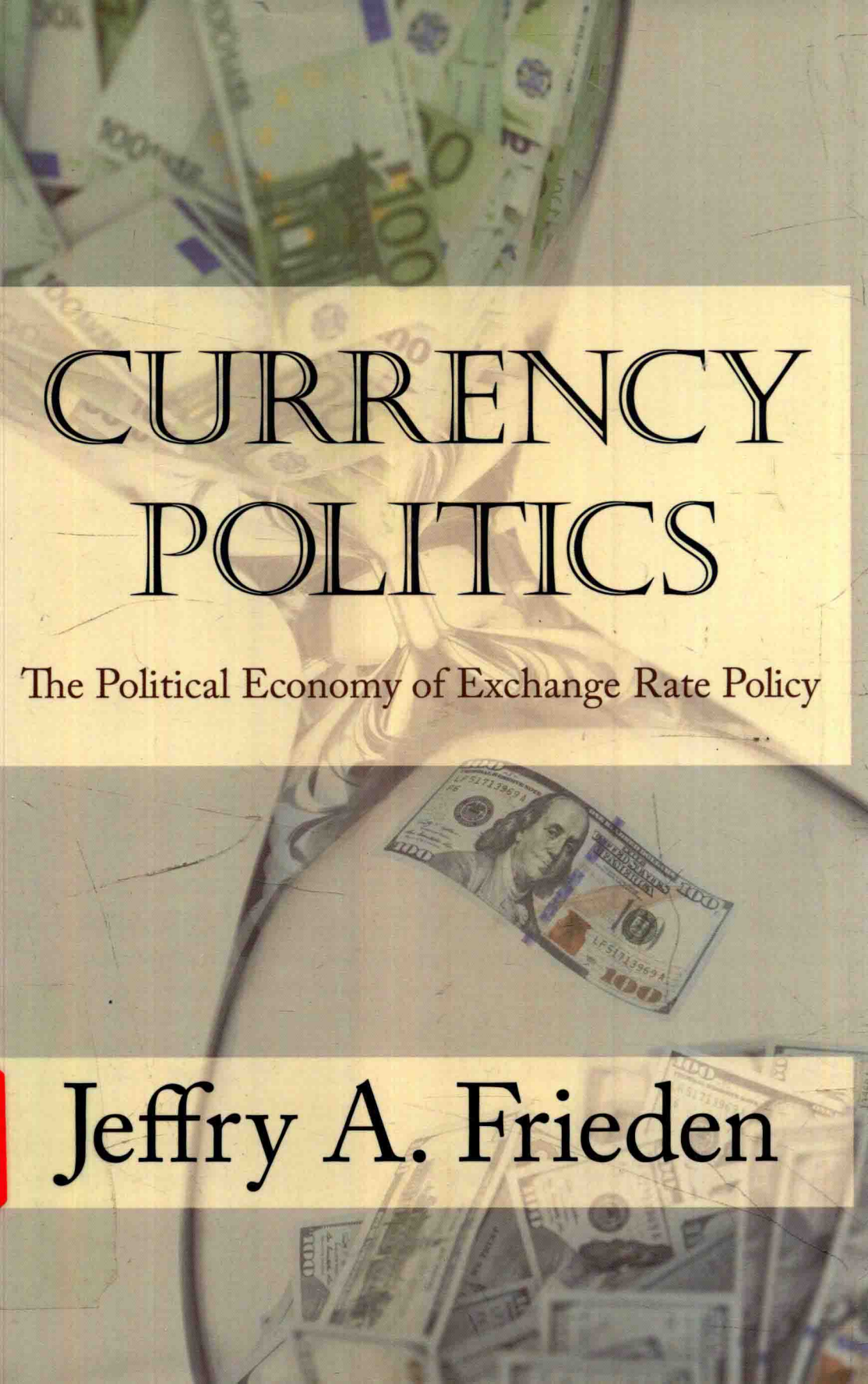

CURRENCY POLITICS

The Political Economy of Exchange Rate Policy

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PREFACE

Currencies and their values are central to the world economy. They affect international trade, investment, finance, migration, and travel. The prevailing exchange rate system often defines the international economic order. The gold standard, a global regime of fixed currencies that prevailed for over forty years before 1914, was so pivotal that the period is often known as the classical gold standard era.[1] After World War I, major governments were unable to adapt the currency order to the changed conditions, and failed exchange rate policies were a major reason why the interwar world economy tottered and eventually collapsed.[2]

In the aftermath of World War II, the Western world organized its economy around the Bretton Woods monetary order of fixed but adjustable exchange rates, with general success.[3] Since the collapse of the Bretton Woods currency system, exchange rate policies have, if anything, gained in importance.

In today's era of "globalization," exchange rate policies have played a major role in virtually all economies. The European Union has for decades attempted to stabilize the currencies of its member states, eventually leading to the 1999 creation of a single European currency—the euro. Although the eurozone has experienced massive difficulties, the single European currency remains a cornerstone of the most ambitious attempt at international economic integration in modern history.

1 Estevadeordal, Franz, and Taylor 2003.
2 Eichengreen 1992; Bernanke and James 1991.
3 See, for example, many of the essays in Bordo and Eichengreen 1993.

Elsewhere in the rich world, currency policies and movements have been a focus of political controversy both within and between nations.

Developing countries, too, have faced crucial decisions about their exchange rates. Some have linked their currencies tightly to the dollar, the euro, or other leading currencies, while others have decided to let their currencies float freely. Still others have made managing their currencies central to their economic strategies. These decisions have powerfully affected subsequent economic developments. Many countries in East Asia, in particular China, would ascribe their extraordinary economic success at least in part to systematic policies to keep their currencies relatively weak in order to stimulate export-led economic growth. On the other hand, currency crises have become commonplace elsewhere in the developing world, such as Mexico in 1994, Asia in 1997–98, Russia in 1998, Brazil in 1999, and Argentina and Turkey in 2001. Many of these currency crises led to major economic, social, and political upheavals. And currency policies have joined or even supplanted trade policies as a major source of friction among governments in today's globalized economy.

National and international currency relations are central features of the world economy, and they are largely the result of government exchange rate policies. We cannot analyze the international trading system without understanding national trade policies; likewise, we cannot analyze the international monetary system without understanding national currency policies. This has led scholars to attempt to explain government policies toward their exchange rates. Such efforts of necessity take into account both economic and political factors in the making of currency policy.

My own interest in the political economy of exchange rate policy dates back over twenty years. My research has emphasized how the distributional effects of currency policies help explain why interest groups would support or oppose particular currency measures. Almost all economic policies create winners and losers, and currency policy is no exception. My early work proposed simple divisions among socioeconomic actors, and applied them to a variety of settings.[4] While there are many other factors that go into the making of currency policy, from domestic and international macroeconomic conditions to political institutions, I continue to believe that the preferences of crucial social

4 See, for example, Frieden 1991, 1994a.

groups are an essential building block of any rounded explanation of government policy, in the monetary realm as elsewhere.

Currency Politics: The Political Economy of Exchange Rate Policy expands both the theoretical and empirical reach of my scholarship on the subject. The theoretical principles presented here go beyond my early ideas. I have been especially interested in incorporating further considerations of how exchange rates affect economic agents—a concern reflected largely in attention to *pass-through*: the extent to which currency movements are transmitted to the domestic economy by way of relative price movements. In addition, I have attempted to expand the nuance and accuracy of the socioeconomic divisions we would expect to find: exporters differ among themselves, as do those with commercial and financial interests. Other scholars have written elegantly on similar topics, and I strive to incorporate their advances in my theoretical and empirical discussions.

Theoretically, this study focuses on identifying and clarifying the distributionally motivated currency policy preferences of economic actors—firms, industries, and groups. It argues that characteristics of an industry, including its exposure to exchange rate risk and the relative price effects of exchange rate movements, determine its exchange rate policy preferences.

There are two relevant dimensions of exchange rate policy choice: the regime (fixed or floating) and level (appreciated or depreciated). With regard to the former, I contend that actors that rely heavily on international trade, investment, or financial ties will, all else being equal, prefer a stable exchange rate—the gold standard, fixed rates, dollarization, and euroization. With regard to the latter, I assert that tradables producers will, all else being equal, prefer a depreciated exchange rate. (The opposite applies: domestically oriented actors prefer a flexible rate and nontradables producers prefer an appreciated one.) These concerns are strongly influenced by the degree to which exchange rate movements are passed through to domestic prices, which in turn is a function of complex features of modern industries. Where pass-through is limited—the impact of currency movements on prices is small—concerns about exchange rate volatility rise and support for a depreciated currency declines.

Empirically, I carry out a range of studies to highlight the potential applicability of my approach across time and space. The first part of the book looks at the US experience with the gold standard in the nine-

teenth century—a period in which monetary politics were hotly contested within the United States, as in many other countries. The second part switches gears to explore a much more recent experience with debates over a fixed exchange rate (and beyond) among open economies—the process of European monetary integration leading toward the adoption of the euro. In the third section, I focus on the currency experiences of Latin America, which vary both in how open the economies of the region have been to the rest of the world and in the multiplicity of exchange rate policies adopted by the region's governments.

We have a long way to go before we have a full understanding of the determinants of national policies toward the exchange rate. We have even further to go before we understand how national decisions interact to create regional and international monetary orders. A wide variety of economic, political, historical, and other factors come together to affect these policies and outcomes. My hope is that the research presented here will shed light on how socioeconomic interests, whether of concentrated groups or broad segments of the population, help shape currency politics and currency policy.

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Introduction

The Political Economy of Currency Choice

The exchange rate is the most important price in any economy, for it affects all other prices. The exchange rate is itself set or strongly influenced by government policy. Currency policy therefore may be a government's single most significant economic policy. This is especially the case in an open economy, in which the relationship between the national and international economies is crucial to virtually all other economic conditions.

Policymakers who have to answer, directly or indirectly, to constituents, such as voters, interest groups, and investors, are the ones who make currency policy. Like all policies, the choices available to currency policymakers involve trade-offs. Currency policies have both benefits and costs, and create both winners and losers. Those who make exchange rate policies must evaluate the trade-offs, weigh the costs and benefits, and consider the winners and losers of their actions.

Exchange rate policy provides an extraordinary window on a nation's political economy. This is particularly true in countries whose economies are open to the rest of the world economy, because in such a situation currency policy has a profound impact on a whole range of

economic activities and political decisions. Debates over exchange rate policy, and the eventual decisions made about it, tell us a remarkable amount about an economy, a society, and its political institutions.

Currency politics reflect the importance of the mass-consuming public, role of elections, organization of economic groups, power of particularistic interests, time horizons of voters and politicians, and responsiveness of political institutions to pressures along with virtually all other features of a national political economy. In some ways, exchange rate policy requires a government to make a relatively simple decision: to fix the currency or allow it to float, to try to keep the currency strong or weak. But these simple decisions reflect extraordinarily complex structures, motives, and pressures. Currency politics summarize many features of a national political economy, for those who make currency policy must take into account the impact of their decisions on almost everyone in society.

Currency Choices

Currency policymakers face two interrelated choices. The first is the desired exchange rate *regime*, and especially whether to fix the exchange rate against either some other nation's currency or a commodity such as gold. The second is the *level* (price) of the exchange rate.[1]

The exchange rate regime has two common meanings. The first refers to the prevailing international monetary arrangements. The gold standard, Bretton Woods gold-dollar standard, and contemporary floating are international monetary regimes; the European Monetary System (EMS) was a regional monetary regime. In this sense, regime choice involves joint decisions by several countries. No one nation can single-handedly create an international monetary regime, given that such a system exists only to the extent that more than one nation adheres to it.

The second meaning of the exchange rate regime is simply the method by which an individual government manages its currency. In this context, a nation can choose a variety of ways to organize its own

1 The economics literature on exchange rates is enormous. For a recent survey of the state of the art, see Engel 2014. For two excellent surveys of previous generations of the literature, see Isard 1995; Sarno and Taylor 2002.

exchange rate in relation to those of other currencies. A *fixed* exchange rate regime commits the monetary authorities to maintain the value of the national currency against a commodity such as gold or another national currency. Sometimes a currency is fixed against a basket of currencies, but this is less purely fixed as it implies substantial variability in exchange rates relative to individual currencies. In addition, if (as is common) the composition of the basket is not announced publicly, the government can alter the exchange rate by altering the basket. In limiting cases, a government can choose to adopt the currency of another country, such as the US dollar, or create a multicountry currency union, such as the euro.[2]

With a *fixed but adjustable* or *adjustable peg* regime, the government promises to keep the exchange rate constant at any given point, yet makes it clear that it will change the exchange rate as deemed desirable. This provides the benefits of short-term exchange rate stability without completely eliminating the ability of national politicians to affect policy. The uncertainty associated with a currency whose value could be changed at any point, however, can make such a regime less than fully credible.

A *floating* exchange rate is one that the monetary authorities do not try to support at a preannounced level. The currency's value is determined on foreign exchange markets, and national policymakers do not commit to defend a particular rate. This does not preclude attention by policymakers to the exchange rate. The authorities might intervene to stabilize the currency or try to keep it from falling (or rising) more than they think acceptable. And national monetary policies—such as interest rate policy—might be undertaken with an exchange rate stance in mind. But there is no explicit public promise to sustain any particular exchange rate.

In addition to the exchange rate regime, monetary authorities make policies that influence the *level* of the exchange rate—the currency's value. A currency can rise in value—appreciate or revalue—in relationship to other currencies or decline in value—depreciate or devalue. Exchange rates can move differently against different currencies. The best summary measure is the *effective exchange rate*, a country's ex-

2 Although some observers regard these last cases as qualitatively distinctive, due to the greater difficulties associated with leaving such a regime—de-dollarizing or exiting the euro, for example—here I consider them as special cases of a fixed rate. After all, there are always costs in abandoning a fixed exchange rate, and the only difference is in the extent of the costs.

change rate against other currencies weighted by their importance in the country's trade. Movements in the *nominal* exchange rate, which simply measures the relative value of the currency, are often less meaningful than changes in the *real exchange rate*, which adjusts for inflation differentials between countries. If the home country has no inflation while the foreign country has 20 percent inflation, with exchange rates held constant, this is the equivalent of a *real depreciation* of the home country's currency: the foreign-currency price of home goods has gone down relative to the foreign-currency price of foreign goods, while the domestic-currency price of foreign goods has risen relative to the domestic-currency price of home goods. It is also equivalent to a *real appreciation* of the foreign currency, as prices of its goods expressed in its own currency have risen relative to those of the home country.

The real exchange rate reflects the impact of the exchange rate on the country's trade and payments. Policymakers, businesspeople, journalists, and others frequently refer to a currency's impact on "competitiveness"—such as to complain that the currency value is making it difficult for home industries to compete with imports or to export. In these cases, what they are complaining about is the real exchange rate. Some industries gripe about an "overvalued" (appreciated or "strong") currency, while others may grumble about an "undervalued" (depreciated or "weak") one.[3]

The real value of the currency is crucial to every open economy because it affects the prices of national goods and services relative to those abroad. As a result, policymakers, economic agents, and others care deeply about the real exchange rate—often expressed as the country's competitiveness. And this in turn makes nominal exchange rate policy key, for in almost all circumstances nominal currency movements have a real effect. To be sure, the effect may vary among countries, among goods, and over time; in fact, this variation can play an important role (more on this below). While scholars disagree on how effec-

3 Some scholars dislike such terms because of their indeterminacy: it is not clear what the currency is over- or undervalued relative to. The reference point is typically some notional equilibrium level of the exchange rate. This might be its *purchasing power parity* (PPP) level, at which the actual ability of currencies to purchase domestic goods and services is roughly equivalent, or a level adequate to secure "internal and external balance"—that is, a noninflationary domestic monetary policy and rough balance in the current account. Although there is some subjectivity to the terms, they are commonly used, and in most cases descriptive enough to make sense.

tive exchange rate policy can be, most accept that nominal currency movements have a significant real impact, at least in the short and medium run.[4]

For our purposes, the key point is that policymakers can affect both the exchange rate regime and level of the exchange rate. They can do so by many means, from altering interest rates to intervention in currency markets. Currency values also have a powerful impact on the well-being of important economic actors—and indeed, the fate of national economies more broadly. Currency policy is just about as powerful as any single national economic policy can be. And the choices that it presents to policymakers and the public are equally crucial.

Currency Trade-offs: One Trilemma and Two Dilemmas

Like all policies, currency policies involve trade-offs. The starkest is most colorfully known as the trilemma.[5] The trilemma—also dubbed the Unholy Trinity, Inconsistent Trio, and other phrases of varying catchiness—says that only two of the following three are possible: financial integration, a fixed exchange rate, and monetary independence. Most important for our purposes, this means that in a financially open economy, the government must choose between a fixed exchange rate and monetary policy autonomy. The idea is central to the Mundell-Fleming approach to balance-of-payments adjustment developed in the 1960s.[6] When financial integration allows capital to move freely among countries, domestic interest rates are given by world interest rates. If the exchange rate is fixed, a monetary expansion (or contraction) has *no effect*, as its impact is negated by a countervailing outflow (or inflow) of funds. For example, if the monetary authority lowers the domestic interest rate in order to stimulate the economy, funds flow out until the domestic interest rate has risen back to the world rate.

4 For a recent survey of studies on the relationship between exchange rate movements and prices—including the real exchange rate—see Burstein and Gopinath 2014.

5 The literature on the trilemma is enormous. For two important recent contributions, see Obstfeld, Shambaugh, and Taylor 2005; Aizenman, Chinn, and Ito 2010.

6 For the original statements of the approach, see Mundell 1960, 1963; Fleming 1962; McKinnon 1963. For critical summaries, see also Mussa 1979, 1984.

In a financially open economy, then, policymakers must choose *either* a stable exchange rate *or* the ability to have an independent monetary policy; they cannot have both. It is also the case that policymakers could choose to limit capital mobility—this is the third leg of the trilemma—although contemporary international financial markets and contemporary technologies may make this a less viable option for all but the most authoritarian regimes. This effectively reduces the trilemma to a dilemma with respect to the choice of exchange rate regime. (I return to closed economies, including instances in which financial integration is not a given, below.)

Policymakers face difficult choices and real trade-offs in making currency policy. This is because there are advantages to both fixed and floating rates as well as both strong and weak currencies. How policymakers weigh these effects depends, among other things, on how their constituents weigh them. And constituency preferences are in turn a function of the expected economic impact of the choices in question. In an economically open economy, there are two dimensions along which these options can be evaluated—two sets of dilemmas, so to speak, on whose horns currency policymakers find themselves.

Regime: Stability versus flexibility. When choosing a currency regime in a financially open economy, in line with the trilemma, the trade-off is between the monetary stability that a fixed rate brings, and the policy flexibility that a floating or adjustable rate allows. A fixed exchange rate makes cross-border trade, payments, finance, investment, and travel more predictable, removing most or all foreign exchange risk from cross-border transactions. It can also bring domestic monetary stability: if the currency is pegged to that of a low-inflation partner, a fixed exchange rate holds domestic inflation roughly at the level of the partner. But this cross-border and internal monetary consistency comes at the expense of national policy autonomy. The currency cannot be devalued (depreciated) to make national goods cheaper than foreign goods, nor can national monetary policy be loosened beyond that of the currency's anchor. After 1998, Argentine farmers and manufacturers found themselves priced out of local and foreign markets, but the Argentine authorities could do nothing so long as they were bound by a currency fixed to the dollar. Ireland's macroeconomic conditions were dramatically different from those of Germany in the 1990s—Ireland was booming, and Germany was stagnating—but Ireland's commitment to peg the Irish pound to the deutsche mark (DM) required Irish

monetary policy to be identical to that of Germany. And such peripheral European countries as Spain and Portugal would have been much better off with monetary policies tailored to their own conditions during the financial crisis that began in 2007, but their membership in the eurozone made this impossible. The trade-off, then, is between monetary stability and predictability, on the one side, and monetary independence and flexibility, on the other.[7]

Level: Purchasing power versus "competitiveness." Choosing a fixed exchange rate means forgoing national control of the currency's nominal value.[8] But even if the monetary authorities retain autonomy, there are difficult choices about the desired strength of the currency. On the one hand, a strong (appreciated) currency increases national purchasing power, allowing domestic residents to buy more with their money. This is the *income effect* of an exchange rate movement: a currency appreciation increases effective national income. On the other hand, a strong currency raises the relative price of domestic products. This makes it harder for national producers to compete with foreigners on domestic or international markets; it also reduces local-currency earnings from foreign sales or profits. This is the *substitution effect* of an exchange rate movement: when a currency appreciates, consumers at home and abroad substitute foreign for domestic products. The trade-off here is as stark as with regard to the regime: a weak-currency exchange rate policy to improve the competitive position of domestic producers reduces the purchasing power of domestic residents, while a strong-currency exchange rate policy that improves the effective income of national consumers puts competitive pressure on national producers.

On both the regime and level dimensions, there are no unambiguous welfare criteria to guide policymakers, even if they were purely benevolent social planners. Exchange rate choices are not typically among policies that are better or worse for aggregate social welfare.[9] A country

7 For an excellent survey of the economics of regime choice, see Corden 2002.

8 Policymakers can engineer a real appreciation or depreciation even with a fixed exchange rate by acting to raise or lower domestic prices. For now, for simplicity, I focus on nominal exchange rate movements with real effects, which in any event are normally far easier to engineer and far more common. In the empirical applications, I analyze examples of real appreciations and depreciations within a fixed rate regime.

9 The literature on optimal currency areas, discussed below, has some implications for aggregate welfare—it indicates whether welfare can be improved by giving up or maintaining the national currency—but this is something of a special case. It cannot be applied directly to the choice of floating or fixing, and is not relevant to the level of the exchange rate. For literature