Currency Politics: The Political Economy of Exchange Rate Policy

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Published by EH.Net (January 2015)

Jeffry A. Frieden, *Currency Politics: The Political Economy of Exchange Rate Policy.* Princeton, NJ: Princeton University Press, 2014. xi + 301 pp. $40 (cloth), ISBN: 978-0-691-16415-1.

Reviewed for EH.Net by Lawrence H. Officer, Department of Economics, University of Illinois at Chicago.

Jeffry A. Frieden, Professor of Government at Harvard University, has written a fine book on the determinants of decision-making regarding exchange-rate regime and, to some extent, exchange-rate level within the selected regime. The book is readable for both economists and political scientists. I recommend *Currency Politics* to both sets of scholars. Economists will learn about the political aspects of exchange-regime choice and political scientists about the economic aspects.

There are seven formal chapters, preceded by an introduction and followed by a brief concluding section. The references constitute a useful if selective body of literature, and the index is well-done. Chapter one, titled "The Political Economy of Currency Choice," presents the author's theory. Chapters two and three, dealing with the U.S. experience from 1862 to 1879, is the section of the book most relevant to economic historians. The exchange-regime controversies during the greenback and silver-controversy periods are well analyzed within the author's theoretical framework. Attention is paid to contemporary views and to pertinent data, and innovative econometric investigations are included.

Chapters four (European Monetary Integration), five and six (Latin American experience) are empirical but not historical, as they deal with recent experience. Chapter seven ("The Politics of Exchange Rates: Implications and Extensions") is bizarre, running breathlessly from case to case, even discussing China's undervalued currency.

The author's model involves exchange-rate regime determination by the relative political strengths of economic groups advantaged by exchange-rate stability (gold standard, euro, peg to dollar or deutschmark) and groups advantaged by exchange-rate flexibility and domestic currency depreciation. The former groups generally include the financial sector, producers of differentiated products ("specialized manufacturers"), and foreign-currency debtors; the latter, mainly tradables producers. Frieden warrants praise by economists for his uniform and careful attention to economic incentives as analytical support for his approach.

Very impressive is Frieden's voting model to test the greenback-period economic groupings for "soft money" (against gold, currency contraction, and deflation) versus "hard money" (in favor of return to the former gold standard, and the contraction and deflation to make this possible). A voting model with Congressional (House) district as the unit has creative dependent and explanatory variables, based on Census data. For the 1860s, twenty-four votes involving the Contraction Act (or its suppression) and the redemption medium (gold or greenbacks) for government bonds, are incorporated. Results are consistent with the author's theory: "Members of Congress specifically were more likely to vote for soft money if their constituency was less wealthy, and if more of their constituency's economic activities were in import-sensitive manufacturing (i.e., in New England and Pennsylvania) or farming, especially of export crops" (pp. 95-96).

For the 1870s, a similar analysis involves six House bills, five of which failed to become law — but no matter. With a later Census, data are richer, and explanatory variables now include debt by Congressional district. This leads to an unexpected result, as districts with larger debt are in favor of gold! Frieden explains this anomaly by inferring that concern about nominal debt was not an important motivating force. Hmm!

The chapter on European monetary integration gives Frieden the opportunity to investigate the impact of domestic-price pass-through effects of exchange-rate change, an integral part of his model. Now the econometrics has countries as the basic unit, as is also the case for the Latin American experience.

The book is full of wise insights, some of which seem obvious. For example, "the more open an economy is, the more politically controversial its currency policy is likely to be" (p. 249). The author also notes the well-known flexibility of wages and prices in enhancing the classical gold standard. He makes the important point, not always emphasized, that the sustainability of the classical gold standard was founded on the consensus of elite groups internationally: countries must follow gold-standard rules, and rules should not be altered to fit the preferences of national governments — whence the U.S. deflationary policy during the greenback period, in order to return to the gold standard. As befitting a political scientist, Frieden notes the lack of democracy — hence the absence of political power of groups benefitting from currency depreciation — in fostering the stability of the gold standard. I wish that he had devoted more attention to this oft-neglected aspect of the gold standard.

I also wish that Frieden had applied his model — both theoretically and, data permitting, econometrically — to other cases of exchange-rate regime controversy, especially the various bullionist periods (in particular, English and Swedish). He says nothing about these experiences.

Without doubt, however, Frieden has set a high political-economic standard against which other interdisciplinary studies of exchange-rate regimes will have to measure themselves.

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Subject(s):	Financial Markets, Financial Institutions, and Monetary History
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