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

could thrive (or stagnate) with a fixed or floating currency, or with a strong or weak one. The principal factors involved in the choice of currency regimes and values are how different options affect the constraints and opportunities available to policymakers, and how they affect economic agents in society. In this, exchange rate politics differs from many other economic policies. In trade policy, for example, there is a clear, generally agreed-on welfare baseline: free trade is the optimal policy, and scholars attempt to explain deviations from it. There is no similar welfare baseline in exchange rate policy, which means that in some sense exchange rate policy is *entirely* the result of political economy factors.

One potential exception to this rule is the literature on optimal currency areas (OCAs), which does in fact suggest clear welfare criteria. Indeed, economists have a well-developed theoretical apparatus to evaluate the desirability of two countries sharing a currency. For our purposes, this could be relevant inasmuch as a currency union is an extreme variant of a fixed exchange rate—one end of the continuum that stretches from freely floating exchange rates to a union that makes the (former national) currency as close to "irrevocably fixed" as is conceivable. The analysis of the OCAs thus can be relevant to the choice of exchange rate regimes. Robert Mundell and others developed this approach in the early 1960s.[10] Previously seen as something of an intellectual curiosity, this literature is now regarded with more respect, in large part because of its relevance to monetary unification in Europe.[11]

The OCA approach weighs the benefits of giving up a national currency against the costs of forgoing the ability to devalue or revalue in response to changing economic conditions. The *benefits* of currency union are rarely clearly stated in the literature, but can be assumed to be the stabilization of expectations with respect to cross-border transactions. The *costs* of currency union depend on the impact of a govern-

that emphasizes the developmental advantages of a weak currency, see Rodrik 2008; Bhalla 2012. I return to this last argument in chapter 7.

10 For the original statement, see Mundell 1961. See also McKinnon 1963; Kenen 1969. For surveys of the approach, see, for example, Tavlas 1993, 1994; Masson and Taylor 1993; Goodhart 1995.

11 The analysis of European monetary integration has generally been carried out, at least as a first cut, in OCA terms. For a summary and interpretation, see Eichengreen and Frieden 1994. For two early European applications, see Bayoumi and Eichengreen 1992; De Grauwe and Vanhaverbeke 1993. For a survey of the vast literature on Europe, see Eichengreen 1993. For a summary of the experience, see Gros and Thygesen 1998.

ment's giving up the exchange rate as a policy tool. These costs in turn are a function of both the actual *effectiveness* and *desirability* of an independent monetary policy. To evaluate the effectiveness of monetary policy, the OCA approach focuses on factor mobility: the more factors are mobile between countries, the less effective monetary policy will be. If labor can move freely between two nations, any attempt to stimulate (contract) one country's economy will lead to an inflow (outflow) of labor and—much as with financial market integration—dilution of the policy's impact. To weigh the desirability of independent policy, the OCA approach considers whether the countries are subject to the same exogenous shocks. If two economies have identical structures and face identical external conditions, they have no (national welfare) reason to pursue different exchange rate policies. The national welfare is improved by giving up the exchange rate as a tool when the countries in question have similar structures or integrated factor markets, or face correlated exogenous shocks. This conclusion has motivated many studies of whether these conditions hold in prospective currency unions.

OCA analyses are entirely oriented to discovering the *aggregate social welfare* effects of currency policy. This is a major consideration, and analytically the proposition that governments do what is best for their countries is certainly worth considering. It is a proposition lacking in firm microfoundations, however, and also (unfortunately) empirical support. Indeed, almost all attempts have shown that the founding members of the EMS, and the later Economic and Monetary Union (EMU), did not constitute an OCA. This reinforces the significance of understanding sources of policy other than national welfare, including the role of politicians themselves and domestic interest groups.

The two dimensions of currency policy require policymakers to make critical decisions about the national economy. On one dimension, they must decide whether a predictable economic relationship with the rest of the world economy is more important than the ability to manage the national macroeconomy in line with domestic concerns. On the other dimension, they must decide which groups in society—consumers, debtors, international investors, manufacturers, and farmers—will be helped and which hurt by the real exchange rate. There is no obviously "right" decision for both sets of choices; both involve weighing costs and benefits that can be—and are—evaluated differently by different people and groups.

The analysis of exchange rate policy requires central consideration of political economy factors. In particular, we can concentrate on the *political* impact of currency policy—that is, how it affects the incentives for politicians and policymakers—and its *distributional* impact—how it influences the fortunes of socioeconomic groups.

The Politics of Currency Policy

Just as exchange rate policy in general reflects virtually every aspect of a nation's political economy, it also reflects virtually every aspect of a nation's political institutions. Politicians make currency policy, and to do so must account for the impact of this policy on their political constraints and opportunities. Scholars have paid quite a bit of attention to how the expected impact of exchange rate policies might influence the behavior of politicians and their appointees.[12] One obvious question is how politicians might expect different exchange rate policies to affect their electoral prospects.

Many scholars, for example, anticipate that politicians with stronger incentives to manipulate monetary conditions for electoral purposes would be more likely to opt for a flexible exchange rate regime that allows an independent monetary policy. For some, this implies that democracies in general will incline more toward flexibility than will authoritarian regimes. By extension, political systems in which politicians are more likely to be able to claim credit for favorable economic conditions may be associated with more flexibility. By this logic, inasmuch as multiparty coalition governments make it difficult for any one party to take credit for economic performance, the benefits to currency flexibility may be more limited. And since electoral systems based on proportional representation are particularly likely to give rise to multiparty coalition governments, some have argued that these systems will incline toward fixed rates. On another dimension, insofar as a strong real exchange rate raises the purchasing power of consumers, the more sensitive governments are to consumer interests in the electorate, the more likely they may be to engineer a real appreciation in the run-up to an election. Such other political institutional variables as parties, inde-

12 For a survey of the literature on the political economy of exchange rate policy, including that on political institutions, see Broz and Frieden 2006.

pendent bureaucracies, and electoral structures have been suggested to have systematic effects on national exchange rate policies.[13]

Exchange rate policy is closely related to domestic monetary policy, so that the enormous literature on the political economy of (typically closed-economy) monetary policy is relevant. In this light, many scholars have brought the institutionalist tools used to analyze domestic monetary policies to bear on exchange rates. More broadly, scholars have investigated government choices of exchange rate policies as part of an integrated array of monetary policy choices.[14]

One strand of this literature focuses specifically on the use of a fixed exchange rate regime as an anti-inflationary commitment device. The idea is that a fixed exchange rate can serve as a nominal anchor for national monetary commitments, raising the costs of inflationary policies; it thus can help the government overcome the time inconsistency of monetary commitments.[15] A government in search of anti-inflationary credibility, for instance, can establish either an independent central bank or fixed exchange rate.[16] This makes the exchange rate primarily valuable as a commitment mechanism.

There is no question that political institutions affect the making of currency policy. Differences between dictatorships and democracies, presidential and parliamentary systems, and other more nuanced characteristics of national political institutions influence the way that politicians think about policy choices. In this study, I consider such factors as they arise. My main focus is elsewhere, though, on the relationship between currency policy and *distributional* (rather than political-institutional) features of national political economies. For example, the use of a fixed exchange rate as a nominal anchor for credibility-enhancing purposes is undoubtedly part of the story in many cases, but

13 For particularly good examples of analyses of institutional, especially partisan, factors, see Bernhard and Leblang 1999; Bearce 2003, 2008; Bearce and Hallerberg 2011.

14 See especially the special issue of *International Organization* 56, no. 4 (Fall 2002), which has several articles along these lines. This issue was republished as a book (Bernhard, Broz, and Clark 2003). See also Bodea 2010.

15 On monetary credibility generally, see Blackburn and Christensen 1989; Persson and Tabellini 1990. For an analysis of the use of the exchange rate as a nominal anchor for the gold standard, see Bordo and Kydland 1995. For an analysis for the EMS, see Giavazzi and Pagano 1989; Weber 1991. For explicit extensions to exchange rate policy, see especially Bernhard, Broz, and Clark 2003.

16 For example, J. Lawrence Broz (2002) suggests that in developing countries, dictatorships are more likely to fix, in large part because they have more limited abilities to commit credibly to low inflation. See also Steinberg and Malhotra 2014.

even here attention must be paid to distributional factors. After all, policymakers have to weigh the decision to fix the currency for credibility purposes against the expected societal demands for changes in the exchange rate, and without a clear picture of these demands, it is hard to know how to assess the commitment value of a fixed rate against the alternatives.

The Distributional Politics of Currency Policy

The theory presented here emphasizes the role of economic interests in the making of exchange rate policy. It concentrates on how different policy choices, both with regard to the currency regime and its level, are expected to affect economic agents. While I accent the position of particularistic interests, I also underscore the impact of currency policy on broader groups, such as consumers or foreign-currency debtors.

The theoretical approach taken here is common in studies of the making of foreign economic policy.[17] We begin with some theoretically grounded principles about the policy's expected distributional impact, from which we derive the anticipated policy preferences of those who would be helped or harmed by the result. On this basis, we examine the potential role of these distributionally relevant interests in the making of the policy in question. This way of thinking about economic policies in general and foreign economic policies in particular is commonplace. Nobody, say, would attempt to explain a country's trade policy without homing in on the role of interest groups in favor of or opposed to trade protection. This book's core argument is that we need to think about currency policy in similar ways, accounting for the interests and influence of economic interest groups. Trade theory is a useful starting point to understand the structure of international trade, but it needs to be supplemented with an analysis of the political economy of trade policy. In the same way, open-economy macroeconomics is a useful jumping-off place to understand international monetary relations, but it needs to be supplemented with an analysis of the political economy of currency policy.

My theoretical approach to the distributional politics of exchange rate policy is presented in full in chapter 1. To be sure, my emphasis on

17 The approach has been dubbed "open economy politics." For a review, see Lake 2009.

this aspect of currency politics is not meant to rule out the importance of other sociopolitical factors. In empirical applications, I note the relevance of other considerations as appropriate. But I stress the position of economic interests, and because the exchange rate affects virtually all interests in society, this is both complex and critical enough as a starting point.

Currency Policies in Open and Closed Economies

Much of the discussion up to now has implicitly or explicitly highlighted the character of currency policy in financially as well as commercially open economies. This is appropriate given the prominence of the policy in open economies along with the many open economies both historically and today. Indeed, in the contemporary globalized international economy, exchange rates are clearly among the most important policies undertaken by national governments. Yet economic openness is far from a constant: there have been many periods over the past two hundred years in which the world economy has been quite closed, and even in eras of generalized openness, some countries have remained shut off from the rest of the world economy. It is crucial to recognize the theoretical and empirical significance of variation in economic openness, both over time and among countries, for the making of currency policy.

The economics and politics of monetary policy are different in a closed economy. Both financial and trade closure change the policy environment, albeit in different ways. In a financially closed economy, monetary policy has only indirect and long-term effects on the exchange rate, so that fixing the currency's value does not constrain short-term monetary autonomy. Monetary policy in a closed economy operates by way of interest rates, which in turn affect real variables. For example, a monetary expansion increases real money balances and lowers interest rates, and lower interest rates stimulate expenditure for investment and consumption. By the same token, a monetary contraction leads to higher interest rates and lower expenditures.[18]

18 This presumes *some* short-term real effect of monetary policy, and is not meant to challenge the

There is a systematic difference between the impact of monetary policy in closed and open economies. In the former it affects interest rates, and through them, aggregate economic activity. In a financially open economy, interest rates are given by world conditions rather than set at home, so that monetary policy is either ineffective if the exchange rate is fixed, or operates by way of the exchange rate: an expansion leads to depreciation, and a contraction to appreciation.

At the same time, an economy closed to trade has fewer tradables producers, and fewer firms exposed to currency risk and affected by a currency movement. It is not surprising that when few economic agents are engaged in cross-border (thus cross-currency) business, interest in the exchange rate is lessened. Conversely, it is not startling that in economies open to trade—such as the small open economies of Europe or the Caribbean—the exchange rate is of great interest.

Although most of the analysis in this book is of open economies, a comparison between closed- and open-economy macroeconomic policies has interesting implications for the politics of monetary policy in the two types of economies. In a closed economy, monetary policy largely implicates the interest rate. The impact of interest rates is typically on such macroeconomic aggregates as inflation, unemployment, and growth. The rates also have direct distributional effects on borrowers and savers, but these are broad categories. Many people may in fact be unclear about the net impact on them of interest rate movements; after all, a mortgage holder may also have pension funds. There are important groups made up of borrowers and savers (or creditors), and there are industries that depend particularly on interest rates. The housing construction industry is especially sensitive to interest rates, as are some small businesses. Nevertheless, the principal impact of interest rate movements is broad and macroeconomic, rather than narrow and distributional. This implies that the political pressures associated with monetary policy in a closed economy will be broad and diffuse. Indeed, most of the scholarly and other analyses of monetary policy that focus on closed-economy effects emphasize such general national-level factors as political instability, the partisan composition of the government,

more modern, rational expectations notion that monetary policy has no real *long-term* impact. If nominal monetary or exchange rate policy had no real impact at all in either the short or long run, its politics would hardly be worth studying—except perhaps as an illustration of mass hysteria. For a much more complete treatment, see, for example, Cumby and Obstfeld 1984.

and the level of unemployment as determinants (or results) of monetary policy.[19]

Open-economy conditions make monetary policy directly relevant to more intensely concerned, concentrated groups than interest rates. Exchange rates have a much more immediate impact on some economic actors than do interest rates. The exchange rate directly affects the relative price of domestic and foreign goods. If the price of wheat is set on world markets, wheat farmers will see the domestic-currency price they receive rise and fall as the exchange rate moves. Import competers will face more or less foreign competition as the currency falls or rises. In this way, open-economy monetary policy implicates the interests of relatively well-defined, concentrated groups of producers and consumers. Individuals may not know whether they are net debtors or net creditors. But exporters, import competers, foreign investors, multinational corporations, and foreign debtors are well aware of their position in international trade and payments, and how movements in the exchange rate affect them.

I anticipate that monetary politics in an open economy will more closely resemble interest group politics than in a closed economy. Better-defined and more concentrated segments of society will be drawn into the political fray to contest the exchange rate than will attempt to influence interest rates. Exchange rate politics will involve particularistic interests, especially those intensely affected by currency movements. And because more economic agents are exposed to the direct effects of monetary and exchange rate policy in an open economy, I expect monetary policy in such an economy to be more politically contentious.

None of this is meant to imply that the difference between closed- and open-economy monetary politics is one of night and day. For one thing, the purely economic differences between them should not be exaggerated: both interest and exchange rates matter in both closed and open economies, and broad and particularistic interests are affected in both settings. The difference is of degree, not kind.

Nonetheless, there should be a noticeable difference between the politics of monetary policy in closed and open economies. In closed economies, it should be more a matter for public opinions, electoral

19 For three surveys, see Lohmann 2006; Franzese and Jusko 2006; Alesina and Stella 2011. For two early classics, see Alesina 1989; Grilli, Masciandaro, and Tabellini 1991.

politics, and national political institutions—for the expression and consideration of concern for national macroeconomic developments. In open economies, it should have a powerful and differentiated impact on well-defined groups, leading to something much more similar to special interest politics. How these differences play themselves out in national political institutions will vary along with these institutions, of course. The principal point is that there will be a predictable and recognizable distinction; in a globalized economy, well-defined groups will hotly contest the exchange rate. While the empirical analyses in this book are largely about open economies, there are enough instances of more closed economies to allow at least some comparisons.

Currency Politics Applied across Time and Space

In the remainder of this study, I present and apply a theory of preferences over exchange rate policy to a wide variety of empirical settings. Most of the applications are to relatively open economies. The first two studies concern the United States in the late nineteenth century and Europe since the 1970s. Both episodes cover open economies in an open world economy, and in both instances, the principal exchange rate issue was whether to adopt and sustain a fixed exchange rate—the gold standard in the US case, and a peg to the DM (and eventually a single currency) in the European case. These investigations allow us to see the common features of the politics of exchange rates in distinct settings.

The third set of studies covers Latin American currency policy since the 1970s. To some extent this, again, involves open economies in an open world economy, especially since the 1990s. But the Latin American experience has an important feature. Until the 1980s, almost all Latin American countries had high trade barriers and substantial controls on cross-border capital movements, so that by most standards they were financially and commercially closed. Over the course of the 1980s, most Latin American governments substantially liberalized trade and financial flows. This allows us to explore the effects on the political economy of currency policy of going from a closed to an open economy.

The periods and regions analyzed here are highly varied. This may appear to be a drawback, as the idea of comparing the United States in the 1870s to the European Union in the 1990s may seem foolish. I prefer to think that this allows for a more rigorous evaluation of my theoretical propositions. And I also believe that there are many similarities—often unrecognized ones—among the many and highly varied national experiences with currency politics. Indeed, one of the purposes of this study is to suggest that a common analytic architecture can help us understand such seemingly unrelated experiences as the classical gold standard, euro, and Argentine currency board.

Plan of the Book

Currency Politics analyzes the politics of exchange rates. It has both theoretical and empirical ambitions. Theoretically, this study focuses on identifying the distributionally motivated currency policy preferences of economic actors—firms, industries, and groups. Empirically, the book evaluates the accuracy of its theoretical arguments in a variety of historical and geographic settings. From a historical perspective, it looks at the politics of the gold standard, particularly in the United States. In a more contemporary mode, it examines the political economy of the process of European monetary integration. And it also analyzes the politics of Latin American currency policy over the past forty years.

Chapter 1 sets forth a theoretical framework for the analysis of the politics of exchange rates, emphasizing the sources of special interests with regard to currency policy. It provides analytic expectations about the sorts of patterns we should observe in exchange rate politics. The book then looks in depth at various settings to see the extent to which these expectations are borne out. It does so by concentrating on carefully delimited instances of exchange rate politics. The analyses are both narrative and, where possible, statistical. Chapters 2 and 3 focus on the United States during the gold standard era, and the complex and conflicted politics of gold in the United States between 1865 and 1896. The frequent congressional votes on currency policy issues allow me to evaluate the impact of some of the factors I argue help determine exchange rate policy preferences.

The subsequent chapters explore more recent instances of exchange rate politics, again with a mix of narrative and statistical analysis. Chapter 4 describes and analyzes the lengthy process of European monetary integration, which began in the early 1970s, culminated in the 1999 adoption of the euro, and continues today. The following two chapters examine Latin America. Chapter 5 gives an overview of Latin American currency policy since the early 1970s and then provides a statistical analysis of exchange rate choices. Chapter 6 focuses on the daunting problem of currency crises, which have been a frequent and debilitating feature of the Latin American economic scene, with a detailed discussion of the recent experiences of Mexico, Argentina, and Brazil. Chapter 7 considers some broader implications of the analysis in the book, after which I conclude with a summary of its findings.