}$) increases, the R policymaker will be more likely to deliver overvaluation.

The assumption in (8) implies that maximizing the welfare of the worker amounts to maximizing the worker's nontradable labor income. The L-type policymaker thus solves the following program:

$$\max_{\tau} w_N L_N = \left(\frac{1+\tau}{\Gamma - (1+\tau)} - 1 \right)^{\frac{1-\gamma}{\gamma}} \left(\frac{\Lambda}{(1+\tau)} - (\lambda \bar{F})^{\gamma} \right)^{1/\gamma} \tag{20}$$

where $\Lambda \equiv \frac{\bar{y}_T \left(\frac{1-\sigma}{\sigma} \right)}{(\lambda \bar{F})^{1-\gamma}}$. The Appendix shows that the L-type policymaker's optimal choice of τ is

[14] That the R-type policymaker sets τ as low as possible follows from the fact that the first-order condition is positive when $T > \lambda \bar{D}$ and because τ and $\hat{p}_T$ move inversely.

given by

$$\tau* = \frac{\Gamma}{1+\gamma} - 1 = \frac{\bar{y}_T\left(\frac{1-\sigma}{\sigma}\right)}{\lambda\bar{F}(1+\gamma)} - 1 \tag{21}$$

which is positive by virtue of the positivity of the real wage rate. This expression captures the second core insight of the model: as capital openness increases—that is, as λ rises—the L-type policymaker desires a more undervalued exchange rate via a lower τ. To understand the intuition for this result, consider a marginal increase in λ. A higher level of λ implies greater access of the capitalist to foreign labor, which results in a lower level of domestic employment and a higher real wage such that the worker's labor income declines. To offset this decline in labor income, the worker prefers a lower τ, which acts in the opposite direction to suppress real wages and raise employment. Conversely, a marginal decrease in λ will increase domestic employment (as less FDI is permitted) but lower real wages, so that the worker prefers overvaluation—and the L policymaker delivers it via a higher τ. We summarize this result in the following proposition:

Proposition 3.2. As international capital mobility (λ, $\bar{F}$) increases, the L policymaker will be more likely to deliver undervaluation.

It is also worth highlighting the role of γ, which measures the substitutability of foreign labor for domestic labor. As γ rises and foreign labor becomes a closer substitute for domestic labor, the optimal level of τ falls. The intuition behind this result is straightforward: a higher degree of substitutability makes the domestic worker more vulnerable to a fall in employment as the real wage rises, because the capitalist can more readily use foreign labor as a production input. The worker thus prefers a more undervalued exchange rate to suppress real wages, which the L-type policymaker delivers.

Figure 2 depicts the incentives of each type of policymaker to overvalue or undervalue the exchange rate, conditional on the level of capital account openness and for fixed values of $\bar{T}$, $\bar{D}$, γ, $\bar{F}$, and $\bar{y}_T$.[15] As Proposition 3.1 claims, an increase in openness increases the incentive of right-leaning policymakers to overvalue. Conversely, left-leaning policymakers are increasingly likely to undervalue the exchange rate as openness increases toward a threshold determined by

[15]The parameter values are chosen such that the threshold for under and overvaluation is the same for both types of policymaker.

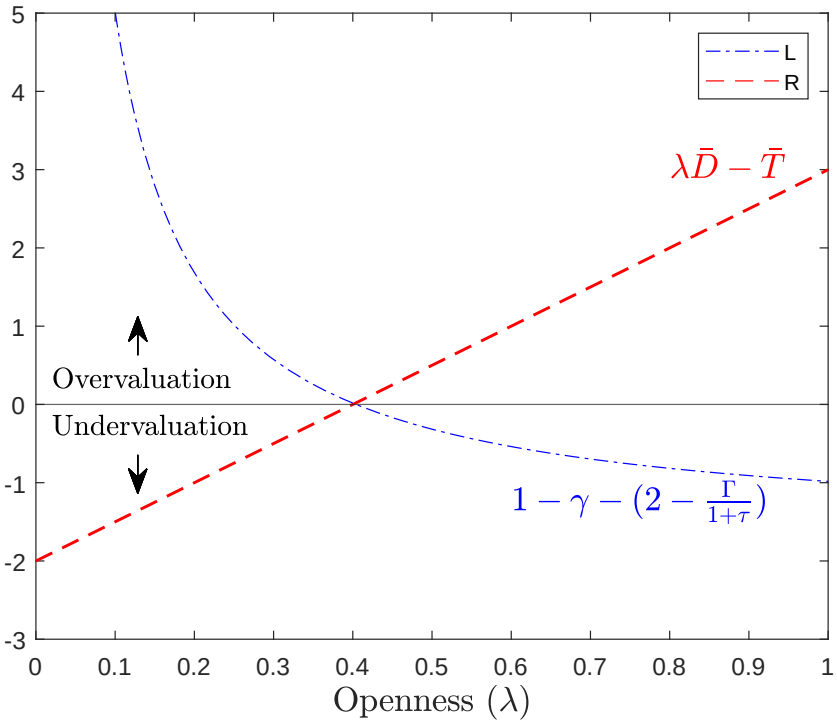

FIGURE 2: Policymaker's Preferences for τ by Type. Figure drawn for $\bar{T} = 2$, $\bar{D} = 5$, $\gamma = .65$, $\bar{y}_T = 10$, $\bar{F} = 10$

the parameter values.

4 Partisan Influences on Exchange Rate Valuation: Evidence from Time-Series-Cross-Section Data

4.1 Data and Methods

The central empirical implication of the model in the previous section is that exchange rate valuation outcomes should vary with both the partisan orientation of the government and the prevailing level of international capital mobility. To test this implication, we estimate a linear interaction model of the form:

$$Overvaluation_{it} = \alpha + \beta_1 Party_{it} + \beta_2 CapMob_{it} + \beta_3 Party_{it} \times CapMob_{it} + \beta \mathbf{X}_{it} + \eta_i + \varepsilon_{it} \quad (22)$$

for a set of i countries and t years via OLS. $\mathbf{X}$ is a vector of covariates to be described below.[16]

To measure overvaluation, we use a measure of currency misalignment from the CEPII EQCHANGE dataset (Couharde et al., 2017). This measure is constructed in three steps. First, a real effective exchange rate (REER) index is constructed for each country using trade-weighted bilateral nominal exchange rates.[17] Second, a measure of the "equilibrium" real effective exchange rate is defined as the fitted value from a regression of real effective exchange rates on several measures of "fundamentals" that influence the equilibrium real effective exchange rate, including relative productivity, terms-of-trade shocks, and net indebtedness.[18] Finally, exchange rate misalignment is defined as the difference between the actual and the equilibrium REERs (i.e. the residual from the aforementioned regression). Positive values of this misalignment variable indicate overvaluation and negative values indicate undervaluation.

We capture government partisanship using the Database of Political Institutions' (Cruz, Keefer, and Scartascini, 2018) classification of the partisan orientation of the executive. The party to which the executive belongs is classified with respect to its overall economic policy stance as either (1) Right, (2) Center, or (3) Left.[19] We subtract one from this variable to normalize "Right" parties to zero. We show in the appendix that all of the results presented in the main text are robust to using a dichotomous variable equal to one if the executive party is classified as "Right" and zero otherwise (i.e. Left or Center).

To measure international capital mobility, we use the updated Financial Globalization Index from the KOF Swiss Economic Institute (Gygli et al., 2019).[20] The index averages de facto and de jure subindexes of capital mobility and ranges from 0 to 100, with higher values indicating more financially open economies.[21] The de facto financial globalization subindex aggregates a variety

[16] Fisher-type panel unit-root test statistics are large for the overvaluation variable and allow for a rejection of the null hypothesis that all panels contain unit roots. Im-Pesaran-Shin tests return similar results. Alternatively, we run Kwiatkowski, Phillips, Schmidt, Shin (KPSS) tests of the stationarity of overvaluation separately for each country and find that the null of level stationarity cannot be rejected for a large percentage of the sample.

[17] We use the measure of REERs corresponding to "narrow', fixed' trade weights over the estimation sample.

[18] Relative productivity captures "Balassa-Samuelson" effects, whereby countries with more productive tradable goods sectors have more appreciated real exchange rates. See Balassa (1964); Samuelson (1964).

[19] Codings are based on several sources, including the party's name, various handbooks, and previous scholars' codings. For example, parties defined as communist, socialist, social-democratic, or left-wing are classified as "Left," while those defined as conservative, Christian democratic, or right-wing are classified as "Right."

[20] This index was initially introduced by Dreher (2006).

[21] Additional information on the aggregation method can be found at https://kof.ethz.ch/en/forecasts-and-indicators/indicators/kof-globalisation-index.html.

of international financial stock and flow variables, including foreign direct investment, portfolio investment, international debt, and factor payments. In contrast, the de jure financial globalization subindex is an aggregation of the level of investment restrictions, capital account openness, and international investment agreements. The index's coverage of actual stocks and flows as well as formal legal restrictions corresponds closely to the way we conceptualize capital mobility in the model above.

We control for a number of variables that could confound the relationship between partisanship, capital mobility, and exchange rate valuation. To account for sectoral-based influences on both exchange rate outcomes and capital mobility, we use the value-added of manufacturing sector as a share of GDP as a proxy for the political influence of the tradable sector (see, e.g. Blomberg et al. (2005); Steinberg (2015)). Because an economy's openness to trade may influence societal preferences for exchange rate valuation, and because trade openness may encourage capital mobility, we also control for the the sum of exports and imports as a share of GDP. We include the share of the population living in urban areas to account for the possibility that urban and rural interests favor overvaluation and undervaluation, respectively (Bates, 1981).[22] Finally, political regime type may also drive both exchange rate policy (Steinberg and Malhotra, 2014; Quinn, Sattler, and Weymouth, 2020) and capital mobility (Eichengreen and Leblang, 2008; Eichengreen and Rose, 2014; Steinberg et al., 2018). Accordingly, we control for democracy using the V-Dem polyarchy index (Teorell et al., 2016). Table 2 in the appendix reports summary statistics for all of the variables.

4.2 Main Empirical Results

Table 1 displays the results from our baseline OLS estimates. All regressions report Driscoll and Kraay (1998) standard errors, which are robust to arbitrary forms of error correlation within countries over time as well as between countries.[23] To account for unobserved country-level heterogeneity, all models include country-level fixed effects.

Models (1) and (2) report the baseline OLS estimates, without and with covariates, respec-

[22] Manufacturing value-added and urban share data are from the World Bank's World Development Indicators.
[23] All of the results are robust to using the usual Liang-Zeger standard errors clustered at the country level.

Dependent Variable: Overvaluation (CEPII)	**(1)**	**(2)**	**(3)**	**(4)**
Specification	*OLS*	*OLS*	*IV*	*OLS*
Party	0.078***	0.095***	0.109***	0.104***
	(0.021)	(0.030)	(0.035)	(0.027)
Financial Globalization Index (FGI)	0.000	0.002**	0.005***	0.001
	(0.000)	(0.001)	(0.001)	(0.001)
Party $\times$ FGI	-0.001***	-0.001***	-0.002***	-0.001**
	(0.000)	(0.000)	(0.001)	(0.000)
Manufacturing/GDP		-0.001	0.001	0.000
		(0.002)	(0.002)	(0.002)
Democracy (V-Dem Polyarchy)		-0.353***	-0.273***	-0.367***
		(0.083)	(0.076)	(0.084)
Trade/GDP		-0.002***	-0.002***	-0.002***
		(0.001)	(0.001)	(0.001)
Urban Share		0.001	0.000	0.001
		(0.001)	(0.001)	(0.001)
Overvaluation (Spatial Lag)			1.137***	
			(0.188)	
Trend				0.002**
				(0.001)
Trend $\times$ Party				-0.001**
				(0.001)
Constant	-0.026	0.198*		0.242**
	(0.030)	(0.105)		(0.103)
Kleibergen-Paap rk LM statistic			12.664	
p-value			0.000	
Kleibergen-Paap rk Wald F statistic			46.242	
10% maximal IV size			7.03	
Observations	2,865	2,049	1,979	2,049
Number of countries	106	91	89	91
R-squared	0.015	0.123	0.150	0.128

*** p<0.01, ** p<0.05, * p<0.1

TABLE 1: Baseline Regressions. Driscoll and Kraay (1998) standard errors in parentheses. All models contain country fixed effects.

tively. In both models, the interaction between partisanship and financial globalization is statistically significant and negative, as anticipated. At low levels of financial globalization, a shift in partisanship to the left increases overvaluation. Conversely, at higher levels of financial globalization, a leftward movement in the partisan orientation of government reduces overvaluation. Most of the control variables are of the expected sign, and increases in trade as a share of GDP are significantly associated with more undervalued currencies. While the coefficient on democracy is negative and significant, contrary to other empirical evidence (Quinn et al., 2020), we suspect this result may be driven by a large of number of cases in our sample of overvaluation in military dictatorships (see Steinberg and Malhotra (2014)).[24]

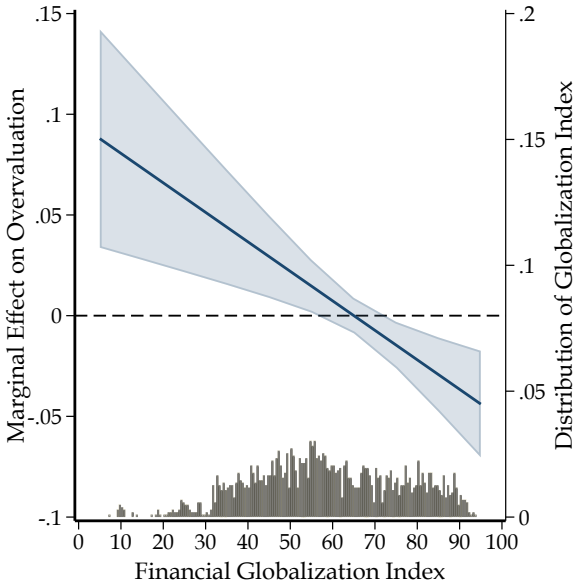

FIGURE 3: Marginal effects of *Party* from baseline regression. Marginal effects correspond to model (2) of Table 1. Shaded areas denote 95% confidence interval using Driscoll and Kraay (1998) standard errors.

Figure 3 plots the marginal effects from model (2), along with the distribution of the financial globalization index. These marginal effects provide strong support for our theory's predictions. For roughly the lowest 50 percent of the distribution of international capital mobility (as proxied by the financial globalization index), a marginal shift leftward in the partisan orientation of the government is associated with significant increase in overvaluation. Quantitatively, a leftward

[24]Our sample includes numerous observations where military dictatorships had highly overvalued exchange rates, such as: Algeria (1974-1990); Benin (1974-1980); Chile (1976-1981); Egypt (1984-1989); Equatorial Guinea (1986-1996); Ghana (1988-1991); Mali (1974-1986); Nigeria (1994-98); Paraguay (1978-1984).

shift in partisan orientation in a country with a financial globalization score of 20 (e.g. China around 1985) is associated with an increase in overvaluation by 0.066. This is a meaningful shift in policy: the mean *levels* of misalignment over the estimation sample were 0.124 and -0.121 for countries with overvalued and undervalued exchange rates, respectively. By contrast, for roughly the highest 27 percent of the distribution of international capital mobility, a leftward shift in partisanship is associated with a statistically significant decline in misalignment. Quantitatively, a leftward shift in partisanship in a country with a financial globalization score of 85 (e.g. Germany in the mid-2000s) is associated with a fall in overvaluation by 0.029.

4.3 Threats to Inference

4.3.1 Endogenous Capital Mobility

One potential objection to the model in (22) is that international capital mobility, in both de facto and de jure respects, is likely to be endogenous to exchange rate policy. For example, countries may impose capital or exchange controls as part of a package of measures intended to affect the value of the currency. To mitigate this endogeneity and isolate the exogenous component of capital mobility, we adopt an instrumental variables (IV) approach, instrumenting capital mobility at home with capital mobility in neighboring countries. The degree of capital mobility among a country's neighbors is a relevant instrument to the extent that it influences that country's own degree of capital mobility. Previous studies find that countries are more likely to liberalize the capital account once other countries—particularly those that are their peers, partners, and neighbors—have already done so (Simmons and Elkins, 2004; Brooks and Kurtz, 2012; Guisinger and Brune, 2017; Steinberg et al., 2018).

As a measure of capital mobility in neighboring countries, we construct a spatial lag of the KOF financial globalization index. For any country i, the spatial lag of financial globalization is a weighted average of financial globalization in j other countries, where the weight for each of the j countries is the inverse geographic distance between country i and country j.[25] We also instrument

[25]We weight countries based on geographic distance because this captures a wide array of peer and partner connections and potentially avoids endogeneity problems that may arise with other commonly-used weighting schemes (Steinberg et al., 2018, 864). The spatial lag variable is constructed as $\Sigma_{j\neq i}^{n} KOF_j \times \frac{(1/Dist_{ij})}{\Sigma_{j\neq i}^{n}(1/Dist_{ij})}$, where $Dist_{ij}$ is the geo-

for the interaction of partisan orientation with financial globalization using the product of the party variable and the spatial lag of financial globalization.

The validity of the spatial lag of financial globalization as an instrument also hinges on its survival of the exclusion restriction. We argue that liberalization in neighboring countries is unlikely have an effect on overvaluation in the home country, other than indirectly via liberalization in the home country itself. The exclusion restriction would also be violated if other countries' exchange rate movements affect overvaluation in the home country (see Betz et al. (2018)). This is a more plausible concern in our case because undervaluation in one country may incentivize other countries to competitively devalue their own currencies. To rule out this channel, we add to our IV specifications as a control variable the spatial lag of overvaluation, defined analogously to the spatial lag of financial globalization. Another challenge with using spatial lags as instruments is that capital mobility in the home country likely exerts an influence on capital mobility in other countries as well (Betz et al., 2018). To mitigate the risk of simultaneity bias, we use the one-year temporal lag of the spatial lag of financial globalization as our instrument.

Model (3) in Table 1 presents IV/2SLS estimates using the temporally- and spatially-lagged KOF index of financial globalization as an instrument for capital mobility, along with its interaction with partisan orientation. We also report results of underidentification and relevance tests. The Kleibergen-Paap rk F-statistic corresponds to the Stock and Yogo (2005) test for weak instruments, in which the null hypothesis is that the instrument set is weak. This modified test statistic is appropriate when disturbances are assumed to not to be independently and identically distributed, and its large value suggests that the temporal-spatial lag of financial globalization and its interaction with partisanship are sufficiently strong instruments. As with the OLS estimates, we report Driscoll and Kraay (1998) standard errors and include country-level fixed effects in the IV/2SLS specification.

The coefficients on the interactions of partisanship with financial globalization are negative and statistically significant, as in the OLS models. The interactive effects in the IV/2SLS cases are close in magnitude to the baseline OLS results as well. Marginal effects plots (see Figure 4 in the appendix) are virtually identical to the OLS case. Together with Figure 3, these results reveal a

graphic distance between the largest cities of countries i and j from the CEPII GeoDist database.

clear partisan reversal in exchange rate valuation, conditional on the level of international capital mobility.

4.3.2 *Accounting for Trends in Overvaluation*

Another concern is that, as we showed in the introduction, exchange rate levels have displayed clear partisan-specific trends over time: the average level of the exchange rate for left-leaning parties has trended from overvaluation to undervaluation since 1975, while the average level of the exchange rate for right-and center-leaning parties has oscillated from undervaluation to overvaluation over the sample. A conservative test of our theory is thus whether there is evidence of a conditional effect of partisanship on exchange rate valuation over and above these party-specific trends. Controlling for partisan trends in overvaluation, in other words, decreases the risk that our estimates have effectively soaked up a secular change in partisan exchange rate policy unrelated to capital mobility. To model these trends, model (4) in Table 1 adds to our baseline specification a linear time trend and its interaction with partisanship.

Both trend variables are statistically significant, consistent with the existence of a secular component in party-specific exchange rate valuation outcomes. Moreover, the interaction between partisan orientation and financial globalization remains negative and statistically significant. As international capital mobility increases, left-leaning governments produce lower levels of overvaluation relative to their right-leaning counterparts.

4.3.3 *Linearity of Marginal Effects*

Next, we assess whether the interactive influence of partisanship on exchange rate valuation is robust to a non-linear specification by implementing the binning estimator proposed by Hainmueller, Mummolo, and Xu (2019), which allows for nonlinear marginal effects and ensures that marginal effects are evaluated at sufficiently data-dense parts of the support of the moderator. We plot the estimates from the binning estimator in Figure 5 in the appendix. With evaluation points defined as the median value of financial globalization in each tercile of the data, the binning estimator reveals a significant positive marginal effect on overvaluation of a leftward movement

in partisanship for the lowest tercile—consistent with our theory and the evidence above. At "medium" and "high" levels of financial globalization, the marginal effects of a more left-leaning executive are negative and near-significant (p-values of 0.053 and 0.123, respectively), again consistent with the notion of a reversal in the exchange rate policies of left-leaning parties as capital mobility rises.

4.3.4 Alternate Measures of Overvaluation and Capital Mobility

We next assess whether our results are an artifact of the way in which the equilibrium real exchange rate and capital mobility are defined. As an alternative to the CEPII currency misalignment variable we employ in the baseline specifications, we follow the methodology in Rodrik (2008) to construct a meausure of overvaluation.[26] We replicate the same specifications from Table 1 in Table 3 in the appendix using this alternate measure of overvaluation. In all specifications, the coefficient on the interaction between partisanship and financial globalization is negative and statistically significant: a leftward shift in the partisan orientation of government continues to be associated with an increase in overvaluation at low levels of capital mobility and a decrease in overvaluation at higher levels of capital mobility.

Second, we use the de jure capital account openness index constructed by Chinn and Ito (2006), which captures only formal exchange controls and restrictions on current and capital account transactions, as an alternative to the KOF financial globalization index as a measure of international capital mobility.[27] Higher values of this index correspond to more financially open economies. We report the results from using the Chinn-Ito index as a moderator in Table 4 in the appendix, which again replicates our baseline OLS and IV/2SLS models. Even limiting our attention to a formal, regulatory conception of capital mobility, the main interaction results continue to hold.

[26] We use Version 9.1 of the Penn World Tables (PWT) to construct a measure of the real exchange rate as the nominal exchange rate (local currency per USD) deflated by the price of output in the base country relative to the price of output in the U.S. We define the equilibrium value of the real exchange rate for each country as the fitted values from a regression of the natural log of the real exchange rate on a constant, a full set of year dummy variables, and the natural log of real per capita GDP (also from the PWT). Finally, we define overvaluation as the equilibrium real exchange rate less the actual real exchange rate.

[27] The Chinn and Ito (2006) index is a component of the broader KOF financial globalization index.

4.3.5 *Dynamic Effects*

As a final robustness check, we allow the interactive influence of partisanship and international capital mobility on exchange rate valuation to unfold over time by estimating an unrestricted first-order autoregressive distributive lag (ADL) model following Warner (2019). The specification is unrestricted in that it allows for a full set of two-way interactions between $Party_t$, $Party_{t-1}$, $CapMob_t$, and $CapMob_{t-1}$. The appendix describes the full specification, which includes the contemporaneous set of covariates described above, and plots the marginal effects from estimating this model. The marginal effects are line with the baseline partisan reversal pattern, though the magnitude of this reversal is slightly less pronounced than in the baseline case.

5 Conclusion

Undervalued exchange rates are a useful tool for promoting economic growth, employment, and financial stability. This paper showed that partisan political considerations help determine whether countries undervalue their exchange rates. However, the way in which partisanship influences exchange rate policy depends on the degree of international capital mobility. Our evidence indicates that partisan shifts to the right increase the degree of exchange rate undervaluation when capital mobility is limited. The opposite pattern arises when capital markets are integrated: left parties maintain more undervalued exchange rates. We argue that this partisan reversal arises because the distributional effects of the real exchange rate on labor and business—core constituents of left and right parties, respectively—change with the degree of international capital mobility. Undervaluation primarily benefits firms when capital mobility is low but is more beneficial to workers when capital mobility is high.

This study makes several theoretical and empirical contributions. First, this work highlights the important role that partisanship plays in shaping exchange rate levels. Political parties appear to have a much stronger impact on the real exchange rate than the conventional wisdom (e.g. Broz and Frieden (2001)) suggests. Second, our research brings a new perspective to longstanding debates about the impact of globalization on domestic politics. Our evidence suggests that a convergence in party positions is not the only way that globalization shapes partisan politics;

globalization also has the potential to reverse party preferences. Finally, our results indicate that the effects of domestic variables—in this case, partisanship—depend on systemic-level factors, such as the degree of international capital mobility. Our analyses therefore further illustrate the explanatory gains that can accrue by integrating domestic and systemic variables into a single theoretical and empirical framework (see also Chaudoin, Milner, and Pang (2015); Oatley (2011)).

Our analyses also have important implications for the future of the global monetary system. While international capital mobility increased steadily from 1970 to 2007, cross-border capital flows have stagnated and a number of countries have reimposed capital controls over the past decade. More recently, the global pandemic and the associated worldwide economic downturn have led to a sharp contraction in cross-border investment. Going forward, these developments have the potential to reinforce this trend away from international capital mobility. If this trend continues, the domestic political economy of exchange rate policy is likely to change as well. We have already observed some movement among left governments away from heavily undervalued exchange rates in the 2010s, as can be seen in Figure 1. Undervalued exchange rates are likely to remain attractive to at least some governments in the coming years. Whether it will primarily be governments on the left or the right who pursue this strategy remains an open question—and one that is likely to depend in part on whether international capital markets remain open.

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A Proof of Equation (21)

Proof. We want to show that the optimal choice of τ is given by (21).

First, take a monotonic transformation of the maximand in (20):

$$(w_N L_N)^\gamma = \left(\frac{2(1+\tau)-\Gamma}{\Gamma-(1+\tau)}\right)^{1-\gamma}\left(\frac{\Lambda}{(1+\tau)}-(\lambda\bar{F})^\gamma\right) \tag{23}$$

where $\Lambda \equiv \frac{\bar{y}_T\left(\frac{1-\sigma}{\sigma}\right)}{(\lambda\bar{F})^{1-\gamma}}$. Differentiating this expression with respect to τ yields

$$\begin{aligned}(1-\gamma)\left(\frac{2(1+\tau)-\Gamma}{\Gamma-(1+\tau)}\right)^{-\gamma}\left(\frac{\Gamma}{(\Gamma-(1+\tau))^2}\right)\left(\frac{\Lambda}{1+\tau}-(\lambda\bar{F})^\gamma\right) \\ -\left(\frac{2(1+\tau)-\Gamma}{\Gamma-(1+\tau)}\right)^{1-\gamma}\left(\frac{\Lambda}{(1+\tau)^2}\right)\end{aligned} \tag{24}$$

Note that when this expression is negative, the L-type policymaker sets τ as low as possible—that is, she delivers undervaluation. When is this the case?

We can rewrite this derivative as

$$\begin{aligned}&\left[\frac{2(1+\tau)-\Gamma}{\Gamma-(1+\tau)}\right]^{-\gamma}\times \\ &\left\{(1-\gamma)\left(\frac{\Gamma}{(\Gamma-(1+\tau))^2}\right)\left(\frac{\Lambda}{1+\tau}-(\lambda\bar{F})^\gamma\right)-\left(\frac{2(1+\tau)-\Gamma}{\Gamma-(1+\tau)}\right)\left(\frac{\Lambda}{(1+\tau)^2}\right)\right\}\end{aligned} \tag{25}$$

Then, note that by the assumption that $1 < \hat{p}_T < 2$,

$$\left(\frac{2(1+\tau)-\Gamma}{\Gamma-(1+\tau)}\right) > 0 \;\; \forall\tau > 0. \tag{26}$$

The terms in brackets can then be combined into a single ratio with positive denominator. The numerator can be written

$$(1-\gamma)\Gamma(\Lambda-(\lambda\hat{F})^\gamma(1+\tau))(1+\tau)-(2(1+\tau)-\Gamma)\Lambda(\Gamma-(1+\tau)) \tag{27}$$

Simplifying and using the fact that $\Lambda = (\lambda\bar{F})^\gamma\Gamma$, we have

$$\begin{aligned}&(1-\gamma)(1+\tau)\Gamma-\Gamma(1+\tau)+2(1+\tau)^2-(1-\gamma)(1+\tau)^2-\Gamma(2(1+\tau)-\Gamma) && (28)\\ &=(1+\tau)[2(1+\tau)-\Gamma+(1-\gamma)\Gamma-(1-\gamma)(1+\tau)]-\Gamma(2(1+\tau)-\Gamma) && (29)\\ &=-[\Gamma-(1+\tau)](2(1+\tau)-\Gamma)+[\Gamma-(1+\tau)](1+\tau)(1-\gamma) && (30)\end{aligned}$$

Then the derivative in (25) will be negative if

$$2(1+\tau)-\Gamma > (1+\tau)(1-\gamma) \tag{31}$$

or

$$2-\frac{\Gamma}{1+\tau} > 1-\gamma, \tag{32}$$

which can be rearranged as

$$\tau > \frac{\Gamma}{1+\gamma} - 1. \tag{33}$$

It follows that the derivative in (25) will be positive if $\tau < \frac{\Gamma}{1+\gamma} - 1$. Then, $\tau^* = \frac{\Gamma}{1+\gamma} - 1$ maximizes the L-type policymaker's utility. □

B Supplementary Empirical Results

Variable	Mean	N	Std. Dev.	Max	Min
Overvaluation (CEPII)	0.00	5368	0.21	1.38	-2.26
Overvaluation (Rodrik (2008))	-0.00	6990	0.45	4.77	-1.94
Party	1.13	3746	0.93	2.00	0.00
Financial Globalization Index	51.13	7005	18.29	98.20	4.67
Manufacturing/GDP (%)	13.46	5689	8.60	192.00	0.00
Democracy (V-Dem Polyarchy)	0.49	5905	0.28	0.95	0.01
Trade/GDP (%)	79.14	6332	48.44	437.33	0.02
Urban Share (%)	52.96	7295	23.84	100.00	3.38
Chinn-Ito Capital Account Openness	0.05	6345	1.41	2.35	-2.00

TABLE 2: Summary Statistics for Variables

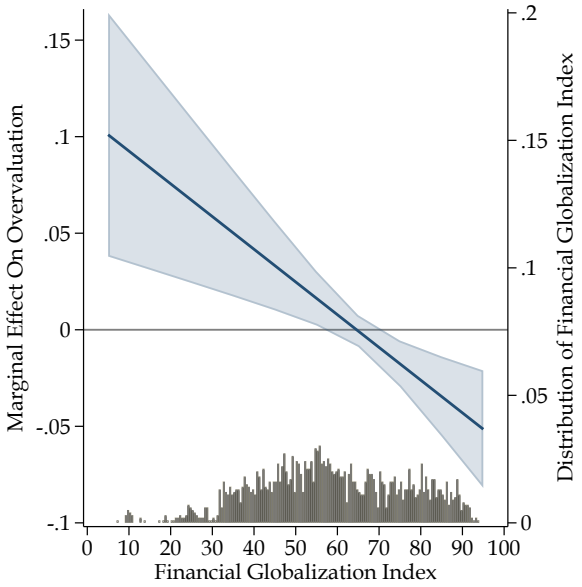


FIGURE 4: Marginal effects from IV/2SLS model with country-level fixed effects and Driscoll and Kraay (1998) standard errors.

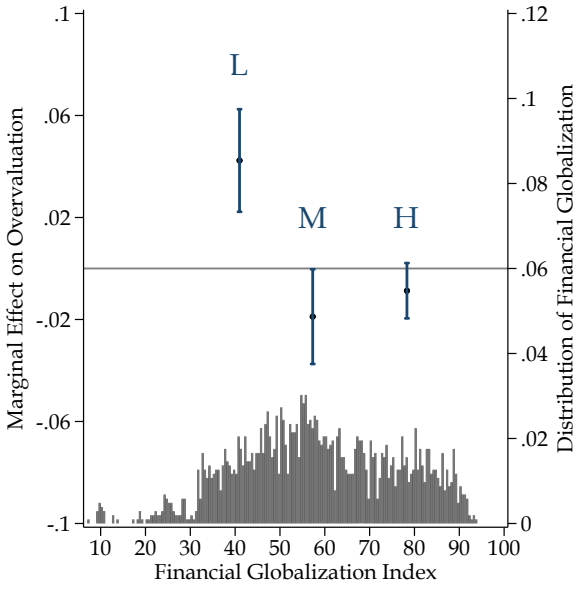


FIGURE 5: Marginal effects from Hainmueller et al. (2019) binning estimator using Driscoll and Kraay (1998) standard errors.

Dependent Variable: Overvaluation (Rodrik (2008)	**(1)**	**(2)**	**(3)**	**(4)**
Specification	*OLS*	*OLS*	*IV*	*OLS*
Party	0.093***	0.097***	0.114***	0.103***
	(0.031)	(0.027)	(0.036)	(0.027)
Financial Globalization Index (FGI)	0.004***	0.004***	0.006***	0.003***
	(0.001)	(0.001)	(0.002)	(0.000)
Party $\times$ FGI	-0.001***	-0.001***	-0.002***	-0.001**
	(0.000)	(0.000)	(0.001)	(0.000)
Manufacturing/GDP		-0.008***	-0.008***	-0.006***
		(0.002)	(0.002)	(0.002)
Democracy (V-Dem Polyarchy)		0.043	0.014	0.019
		(0.050)	(0.067)	(0.049)
Trade/GDP		-0.003***	-0.003***	-0.003***
		(0.000)	(0.000)	(0.000)
Urban Share		-0.005***	-0.006***	-0.008***
		(0.001)	(0.001)	(0.002)
Overvaluation (Spatial Lag)			0.704***	
			(0.137)	
Trend				0.004**
				(0.002)
Trend $\times$ Party				-0.001
				(0.001)
Constant	-0.217***	0.389***		0.536***
	(0.049)	(0.084)		(0.094)
Kleibergen-Paap rk LM statistic			12.416	
p-value			0.000	
Kleibergen-Paap rk Wald F statistic			67.295	
10% maximal IV size			7.03	
Observations	3,638	2,398	2,304	2,398
Number of countries	126	105	101	105
R-squared	0.029	0.090	0.113	0.096

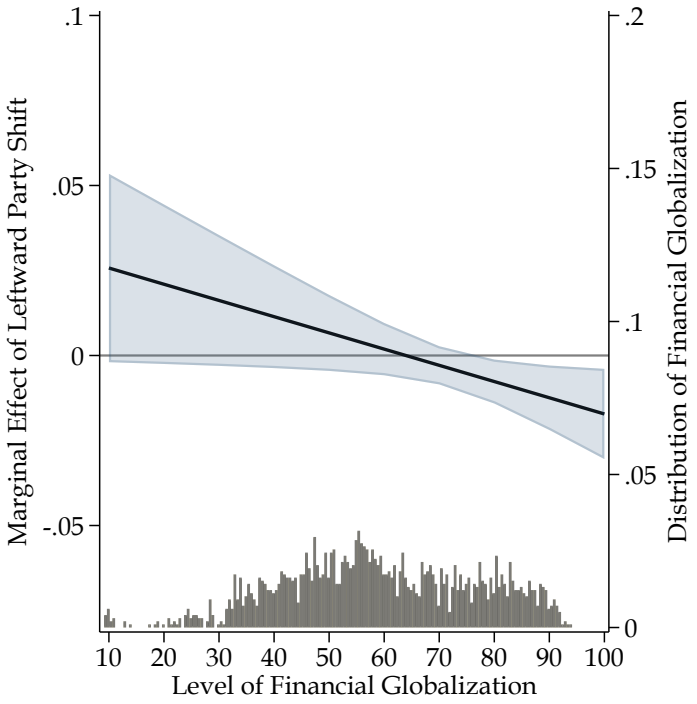
*** p<0.01, ** p<0.05, * p<0.1

TABLE 3: Regressions using alternate measure of overvaluation. Driscoll and Kraay (1998) standard errors in parentheses. All models contain country fixed effects.

Dependent Variable: Overvaluation (CEPII)	**(1)**	**(2)**	**(3)**	**(4)**
Specification	*OLS*	*OLS*	*IV*	*OLS*
Party	-0.001	0.010	0.013*	0.039**
	(0.004)	(0.008)	(0.007)	(0.015)
Chinn-Ito Capital Account Openness	0.010	0.034***	0.061***	0.045***
	(0.008)	(0.011)	(0.016)	(0.009)
Party × Chinn-Ito Capital Account Openness	-0.006	-0.012**	-0.015***	-0.014***
	(0.004)	(0.005)	(0.006)	(0.004)
Manufacturing/GDP		0.000	0.001	-0.005*
		(0.002)	(0.002)	(0.002)
Democracy (V-Dem Polyarchy)		-0.343***	-0.256***	0.048
		(0.083)	(0.067)	(0.046)
Trade/GDP		-0.002***	-0.002***	-0.003***
		(0.001)	(0.001)	(0.000)
Urban Share		0.001	0.001	-0.008***
		(0.001)	(0.001)	(0.002)
Overvaluation (Spatial Lag)			1.154***	
			(0.190)	
Trend				0.004**
				(0.002)
Trend × Party				-0.001
				(0.001)
Constant	-0.001	0.307**		0.701***
	(0.011)	(0.121)		(0.078)
Kleibergen-Paap rk LM statistic			9.143	
p-value			0.003	
Kleibergen-Paap rk Wald F statistic			47.168	
10% maximal IV size			7.03	
Observations	2,802	2,018	1,948	2,337
Number of countries	105	91	89	102
R-squared	0.002	0.119	0.150	0.102

*** p<0.01, ** p<0.05, * p<0.1

TABLE 4: Regressions using Chinn-Ito index of capital account openness. Driscoll and Kraay (1998) standard errors in parentheses. All models contain country fixed effects.



Specification: $Overvaluation_{i,t} = \alpha + Overvaluation_{i,t-1} + \beta_1 Party_{i,t} + \beta_2 Party_{i,t-1} + \beta_3 CapMob_{i,t} + \beta_4 CapMob_{i,t-1} + \beta_5 Party_{i,t} \times CapMob_{i,t} + \beta_6 Party_{i,t-1} \times CapMob_{i,t} + \beta_7 Party_{i,t} \times CapMob_{i,t-1} + \beta_8 Party_{i,t-1} \times CapMob_{i,t-1} + \beta \mathbf{X}_{it} + \eta_i + \varepsilon_{it}$

FIGURE 6: Marginal effects from ADL model. Driscoll and Kraay (1998) standard errors and country fixed effects.