To fix or not to fix: Jeffry Frieden's "Currency Politics"

February 12, 2015

The decision by the Swiss National Bank to abandon its peg to the euro serves as an example of the relatively limited life spans of fixed exchange rate regimes. While the fragility of exchange rate commitments has been known since the publication of a 1995 paper by Obstfeld and Rogoff, the question of why some central banks fix the value of their currencies and others do not is less well understood. Jeffry Frieden's *Currency Politics* provides a thoughtful guide to the political economy of exchange rate policy.

Frieden, the Stanfield Professor of International Peace at Harvard's Department of Government, analyzes the decisions on the choice of exchange rate regime and also the level of the exchange rate. There is rarely a consensus within a country on these issues, and the position of the domestic parties depends on how they are affected by fluctuations in the exchange rate. The principal supporters of a fixed rate will be those who are exposed to substantial foreign exchange rate risk in their global activities, such as financial institutions and multinational corporations. Those who have borrowed in a foreign currency will also have a stake in keeping the domestic value of their debt fixed. Producers of tradable goods tied largely to world prices, such as commodities and standardized manufactured goods, will favor a depreciated exchange rate, as will those who use nontradable goods as inputs. While decisions over the choice of regime and the level of a currency's value are conceptually separate, Frieden writes that the politics usually lead to a split between those who favor a fixed rate versus those who seek a depreciation.

Frieden tests these hypotheses with data from a range of historical experiences: the U.S. from the Civil War through the end of the 20th century, Europe during the period from the end of the Bretton Woods regime to the introduction of the euro, and Latin America from 1970 to 2010. He uses both qualitative and quantitative analysis in these sections of the book, and his use of data from the earlier periods is particularly skillful. The results show that a consideration of exchange rate-related issues sheds light on the divisions that exist over policies, and can lead to revised views of accepted versions of history.

In the case of the U.S., for example, Frieden breaks the post-Civil War era into the 1862-79 period, when the U.S. returned to the gold standard, and the period of 1880-96, when the gold standard came under attack from the Populist movement. In the first era, those business and financial interests who were most exposed to currency volatility sought to resume the linkage to gold that had been broken in order to finance the Civil War. They were opposed by tradable good producers, including many (but not all) manufacturers, farmers and miners. After 1873, the political divisions centered on whether the U.S. would go on a bimetallic standard of gold and silver, or base the dollar solely on gold. Frieden uses Congressional voting patterns to test whether economic divisions were reflected in Congressional voting on measures related to currency policy. The results generally confirm the influence of the interests he suggests were governing factors. For example, Congressional districts from New England and Pennsylvania, which included manufacturers who competed with foreign producers, were more likely to oppose measures that would return the U.S. to the gold standard. Similarly, representatives of farm products that were exported also opposed a return to gold, while other farming districts tended to support it.

The return of the U.S. to the gold standard in 1879 did not end the dispute. Falling agricultural prices prompted farmers to agitate for a bimetallic regime that would lead to a devaluation of the dollar. Miners concentrated in the Rocky Mountains also supported the use of silver. Manufacturers, on the other hand, abandoned the anti-gold movement as they were protected by high tariffs. Frieden's empirical analysis of votes on monetary measures between 1892-95 shows that debt, which has often been viewed as the source of farmers' concerns, did *not* sway representatives to vote against gold; indeed, the districts with the largest debt levels were pro-gold. But representatives of export-oriented farm districts were more likely to vote against the gold standard. The People's Party (the "Populists") united the farmers, miners and other groups in supporting a bimetallic standard, and in 1896 joined the Democratic Party in supporting William Jennings Bryant for President. Bryant's loss, followed by a second loss in 1900, signaled the end of organized opposition to the gold standard.

Frieden undertakes similar analyses of depreciation and variation in European exchange rates between 1973-94 and reports evidence supporting the argument that producers exposed to currency risk favored stability, while tradable producers preferred flexibility. Similarly, an analysis of the determinants of Latin American choices of exchange rate regime between 1960 and 2010 finds that the more open economies favor fixed exchange rates. However, manufacturers in the more open economies preferred flexibility.

Frieden convincingly demonstrates, therefore, that exchange rate policy is governed by distributional concerns. Different interests take opposing sides over whether a fixed or flexible regime will be chosen, and whether it will be used as a policy tool to favor domestic producers. The relative influence of the competing interest groups can change over time. An increase in trade or financial openness, for example, can lead to a new alignment of parties.

Can these considerations be applied to the Swiss case? The dropping of the currency peg discomforted both those who favored a fixed rate and those who will be adversely affected by the subsequent appreciation. But the Swiss central bank must be concerned about the impact of the European Central Bank's policy of quantitative easing, which would require further intervention and the accumulation of more foreign exchange. The Swiss move may be more of a tactical maneuver during a volatile period than a strategic change in policy. However, those Swiss firms who will see their profits from foreign sales plummet will not be quiescent about the new regime.