EconoFact Chats: The Politics of Exchange Rates

Jeffry Frieden, Harvard University

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

Economists spend a lot of time thinking about exchange rates; what determines the value of foreign currencies, how international capital flows cause and respond to changes in exchange rates, what a strong or a weak currency means for a country's trade, and a host of other issues. But we don't spend much time thinking about the political dimensions of exchange rate policies and currency swings, despite the fact that these are important real world issues. These topics have been taken up by political scientists, and foremost among them is my guest on EconoFact chats today, Professor Jeffry Frieden of Harvard University. Jeff has published pathbreaking research on the linkages between politics and economics, and especially on the role of exchange rates. Among his many publications is the book, Currency Politics: The Political Economy of Exchange Rates. Jeff, I'm very happy to welcome you once again to a EconoFact chats.

Jeffry Frieden:

Thank you, Michael. It's always a pleasure to speak with you.

Michael Klein:

Well, it's great to have you on again. Jeff, how did you decide to begin to do research on the politics of exchange rates?

Jeffry Frieden:

I guess there was both the practical experience and the theoretical experience. The practical experience was, early in my career, I did a lot of work on Latin American debt, and one thing I noticed was that every single Latin American debt crisis, and there were a lot of them, and there continued to be a lot of them, was also a crisis of the currency. People talked about the politics of debt crises and the politics of debt, but very few people talked about the politics of currencies -- why it was that there were currency collapses, currency crashes. So that was one spur. The other spur was more theoretical, if you will, was we always learn in macro that the exchange rate is the most important price in any economy, and it is a price that is either set by or heavily affected by the government. And yet I felt as a political economist that we weren't talking about why governments set the exchange rate where it was. So theory and practice in a way.

Michael Klein:

What do political scientists bring to the study of exchange rates that economists ignore, or just haven't focused on enough?

Jeffry Frieden:

Well, I think political scientists and political economists more generally tend to focus on winners and losers who gains from a particular set of policies and who loses from a particular set of policies. So we focus on what we might call distributional effects. That is who is benefited by a set of exchange rate policies and who might be harmed by those policies? All policies have trade-offs and exchange rates are no different. They have lots and lots of trade-offs, whether it's about the fixing or floating the exchange rate, or the level of the exchange rate. And so I think exchange rates are a great example of how any policy a government puts in place is going to help some people and hurt other people. And that's really what we focus on.

Michael Klein:

Can you offer a couple of examples to illustrate that point?

Jeffry Frieden:

Well, currently or for the last few years, one of the most prominent issues in U.S.-Chinese relations has been over American accusations that the Chinese have been manipulating their currency, keeping it artificially weak. An artificially weak Chinese currency helps some people in China and helps some people in the United States, and hurts other people. So it's been very highly politicized with charges of currency manipulation. Another example going back a long ways is when the Dollar skyrocketed in the early and mid 1980s. So we had a very, very strong Dollar, which put tremendous pressure on American manufacturers and really was one of the principle sources, or a major source of deindustrialization...of pressure on American industry. It led to what I think is the single biggest protectionist trade policy in modern American history, the auto policy towards Japanese automobile imports in the 1980s. So the very strong Dollar led to a very powerful protectionist response. And then going back to my Latin American experience, currency collapses in developing countries have been devastating. They've led to mass...they've led to revolutions, revolts, to changes in governments. So all of these have been responses to big movements and exchange rates.

Michael Klein:

Jeff, these examples take exchange rate movements as causes not outcomes. And the parlance of economics, it would treat currency swings as exogenous, not endogenous. Are there ways in which political factors figure into the changes in exchange rates?

Jeffry Frieden:

Absolutely. This is really what my own work focuses on is how politics, how interest groups, how electoral factors affect government's choices of exchange rates. A very prominent example would be the highly political choice of many members of the European Union to join a single currency, the Euro. But every choice that a government makes really is made in a political context. If a government chooses to fix its exchange rate against the U.S. Dollar, or to join the Euro, it's doing that in a highly political environment.

Jeffry Frieden:

In a more, I wouldn't say trivial, but a more mundane or a day to day effect, governments often manipulate exchange rates around elections to try to pump up the economy, to try to benefit some of the crucial political constituents in the run up to an election. We are able to identify cycles around elections in exchange rates.

Michael Klein:

Can you give an example of an electoral cycle exchange rate management?

Jeffry Frieden:

Yeah. So in Latin America, urban consumers are a crucial constituency. This is in democratic Latin American countries. And so Latin American countries, Latin American governments typically try to keep the currency strong in the run up to an election. And what that means is it provides greater purchasing power to local consumers. Take the example of the Peso. If the Peso is strong, it means the Mexicans or Argentines can buy more of the world's goods, buy more stereos, buy more cars, buy more imported liquor, whatever it may be. They have greater purchasing power. So governments often artificially keep the currency particularly strong in the run up to an election. There's an interesting twist on this because as you might imagine, who you're trying to benefit depends on who is electorally important. In Latin America, generally speaking, urban consumers are very important and exporters are not that important. Latin American societies are relatively closed. In East Asia, East Asian societies are very export-oriented, and the export sector is politically very powerful. So unlike in Latin America, East Asian governments often try to keep the currency weak in the run up to an election to benefit the export sector. So we can identify unique Latin American exchange rate cycles and electoral cycles, and East Asian electoral cycles as well.

Michael Klein:

Jeff, so you're talking about the management of exchange rates. When I teach about exchange rates in my classes, I use the polar extremes of a fully fixed exchange rate or a fully market determined exchange rate. What insights does political science bring to this choice between floating and fixed exchange rates?

Jeffry Frieden:

Yeah, I think that's central. Again, it's all about trade-offs. With a fixed rate, what you get is stability and predictability and that's great if you are a international investor, if you're borrowing from abroad, if you're trading with the rest of the world. So we might say those who are most directly engaged in international economic activity are particularly benefited by a fixed rate, because they get a lot of stability.

Jeffry Frieden:

But what's the cost of having a fixed rate is you have no monetary independence. Your monetary policy is fixed by your exchange rate, and that means you can't respond to local conditions. And for that matter, you can't depreciate the currency. So if you are entirely engaged in domestic economic activities, the fact that you have fixed exchange rate means that the government can't respond to local conditions with appropriate local monetary policy. So that's a really important trade off. You're trading off stability and predictability for the lack of any independent monetary policy.

Michael Klein:

So what you're mentioning is called the policy trilemma. I was quoted in The Economist magazine about something that I wrote once that said, "all you need to know about international macroeconomics is a policy trilemma, the rest is commentary." And the policy trilemma is this idea that you can have two of the following three, management of exchange rates, central bank independence, or allowing the free flow of capital across borders.

Michael Klein:

This theoretical idea has been shown to be true in practice through empirical analyses. What are the politics of the policy trilemma? You've alluded already to this idea of being able to focus on domestic considerations and not just the exchange rate if you have a floating exchange rate, but perhaps especially with respect to capital mobility and other issues of central bank independence. What are the political aspects of this economic concept of the policy trilemma?

Jeffry Frieden:

Well, imagine that you're an international investor and if the government chooses to limit capital mobility, that's limiting your ability to invest abroad or ultimately to borrow from abroad. So since the third leg, we've talked about, a fixed exchange rate and monetary independence, the third leg is capital mobility. If capital mobility is a choice as it was for many decades after World War II, choosing not to allow capital mobility really restricts some potentially very powerful economic actors -- international investors, international borrowers, international banks. So that would be one example of a trade-off, right? If you're trading off capital mobility for the other two legs of the trilemma. Each of the legs involves trade-offs. But the trade-offs, I want to emphasize, the trade-offs are not abstract. They affect groups, they affect industries, they affect people. And so when we think about this in a political context, I think not about the abstract notion of monetary independence or the abstract notion of a fixed exchange rate, I think about the groups that are going to be benefited by each of the legs of the trilemma. And in the capital mobility case, it's international investors, international borrowers, international banks are benefited by allowing capital mobility, and can be harmed by restricting it.

Michael Klein:

Right now we have an interesting example of that with Russia where after the invasion, the rubles started to plummet. But in response, the Russian Central Bank raised interest rates quite a bit and also restricted capital mobility because as some people have argued, the decline of the ruble was a very bad sign to the Russian population that things weren't going well. So we've seen a recovery of the ruble. Is that a good example of how there's a political aspect of the choice of capital mobility?

Jeffry Frieden:

Absolutely. It's not just a signal. I think it was an important signal as you say. But it was also the case that as the ruble plummeted, the cost of imported goods skyrocketed in Russia. And the Russian government knew very well that [if] the ruble stayed that weak, the cost of imported goods and lots of other goods in the economy were going to rise dramatically.

Jeffry Frieden:

So yes, that's a very good example. It's often the case in developing countries and emerging markets that when a crisis hits, the government will impose capital controls and currency controls in an attempt to keep the currency from collapsing. And again, it's all about trade-offs. It means that your firms can't borrow. It means that your residents can't put their money abroad, things along those lines. So any one of these choices is going to have costs. The cost to the Russians, I should point out is that they are maintaining an artificially strong ruble and using a lot of their reserves to keep the ruble strong. Whether they're going to be able to continue to do that over a very long period of time remains to be seen. In many instances, countries have tried to maintain their currency at the level that they want to keep it at, at a particularly strong level, and eventually have not been able to do that, and they enter into dramatic, and sometimes really devastating currency crises.

Michael Klein:

And the Russian Central Bank has lost access to a lot of its Dollar reserves abroad in the wake of the war.

Jeffry Frieden:

That's right.

Michael Klein:

Jeff, let's look at a little bit of history here. In the 1960s, the French Minister of Finance, Valéry Giscard d'Estaing said that the United States enjoyed what he called an exorbitant privilege because of the Dollar's central role in the Bretton Woods's fixed exchange rate system. Can you briefly explain what he meant by this, and its political implications?

Jeffry Frieden:

Right. The Bretton Woods system was a system of the U.S. Dollar was fixed to gold at $35 per ounce. And every other currency in the system was fixed to the U.S. Dollar. So those currencies, they could move sometimes, but they didn't much. I mean, they were pretty much fixed for long periods of time. And because all the other currencies were fixed to the Dollar, essentially they had to follow American monetary policy. If the U.S. was running a very loose monetary policy, then other countries had to run loose monetary policies. If the U.S. was running a very tight monetary policy, they had to follow the U.S.. So that was what he meant that the U.S. was essentially dictating monetary policy to the rest of the world or the rest of the Bretton Woods system.

Michael Klein:

And what was happening was the U.S. was running a very loose monetary policy because there was simultaneously Johnson's Great Society Program and the war in Vietnam. So what were the political implications of this?

Jeffry Frieden:

So we had two wars that were not particularly popular, or at least that weren't funded fully by taxes, and that were funded to some extent by printing money, and that led to what was then considered very high inflation in the U.S.. What that meant was the rest of the world was being asked to use a Dollar that was losing real value, and protested vehemently. Giscard d'Estaing said at one point, "the world cannot be required to keep time by a clock that is constantly losing minutes every hour."

Jeffry Frieden:

So everybody was being asked to use the Dollar when the Dollar was losing real value. So that then led to tremendous conflict between the Europeans especially, and the United States, [and] eventually led to the collapse of the system.

Michael Klein:

I imagine the inflation that was in some ways imported from the United States was politically very unpopular in these countries.

Jeffry Frieden:

Yes. So these are countries that had no reason to print money, did not want to run inflation, that were being required in a sense to run inflationary policies because of their link to the U.S. Dollar.

Michael Klein:

So the Bretton Woods system broke down completely in 1973, and there was no longer fixed exchange rates with the Dollar. There were, as we know, fixed exchange rates within Europe. But people still speak of the Dollar's central role in the world monetary system; of the Dollar as a reserve currency. Although strictly speaking, it's not anymore. Not in the sense that it was during the Bretton Woods period. What is the Dollar's role now, and what are the political and not just economic implications of this?

Jeffry Frieden:

Right. So the Dollar still is the world's currency. The vast majority of world trade including trade among countries that are not the U.S., get denominated in Dollars. The vast majority of international financial transactions are denominated in Dollars, and the Dollar is still the world's dominant currency held in foreign currency and private reserves.

Jeffry Frieden:

There are a lot of implications. On the more or less economic front, which has political implications, I think it gives advantages to both the U.S. government, and to American firms. It makes it easier for the U.S. government to borrow because people hold Dollars, want to hold Dollars. It makes it easier for American firms and banks to engage in international transactions because the Dollar is the world's currency. And so they have a sort of a denominational advantage.

Jeffry Frieden:

And then you've got the more explicitly political and in some sense geopolitical implications. You mentioned one. The Russian Central Bank called 650 some billion Dollars in foreign currency reserves. And they're in Dollars, the vast majority of them. Because they are in Dollars, they run eventually at some point through the American financial system. And that means that the U.S. government can [inaudible] them, and has. So the fact that the U.S. Dollar is still the world's principle currency gives American firms advantages, gives the U.S. government advantages, and also has geopolitical implications. I should also say we used to talk in thinking historically about whether the Dollar followed the flag or the flag followed the Dollar. Our allies used Dollars. Our allies are more likely to use Dollars. Our allies are more likely to peg their currency explicitly or implicitly to the Dollar. We could think in fact about a Dollar block, which is pretty much coterminous with the Western alliance. So in a sense, both the flag follows the Dollar, and the Dollar follows the flag. There are very important geopolitical and political effects.

Michael Klein:

Well, when you're talking about exchange rate blocks, of course the most famous one is the Euro area. And the move to a single currency had economic implications, but also there was a real big political impetus for this as well. Could you talk about that a little bit?

Jeffry Frieden:

Right. Well, I think we can talk about it both in political economy and broader geopolitical terms. In the political economy sense, it was hard for a lot of Europeans to imagine, and it is hard to imagine having a single market in Europe, if national governments could devalue their currency at will. And that's what happened in the early 1990s. And that was a major source of the impetus for the creation of the Euro.

Jeffry Frieden:

If the Spanish or Italian governments could devalue their currencies, we know a 10% devaluation is equivalent to a 10% tariff and a 10% export subsidy. So it's hard to imagine a commercial single market like the European Union has with different currencies moving around as much. And there were political pressures to try to avoid those currency movements as well. But then there's the broader political one, which is the European Union embarked on a project to create a more integrated market with more integrated regulatory environments, with more integrated even eventually foreign policies. And the Euro was seen as a very, very important political step in that direction. In fact, there is some indication that the French and German governments, which are central to the European Union, and to the politics of the European Union, essentially made a trade. The French were very eager to have a single currency. The Germans were less eager, but the Germans were very eager to unify Eastern and Western Germany after 1989 when the Berlin Wall came down. So it is said that the Germans and French made a deal where the Germans would give the French currency union if the French would sign on to German unification. So you see there the connection between the goal of a single currency and the goal of a single European market and a single European entity.

Jeffry Frieden:

I think we see that the Euro has contributed in many ways to the creation of a greater sense of European Union, European integration of a European identity, especially among young people. We also see that country after country as it tries to join the European Union is desperate to get into the Eurozone. When the Baltic states join, their primary consideration was, "can we get into the Eurozone?" And they did.

Michael Klein:

And a broader historical context, it's easy maybe now for people to forget that Europe was filled with blood for hundreds of years, with wars within Europe and of course in the 20th century, two devastating wars. And was there an idea that greater market integration fostered by a single currency would also lead to a more peaceful Europe?

Jeffry Frieden:

Absolutely. I mean, the principle impetus for European integration going back to the late 1940s and 1950s was to avoid falling into another, especially Franco-German conflict, or broader European conflict. And we've seen over time that that has expanded. When the Berlin Wall came down and the former Soviet allies in Eastern and Central Europe left the Soviet...well, Soviet Union collapsed as well...then incorporating those countries into first the European Union, and in many instances, the Eurozone was seen as a crucially important geopolitical move to try to limit the conflicts within the continent.

Jeffry Frieden:

We see that even in the form of Yugoslavia. What is the principle consideration as people in Europe and elsewhere try to deal with some of the conflicts that have ensued after Yugoslavia broke up? Can we get those countries into the EU? And the countries that have joined the EU, like Slovenia and Croatia are seen as having made the transition into a more peaceful, collaborative, cooperative European environment. So I think that the connection between economics and politics is always there. And the connection between economics and geopolitics is always there. An integrated Europe is seen by most Europeans as being crucial to a peaceful Europe and vice versa.

Michael Klein:

So Jeff, I always enjoy speaking with you about the connections between politics and economics, and I learn a lot, which really informs my view of economics, and my ideas about exchange rate policy. So thank you once again for joining me on EconoFact Chats and thanks for all your insights that you've offered today.

Jeffry Frieden:

Always a pleasure, Michael.

Michael Klein:

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