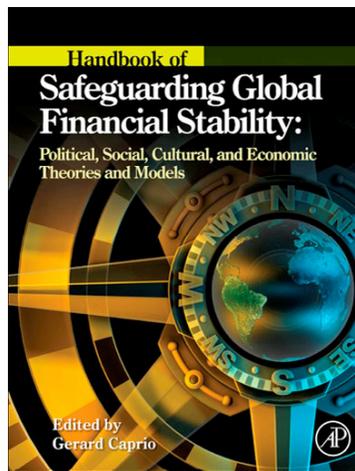


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The Political Economy of Exchange-Rate Policy

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INTRODUCTION

A country's exchange rate conveys the price of the country's currency in another currency. When the exchange rate appreciates, the national currency becomes more expensive. Conversely, when the exchange rate depreciates, the value of the national currency declines. In internationally integrated economies, the exchange rate is the most important price in the economy. Through their exchange-rate policies, governments can determine the price of foreign currency as well as the stability of this price; by doing so, governments influence the size and the stability of their country's international financial and trade flows. By implementing suitable exchange-rate policies, policymakers can foster exports and international competitiveness, and can increase domestic macroeconomic stability.

Unfortunately, however, policymakers often implement their exchange-rate policy in a way that inflicts considerable damage on their own economies. Misaligned exchange rates reduce economic growth, increase unemployment, and often result in financial crisis.

Unstable exchange rates can make it hard for economic agents to plan for the future, stymieing investment. Excessively rigid exchange rates imply a loss of control over the domestic money supply, which can intensify business cycle fluctuations or increase unemployment and inflation. From a political-economy perspective, a number of questions follow. Why do some policymakers fix the value of their currencies while others are more tolerant of exchange-rate fluctuations? Why do some policymakers allow their exchange rates to become misaligned, and why are others more successful at avoiding exchange-rate misalignments? How do interests and institutions shape exchange-rate policies? This chapter critically reviews the recent political economy literature on these questions, and demonstrates that while the understanding of the political economy of exchange rates has improved dramatically in recent years, many open questions remain.

After briefly reviewing some prominent economic models of exchange rates, the remainder of the chapter examines the effects of domestic politics on exchange rates. The discussion is divided into different sets of

causal variables, beginning with the preferences of various actors – sectors, politicians, political parties, and voters – and then discussing several institutional factors – democracy, elections, electoral systems, veto points, and central bank independence (CBI) – that influence exchange-rate policy. (See Broz and Frieden (2001) for a discussion of international aspects of exchange-rate policy.) Theory and evidence confirm that preferences and institutions both shape exchange-rate policy. However, no single variable always matters, and many variables appear to have different effects in different circumstances. Our review of the existing literature reveals that different studies come to opposite conclusions about the effect of many of the most popular explanatory variables. For example, while many studies find that political factors such as large tradable sectors, right-wing governments, and nondemocratic regimes promote fixed exchange-rate systems, other studies find that these factors are associated with more flexible and volatile exchange-rate regimes. This leads one to conclude that most political factors have contingent effects on exchange-rate policy. Recent research has started to give greater attention to how various political factors interact to jointly determine exchange-rate policies, and future research needs to continue exploring these complex causal relationships.

ECONOMIC EXPLANATIONS OF EXCHANGE-RATE POLICY: IMPORTANT BUT INSUFFICIENT

Most political explanations of exchange-rate policy build and extend upon theories of exchange rates that were developed by economists. The open-economy trilemma – which has also, more provocatively, been labeled the ‘unholy trinity’ – has been the standard framework for understanding the economic effects of exchange-rate policy since the 1960s. The trilemma states that maintaining a stable exchange rate requires countries to give up either international capital mobility or domestic monetary policy autonomy. This implies that, when capital is mobile internationally, fixing the exchange rate means that interest rates cannot be manipulated in pursuit of domestic economic objectives. (For a detailed discussion of the open-economy trilemma, see the corresponding chapter in this Handbook.) Likewise, the ability to gear monetary policy toward domestic objectives comes at the cost of giving up exchange-rate stability.

The theory of optimum currency areas (OCA), a related economic model, argues that the characteristics of the national economy determine which types of exchange-rate policies are optimal. OCA theory suggests that larger, less trade-dependent economies should find the costs of exchange-rate adjustments lower in terms of

aggregate economic efficiency, while valuing monetary policy autonomy more. In contrast, small open economies prioritize fixed exchange-rate regimes because externally oriented economies will fare better with exchange-rate stability than with control over domestic interest rates. These economic models illuminate the costs and benefits of different exchange-rate policies, and provide a necessary starting point for a political analysis of exchange rates.

However, economic theories of exchange rates, by themselves, leave much unexplained. The aggregate economic efficiency effects stressed by traditional OCA analyses are often not the major factor influencing policy. Rather, policymakers are often concerned with many considerations beyond aggregate economic efficiency. Their own political fortune is one such concern. After all, policymakers’ own survival is often at stake as a result of exchange-rate-related events: empirical research has demonstrated that finance ministers and prime ministers are significantly more likely to lose office if they devalue the currency. Moreover, exchange-rate policy has strong redistributive effects. Most authors observe that political considerations are particularly relevant in exchange-rate policy because the trade-offs governments face are between macroeconomic outcomes, which different sociopolitical actors value differently. Exchange-rate policy decisions are therefore not purely a question of economic contingencies, but a question of political priorities as well. The rest of this chapter explains how the preferences of various social and political actors and domestic political institutions codetermine exchange-rate policy choices.

PREFERENCES: THE DEMAND FOR EXCHANGE-RATE POLICY

Exchange-rate policy has strong distributional consequences. Not surprisingly, opinions on the ‘right’ kind of exchange-rate policy therefore tend to vary among different socioeconomic groups. Some groups favor fixed exchange rates, while others benefit from more flexible exchange-rate regimes. Some benefit from an appreciating currency, while others gain when the exchange rate depreciates. How can the opponents and proponents of certain exchange-rate policies be identified? Also, to what extent do policymakers heed these preferences in the political process? Recent evidence convincingly demonstrates that distributional considerations influence exchange-rate policy. At the same time, qualitative and quantitative evidence both indicate that the effect of preferences and the ability of interest groups, parties, or voters to influence exchange-rate policy in line with these preferences are contingent upon a host of factors.

Sectors

Jeffrey Frieden's seminal 1991 article, 'Invested Interests,' on the distributional effects of exchange-rate policy has formed the basis for much of this work. Frieden argues that different sectors of the economy are divided over two aspects of exchange-rate policy: the degree of exchange-rate flexibility/stability and the level of the exchange rate. The open-economy trilemma discussed above implies that fixed exchange-rate regimes reduce uncertainty about the value of the currency, whereas flexible exchange rates are beneficial because they enhance monetary policy autonomy (under conditions of capital mobility). Frieden hypothesizes that industries that are involved in international trade and finance, such as exporters and international traders and investors, favor fixed exchange rates because they care more about exchange rate predictability than domestic macroeconomic conditions. They face opposition from import-competing industries and producers of nontradable goods and services (e.g., real estate), who prefer flexible exchange rates because such an exchange-rate policy maximizes domestic monetary policy autonomy. The exchange-rate level also redistributes income across industries. A strong (appreciated/overvalued) currency makes imported goods cheaper, thus increasing actors' purchasing power – the total amount that can be purchased with a given income. A weaker (depreciated/undervalued) exchange rate, conversely, makes foreign goods more expensive, which means that domestically produced goods are cheaper and more competitive in both home and foreign markets. According to

Frieden, nontradable firms and international traders and investors favor a strong exchange rate because they purchase imports and assets from abroad. Export-oriented and import-competing industries – collectively referred to as tradable industries – prefer a weak exchange rate to enhance their international competitiveness.

Several studies have tested Frieden's predictions that sectors hold differing exchange-rate policy preferences, and that these preferences, in turn, influence which exchange-rate policies are selected. Statistical analyses using time-series-cross-sectional datasets have been the most common methodology for this purpose. The standard setup for these regression models is to use a sector's share of income as a proxy for its political influence as an independent variable, and dichotomous or categorical measures of exchange-rate regimes as dependent variables. The influence of the manufacturing sector, a tradable industry that is export-oriented in some countries and import-competing in others, on exchange-rate regime choice varies across these studies to a shocking degree (Table 3.1). A larger manufacturing sector significantly reduces the use of fixed exchange rates in three studies, whereas two other studies come to the exact opposite conclusion: larger manufacturing sectors increase the probability of fixing the exchange rate. Yet another study fails to find any significant effect for this sector. These findings are not irreconcilable, however, because it is possible that manufacturers favor flexible exchange rates in some contexts, but have more favorable views of fixed exchange rates in other circumstances. One possibility, consistent with these findings, is that manufacturers only dislike fixed exchange rates in regions or countries with experiences of high inflation,

TABLE 3.1 The Effects of Interest Groups on the Choice of Fixed Exchange-Rate Regimes

Study	Manufacturing	Tradables	Sample
Bernhard and Leblang (1999)	x	+	Industrial democracies, 1974–1885
Blomberg et al. (2005)	–	–	Latin America, 1960–99
Broz (2002)	x	+	All countries, 1973–95
Frieden et al. (2001)	–	+	Latin America, 1960–94
Frieden et al. (2010)	–	+	Central and East Europe, 1992–2004
Hall (2008)	0	0	Developing countries, 1977–98
Leblang (1999)	x	+	Developing countries, 1974–1994
Schamis and Way (2003)	x	0	Latin America, 1970–99
Shambaugh (2004)	+	–	Developing countries, 1973–2000
Singer (2010)	+	+	Developing countries, 1982–2006
Thies and Arce (2009)	x	–	Latin America, post-1973

Note: + indicates variable significantly increases probability of fixed exchange-rate regime; – indicates variable significantly decreases probability of fixed exchange-rate regime; x indicates variable was not included; 0 indicates variable is not statistically significant in any models.

because in these contexts greater exchange rate fixity usually implies more overvalued exchange rates.

Existing research has also failed to find a consistent relationship between the size of the tradable sector, typically measured as (exports+imports)/gross domestic product (GDP), and the exchange-rate regime. Consistent with the idea that firms involved in international trade favor more stable exchange rates, six published studies have found that larger tradable sectors increase the use of fixed exchange rates. On the other hand, three articles have found a negative association between trade dependence and fixed exchange rates. There was no statistically significant relationship between these two variables in two other studies. Interestingly, even studies using similar samples and measures come to opposite conclusions.

There are strong theoretical grounds for believing that tradable sectors have different exchange rate preferences from nontradable sectors. The existing quantitative evidence confirms that sectors matter. But the evidence also suggests that the nature of particular sectors' preferences remains elusive. Tradable sectors seem to favor fixed exchange rates sometimes, while opposing them at other times.

Policymakers' Beliefs and Ideas

In light of these contradictory findings, it is tempting to conclude that material interests are less important than subjective beliefs and understandings. Previous scholarship provides three theoretical grounds for skepticism about the importance of interest groups. The first is that interest group mobilization on exchange-rate policies is limited because the effects of exchange-rate policy are complex and uncertain. Second, even when interest groups can identify their objective interests, exchange rates are public goods that are subject to immense collective action problems. Finally, even if interest groups are able to organize, monetary policymakers are often insulated from the political process, and can therefore resist pressures from lobbyists.

Given these supposed difficulties of interest groups to articulate clear policy positions with regard to the exchange rate, some authors have emphasized the importance of the beliefs and ideas of policymakers themselves. These authors argue that prevalent mental models – such as the belief in Keynesian state intervention or in neoliberalism – guide policymakers' attitudes with regard to exchange-rate policy. Several case-study analyses have demonstrated this impact of ideas on exchange-rate policy choices.

Ideational research has enriched our understanding of exchange-rate politics and has been particularly strong in pointing out that no single material factor

translates into exchange-rate policy in a straightforward manner. However, several challenges remain for this perspective. First, ideational theories tend to overstate decision-makers' ability to independently choose exchange-rate policy, and understate how the complex interplay of societal preferences and state institutions encourage leaders to choose particular exchange-rate policies. Second, the measurement of beliefs and ideas is inherently difficult. Even if these scholars are correct that 'interests' are indeterminate, the effect of ideas appears indeterminate and often contradictory. For example, while some scholars have argued that the shift from Keynesian ideas to monetarist/neoliberal ideas accounts for America's shift to floating exchange rates, other researchers have argued that the same ideational change explains Europe's increased success maintaining fixed exchange-rate arrangements. Thus, ideas alone do not appear to provide a sufficient explanation for exchange-rate policy. One fruitful avenue for future research should be greater consideration of why similar ideas can produce different outcomes in different contexts. Likewise, ideational theories make the important point that interest group pressures are not always important. But rather than dismiss interest group theories altogether, it would be more useful to consider *when* ideas or interest groups are more important.

Extensions to the Sectoral Model

Rather than discard the sectoral theory, some scholars have used it as a foundation to build a more complicated interest group theory. Political economists have built upon and extended Frieden's sectoral model in several directions to better account for some real-world complications that were not addressed in the original theory. Recent scholarship points to three additional economic factors that determine group's preferences with respect to exchange-rate stability and valuation: the level of standardization of the product a sector produces; a sector's reliance on imported inputs into production; and the structure of firms' balance sheets, particularly the reliance on foreign finance. An additional avenue of research has been to examine trade-offs among multiple policy issues. These extensions have improved the explanatory power of interest group theories.

Level of Standardization

The first extension distinguishes between 'simple tradables' and 'complex and specialized tradables.' Some products, such as agricultural commodities and textiles, are relatively standardized and homogeneous, and are not differentiated on the basis of quality. Producers of simple tradables compete on the basis of their price, and, consequently, they are highly concerned with

the level of the exchange rate because a depreciation of the exchange rate can make their products cheaper – and hence more competitive – in domestic and international markets. However, fixed exchange rates provide limited benefits for exporters of standardized products, and they may even oppose fixed exchange rates in order to preserve the ability to depreciate and maintain a favorable value of the exchange rate. By contrast, goods that are specialized so that they can be differentiated on the basis of quality are less price sensitive. Producers of specialized goods gain limited advantage from an undervalued exchange rate, but are very sensitive to currency volatility, which tends to disrupt international trade. Specialized exporters are therefore expected to favor fixed exchange rates – even if this means a less favorable rate of exchange. In support of this proposition, research by Frieden has shown that European countries that exported specialized manufactured goods to Germany and the Benelux countries experienced greater exchange-rate stability and less exchange-rate depreciation vis-à-vis the German mark. Similarly, an analysis of Germany concluded that German firms with more differentiated products were less concerned with keeping the exchange rate undervalued than were German firms that produced more homogeneous goods.

Reliance on Imported Inputs

Many tradable firms use foreign products as inputs, and, as a result, exchange-rate depreciation raises their production costs. This suggests that tradable firms may not always favor more depreciated exchange rates; those that heavily rely on imported inputs into production should care little about the level of the exchange rate or they might even prefer a stronger exchange rate. This argument has been supported by several case studies: one article showed that Mexican exporters supported a fixed but overvalued exchange rate during the early 1990s in large part because they were heavily reliant upon imported inputs into production; and a study of Canada revealed that Canadian firms' heavy reliance on imported inputs lessened their opposition to exchange rate appreciation.

Structure of Firms' Balance Sheets

Firms and individuals with mismatched balance sheets – debts denominated in foreign currency but assets denominated in domestic currency – will prefer more appreciated exchange rates because this lowers their debt burden. Such foreign currency denominated debt has become increasingly common as international finance has become liberalized and now constitutes by far the most common form of private credit in some countries (such as Latvia). Not surprisingly, firms with foreign-currency debts were more opposed to the devaluation of fixed exchange rates in countries as diverse as

Russia, Argentina, Korea, Thailand, Hong Kong, and Indonesia.

An additional set of complications arises from the fact that the exchange-rate regime and exchange-rate level are chosen neither in isolation from one another nor in isolation from other policies. The exchange-rate regime and the currency's level are related because fixed exchange rates are much more likely to become misaligned than flexible exchange rates, which can easily adjust as market conditions change. As a result, fixed exchange rates tend to be more overvalued than most flexible regimes. While Frieden's initial theory was ambiguous about how interest groups react when facing a trade-off across these two dimensions of policies, his subsequent work concludes that exporters are often torn between a concern for currency stability and a concern for a competitiveness-enhancing level of the exchange rate. Qualitative and survey research supports the argument that preferences about the exchange-rate regime are influenced by the level of the exchange rate. Survey data of firms across many developing countries reveal that manufacturing firms dislike unstable exchange rates, and that their opposition to flexible exchange rates is strongest following an appreciation of the real effective exchange rate. Similarly, research on China has found that Chinese manufacturers supported the fixed exchange-rate regime in large part because of its favorable and competitive level.

Exchange-rate stability and valuation are also functions of other policies, especially domestic monetary and fiscal policies. The relationship between exchange-rate, monetary, and fiscal policy once more goes back to the open-economy trilemma model, which holds that in a world of internationally mobile capital, 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. As a result, industrialized countries tend to have more stable exchange rates when their fiscal policies are tight, and this can reinforce some interest groups' exchange-rate preferences: import-competing and nontradable industries oppose both tight fiscal policies and fixed exchange rates, while capital-intensive internationally oriented firms benefit from both low levels of government spending and stable exchange rates. Similarly, whether the financial sector supports or opposes fixed exchange rates may depend on whether doing so will increase or decrease inflation. Moreover, when fixed exchange rates come under severe speculative pressure, governments must raise interest rates to defend their pegs. Under these circumstances, interest group preferences for maintaining or abandoning a fixed exchange-rate regime will strongly depend on how vulnerable these groups are to tight domestic macroeconomic policy. For example,

increasingly restrictive monetary and fiscal policies reduced support for overvalued pegs in various East Asian countries.

Furthermore, exchange-rate policy preferences can depend on the country's trade policy as well, because tariffs and subsidies can serve as substitutes for devaluations: a 10% devaluation has identical effects to a 10% increase in tariffs and export subsidies. Interest group pressures over exchange-rate policy may therefore be dulled by the use of these commercial policies. For example, protectionist trade policies weaken the manufacturing sector's demands for more flexible/competitive exchange rates. Targeted commercial measures, such as export subsidies and tariff barriers, were integral to building support for fixed and overvalued exchange rates in places as diverse as nineteenth-century America, Colombia in the 1970s, and China during the late 1990s. More indirect linkages between exchange-rate policy and other aspects of foreign policy, such as economic integration, foreign aid, and security policy, have increased support for currency unions in Europe and West Africa.

In sum, interest groups are often divided over the exchange rate, but the nature of these divisions is not dictated by any single structural variable. Certain characteristics of firms, such as their export orientation, significantly shape firms' exchange-rate policy preferences, but whether a given sector supports or opposes a particular exchange-rate policy also depends on the combination of exchange rate, macroeconomic, and commercial policies. As a consequence, preferences over the exchange rate can be dynamic in nature, and interest groups that support a given exchange-rate policy one day may change their positions as other characteristics of the policy environment change. Predicting interest group preferences may therefore require consideration of the package of policies under consideration. Even if a simple interest group explanation of exchange rates has limited explanatory power, interest group theories can still shed much light on exchange-rate politics. Incorporating various characteristics of the firm and of the economic environment has improved our understanding of exchange-rate policymaking. To be sure, many anomalies remain unexplained. The solution is not to abandon interest group approaches, but to continue theorizing about the context-dependent nature of exchange-rate preferences.

Partisan Preferences on Exchange-Rate Policymaking

Political parties are one mechanism through which the preferences of social groups can be translated into actual policies. The most common argument about the role

of partisanship is that right-wing and conservative parties are more likely to adopt and sustain fixed, stable exchange rates because their constituents value financial stability and low levels of inflation, which fixed exchange rates can help to achieve. Constituents of left parties, such as the working class and domestically oriented firms, in contrast, value domestic monetary autonomy and more expansive fiscal policies, which are inconsistent with fixed exchange-rate regimes under conditions of international capital mobility. In support of this argument, econometric evidence has shown that right parties are associated with more stable exchange rates among Organization for Economic Co-operation and Development (OECD) countries in the post-Bretton Woods system. Similarly, qualitative analysis reveals that conservative parties in France and Italy were more supportive of European monetary integration in the 1980s than left parties, while the general continent-wide shift from left to right governments during the early 1980s accounts for the greater success of exchange-rate stability in that decade compared to the 1970s. An examination of the interwar period produced a similar finding; right parties were more likely to stay on the gold exchange standard than left parties. More indirect evidence also supports the view that left governments are more inclined to forego exchange-rate stability. Several authors show that left-leaning governments experience more frequent speculative attacks on their exchange rates than right-leaning governments, as financial markets seem to expect that these governments are less likely to resist this pressure and to devalue the exchange rate instead, and the crisis probability also significantly rises when there is a shift in the government's partisan orientation to the left. Moreover, foreign exchange markets become more volatile when they expect left-leaning parties to gain power.

Despite this evidence, some studies question the association between conservative parties and fixed exchange rates. Several empirical studies find no effect of partisanship on exchange-rate policy; for example, one quantitative study of 20 industrial democracies in the post-Bretton Woods period found no relationship between partisanship and exchange-rate regime choice. Similarly, neither the incumbent's partisanship nor partisan change of government have been found not to affect the risk premium on the exchange rate in election periods.

Others argue that left governments are in fact more likely to maintain fixed exchange rates. Studies looking at both Western Europe and at former Communist countries have found that exchange rates are significantly more stable under left-wing governments; these authors argue that left governments face greater incentives to use the exchange rate as a short-run stabilization tool and/or have more incentives to signal monetary credibility.

Similarly, pairs of countries with left governments have more stable bilateral exchange rates than other types of dyads, including pairs with right governments. In addition, several studies have found that left-leaning governments are more likely to defend their exchange rates against speculative attacks.

This discussion shows that while most researchers agree that partisanship influences exchange rate policy, the nature of its influence is debated. Nonetheless, the different findings may be reconciled. For example, left governments might face a higher probability of experiencing speculative pressure on their currencies, but defend their currencies more strongly than right governments. Left governments' ability to stabilize exchange rates may also depend on the partisan orientation of foreign governments. Partisan differences also depend on domestic political institutions; some argue that left parties will favor fixed exchange-rate regime when the central bank is independent as fixing in this case helps them circumvent tight monetary policies and the trade-offs associated with achieving exchange-rate stability versus other policy goals. Once more, it appears to be the interaction of partisan preferences with institutions and other policies that shape their overall effect on policy outcomes. These issues warrant further research.

Voters

Democracies ultimately rest on the support of the populace. Voters can influence exchange-rate policy during elections or through referenda. Of course, when citizens go to the polls, exchange-rate policy is, at most, only one of many considerations informing their vote choice. However, exchange-rate policy has probably been decisive in some elections. For example, Argentine voters reelected the incumbent, Carlos Menem, in 1995 because they overwhelmingly supported Menem's policy of keeping the exchange rate fixed and overvalued.

Previous studies indicate that voters often have well-identified preferences on exchange-rate policy. In general, the average voter appears to favor stronger over weaker exchange rates, and stable to unstable exchange rates. This fact is supported by cross-national studies, which generally find that governments tend to keep their exchange rates fixed and overvalued during pre-election periods (see section 'Elections'), and studies of public opinion toward the European Monetary Union. Several articles 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.

Public opinion research also finds that not all voters are of the same mind, and some people oppose fixed and appreciated exchange rates. Several articles find that individuals with higher income and skills have more favorable attitudes toward European monetary integration than others. Support for the Euro was greater in Sweden among business owners and white-collar workers than among blue-collar workers. Education is positively related to Euro support, but educated people care less about an appreciated exchange rate than others. Individuals' sector of employment also matters. Consistent with the argument that nontradable industries favor flexible exchange rates, one study found that those employed in the sales sector, an archetypal nontradable industry, opposed the Euro in Denmark. Similar to firms, voters' preferences should also depend on their reliance on imports and their balance sheets, but thus far little research has addressed these issues. Public opinion research about the euro has also found that nonmaterial factors, such as concerns about national identity and sovereignty, influence preferences on exchange-rate policy. Voters' preferences for exchange-rate policy appear to be influenced by a combination of various individual- and national-level factors. However, research has focused almost exclusively on Europe, and more analysis of other regions is needed.

INSTITUTIONS AND EXCHANGE-RATE POLICY

Preferences, whether of societal, partisan, or ideological origin, do not directly translate into policy outcomes. Rather, they are mediated by political institutions. Institutions are important because they 'aggregate preferences,' meaning that they can determine whether decision makers are more sensitive to the preferences of a specific interest group, voters as a whole, or other actors. For this reason, the same set of preferences can result in very different policy outcomes depending on a country's institutional structure. Institutions also matter because they can constrain policymakers from implementing the policy that they and their constituents favor. For example, independent central banks and political systems with several veto points can make it difficult for the national leader to implement his/her preferred exchange-rate policy. Political economists have therefore focused a lot of attention on the influence of institutions on economic policy. The conclusion from this research is that institutions, such as the political regime type, elections, and other domestic political structures, can significantly shape the choice of exchange-rate regimes, daily exchange-rate management, as well as the crisis-proneness of the currency. However, these effects are rarely uniform across all countries and times. Rather, just like

preferences, the effects of individual institutions typically depend on the larger context in which they are embedded.

Democracy

The distinction between democracies and autocracies is probably the most fundamental categorization of political systems. Unsurprisingly, considerable attention has been paid to the effects of political regime type on exchange-rate policy. A number of quantitative studies demonstrate that democratic countries are more likely to implement flexible exchange-rate regimes than autocratic countries. One study found that several distinct characteristics of democracies, such as electoral competition and the presence of multiple veto points, are each associated with flexible exchange-rate regimes. Historical analyses similarly attribute the collapse of the Gold Standard in the 1920s, at least in part, to the enfranchisement of large segments of the population. Two arguments have been put forth to explain this effect of democracy on exchange-rate flexibility. First, exchange-rate flexibility allows policymakers to autonomously conduct monetary policy in order to improve domestic economic conditions, a policy option which offers high political rewards when politicians need to maintain voters' approval to remain in office. A second argument maintains that monetary commitment transparency and the transparency of the political system are substitutes. According to this theory, because autocracies have less transparent political systems than democracies, autocracies have a stronger need for a transparent monetary commitment device such as a fixed exchange-rate regime.

However, some evidence appears to contradict the finding that democratic governance encourages flexible exchange-rate regimes. For example, 'fear of floating', that is, countries' propensity to officially announce a flexible exchange-rate regime while in fact intervening so as to prevent true floating, is more pronounced in democratic countries, while 'fear of pegging' is less prevalent. More directly, an analysis of exchange-rate regime choices in 21 Eastern European countries found that democracies were associated with a higher likelihood of fixing their exchange rates.

Other research suggests that the effect of democracy upon foreign exchange markets is context dependent. For example, the effect of the political regime type on *de facto* exchange-rate policy has been found to be conditional on the declared, or *de jure*, exchange-rate regime; autocracies are more likely to defend their exchange rates against speculative pressure when they have officially fixed exchange rates, but democracies are more likely to defend their exchange rates under intermediate than fixed regimes. Democracies therefore appear to

decrease the use of fixed exchange rates in many circumstances, but not in others. As a group, democracies behave differently from autocracies, but within the group of democracies heterogeneous behavior can be observed as well. Therefore, now, attention is turned to the question of how variations in democratic institutions such as the electoral cycle, electoral system, and CBI explain this variance in exchange-rate policy choices.

Elections

Elections – the key constitutive feature of democracy – also matter for exchange-rate policy. Extensive evidence has documented that exchange rates are influenced by the electoral cycle. For example, exchange-rate-based stabilization programs are typically implemented when elections are pending. Similarly, there is a lot of evidence that devaluations tend to be delayed until after an election in order to preserve voters' purchasing power on the day of election.

The strength of this electoral exchange-rate cycle is conditioned by several factors. For example, when speculative pressure is very severe in the preelectoral period, devaluations are rarely delayed before elections, and devaluations are particularly likely after the subset of elections that have resulted in a transfer of executive power. Furthermore, research examining industrial countries operating freely floating exchange rates points in the opposite direction; exchange rates become more volatile in the run-up to elections as traders become more uncertain about future economic policies. Whether elections increase or decrease, exchange-rate stability therefore depends on the economic and political pressures facing the politicians.

Electoral System

The electoral system is one of the main sources of institutional diversity among democratic countries. The most common distinction is between proportional representation systems and plurality-majoritarian regimes. Under proportional representation, a party's vote share determines their share of electoral seats – an arrangement that tends to produce multiparty coalition governments. By contrast, in plurality systems the party with the most votes typically controls policy alone. It is not surprising that the electoral system affects incentives for choosing certain types of exchange-rate policies, even though the findings have been somewhat contradictory. Some research finds that democratic politics with majoritarian electoral systems are more likely to choose fixed exchange rates and experience less exchange-rate volatility after cabinet dissolutions than those with proportional systems. In contrast, other authors find that industrial

countries with majoritarian systems experience higher exchange-rate volatility than countries with proportional electoral systems, whereas another study concludes that electoral systems do not affect currency markets in emerging markets.

The range of estimates of whether and how the electoral system affects exchange rates once more suggests the need to consider how this institutional feature interacts with other aspects of the political system. The existing literature suggests that the level of opposition influence is one such conditioning factor. For instance, one article observed that countries with both majoritarian systems and low opposition influence are least likely to fix, whereas proportional representation (PR) systems in which the opposition exerts a lot of influence are most inclined to adopt some type of fixed exchange rate. The electoral system thus influences some countries' exchange-rate policy, but the direction and strength of influence depend on other political-economic factors.

Number of Veto Players

Several authors have pointed out that the number of veto players – actors whose consent is required to change policy – also shapes exchange-rate policy choices. Some research shows that developing countries with fewer veto players have a tendency toward choosing pegged exchange-rate regimes. One explanation for this finding is that in countries with few veto players, and hence strong political accountability, policymakers value their ability to influence domestic conditions through an autonomous monetary policy, whereas fixed exchange rates serve as a focal point for policymaking that can reduce conflicts about macroeconomic policy decisions in countries with many veto players. Another explanation is that divided governments find it more difficult to implement painful but necessary internal adjustment policies and therefore are more likely to devalue when confronted with speculative pressure than unified governments. As a consequence, divided governments also face a higher risk of speculative attacks on their currencies. Others argue that veto players and exchange rate outcomes have a nonlinear relationship; countries with very few and very many veto points are prone to suffer currency crises, whereas countries with intermediate numbers of veto players are least crisis prone.

Once more, most research indicates that the effect of veto players on exchange-rate policy is context dependent. For example, increasing the number of parties in the governing coalition reduces the probability of fixing the exchange rate for developing countries, but the opposite occurs when using a sample that includes both industrial and developing countries. Along these lines, another study found that countries with multiple

partisan veto players commonly fix their exchange rates in unitary systems, but not in federal systems. This suggests that the number of veto players impacts the desire and ability of policymakers to maintain fixed exchange rates, but does so differently for various types of countries. Moreover, the number of veto players also conditions the ability of governments to operate their exchange-rate regime. As discussed above, more veto players tend to increase the risk that governments fail at this task and experience a currency crisis, but this risk is highest when they have adopted an intermediate exchange-rate regime. Paying attention to the institutional and country-specific context in which veto players operate has thus resulted in a more detailed understanding of how veto players affect exchange-rate policymaking.

Central Bank Independence

CBI is very closely linked to exchange-rate politics because exchange rate and monetary policy are themselves tightly linked, and because independent central bankers are more sheltered from popular opposition to tight monetary policy or uncompetitive exchange rates. CBI and fixed exchange rates both can decrease inflationary bias and are therefore two possible solutions to the same time-inconsistency problem of monetary policy. The two institutions are therefore often seen as substitutes, even though more recent research indicates that they can act as complements when both are not fully credible. This latter argument is consistent with research that shows that CBI increases exchange-rate stability. For example, research has shown that European countries with independent central banks had greater currency stability vis-à-vis the German mark than those with lower levels of CBI and that countries with independent central banks tend to have more appreciated exchange rates. Some authors also find that CBI lowers the risk of experiencing a speculative attack, even though other authors find that CBI is not statistically significantly related to the risk of currency crisis.

The relationship between CBI and the exchange-rate regime is conditioned by several other factors. One study finds that CBI encourages the adoption of fixed exchange rates, but only for leftist governments. Another suggests that independent central bankers advocate fixed exchange rates when they are weak domestically and need an external anchor to tie the governments' hands, an argument that echoes the argument of the complementarity of CBI and fixed exchange-rate regimes. On the other hand, one article argues that CBI often makes it harder to stabilize the exchange rate because independent central bankers are reluctant to cut interest rates to do so, and shows that CBI reduces exchange-rate stability in OECD countries with *de jure* fixed exchange-rate regimes.

According to one comparative analysis, in countries where the private sector holds a strong preference for weak exchange rates, CBI reduces the private sector's ability to convince policymakers to undervalue the exchange rate, but CBI does not affect the level of the exchange rate when private sector preferences are weak. In sum, countries with independent central banks select different types of exchange-rate policies than those with politically dependent central banks, but the direction and size of this difference appear to depend on other political factors, such as government preferences.

CONCLUSION

Like most other policy issues, the choice of exchange-rate policy is a politically driven one. Considerations of aggregate welfare are not irrelevant, but they typically do not fully determine exchange-rate policy either. To make sense of exchange-rate policy choices therefore requires an understanding of political incentives. This chapter has shown that a variety of political factors – the preferences of sectors, parties, voters, and the nature of political institutions – shape exchange-rate policy. Scholarly understanding of how such preferences and institutions shape exchange-rate politics has dramatically improved in recent years. But many puzzles remain. Why, for example, do tradable industries favor fixed exchange rates in some conditions but not others? Or, why does democracy encourage the adoption of flexible exchange-rate regimes in most times and places while promoting fixed exchange rates in some situations? It would be wrong to conclude that interests and institutions do not matter. The task at hand is to develop better theories of why the same political variables have different effects on exchange-rate policy across different contexts. Therefore, it is argued that the effects of preferences and institutions on exchange-rate politics are conditional upon one another. This message may not be surprising, but it is often under-appreciated. There is not one major political variable that always has a consistently strong effect upon exchange-rate policy, and many variables have opposite effects in different circumstances.

SEE ALSO

[Political Economy of Financial Globalization: Interest Group Politics; The Political Economy of International Monetary Policy Coordination.](#)

Glossary

- Central bank independence** The freedom of monetary policymakers from governmental interference. Central banks are considered independent when they are able to define their own policy objectives, and can implement policy without requiring the government's approval.
- Democracy** A type of political system in which government officials are selected through free and fair elections.
- Economic sector** Economies are divided into various distinct sectors, or industries. Agriculture, manufacturing, and services are three major sectors in the economy.
- Exchange rate** The price of foreign currency. An exchange rate is defined as the amount of domestic currency that is required to purchase one unit of foreign currency.
- Exchange-rate regime** The system, or set of rules, used to determine the currency's exchange rate. Exchange-rate regimes vary from fixed exchange-rate regimes, where the government keeps the currency's foreign exchange value stable, to floating exchange-rate regimes, in which the currency's external value fluctuates with market supply and demand.

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