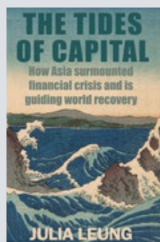
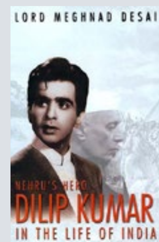
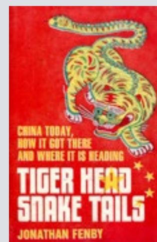






Currency winners and losers

The politics of exchange rate determination

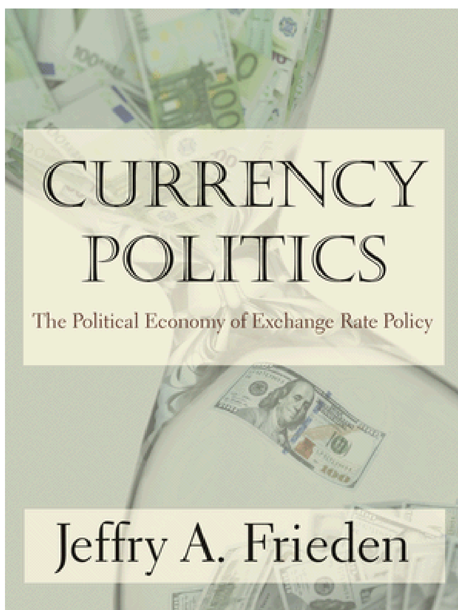
George R. Hoguet, Advisory Board

One may question Jeffry Frieden's assertion that the exchange rate is the most important price in any economy. What about interest rates? But there can be no doubt that he has written an ambitious and illuminating book.

In *Currency Politics – The Political Economy of Exchange Rate Policy*, Frieden, professor of government at Harvard, presents a socioeconomic theoretical framework for analysing the politics of exchange rate determination. He then tests the theory against historical experience in the US, Europe and Latin America.

Frieden argues that international coordination on exchange rate policy could be 'Pareto improving' – harming no-one and benefiting at least one party.

Yet exchange rate policy creates winners and losers. A country's exchange rate policy preference reflects the structure of output and the relative strength of interest groups, including urban consumers. The relevant dimensions are the regime (fixed or floating), and the level (appreciated or depreciated). Everything else being equal, foreign-currency debtors, financial firms and institutions heavily involved in cross-border trade and investment will favour a fixed exchange rate.



Firms with large tradable output will tend to support a weaker exchange rate. Firms with large net foreign currency liabilities will favour a stronger one. The degree of pass-through (the extent to which changes in the exchange rate are transmitted to domestic prices) is an important variable. Tradable producers (high pass-through) will favour a depreciated currency. The more open an economy, and the lower the level of tariffs, the greater the interest in currency policy.

US policy

Frieden then applies this framework to the politics of US exchange rate policy from 1862-96. The debate on the gold standard, pitting Wall Street proponents of hard money against Main Street and agricultural proponents of soft money, was acrimonious. He tracks the dollar to sterling exchange rate during this period and the reaction to it.

In a particularly impressive piece of scholarship, Frieden analyses votes by Congressional district on various pieces of monetary legislation, including the Contraction Act, the Inflation Act, and the Free Coinage Bill. He regresses these votes against factors such as 'farm output per capita'. While there are many cross-currents (some agricultural products are not tradable), the data during this period tend to confirm his hypotheses about the exchange rate preferences of various groups.

Frieden views the euro area as a special case of a fixed currency regime. He rejects the view that economic and monetary union was a quid pro quo for German unification. Rather, the political economy of trade integration led to monetary integration. As Frieden suggests in his discussion of the impact of the Brazilian devaluation of 1999 on Mercosur, protectionist pressures frequently result when a neighbour devalues.

In the context of the EU, these pressures could have threatened the foundation of the single market.

The chapters on Latin America, a fecund currency laboratory, review the region's transition since 1971 from import substitution policies to a more outward looking orientation. Special interest groups, including urban consumers, manufacturers and foreign currency debtors heavily influenced policy choices. As countries became more democratic and beholden to consumers, governments tended to delay required exchange rate adjustments, often with devastating consequences.

This book is rich in historical detail. We tend to forget, for example, that US manufacturers benefited for many years from substantial tariff barriers. Frieden's thesis is surely correct. Exchange rate policy must take powerful political pressures into account, and the distributional aspects of exchange rate policy cannot be ignored.

Aspects, however, of Frieden's impressively granular taxonomy could be questioned. For example, Paul Volcker, former Fed chairman, has argued that banks desire currency volatility, as it is a potential source of trading profits. And a curious omission in the book is any lengthy discussion of East Asian currency policy.

Given the vast literature on theories of exchange rate determination, this book reminds us of the primacy of politics. It integrates theory, statistical methods, and historical analysis, and will be of interest to social scientists, policy-makers, and money managers alike. ▪

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