The Political Origins of Exchange Rate Valuations*

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ABSTRACT

The relative strength of a country's currency is central to its economic performance. Real exchange rate *overvaluation* and volatility are linked to macroeconomic instability and slower growth, whereas *undervaluation* appears to promote growth. In this light, why do countries not consistently maintain undervalued currencies? We propose that the offsetting inflationary and growth effects of undervaluation lead countries with high levels of political competition to avoid sustained undervaluation. Currency volatility, undervaluation, and overvaluation each harm constituencies that can mobilize in competitive political contexts. We find that the *degree of competitiveness* of political institutions, rather than other attributes of democratic institutions, explains why countries do (or do not) undervalue their currencies, and why some countries maintain stable currency values. Democratic societies with politics that favor consumers have systematically, if modestly, overvalued exchange rates. Sustained bouts of competitive devaluation ("currency wars") are highly unlikely among democratic countries. We find electoral evidence that voters punish incumbent governments for bouts of sustained currency undervaluations, providing an electoral motivation for democratic governments avoiding currency wars.

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