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Political Responsibility for Economic Crises

This brief summarizes the results of research on the political costs of large-scale economic crises. In a large historic sample of countries, we study the impact of different types of crises, such as sovereign and domestic defaults, banking crises and economic recessions, on political turnover of top politicians: heads of the state and central bank governors. According to the findings, only default on domestic debt increases the probability of politicians' turnover but not the default on external debt. As argued, this is due to the fact that the latter is not directly felt by the voters. In addition, we find that although currency crises increase chances of head of central bank turnover, it does not affect tenures of heads of state. Presumably, this is the case since currency crises are in the eyes of the public the responsibility of CB governors. These findings are relevant for both developed and transition economies, but are especially important for the latter as political turmoil and economic recessions are more prevalent in developing nations.

Overview and Key Findings

Large-scale economic crises are associated not only with the economic downturns, but also with political turnover. When the national economy is in a critical state, a default declaration often turns the economy back to growth as it is typically viewed as an act of acknowledging a problem and showing readiness for changes. However, politicians responsible for the economy and leaders of the states are often reluctant to declare default and try to postpone it, which worsens the situation. One of the reasons behind such unwillingness to act is a fear of a political turnover following the open acknowledgement of a problem.

This brief summarizes the findings Lvovskiy and Shakhnov (2018). We investigate the statistical evidence of political costs related to different types of economic crises.

We find that the effects of a crisis depend on the crisis type and on whether it was in the area of responsibility of a given politician. For example, external sovereign defaults have no effect on political turnover, which we interpret as external sovereign default having a small impact on the general public. On the contrary, domestic sovereign defaults have a large impact on the country population and often lead to the replacement of the top executive. In turn, banking crises are followed by the downfall of the government at the level of chief executive as well as the governor of the central bank.

While there is large literature on career concerns of politicians and political turnover, the majority of papers either focus on the regular changes through elections in democratic regimes (Treisman, 2015) or study a particular non-democratic country, like China (Li and Zhou, 2005). However, throughout history, crises have often happened in transition, non-democratic or not fully democratic countries. Furthermore, even in democratic countries many changes of government have been irregular. Since a delay in default declaration usually harms economies it is important to understand the mechanisms behind it in different institutional settings. Our paper contributes to this understanding by analyzing the impact of economic crises on political survival in a wide set of countries and regimes. Better understanding of the political costs that the top executives face while making such decisions is crucial for the prediction of these decisions as well as for international default negotiations and consultations.

Below we describe our finding in some more detail.

Statistical Analysis and Results

Our analysis consists of two main parts. We start with the political turnover for heads of state, who are in charge of the performance of the whole economy, which we measure by the GDP growth. Then, we look at central bank (CB) governors, who are in charge of the monetary policy, price stability, stability of the financial sector and banking supervision.

Table 1 presents the estimated linear probability regression models for the head of state turnover. As expected, elections have a strong impact on the probability of the turnover of the head of state. Further, as Column 1 in Table 1 shows default on external debt has no significant impact on the head of state tenure while default on domestic debt increases the yearly chances of being displaced by 34 %. This supports the idea that voters care more about their own savings than about the general situation with the state's budget. When we look at the effect of past crises (the predictor variable in this case is whether a crisis took place last year), Column 2 coefficients for both external and domestic defaults appear to no longer be statistically significant. Instead, banking crises become significant. This situation could be due to the fact that one of the common consequences of domestic defaults is an ongoing distortion of savings which often leads to deposit runoffs, so the effect of the previous year's domestic default now acts through a banking crisis.

Table 1. Head of state changes

	(1) Linear	(2) Linear, lagged
External	0.0489	
	(0.0544)	
Domestic	0.340***	
	(0.0822)	
Banking	0.0652	
	(0.0341)	
Pres. election	0.674***	0.649***
	(0.0982)	(0.111)
Parl. election	0.757***	0.778***
	(0.0605)	(0.0612)
Currency	0.0329	
	(0.0243)	
Stock Market	-0.0199	
	(0.0232)	
L.External		0.0193
		(0.0553)
L.Domestic		0.0868
		(0.0854)
L.Banking		0.0995**
		(0.0359)
L.Currency		-0.00299
		(0.0254)
L.hyperinfaltion		0.00997
		(0.0392)
L.Stock Market		0.0493
		(0.0256)
Effects	FE	FE
N	3513	3448
R2	0.0657	0.128

Standard errors in parentheses

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Note: The linear probability models with country-year fixed effects. Lagged stands for the lag of crisis dummies.

Table 2. Central bank governor changes

	(1) Linear	(2) Linear, lagged
External	-0.0390	
	(0.0933)	
Domestic	1.071***	
	(0.147)	
Banking	0.0600	
	(0.0563)	
Pres. election	-0.0413	-0.0483
	(0.145)	(0.162)
Parl. election	0.107	0.122
	(0.0903)	(0.0925)
Currency	0.124**	
	(0.0421)	
Stock Market	-0.0272	
	(0.0364)	
L.External		0.0808
		(0.0950)
L.Domestic		0.671***
		(0.157)
L.Banking		0.221***
		(0.0591)
L.Currency		-0.00131
		(0.0433)
L.hyperinfaltion		0.0428
		(0.0666)
L.Stock Market		0.0327
		(0.0406)
Effects	FE	FE
N	1637	1618
R2	0.0429	0.0771

Standard errors in parentheses

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Note: The linear probability models with country-year fixed effects. Lagged stands for the lag of crisis dummies.

Table 2 presents similar results but this time the left hand side variable is CB governor turnover. Similarly to the case with the head of state turnover, only default on domestic debt has a significant effect on the CB's governor tenure and not the one on external debt. The main differences with Table 1 are that elections do not statistically predict turnover of CB heads while currency crises do. The former result is expected since in most countries there are no direct elections of central bank governors and central banks often have some degree of independence from the government. The latter result, that currency crises have a significant impact on CB governors' tenures, implies that since currency control is one of the roles of a CB, its head is held accountable for currency crises and not the head of a state.

Conclusion

We examine the political cost of different types of economic crises, and find non-uniform effects of different types of crises on the political survival of various key officials. Domestic defaults, and recent banking crises are shown to be costly both for heads of states and central bank governors, while currency crises only have an impact on the political survival of the latter.

Interestingly and importantly, we find no evidence of the impact of (external) sovereign default on political turnover of the head of state or central bank governors. In other words, contrary to Yeyati and Panizza's (2011) suggestion, it seems that there is no immediate political cost at the top associated with (external) sovereign default. One possible explanation is that the public does not punish a politician for defaults because by defaulting, the politician makes the optimal decision. In a modern world, many developing nations experience rapid growth of their sovereign debt. The presented evidence brings partial optimism that even if economic mistakes have already been made, top politicians would understand that acknowledging a problem and making steps toward its solution may not always be as costly for them as has previously been thought.

References

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