



Handbook of the International Political Economy of Monetary Relations

Edited by **Thomas Oatley** and **W. Kindred Winecoff**



Handbooks of Research on International Political Economy

Handbook of the International Political Economy of Monetary Relations

'In this book, outstanding political economists provide wide-ranging and accessible essays on the global monetary system and its interaction with dynamic and crisis-prone financial markets. The essays are filled with fresh and well-articulated insights. This timely survey of an increasingly important field deserves a prominent place on the syllabi of graduate and advanced undergraduate courses in international political economy, global governance, and international finance.'

Louis W. Pauly, University of Toronto, Canada

'Here is an intellectual feast for anyone interested in the political economy of international monetary and financial systems, served up by an impressive collection of experts.

Students and specialists alike can gorge themselves on the many fascinating analyses of core issues and latest debates in the field. Highly recommended for anyone with an appetite to learn more about global money and finance.'

Eric Helleiner, University of Waterloo, Canada

This extensive *Handbook* provides an in-depth exploration of the political economy dynamics associated with the international monetary and financial systems. Leading experts offer a fresh take on research into the interaction between system structure, the self-interest of private firms, the political institutions within which governments make policy, and the ideas that influence beliefs about appropriate policy responses. Crucially they also assess how these factors have shaped the political economy of various facets of monetary and financial systems.

Organized into four comprehensive sections, the *Handbook* begins with a focus on the international system and explores how the distribution of power in the system shapes its structure and dynamics. The next section then considers the politics of exchange rate regime choice before analyzing current research on financial crises and financial regulation. Key questions are asked, such as: what drives financial crises and why do some economies suffer banking and currency crises while others do not? How does politics shape the central characteristics of the IMF's approach to crisis management? And how does change in the distribution of power in the international system change the structure of the global monetary and financial systems? The *Handbook* addresses these concerns and concludes with an examination of international governance, including the IMF and institutional reform in the post-crisis eurozone.

This detailed *Handbook* brings together original contributions from some of the leading authorities in the field, making it an invaluable resource to academics and students of international relations, governance, and political economy.

Thomas Oatley is Associate Professor of Political Science at the University of North Carolina at Chapel Hill, USA and **W. Kindred Winecoff** is Assistant Professor of Political Science at Indiana University, Bloomington, USA.

EDWARD ELGAR

A FAMILY BUSINESS IN INTERNATIONAL PUBLISHING

The Lyptatts, 15 Lansdown Road, Cheltenham, Glos GL50 2JA, UK
Tel: + 44 (0) 1242 226934 Fax: + 44 (0) 1242 262111 Email: info@e-elgar.co.uk

William Pratt House, 9 Dewey Court, Northampton, MA 01060, USA
Tel: +1 413 584 5551 Fax: +1 413 584 9933 Email: elgarinfo@e-elgar.com

www.e-elgar.com www.elgaronline.com

ISBN 978-0-85793-836-7



9 780857 938367

9 Private actor exchange rate policy preferences

Stefanie Walter

INTRODUCTION

The level and the stability of the exchange rate can have significant consequences on the material well-being of individuals and firms, especially when they live or operate in countries with a high level of economic and financial integration into the world economy, or when these actors are strongly involved in international trade or finance. Since the interests of private actors are therefore likely to influence policymakers' exchange rate policy decisions, it is important to understand the nature and intensity of these policy preferences. To facilitate such an understanding, this chapter provides an overview about the current state of the literature on private actors' exchange rate policy preferences.

In this chapter I focus on the policy preferences of both individuals and the corporate sector. Much of the literature has focused mainly on the interests of firms and different economic sectors who often hold very distinct policy preferences with regard to exchange rate policy and are therefore much more active in lobbying the government on macroeconomic policies than other groups (e.g. Frieden 1991, 2002). More recent work has shown, however, that voters' interests also play an important role in the realm of exchange rate policymaking (e.g. Hobolt and Leblond 2009). Even though individuals may not be able to formulate consistent exchange rate policy preferences when asked directly (McNamara 1998; Bearce and Tuxhorn 2012), there is evidence that voters do punish or reward policymakers for exchange rate policy decisions *ex post* (Walter 2009, 2012). As a result, policymakers are likely to consider both their voters' preferences as well as the preferences of different economic sectors when taking decisions that concern the exchange rate. In addition, most research on exchange rate policy preferences has traditionally assumed that these preferences are relatively clear-cut, vary across economic sectors, and mainly originate in the effects of exchange rate policy on actors' purchasing power, international competitiveness, and reliance on the domestic economy. As this chapter will show, however, exchange rate policy can have more complex effects, including severe financial consequences, which can cut across economic sectors. As a result, exchange rate policy preferences can be more heterogeneous than previously acknowledged. While this can negatively impact on actors' ability to organize effectively along existing lines, it also creates the potential for coalition-building with unexpected partners.

Two aspects of exchange rate policy are of particular relevance: the level of the exchange rate, and the stability of the currency. The exchange rate level refers to whether the national currency is relatively expensive in terms of other currencies (in this case, the exchange rate is appreciated) or relatively cheap (a depreciated exchange rate). An exchange rate appreciation consequently means that the value of the currency increases, so that more foreign goods can be purchased for the same amount of national currency units. Likewise, a depreciation means that the value of the currency declines; more

national currency is needed to purchase foreign goods, whereas domestic goods become cheaper for foreign buyers.

Exchange rate stability refers to how much the value of a currency fluctuates. Here, the choice of exchange rate regime plays an important role, because the regime can strongly limit such fluctuation. In fixed exchange rate regimes, the exchange rate does not fluctuate at all, but is fixed to another currency at a predefined value.¹ For example, the Hong Kong dollar, which is fixed in a very rigid exchange rate regime, a so-called currency board, has been traded at HK\$7.8 per United States (US) dollar since 1983. In contrast, in flexible exchange rate regimes the value of the currency is determined by the market, which can lead to considerable volatility in the exchange rate. In between these two extremes, a number of intermediate exchange rate regimes (such as basket pegs, crawling pegs, or managed floats) exist, which allow some limited exchange rate fluctuation.

Private actors tend to have preferences with regard to both of these aspects of exchange rate policymaking. Even though these aspects are of course interrelated, this chapter will cover private actor preferences for each of them separately to improve analytical clarity. The second section will focus on preferences regarding the level of the exchange rate, while the third section will focus on preferences regarding exchange rate regimes. The fourth section will demonstrate that especially in times of crisis, these issues often need to be considered jointly. The final section concludes.

STRONG VERSUS WEAK: PREFERENCES ABOUT THE EXCHANGE RATE LEVEL

Depreciations or devaluations as well as appreciations or revaluations² of the national currency strongly affect most individuals living and firms operating in economically open economies. These effects emerge both directly and indirectly and originate from both real and financial processes.

A loss in the currency's value directly decreases individuals' and firms' purchasing power. On the positive side, a weakened currency increases the international competitiveness of domestic products, which directly benefits producers of tradable goods. Appreciations have the opposite effect: they increase purchasing power but decrease exporters' international competitiveness. In addition, changes in the value of the currency affect private actors who own foreign-currency-denominated assets or owe debt in a foreign currency, since they experience a direct effect on their net wealth: positive in the case of foreign-currency assets, but negative in the (more frequent) case of foreign-currency debt.³ Indirectly, private actors are affected by how the depreciation impacts on the economy more generally. To understand the overall effect of the exchange rate level on private actors, one therefore needs to jointly consider these different aspects. In some cases, these effects will reinforce each other, but in other cases they can offset each other. Private actors' policy preferences about the level of the exchange rate result from the net effect of exchange rate adjustment on their economic situation overall. These overall effects are likely to vary across different domestic groups.

Purchasing Power Concerns

Changes in the exchange rate strongly affect relative prices, at least in the short to medium run, and can therefore increase or decrease the purchasing power of individuals and firms. Depreciation increases the domestic price of imported goods and, more generally, the prices of all internationally tradable goods relative to non-tradable goods. This depresses purchasing power, especially when actors consume or use large shares of tradable goods, which cannot easily be substituted with domestically produced products. In addition to domestic consumers, this loss in purchasing power particularly hurts companies in the non-tradables sector, especially when they use a lot of imported inputs. Moreover, depreciation-induced price increases for tradable goods are usually passed through to domestic prices. Even though this pass-through is not perfect and the extent tends to vary by industry, depreciation can therefore lead to increases in inflation.⁴ The general increase in prices, in turn, further decreases domestic actors' purchasing power. Appreciations have the opposite effect and increase the purchasing power of domestic firms and consumers. Again, the positive effect is most pronounced for those groups consuming or employing a high share of foreign products.

Since these consumption effects tend to be particularly pronounced for individual consumers,⁵ many studies on the political economy of exchange rate policy take it as the starting point for their analyses and assume that individuals will always oppose depreciation because they oppose the concomitant loss of purchasing power (e.g. Frieden and Stein 2001; Stein and Streb 2004; Blomberg et al. 2005), while they are more likely to favor an overvalued currency that boosts their purchasing power. More recent research has argued, however, that changes in the value of the currency affect individuals in more ways than only through their purchasing power (Walter 2013, 2012). For one, individuals' personal finances can be directly affected by such changes if they hold any debt or receive income in a foreign currency. In addition, individuals are also indirectly affected by the effects of exchange rate adjustment on their employers and on the economy more generally.

Competitiveness Concerns

The conventional wisdom holds that producers of tradable goods are the main beneficiaries of exchange rate depreciation because it increases their competitiveness, while non-tradable producers are hurt by the loss in the currency's value, and vice versa for appreciation (Frieden 1991). Exporters gain from depreciation, because a weakening of the domestic currency lowers the price of the exported goods abroad and thus boosts exporters' international competitiveness. Firm-level evidence indicates, for example, that firms with greater foreign sales perform significantly better after depreciations than firms that do not sell their products abroad (Forbes 2002). Depreciation is usually beneficial for import-competing producers as well. As foreign products become more expensive in domestic currency terms, their domestically produced goods become more competitive and attractive as substitutes for imported goods.⁶ Thus, in terms of competitiveness, depreciations (appreciations) tend to benefit (hurt) firms in the tradable sector, whether they export or compete against imported products.

Recent research has shown, however, that the competitiveness effects of exchange rate

adjustment are less clear than this traditional view suggests. Firm-level studies on the relationship between devaluations and export performance indicate that while devaluations overall tend to have a positive net effect on exporters, not all export-oriented firms benefit equally (Dollar and Hallward-Driemeier 2000). How a depreciation or appreciation of the currency affects a firm's competitiveness depends on a variety of factors, including the firm's cost and revenue structure, type of product, competitive environment, and the effect of exchange rate changes on its input and output markets (Muller and Verschoor 2006). Depreciations are not necessarily unambiguously good for export-oriented firms, because the increased competitiveness of their exported products can be dampened by higher prices for imported inputs and intermediate goods. Moreover, producers of standardized goods tend to be much more price-sensitive than producers of highly specialized goods, who mainly compete in terms of quality. As a result, exporters of standardized goods are likely to benefit from depreciation much more than producers of specialized goods.

In terms of competitiveness, the tradables sector is hence likely to prefer and to lobby for a weaker currency over a stronger currency, although not all firms are likely to share this preference or exhibit the same level of preference intensity for a weak and against a strong currency. Rather, this preference is likely to be additionally influenced by the level of standardization regarding the products a firm produces (Broz and Frieden 2001; Frieden 2002), its reliance on imported products (Kessler 1998; Helleiner 2005) or other competitiveness concerns (e.g. Kinderman 2008; Cleland Knight 2010; Duckenfield and Aspinwall 2010).

Balance Sheet Concerns

Changes in the exchange rate directly affect the value of all balance sheet positions that are at least partly denominated in foreign currency.⁷ Any firm or individual engaged in cross-border transactions will naturally exhibit such positions: exporters' revenues abroad or remittances sent back to domestic residents result in foreign currency denominated assets, while importers often accrue foreign currency denominated liabilities when they buy products abroad. Moreover, both firms and consumers in financially open economies increasingly borrow money in foreign currency, either because loans in domestic currency are not available, or because the interest rates on these loans are much higher than those on foreign currency loans.

With the increase in international capital mobility, foreign currency denominated assets and liabilities have become quite common. In many developing countries, the sum of remittances sent back to the citizens of these countries is now larger than the inflow of foreign direct investments into these countries (Singer 2010). Borrowing in foreign currencies is no longer limited to sovereign borrowing by the government or by large corporations, but is now undertaken by many private actors including small and medium-sized firms and consumers (e.g. Jeanne 2003), and in some countries, private foreign currency denominated borrowing has become the rule, rather than the exception. For example, in 2008, almost 90 percent of all Latvian bank loans were denominated in foreign currencies (Brown et al. 2009). Under such circumstances, the effects of changes in the exchange rate level affect private actors at least as strongly as the relative price effects discussed above and are therefore likely to significantly influence actors' preferences about exchange rate

policy (Walter 2012). This is because under these circumstances, any change in the value of the currency immediately affects the value of assets and liabilities denominated in a foreign currency. Thus, in domestic currency terms depreciations immediately increase the debt burden for holders of foreign currency denominated debt and increase the value of foreign currency denominated assets, and vice versa for appreciations.⁸ This can seriously disturb previously well-balanced balance sheets. Depreciations are particularly problematic if individuals' and firms' assets, such as wages and revenue, are predominantly denominated in domestic currency. Empirical studies show that large depreciations substantially increase the risk of bankruptcy and decrease investment and the profitability of firms with a high international debt exposure (e.g. Claessens et al. 2000; Aguiar 2005).

The increasing proliferation of foreign currency denominated assets and liabilities has therefore turned foreign currency balance sheet positions and potential balance sheet mismatches into important determinants of private actors' exchange rate policy preferences. Since anyone who holds more foreign currency denominated liabilities than assets is directly vulnerable to a depreciation, such prospects can produce a large and vocal constituency against such a policy course, while appreciations tend to be viewed positively (Shambaugh 2004; Hall 2005; Woodruff 2005; Walter 2008). Not surprisingly, empirical studies relying on survey data of both firms (Walter 2013) and individuals (Walter 2012) show that those firms and individuals exposed to foreign currency debt were much more likely to evaluate their government's exchange rate policy and its general performance negatively when the exchange rate had recently depreciated, and more positively when it had appreciated. Other studies show that firms which have hedged against changes in the exchange rate level, and whose balance sheets are therefore less vulnerable to a depreciation or appreciation of the currency, are less likely to become politically active with regard to exchange rate policy than firms which have not hedged (Kinderman 2005; Cleland Knight 2007).

Concerns about Effects on the Aggregate Economy

Since changes in the value of the currency usually also impact on a country's general economic conditions, private actors are likely to consider these effects as well when forming exchange rate policy preferences. Depending on the country's economic structure, these effects can be positive or negative and more or less pronounced. How exactly exchange rate movements affect the national economy depends mostly on how the country-specific real and financial effects discussed above add up in the aggregate.

The traditional textbook view has been that depreciations often have expansionary effects on output and employment, because a depreciated exchange rate increases foreign demand for domestic products and therefore boosts exports, which then spill over into the general economy. However, it is by now well established that devaluations of the currency can also have significant contractionary effects, because the effects discussed above can depress both aggregate supply and aggregate demand (Caves et al. 2002). Moreover, sudden devaluations can result in credit crunches, bank runs and full-blown financial crises, especially when a country's financial institutions exhibit large currency mismatches (e.g. Chang and Velasco 2001). It is therefore not surprising that currency and banking crises, which tend to be very costly and painful to resolve, often coincide (Kaminsky and Reinhart 1999).

Even if appreciations are a sign of investor confidence in a national economy and increase the purchasing power for individuals and firms, they can also create problems, especially for the tradables sector. For example, the significant appreciation of the Swiss franc during the recent global financial crisis and the euro crisis have created considerable problems for the Swiss economy, which prompted the Swiss National Bank to introduce a maximum value for the currency which the National Bank actively defends through interventions on the foreign exchange market.

As a result, depending on the specific structural, economic, and financial environment in which an appreciation or depreciation takes place, it can have substantial indirect effects on firms and individuals, both positive and negative, which in turn are likely to influence their exchange rate policy preferences.

Understanding Private Actors' Preferences about the Exchange Rate Level

In sum, changes in the exchange rate level can affect private actors in very different ways that can partially offset or reinforce each other. Individuals and firms are directly affected in terms of their purchasing power, international competitiveness, and personal balance sheets. Indirectly, they are affected by the consequences of a change in the currency's value on the general economy. Private actors' preferences about the exchange rate level consequently arise from a joint consideration of consumption patterns, type of economic activity, financial situation, and the general aggregate effect of an exchange rate adjustment on the economy, rather than any of these factors on their own. The more positive the direct and indirect consequences of such a change, the more supportive private actors will be of such a change, and vice versa when the consequences overall are negative.

At the same time, however, vulnerable actors need to consider the opportunity costs of opposing exchange rate adjustment, because resisting market-driven changes in the exchange rate usually comes at the cost of adjusting more domestically oriented policies (such as monetary or fiscal policy) instead. This brings me to the more general topic of exchange rate stability versus variability.

FLEXIBILITY VERSUS STABILITY: PREFERENCES ABOUT THE EXCHANGE RATE REGIME

The exchange rate regime determines how much the level of a country's exchange rate is allowed to fluctuate. Exchange rate regimes can be ordered on a continuum, ranging from fixed exchange rates to flexible exchange rates. Fixed exchange rates imply that the level of the exchange rate is fixed to some prespecified value of another currency and does not change at all. In its most extreme form, fixed exchange rates even imply that a country gives up its own currency (either by adopting a foreign currency, or by joining a common currency such as the euro). In the more frequent form, countries retain their domestic currency, but specify exactly at which value of another currency this currency will be exchanged. At the other end of the continuum are flexible exchange rate regimes, in which the level of the exchange rate is determined by market forces alone. In between these two ends of the continuum one can find a number of so-called 'intermediate' exchange rate regimes, which combine elements of both fixed and flexible exchange

rates. For example, in 'crawling peg' regimes, policymakers specify a certain value of the currency at which it will be exchanged for another currency, but this value is allowed to change over time in a predefined manner.

Both fixed and flexible exchange rates have advantages and disadvantages. Most of these advantages and disadvantages relate to the so-called 'unholy trinity' or Mundell–Fleming model, which shows that, when capital is mobile internationally, a trade-off exists between exchange rate stability and domestic monetary policy autonomy (Mundell 1961; Fleming 1962; for a discussion and the labeling of this model as 'unholy trinity,' see Cohen 1995). Thus, in financially open economies fixing the exchange rate means that national monetary policy cannot be used for domestic economic objectives. Likewise, the model implies that when capital is internationally mobile, retaining domestic monetary policy autonomy comes at the cost of giving up exchange rate stability. Given these constraints, private actors' preferences regarding the exchange rate regime are strongly influenced by the importance they attribute to a monetary policy geared towards the domestic economy in relation to the importance they attribute to a stable exchange rate. Although this will be influenced by characteristics of the national economy, different groups within a country are likely to evaluate the trade-off between domestic monetary policy autonomy and exchange rate stability differently, resulting in different private actor preferences about the exchange rate regime.

Producers

The group of private actors whose policy preferences regarding the exchange rate regime are best researched are firms and economic sectors more generally. Once more the most influential contribution for this research has been Frieden's (1991) distinction between producers heavily involved in foreign trade and investment, and domestically oriented producers. Frieden argues that both groups are likely to evaluate the trade-off between exchange rate stability and domestic monetary policy autonomy quite differently. Whereas internationally oriented producers, especially the export sector (and international investors, whose preferences I discuss below), care strongly about stable exchange rates because exchange rate volatility makes their business operations riskier, non-tradables producers and import-competing producers value a stable domestic economic environment much more strongly than exchange rate stability. The latter are therefore predicted to prefer a flexible exchange rate regime, because this allows policymakers to retain national monetary policy autonomy.

Many studies have tested these predictions empirically. In addition to case study research (e.g. Frieden 1996), the most common approach has been to examine to what extent a sector's share of gross domestic product (GDP) – as a proxy for its economic power and political influence in a country – influences a country's choice of exchange rate regime. While many empirical studies support Frieden's conjecture that a stronger tradables sector⁹ increases the odds of an exchange rate regime which limits exchange rate fluctuations (e.g. Bernhard and Leblang 1999; Leblang 1999; Broz 2002; Frieden 2002; Frieden et al. 2010; Singer 2010), several studies also find that a larger manufacturing sector decreases the government's willingness to maintain a fixed exchange rate (e.g. Frieden et al. 2001; Blomberg et al. 2005).

Given these inconsistent findings, more recent research has begun to refine the Frieden

model in several directions (for a more detailed discussion of these extensions see Steinberg and Walter 2013). For example, as discussed above, firms' products differ with regard to their standardization. Some products are relatively standardized and do not differ much in terms of quality, so that they compete mainly on the basis of their price. This increases the attractiveness of depreciations for producers of standardized goods, so that they tend to be less interested in the benefits of exchange rate stability than producers of highly specialized products (Frieden 2002). This points to a second complication, the fact that the exchange rate regime and exchange rate level are not independent from one another, nor are they chosen in isolation from other policies and institutions (Steinberg and Walter 2013). For example, fixed exchange rates are much more likely to become overvalued than flexible exchange rates, that can easily adjust as market conditions change. This creates a trade-off for producers interested in both exchange rate stability and a favorable (that is, depreciated) exchange rate level (Kaplan 2006; Broz et al. 2008). In addition, as discussed above, exchange rate policy decisions also affect monetary and fiscal policy and vice versa. In financially open economies, monetary policy is only effective under flexible exchange rates (but not under fixed exchange rates), whereas fiscal policy is most effective under fixed exchange rates, and much less so under flexible exchange rates, and this can affect some producers' exchange rate policy preferences. Likewise institutional characteristics such as central bank independence and fixed exchange rate regimes can act as complements or substitutes (Bearce 2008), which again is likely to condition producers' exchange rate policy preferences.

Overall, this suggests that although on average, internationally oriented producers are going to be more interested in exchange rate stability than domestically oriented producers, these preferences are likely to depend on the country- and firm-specific context.

Financial Interests: Investors and Borrowers

A second group of private actors with distinct exchange rate policy preferences is the group of investors and debtors, whose policy preferences are driven by their financial interests. Research shows that the reliance on or investment in different types of capital generates distinct capital-specific policy preferences about exchange rate regime choice, as financial market participants try to limit the riskiness of their financial operations. Here, the preferences of domestic and international investors can be distinguished.

The exchange rate regime preferences of domestic financial interests are mainly determined by the type of their investments and borrowings. Shambaugh (2004) argues that actors who are heavily involved in commercial bank lending, as both lenders and borrowers, are likely to prefer the stability of fixed exchange rates over the domestic policy flexibility that comes with floating exchange rates. This is particularly true for those individuals holding foreign currency denominated debt and exhibiting severe currency mismatches in their balance sheets (Hall 2005; Woodruff 2005; Walter 2008). This is because – as discussed above – a depreciation of the currency can create significant problems for the holders of such debt, so that this group of financial market participants is particularly interested in exchange rate stability. In contrast, actors who rely strongly on funds generated by portfolio investment are more likely to prefer flexible exchange rate regimes, because they enhance the government's ability to respond to external shocks and to limit the risks of capital flight (Shambaugh 2004). Moreover, whether the financial

sector supports or opposes fixed exchange rates may depend on whether doing so will increase or decrease inflation (Henning 1994; Helleiner 2005).

International investors also have preferences regarding the exchange rate regime of the countries in which they invest. In his seminal article, Frieden (1991) argued that international investors prefer fixed exchange rates, because this reduces the riskiness of their investments, whereas they care less about the ability of the government to directly influence domestic economic conditions.¹⁰ In contrast, international investors engaged in foreign direct investment (FDI) are likely to share the exchange rate policy preferences of the industrial sectors in which they invest: foreign investors in export-oriented industries, especially those producing standardized goods have been argued to prefer flexible exchange rates, whereas those investing in domestically oriented sectors or in export sectors producing specialized goods should prefer more stable exchange rate regimes (Shambaugh 2004).

Individuals: Workers, Financial Market Participants, and Consumers

Exchange rate policy can have major ramifications for individuals as well. They are affected in a variety of ways: as workers, they are tied to the economic success of their employers as well as the economy more generally; as financial market participants they worry about the value of their investments or their debt burden, respectively; and as consumers they are concerned about their purchasing power.

To the extent that their income is tied to the economic fate of their employers, individuals as workers are likely to share the exchange rate policy preferences of their employers. This means that individuals employed in export-oriented industries are more likely than individuals employed in domestically oriented sectors to prefer fixed exchange rates. At the same time, as labor market participants and recipients of government transfers more generally, individuals tend to value the domestic monetary autonomy and oftentimes more expansive fiscal policies, which are often associated with flexible exchange rate regimes and which allow policymakers to target the needs of the domestic economy.¹¹ As investors or borrowers, however, individuals are more likely to prefer stable exchange rates, as this decreases the riskiness of their investments or debt burden, especially when these investments or debts are tied to foreign currencies.

While individuals' preferences thus mirror the preferences of other groups in many respects, their role as consumers presents an additional dimension. As discussed above, changes in the exchange rate can strongly affect the purchasing power of individuals (and firms). Although this is typically thought of as an issue regarding the exchange rate level, it also affects individual consumers' preference about the exchange rate regime, because fixed exchange rates not only preclude purchasing-power-eroding depreciations, but often lead to appreciating real exchange rates, and hence an increase in purchasing power for domestic consumers. Moreover, fixed exchange rates can help policymakers in a high-inflation environment to contain inflationary pressure. This again enhances consumers' purchasing power and tends to boost individuals' support for stable exchange rates.

Since the political influence of individuals in democracies is highest in the run-up to elections, the issue of voter preferences about exchange rate regime choice is mostly discussed in studies investigating the effect of elections on exchange rate policymaking. These studies typically find that during pre-election periods, governments are more likely

to install fixed exchange rate regimes (Schamis and Way 2003) or keep their exchange rates fixed and overvalued, while a move to more flexible exchange rate regimes is most likely in the aftermath of elections (Blomberg and Hess 1997; Frieden et al. 2001; Stein and Streb 2004; Blomberg et al. 2005; Walter 2009).

Although these studies show that elections affect exchange rate policy choices in democratic countries, relatively few studies have investigated individuals' exchange rate regime preferences directly. One notable exception in this regard are studies of public opinion about the euro and participation in European Monetary Union (EMU). This research underlines the notion that individual policy preferences about the exchange rate regime can vary quite widely. It shows that this variation can be explained in part by the material interests discussed above. In line with individuals' role as workers, this research has shown, for example, that manual workers (Hooghe and Marks 2005) and Danish employees in a non-tradable industry (Jupille and Leblang 2007) were more opposed to joining the euro. In contrast, Swedish business owners and white-collar workers were more supportive of joining EMU than blue-collar workers (Jupille and Leblang 2007). These studies also support the notion that purchasing power concerns play an important role for individuals' exchange rate regime preferences. Several studies find that individuals favor replacing their national currency with the euro when the euro is strong against the dollar, but they prefer to keep their national currency when it has appreciated in value vis-à-vis the euro (Banducci et al. 2003, 2009; Hobolt and Leblond 2009).

Public opinion research on preferences about the single European currency also demonstrates, however, that these preferences are equally strongly influenced by non-material factors, such as concerns about national identity and sovereignty, or individuals' opinions about European integration more generally (Kaltenthaler and Anderson 2001; Jupille and Leblang 2007; Hobolt and Leblond 2009; Allam and Goerres 2011). Overall, this research thus demonstrates that for individuals, the question of exchange rate regime choice is not just an issue of exchange rate stability or variability, but one to which considerable symbolic value is attached as well.

Conclusion: Private Actors' Preferences about the Exchange Rate Regime

All in all, research on the role of private interests in shaping policymakers' choices about the exchange rate regime shows that these interests play a considerable role in the politics of exchange rates. Given that these interests range from preferences for very tightly fixed to completely flexible exchange rates, the actual influence on a particular government's exchange rate choice depends on the political strength of the different groups of actors interested in the decision. At the same time, private actor interests are not the only determinant of exchange rate regime choices. Rather, the institutional setting also plays an important role, as David Bearce discusses in Chapter 10 in this volume. Institutions matter, not only because they influence the decision-making calculus of policymakers, but also because they can condition both the preferences of private actors and their political strength. It is the interplay between interests and institutions that typically shapes exchange rate regime choices.

EXCHANGE RATE POLICY PREFERENCES IN THE GLOBAL FINANCIAL AND EURO CRISES

In recent years, exchange rate policy has become a hotly debated issue in many countries. As the global financial and economic crisis spread around the globe, and during the ongoing euro crisis, many governments found themselves confronted with significant market pressures on their exchange rates. Iceland, Latvia, Hungary, and Greece – to name but a few countries – have all faced difficult trade-offs related to both the level and the stability of their exchange rates. These trade-offs have been particularly pronounced in countries facing balance-of-payments problems (in particular, a current account deficit), because such countries typically face strong pressure to adjust their economic policies when external financing dries up.¹²

In addition to the short-term solution of financing the deficit, for example through sterilized foreign reserve sales, there are two ways to react to such pressure, especially when the current account deficit results from deeper macroeconomic and structural problems, such as an unsustainably high level of consumer demand coupled with a weak industrial and services sector, high budget deficits, high growth rates of money and domestic credit, and/or overvalued exchange rates. In these situations, it is necessary to implement policies that lead to macroeconomic adjustment and a rebalancing of the current account. This can be achieved in two ways (as well as a combination of both). The first possible adjustment strategy is external adjustment, which mainly implies an exchange rate depreciation. By making domestic products more competitive internationally and raising the price of imports, this strategy switches expenditure away from the consumption of internationally tradable goods and towards the production and export of such goods. A second possible adjustment strategy is internal adjustment, in which monetary and fiscal policy are tightened and structural reforms are implemented to increase the economy's competitiveness, while maintaining a stable exchange rate. Here, the goal is to deflate domestic prices through a reduction in overall spending and productivity gains, which once more makes domestic products more competitive internationally and reduces the demand for imports.

Both of these macroeconomic adjustment strategies are usually painful, although the relative cost of different adjustment strategies differs by context. Research on optimum currency areas (OCAs) has shown, for example, that the costs of external adjustment are lower in larger, less trade-dependent economies, whereas internal adjustment is the less costly adjustment strategy for small open economies (Mundell 1961; McKinnon 1963; for reviews see Frankel 1999; Willett 2003). At the same time, however, the choice between different adjustment strategies is not predetermined by economic considerations alone (see, e.g., Eichengreen et al. 2003 [1995]; Kraay 2003) but is also a thoroughly political decision (see, e.g., Cohen 2003; Willett 2006; Walter 2013).

Here, private actor preferences play an important role, because changes in exchange and interest rates, in fiscal policy, and structural reforms can significantly hurt certain groups of citizens, while benefiting others. Some groups will consequently be more vulnerable to the consequences of external adjustment, while for others internal adjustment is more painful. The vulnerability of citizens to the external and internal adjustment of macroeconomic policies has been increased in recent years by the globalization of capital, which has not only allowed domestic citizens and firms to engage on foreign financial markets

and to borrow and invest in foreign currencies, but has also intricately linked exchange rate policy to monetary policy. As a result, private actors' vulnerabilities to different adjustment strategies depend on how the effects of exchange rate, monetary, and fiscal policy changes as well as structural reforms sum up to affect their material well-being.

These distributional issues strongly influence the politics of macroeconomic adjustment (Walter 2013). When a majority of private actors are more negatively exposed to losses in the currency's value than internal adjustment, policymakers are more likely to implement policies that tighten domestic economic conditions. In contrast, when a majority of constituents are more vulnerable to exchange rate changes than monetary and/or fiscal contraction as well as structural change, internal adjustment becomes more likely. The situation becomes complicated when citizens are highly vulnerable to both external and internal adjustment. In this case, any type of adjustment has painful consequences for the country's private sector and citizens. This creates strong incentives not to adjust at all, which in itself is unproblematic as long as the balance-of-payments problems result from transitory economic shocks that will eventually rectify themselves without any major intervention. But adjustment cannot be avoided in the long run when the economy experiences fundamental problems. Under these circumstances, adjustment eventually will have to occur, either voluntarily by changing economic policies, or involuntarily in the form of a crash. Since delay without reform usually results in a further deterioration of the imbalances, the adjustment eventually has to be much more extensive than adjustment which is implemented early on, and therefore often results in a full-blown crisis. The distributional effects of adjustment consequently affect both the timing and the type of adjustment strategy chosen.

A look at private actor preferences helps to explain some puzzling variation in exchange rate policy decisions during the recent global financial and economic crisis. A set of four countries has particularly puzzled many observers: the three Baltic countries and Bulgaria successfully confronted their balance-of-payments problems by implementing internal adjustment strategies, although implementing such policies has usually been argued as too painful to implement in democratic countries (Eichengreen 1992; Simmons 1994) – an argument that is vividly demonstrated by the difficulties of the Greek government to implement such policies during the ongoing euro crisis. However, looking at the vulnerability profiles of private actors in these countries, one can see that they combined a moderate vulnerability to internal adjustment with a very high vulnerability to external adjustment. In particular, voters and firms in these countries held unusually large amounts of foreign currency denominated debt, which significantly raised the potential costs of a devaluation of the currency. I argue that this vulnerability profile explains why the governments of these countries were able to push through contractionary fiscal and nominal wage policies without serious public opposition (Walter 2013, Chapter 7). In contrast, private actors' vulnerability profiles in other Eastern European countries, where governments chose externally oriented adjustment strategies (the Czech Republic and Poland), exhibited a significantly lower vulnerability to external adjustment and a higher vulnerability to internal adjustment than in the Baltic countries and Bulgaria. In those countries which initially delayed adjustment and eventually adopted mixed adjustment strategies (Hungary and Romania), private actors in general exhibited a high vulnerability to both types of adjustment strategies.

Exchange rate policymaking in the recent crises has hence highlighted the importance

of considering private actor preferences for a full understanding of the trade-offs faced by and the policy choices taken by national governments in times of economic stress.

CONCLUSION

This chapter has shown that the interests of private actors play an important role for policymakers' exchange rate policy decisions, regarding both the level and the stability of the national currency. As we have seen, these interests are shaped by a number of cross-cutting considerations, such as concerns about purchasing power, competitiveness, and financial concerns, but also non-material considerations. Moreover, private actors' preferences about the level and the stability of the exchange rate are related, and also depend on the trade-offs they pose for other economic policies. These trade-offs become particularly strong during economic crises, where private actor preferences can be shown to have a particularly strong influence on exchange rate policy decisions.

NOTES

1. The most extreme form of fixed exchange rate regime is a currency union (such as the European Monetary Union), in which all member states share a common currency.
2. The term depreciation (appreciation) refers to a decline (rise) in the value of a flexible currency, while devaluation (revaluation) denotes the decline (rise) in the value of a fixed or pegged exchange rate (and hence also implies a breach of the rules of the exchange rate regime). Since the implications with regard to the exchange rate level are similar, however, I will refer to these phenomena only as depreciations and appreciations.
3. Unless they have hedged against currency fluctuations.
4. For an overview of the literature on this topic see Goldberg and Knetter (1997).
5. At the same time real depreciations increase the purchasing power of consumers of non-tradable goods (such as food and housing).
6. An alternative interpretation leading to the same conclusions is that tradable producers prefer a more depreciated exchange rate because it raises the price of their products relative to the price of non-tradable inputs (Frieden and Stein 2001).
7. Balance sheets are statements of assets and liabilities. Every firm and institution has balance sheets, but the financial situation of each individual person can be conceptualized in similar terms.
8. Unless foreign currency liabilities are hedged (that is, simply put, insured against exchange market risk).
9. Also measured as the relative size of the manufacturing or the export sector.
10. Shambaugh (2004) echoes this argument but finds no empirical support for it.
11. Not surprisingly, several studies find that left-wing parties, as representatives of the working class, tend to be more supportive of or more associated with flexible exchange rate regimes than conservative parties (e.g. Frieden 2001; Bearce 2003, 2007).
12. A current account deficit typically implies that a country is importing more goods and services than it exports and that domestic savings are smaller than domestic investments, which is why current account deficits are associated with capital inflows into a country. When these capital inflows dry up – either because of a change in the global investment climate or because international investors become skeptical about the sustainability of the country's economic policies – policymakers need to act, because the current account deficit can no longer be financed with foreign capital.

REFERENCES

- Aguiar, Mark. 2005. 'Investment, Devaluation, and Foreign Currency Exposure: The Case of Mexico.' *Journal of Development Economics* 78: 95–113.

- Allam, Miriam, and Achim Goerres. 2011. 'Economics, Politics or Identities? Explaining Individual Support for the Euro in New EU Member States in Central and Eastern Europe,' *Europe-Asia Studies* 63(8): 1399–1424.
- Banducci, Susan A., Jeffrey A. Karp, and Peter H. Loedel. 2003. 'The Euro, Economic Interest and Multi-Level Governance: Examining Support for the Common Currency,' *European Journal of Political Research* 42(5): 685–703.
- Banducci, Susan A., Jeffrey A. Karp, and Peter H. Loedel. 2009. 'Economic Interests and Public Support for the Euro,' *Journal of European Public Policy* 16(4): 564–81.
- Bearce, David H. 2003. 'Societal Preferences, Partisan Agents, and Monetary Policy Outcomes,' *International Organization* 57: 373–410.
- Bearce, David H. 2007. *Monetary Divergence: Domestic Policy Autonomy in the Post-Bretton Woods Era*. Michigan Studies in International Political Economy. Ann Arbor, MI: University of Michigan Press.
- Bearce, David. 2008. 'Not Complements, But Substitutes: Exchange Rate Commitments, Central Bank Independence, and External Currency Stability,' *International Studies Quarterly* 52: 807–24.
- Bearce, David and Kim-lee Tuxhorn. 2012. 'Do Individuals have Egocentric Monetary Policy Preferences,' Presented at the IPES Conference 2012, Charlottesville, VA.
- Bernhard, William and David Leblang. 1999. 'Democratic Institutions and Exchange-rate Commitments,' *International Organization* 53(1): 71–97.
- Blomberg, Brock, Jeffrey Frieden, and Ernesto Stein. 2005. 'Sustaining Fixed Rates: The Political Economy of Currency Pegs in Latin America,' *Journal of Applied Economics* 8(2): 203–25.
- Blomberg, S. Brock, and Gregory D. Hess. 1997. 'Politics and Exchange Rate Forecasts,' *Journal of International Economics* 43: 189–205.
- Brown, Martin, Steven Ongena, and Pinar Yesin. 2009. 'Foreign Currency Borrowing by Small Firms,' Swiss National Bank Working Papers 2009-2.
- Broz, J. Lawrence. 2002. 'Political System Transparency and Monetary Commitment Regimes,' *International Organization* 56(4): 861–87.
- Broz, J. Lawrence and Jeffrey A. Frieden. 2001. 'The Political Economy of International Monetary Relations,' *Annual Review of Political Science* 4: 317–43.
- Broz, Lawrence, Jeffrey Frieden, and Stephen Weymouth. 2008. 'Exchange-Rate Policy Attitudes: Direct Evidence from Survey Data,' *IMF Staff Papers* 55(3): 417–44.
- Caves, Richard, Jeffrey Frankel, and Ronald Jones. 2002. *World Trade and Payments: An Introduction*. Boston, MA: Addison Wesley Longman.
- Chang, Roberto and Andrés Velasco. 2001. 'A Model of Financial Crises in Emerging Markets,' *Quarterly Journal of Economics* 116(2): 489–517.
- Claessens, Stijn, Simeon Djankov, and Lixin Colin Xu. 2000. 'East Asian Corporations, Before and During the Recent Financial Crisis,' *World Bank Research Observer* 15(1): 23–46.
- Clelland Knight, Sarah. 2007. 'When Exchange Rates become Political,' Doctoral dissertation, Washington DC: Georgetown University.
- Clelland Knight, Sarah. 2010. 'Divested Interests: Globalization and the New Politics of Exchange Rates,' *Business and Politics* 12(2): Article 3.
- Cohen, Benjamin J. 1995. 'The Triad and the Unholy Trinity: Problems of International Monetary Cooperation,' In Jeffrey Frieden and David Lake (eds), *International Political Economy: Perspectives on Global Power and Wealth*. New York: St Martin's Press, pp. 255–66.
- Cohen, Benjamin J. 2003. 'Monetary Union: The Political Dimension,' In Dominick Salvatore, James W. Dean, and Thomas D. Willett (eds), *The Dollarization Debate*. Oxford: Oxford University Press, pp. 154–71.
- Dollar, David and Mary Hallward-Driemeier. 2000. 'Crisis, Adjustment, and Reforms in Thailand's Industrial Firms,' *World Bank Research Observer* 15(1): 1–22.
- Duckenfield, Mark and Mark Aspinwall. 2010. 'Private Interests and Exchange Rate Politics: The Case of British Business,' *European Union Politics* 11(3): 381–404.
- Eichengreen, Barry. 1992. *Golden Fetters: The Gold Standard and the Great Depression*. New York: Oxford University Press.
- Eichengreen, Barry, Andrew Rose, and Charles Wyplosz. 2003 [1995]. 'Exchange Market Mayhem: The Antecedents and Aftermath of Speculative Attacks,' In Barry Eichengreen (ed.), *Capital Flows and Crises*. Cambridge MA: Massachusetts Institute of Technology, pp. 99–154. Original edition, *Economic Policy* 21 (October 1995).
- Fleming, Marcus J. 1962. 'Domestic Financial Policies under Fixed and under Floating Exchange Rates,' *IMF Staff Papers* 9: 369–80.
- Forbes, Kristin J. 2002. 'How Do Large Depreciations Affect Firm Performance?' *IMF Staff Papers* 49 (Special Issue): 214–37.
- Frankel, Jeffrey A. 1999. 'No Single Currency Regime is Right for All Countries or at all Times,' Essays in International Finance No. 215, Princeton, NJ: Princeton University.
- Frieden, Jeffrey, 1991. 'Invested Interests: The Politics of National Economic Policies in a World of Global Finance,' *International Organization* 45(4): 425–51.
- Frieden, Jeffrey A. 1996. 'The Impact of Goods and Capital Market Integration on European Monetary Politics,' *Comparative Political Studies* 29(2): 193–222.
- Frieden, Jeffrey. 2001. 'Making Commitments: France and Italy in the European Monetary System, 1979–1985,' In Barry Eichengreen and Jeffrey Frieden (eds), *The Political Economy of European Monetary Integration*. Baltimore, MD: Westview Press, pp. 23–47.
- Frieden, Jeffrey. 2002. 'Real Sources of European Currency Policy: Sectoral Interests and European Monetary Integration,' *International Organization* 56(4): 831–60.
- Frieden, Jeffrey, Piero Ghezzi, and Ernesto Stein. 2001. 'Politics and Exchange Rates: A Cross-Country Approach,' In Jeffrey Frieden and Ernesto Stein (eds), *The Currency Game: Exchange Rate Politics in Latin America*. Washington, DC: Inter-American Development Bank, pp. 21–63.
- Frieden, Jeffrey, David Leblang, and Neven Valev. 2010. 'The Political Economy of Exchange Rate Regimes in Transition Economies,' *Review of International Organizations* 5(1): 1–25.
- Frieden, Jeffrey and Ernesto Stein. 2001. 'The Political Economy of Exchange Rate Policy in Latin America: An Analytical Overview,' In Jeffrey Frieden and Ernesto Stein (eds), *The Currency Game: Exchange Rate Politics in Latin America*. Washington DC: Inter-American Development Bank, pp. 1–19.
- Goldberg, Pinelopi Koujianou and Michael Knetter. 1997. 'Goods Prices and Exchange Rates: What Have We Learned?' *Journal of Economic Literature* 35(3): 1243–72.
- Hall, Michael G. 2005. *Exchange Rate Crises in Developing Countries. The Political Role of the Banking Sector*. Burlington, VT: Ashgate.
- Helleiner, Eric. 2005. 'A Fixation with Floating: The Politics of Canada's Exchange Rate Regime,' *Canadian Journal of Political Science* 38(1): 23–44.
- Henning, Randall C. 1994. *Currencies and Politics in the United States, Germany, and Japan*. Washington DC: Institute for International Economics.
- Hobolt, Sara, and Patrick Leblond. 2009. 'Is My Crown Better than Your Euro? Exchange Rates and Public Opinion on the Single European Currency,' *European Union Politics* 10(2): 202–25.
- Hooghe, Liesbet and Gary Marks. 2005. 'Calculation, Community and Cues: Public Opinion on European Integration,' *European Union Politics* 6(4): 419–43.
- Jeanne, Olivier. 2003. 'Why do Emerging Market Economies Borrow in Foreign Currency?' IMF Working Paper WP/03/177.
- Jupille, Joseph and David Leblang. 2007. 'Voting for Change: Calculation, Community, and Euro Referendums,' *International Organization* 61(4): 763–82.
- Kaltenthaler, Karl and Christopher Anderson. 2001. 'Europeans and Their Money: Explaining Public Support for the Common European Currency,' *European Journal of Political Research* 40(2): 139–70.
- Kaminsky, Graciela L. and Carmen M. Reinhart. 1999. 'The Twin Crises: The Causes of Banking and Balance-of-Payments Problems,' *American Economic Review* 89(3): 473–500.
- Kaplan, Stephen B. 2006. 'The Political Obstacles to Greater Exchange Rate Flexibility in China,' *World Development* 34(7): 1182–1200.
- Kessler, Timothy P. 1998. 'Political Capital: Mexican Financial Policy under Salinas,' *World Politics* 51(1): 36–66.
- Kinderman, Daniel. 2005. 'The Microfoundations of Sectoral Exchange Rate Preferences and Lobbying: An Empirical Adjudication, 1960–2004,' American Political Science Association Annual Conference, Washington, DC.
- Kinderman, Daniel. 2008. 'The Political Economy of Sectoral Exchange Rate Preferences and Lobbying: Germany from 1960–2008, and Beyond,' *Review of International Political Economy* 15(5): 851–80.
- Kraay, Aart. 2003. 'Do High Interest Rates Defend Currencies During Speculative Attacks?' *Journal of International Economics* 59: 297–321.
- Leblang, David. 1999. 'Domestic Political Institutions and Exchange Rate Commitments in the Developing World,' *International Studies Quarterly* 43(4): 599–620.
- McKinnon, Ronald I. 1963. 'Optimum Currency Areas,' *American Economic Review* 53(4): 717–25.
- McNamara, Kathleen. 1998. *The Currency of Ideas: Monetary Politics in the European Union*. Ithaca, NY: Cornell University Press.
- Muller, Aline and Willem Verschoor. 2006. 'Foreign Exchange Risk Exposure: Survey and Suggestions,' *Journal of Multinational Financial Management* 16(4): 385–410.
- Mundell, Robert A. 1961. 'A Theory of Optimum Currency Areas,' *American Economic Review* 51(4): 657–64.
- Schamis, Hector E. and Christopher R. Way. 2003. 'The Politics of Exchange Rate-Based Stabilization,' *World Politics* 56: 43–78.
- Shambaugh, George E. 2004. 'The Power of Money: Global Capital and Policy Choices in Developing Countries,' *American Journal of Political Science* 48(2): 281–95.

- Simmons, Beth. 1994. *Who Adjusts? Domestic Sources of Foreign Economic Policy During the Interwar Years*. Princeton, NJ: Princeton University Press.
- Singer, David. 2010. 'Migrant Remittances and Exchange Rate Regimes in the Developing World.' *American Political Science Review* **104**(2): 307–23.
- Stein, Ernesto, and Jorge Streb. 2004. 'Elections and the Timing of Devaluations.' *Journal of International Economics* **63**(1): 119–45.
- Steinberg, David and Stefanie Walter. 2013. 'The Political Economy of Exchange Rates.' In Gerard Caprio (ed.), *Handbook of Safeguarding Global Financial Stability: Political, Social, Cultural, and Economic Theories and Models*. Oxford: Elsevier, pp.27–36.
- Walter, Stefanie. 2008. 'A New Approach for Determining Exchange-Rate Level Preferences.' *International Organization* **62**(3): 405–38.
- Walter, Stefanie. 2009. 'The Limits and Rewards of Political Opportunism: How Electoral Timing Affects the Outcome of Currency Crises.' *European Journal of Political Research* **48**(3): 367–96.
- Walter, Stefanie. 2012. 'Distributional Politics in Times of Crisis. Eastern European Policy Responses to the Global Financial and Economic Crisis 2008–10.' Presented at the EPSA Annual Convention, Berlin.
- Walter, Stefanie. 2013. *Financial Crises and the Politics of Macroeconomic Adjustments*. Cambridge: Cambridge University Press.
- Willett, Thomas D. 2003. 'The OCA Approach to Exchange Rate Regimes. A Perspective on Recent Developments.' In Dominick Salvatore, James Dean and Thomas Willett (eds), *The Dollarization Debate*. Oxford: Oxford University Press, pp.154–71.
- Willett, Thomas D. 2006. 'Optimum Currency Area and Political Economy Approaches to Exchange Rate Regimes: Towards a Framework for Integration.' *Current Politics and Economics of Europe* **17**(1): 25–52.
- Woodruff, David M. 2005. 'Boom, Gloom, Doom: Balance Sheets, Monetary Fragmentation, and the Politics of Financial Crisis in Argentina and Russia.' *Politics and Society* **33**(1): 3–45.