3. THE POLITICS OF EXCHANGE RATES

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There are many dimensions to the origins, trajectory, and aftermath of the Mexican crisis of 1994-95, and many of them are political. While much is written about international monetary events both in Mexico and generally, the politics of currency policy is rarely subjected to serious analysis. In this essay, I focus on the domestic politics of exchange rates and on what theory and experience tell us about Mexico's recent and continuing travails. I start with some general principles of the political economy of international monetary policy, then go on to the Mexican specifics. I state my case starkly, avoiding evenhandedness and contingent stipulations in the interests of time, space, and provocation.

FIRST PRINCIPLES

1. The exchange rate is a policy variable. It is set by policy-makers. The attention paid, for good reason, to the stringent demands and vagaries of currency markets has tended to obscure this fact. Certainly the foreign exchanges can bid currencies up and down with tremendous, virtually inexorable power. But "the markets" are usually responding to expectations about the relevant policies of monetary and other authorities.[1]

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[1] I leave aside here the argument of some (see Obstfeld 1986, and, for an application, Eichengreen and Wyplosz 1993) that there may be (or, more strongly, are) rational and self-reinforcing runs on currencies that are not justified by any underlying factors other than the self-fulfilling expectations of currency traders. I am not convinced that these events are common, but to avoid controversy let me posit that such exchange-market attacks are not included in my discussion.

I also, perhaps more obviously, leave aside the insistence of some that nominal exchange rate movements are not relevant. Certainly in some (particularly high-inflation) environments, nominal currency movements have little real effect; but in the majority of cases there is clear evidence for a strong link between nominal and real exchange rates.

While politicians and observers often present international monetary events as though the markets were tossing and turning currencies at will, in fact governments are almost always capable of sufficiently affecting traders' incentives to drive currencies as they wish. Most trivially, a substantial increase in interest rates is generally capable of encouraging more domestic and foreign savers to buy local currency-denominated instruments.[2]

*2. **Policy variables are determined politically.*** Policy-makers respond to political pressures. No policy-maker, no matter how strong his or her personal convictions, can long undertake measures that will result in getting thrown out of office. Politics is the process by which governments are chosen and constrained by their constituents—whether those constituents are voters, powerful interest groups, or a cabal of military rulers and their supporters. By definition, then, the only policies that can be sustained are those that are politically sustainable.

So it may be that a government faced with large sales of its currency always has the option of raising interest rates to reverse this trend. But it may also be that a government that did this would soon cease to hold office and, therefore, that foresighted governments will not sacrifice the local economy in order to support a particular level of the exchange rate.

3. There is no such thing as a technically unsustainable exchange rate. There is no level of the exchange rate that cannot be maintained for purely economic reasons. It is common to see assertions that if, for example, a country with an inflation rate 20 percentage points higher than that of an anchor fixes its currency to that of the anchor, the rate will quickly become unsustainable. What is meant, of course, is that the real appreciation will begin to have substantial negative effects on the local economy. Eventually the exchange rate may be altered to accord with the country's macro-

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[2] It might be objected that if markets do not believe government commitments even though they are "true," governments may be at the mercy of "irrational" trading. In this instance, it is true that incomplete and asymmetric information makes credibility a problem. But it is also true that governments can act on *their own* knowledge that they are serious to "counter-speculate," as it were. If indeed the government commitment to the exchange rate is rock solid and markets do not believe this, a defense of the currency can be fully successful. Problems might arise if the short-term cost of the currency defense is daunting, even given the certainty of earning it back. In any case, here I am dealing mostly with tendencies, not either/or certainties.

economic conditions. But the authorities always have the option of doing the opposite: forcing the country's macroeconomic conditions to accommodate the exchange rate. Prices, wages, and profits can be reduced so that, even if the *nominal* exchange rate appreciates, the *real* exchange rate does not. In other words, the local economy can be forced to fit the exchange rate rather than vice versa.

It is not simply an academic curiosity to insist that conflict between the nominal exchange rate and macroeconomic fundamentals does not necessarily end with the exchange rate adapting. For much of modern history, in fact, the contrary has been more common. Before World War II, price-level differentials among countries on specie standards were often eliminated by dramatic reductions in the overall price level of one or more of the countries. American prices more than doubled during the Civil War and were then forced back down to pre–Civil War levels—with great economic distress—in order to resume participation in the gold standard. This pattern was common, perhaps even the norm, until the 1930s. If we find it difficult to imagine countries actually reducing their price levels—not by 2-3 percent, but by 40-50 percent—it is not because the feat is not technically feasible but rather because it has become unthinkable for other reasons.

4. The sustainability of a nominal exchange rate is a purely political concept. Political conditions determine the range of policy options available to authorities. In some cases, it may be politically feasible to force wage and price reductions to bear the brunt of an appreciated exchange rate. In other instances, such a strategy would quickly be reversed by active opposition. Whether the national economy is forced into conformity with the exchange rate or vice versa depends on how intensely the government's constituents feel about the issue and the power of the relevant constituents. There may be active, broad, and influential support for a fixed exchange rate, even at the expense of national austerity; or there may be powerful lobbies for devaluation. In any case, *political* pressures circumscribe the range of action of monetary policy-makers.

This helps explain why we see so much variation in national currency-policy responses to similar conditions, both across countries and over time. Some members of the European Monetary System (EMS) were willing to undergo great hardship in order to maintain their currencies fixed against the deutsche mark; others never tried. These differences largely respond to differences in the national political lineups of the countries in question. Today, forcing severe deflation (not just disinflation) to protect a nominal exchange rate is

very rare; it has been argued that this is largely due to the rise of the labor movement, which resists deflation.[3]

*5. **Pressures on the making of currency policy are both general and specific.*** They emanate both from very broad popular pressures and from more concentrated social groups. Those who care profoundly about the level or stability of the exchange rate can be sure to make their concerns known to politicians. In this sense, monetary policy is like other arenas in which "special interests" with large stakes have strong incentives to attempt to obtain favorable consideration. How successful such interest groups are varies widely among political systems, among groups, and over time. Views of how legitimate such interest-group pressures are also vary widely.[4] Nonetheless, particularistic groups can and do affect the political constraints on exchange rate policy; in this, it resembles other realms of the political economy.

Monetary policy is *unlike* most special-interest politics, however, in the great breadth of its impact. All policies affect everyone to some degree, but currency policy determines what is often regarded as the most important single price in any economy. Changes in the exchange rate can often affect growth, unemployment, inflation, and other aggregates. Even if these effects are relevant only in the short run, most of politics has to do with short-term pressures.[5] And while the macroeconomic aggregates are so diffuse that their direct impact on politicians is not always clear—after all, growth rates and Gini coefficients do not vote—they do often translate into politically meaningful public opinion. Policy-makers must of necessity attend to the wishes of the populace as a whole, although this may be only one of many of their concerns. A less contented populace can increase political, social, and economic instability in ways that even the most authoritarian regime must take into account.

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[3] Eichengreen (1992).

[4] For the record, like most political scientists I regard these pressures as perfectly legitimate. I see no principled reason why those with strong preferences—and the willingness to take the time, energy, and money to express them—should not have a disproportionate impact on policy. A one-person, one-vote expression of preferences is not the only social choice mechanism used by societies, nor is it typically sufficient on its own to reach results that most of us would regard as normatively desirable (whether they satisfy Pareto criteria or not).

[5] This is not, in my view, because people have inherently shorter time horizons in the political arena than elsewhere. It is because elections have important characteristics of winner-take-all markets in which there are high levels of risk, especially for politicians. The price of losing an election six weeks off may be permanent political death, and the threat of political execution helps concentrate the mind, and raise the discount rate, of all involved. Analogous considerations apply to societal groups, for whom the identity of the policy-maker they will face in the future is always uncertain.

6. There are specific interest groups with currency policy preferences. Social groups are identifiable that might and do care about the exchange rate. Most analyses of national or international monetary policy emphasize broad electoral and related pressures, but like most economic policies, currency policy also has disproportionate effects on people in society. Investigations of exchange rate politics in historical and contemporary perspective provide us with some hints about the general characteristics of the potential interest-group lineup, although much depends on national particularities.[6]

Interest-group preferences on the exchange rate typically relate to two dimensions: its level and its stability. The level is relatively straightforward: Inasmuch as a depreciation helps tradables producers, they are its principal supporters and the principal opponents of a real appreciation. Currency stability is particularly important to those involved in cross-border economic activity, for whom uncertainty can be costly; internationally oriented investors and traders tend to value exchange rate predictability. On the other hand, those without international economic ties have little reason to want to sacrifice national monetary autonomy in the interests of currency stability.[7] Typically the most important specific pressures are from exporters and import competitors in opposition to a substantial real appreciation and from internationally oriented investors, financiers, and traders in opposition to substantial currency volatility. While these special-interest pressures can be very important at times, they are not a constant of currency politics but appear to be most prominent when either the real level or the volatility of an exchange rate is relatively extreme.

7. Broad political pressures are especially important for exchange rate policy. Policy-makers must worry about the wide-ranging political effects of their international monetary policies. While interest groups often care about currency values and movements, the general macroeconomic impact tends to be more politically pronounced. This includes popular concerns about growth and unemployment, which are often reflected in trends relevant to elected and unelected policy-makers alike. Such concerns are particularly important in the context of attempts to stabilize exchange rates; this is

[6] I present here my own undoubtedly biased views, summarized in Frieden (1994). Apart from the obvious reason for this, the modern literature on the politics of exchange rates is quite limited in this regard. For another example, see Henning (1994).

[7] A more detailed discussion would have to be much more careful and disaggregated. This is meant only to indicate broad lines of division.

because in many instances the policies required to sustain a currency's value imply austerity. If, as is typically the case, there is little popular enthusiasm for a fixed or even stable exchange rate *per se*, the sacrifices needed to obtain this are unlikely to be politically convenient.

Another common general concern regarding exchange rates has to do with their relationship to the anti-inflationary credibility of the authorities. Many contemporary stabilization programs, especially in high-inflation environments, have an external hard-currency component. Where the government has invested its expertise and reputation in an exchange rate peg as part of an inflation stabilization package, letting the exchange rate slide could so affect expectations that it would damage the government's ability to stick to a policy course it might otherwise like to maintain. Here again, policy-makers are subjected to broad political influences—both from those who want a relaxation of the exchange rate constraint to allow for more growth and from those who insist on sustaining the exchange rate to help fight inflation.

8. The exchange rate is not an inherent measure of a government's credibility. There is no intrinsic significance to the particular exchange rate stance of economic policy-makers. While exchange rates have been and can be linked to credibility, this is not innate but, rather, constructed. The exchange rate is typically an instrument, a means to achieve an end. Credibility, however, is about targets—about how serious the government is about hitting them, not what tools they use to do so.

There are plenty of instances in which governments have proved their general policy reliability without using the exchange rate. There are even plenty of instances in which monetary authorities have designed and implemented successful anti-inflation (or low-inflation) policies without any explicit link to the currency. Indeed, exchange rate policy is often seen first and foremost as a way of regulating the relationship between domestic and foreign prices, not as a way of stabilizing the price level. Cases in which the exchange rate is a symbol of anti-inflationary credentials are probably a minority.

9. Government policy can make the currency a repository of its credibility. The monetary authorities can choose to tie their integrity to a particular value or to the stability of the exchange rate. This complements what was said above: While the exchange rate says nothing in and of itself about government credibility, the govern-

ment can make it speak this language. Should the authorities, for whatever reasons, imply or declare that the currency's value is itself a target, it would be perfectly reasonable for private agents to interpret exchange rate developments as direct indicators of the government's intentions and seriousness.

Use of the exchange rate to underpin stabilization programs has in fact become something of a trend. But it is worth remembering that there are many conditions for which exchange rates may be useful policy tools, and symbolizing the tenacity and honesty of the policy-makers is only one of them. It may in fact not be a very good symbol, in that a one-to-one link between the exchange rate and credibility effectively removes the exchange rate from the tool kit of monetary policy-makers. This may or may not be wise; it certainly runs the risk of unduly constraining policy.

10. Credibility cannot be "purchased" by technical measures. There is no cheap substitute for a government actually following through on its policy commitments. This flows from much of what has come before. If the exchange rate is used as a symbol of government seriousness, the government is compelled to retain it. This requires that the government force the national economy to conform to the exchange rate should there be pressure on one or the other. Inasmuch as carrying out the macroeconomic adjustments required for this purpose can be economically and politically difficult, the government will eventually be forced to earn its reputation rather than buy it with declarations about commitments to a hard currency.

A currency peg can serve to focus the attention of the markets on this indicator of government reliability. But this also means that any weakening of the exchange rate, for whatever reason, will call into question the government's seriousness. If the exchange rate as a symbol of credibility works on the upswing, it can also work on the downturn—in reverse.

These rudimentary points can be summarized. Whatever the underlying domestic and international economic conditions, the nominal exchange rate rests on the government's political ability to sustain it. Currency values are only sustained if governments have the political support necessary to sustain them. A wide variety of other factors are commonly adduced as the "true reasons" for a devaluation: the central bank ran out of reserves, there were adverse terms of trade shocks, confidence eroded. All of these can come to pass with no change in the nominal exchange rate if in the final analysis the government has the political ability to implement the domestic policies necessary to sustain the currency's value. This

political ability depends on the domestic constellation of political forces and the government's position within it. Such political forces include broad popular desires for aggregate outcomes, and specific concerns of important social groups for more particularistic results. While this emphasis on the centrality of *political* constraints on exchange rate policy is unlikely to be particularly controversial, it is helpful to make the general point, and the constraints, explicit.

THE MEXICAN CURRENCY CRISIS

Insistence on the political underpinnings of the exchange rate implies that analysis of the Mexican crisis requires explicit attention to Mexican politics. The domestic politics of the currency crisis indeed has been neglected by scholars and other analysts. Nonetheless, the political dimensions of the crisis can be analyzed as systematically as the economic dimensions, at least in principle. In what follows, I present the bare bones of an analysis of the Mexican case. My goal is not to argue for one particular interpretation or another, but simply to highlight the kinds of issues worthy of attention both in this case and in others.

The Mexican events involve a chronology familiar to those who know modern Latin American monetary and financial history. The story typically begins with a very large capital inflow and a resumption of economic growth (leaving aside which may have caused which). The capital inflow is associated with a substantial increase in local demand, felt especially in the markets for non-tradable goods and services. The resulting real appreciation is experienced as some combination of rapid increases in non-tradables prices, downward pressure on (relative) tradables prices, and a widening gap in the trade balance. Eventually, the real appreciation gives rise to political pressures in two directions: some want a depreciation to provide relief for tradables producers and for the economy as a whole, while others want to stick to the existing exchange rate in order to maintain access to relatively inexpensive foreign goods and capital. Sooner or later, the pressures for depreciation gain strength, perhaps in tandem with a slowdown in the capital inflow, and the exchange rate is adjusted.

In Mexico, the substantial economic reforms of the late 1980s and ratification of the North American Free Trade Agreement (NAFTA) both led to a large flow of funds into (or back to) Mexico. Both long- and short-term investment in the country rose dramatically until in the early 1990s the net resource transfer was in the 5-6 percent of GDP range. This was associated with a resumption of

economic growth and modernization, including a surge in imports even while exports grew rapidly. It was also associated with a real appreciation of the peso, as Mexican inflation (especially in non-traded goods and services) outpaced that of the United States by a wide margin.

Politically, this contributed to general satisfaction—especially among the urban middle and working classes crucial to the ability of the Partido Revolucionario Institucional (PRI) to maintain its predominant position in the political system. Growth was politically popular, as it always is. The capital inflow and real appreciation had particularly favorable effects on some politically important segments of society. Middle-class (and some lower-middle class) consumers benefited from direct or indirect access to less expensive imported goods, which make up a far larger proportion of their consumption basket than that of the poor. The capital inflow provided for relatively cheap borrowing by businesses interested in expanding and modernizing. To the extent that they reduced the costs of borrowing and servicing existing debt, foreign funds allowed the government to maintain high levels of spending on politically influential sectors, such as small- and medium-size businesses, selected elements of the labor movement, and other beneficiaries of Pronasol (the government's "solidarity" program to ease economic adjustment).

But the real appreciation did not have unambiguously positive effects. It put competitive pressures on tradables producers, reflected in a widening current-account deficit. Certainly many Mexican manufacturers were still able to tap North American markets, especially with the expansion of closely held intra-industry trade (in auto parts, for example). Nonetheless, the real appreciation was taking its toll. In addition, the capital inflow began slowing, and during 1994 the government was forced to offer high interest rates and dollar-based instruments to keep money coming into the country. The former affected domestic borrowers; the latter threatened public finances.

This provides us with a simple picture of the political pressures on policy-makers as of the first half of 1994. In principle, the government had two choices: It could allow the peso to depreciate, or it could implement deflationary policies to sustain the peso. Both options had political pros and cons.

Depreciation. It can be argued in favor of this option that it would have reduced pressure on exporters and import-competers facing difficulties. It would also have permitted a lowering of domestic interest rates—a measure of interest to indebted and borrowing

firms. On the other hand, depreciation would have reduced purchasing power, especially that of swing voters in the urban middle and working classes.

Deflation. This would have been popular with those (especially members of the business and financial community) who were worried about domestic inflation and wages. But it would certainly have weakened the government's broad political position—again especially in the cities, where deflationary measures are likely to have the most impact.

Either of these measures would have been difficult in the best of times. In 1994, the PRI faced a hotly contested presidential election, under international scrutiny. The government could not afford to alienate electorally important groups, such as the urban middle class. Adverse price pressures on manufacturers due to the real appreciation were less urgent, as was the longer-term concern about the fate of public finances.

Depreciation and its impact on middle-class purchasing power would threaten the PRI's base among urban consumers, crucial to winning the presidential election. Deflation would threaten relations with the PRI's allies in the business community and labor, both of which had generally cooperated in the policy developments of the previous years.

It is easy to understand why the Mexican government postponed adjustment, for adjustment would have threatened the PRI's presidential chances. But this was just a postponement; eventually, policy would have to tackle the issues. In this context, one potential strategy would be to maintain the exchange rate, at least until the election, while imposing moderate austerity measures with the cooperation of the labor-management "social partners." After the election, a modest depreciation and some continued austerity could be pursued.

The success of this strategy, which appears both reasonable and akin to what the government actually had in mind, depended heavily on the government's ability to convince participants in the *Pacto* to accept aspects of austerity. This had been a major contributor to policy success after 1987, and it would be needed again. The seasoned politicians who ran the PRI seemed capable of convincing labor and business, especially, that whatever measures were taken would be temporary and would be counterbalanced by favorable consideration once the course correction was complete. As long as the PRI could be expected to maintain its ability to balance the interests and maintain the loyalties of powerful social actors, especially labor and business, the situation seemed manageable.

To put it differently, business and labor were important to the government in their capacity to cooperate in the implementation of stabilization programs; the middle class was important as an electoral base of support. If the government and the PRI could sustain good relations with business and labor in carrying out a small adjustment without a devaluation, the middle class would not be too hardhit, and the elections would be safe.

The situation was complicated, however, by the government's use of the exchange rate as a symbol of its overall policy credibility. This meant that any adjustment to the currency might cause a collapse of confidence in policy-makers. The impact would be manifold—including an erosion of trust between the government and members of the *Pacto* and an erosion of faith in government policy more generally. Tying the currency to overall credibility thus constrained policymakers in their search for politically feasible alternatives.

In any case, all of this depended on the government's ability to manage and reconcile its various bases of support both within and outside the PRI. Labor and business leaders needed to be convinced that modest austerity was worth the cooperation and that they could expect eventually to be repaid for their support. Urban voters needed to be massaged into voting for the PRI—either indirectly, by continuing their access to inexpensive consumption goods, or directly, with the use of government spending (financed abroad). This was a delicate balancing act, but the PRI had managed more delicate ones in recent memory.

However, the March 1994 assassination of Luis Donaldo Colosio called into profound question the PRI's ability to broker this resolution, and the September 1994 assassination of José Francisco Ruíz Massieu made matters even worse. Evidence of serious divisions in the PRI raised questions about the reliability of any deals that might be struck. It was widely—and probably correctly—believed that Ernesto Zedillo's lack of an independent base of support in the PRI would hamstring his ability to hold together the disparate forces needed to sustain an orderly adjustment.

The erosion of confidence in the government's political strength was undoubtedly exacerbated by memories that two of the previous three transitions had been characterized by a cycle of capital inflows, real appreciations, large devaluations, and crises. The situation in 1994 was similar enough to that in 1976 and 1982 to raise concerns about the possibility of a major devaluation of the peso.

Most of the fears expressed after the Colosio assassination were indeed borne out. Factional conflict and a vulnerable presidential

candidate caused serious doubts about the PRI's ability to hold together the *Pacto* and, more generally, the disparate component parts of its political support base. And in fact Zedillo, lacking as he did a base of his own or long-term ties with major political players, had difficulties establishing stable coalitions in support of the measures he tried to implement.

The political economy of the currency crisis thus seems straightforward. In an election year, the PRI could not afford a devaluation due to its impact on politically crucial middle-class and lower middle-class urban consumers. The association of monetary policy credibility with the nominal exchange rate tied the government's hands even further. The government could try to prevail upon its social allies in business and labor to help manage a mild adjustment, but this delicate balance was disturbed by the Colosio assassination and the infighting it revealed. The disturbance was aggravated by the perception that Zedillo's political weakness left him in a poor position to maintain the cooperation of essential business and labor leaders.

What might have been a simple currency crisis burgeoned into an all-encompassing economic and political crisis precisely because the government had insisted that it be judged on the basis of how well it maintained the peso fixed against the dollar. In this way, the administration's attempt to use the exchange rate as a commitment technology came back to haunt it. This was exacerbated by the fact that the incoming Zedillo administration inherited the previous government's insistence on tying the government's credibility to the peso. While it is arguable that the successful peg augmented the regime's credibility in the early 1990s, it is unquestionable that the peg's failure exacerbated the loss of confidence in the government. This helped put the government on a downward spiral from which it emerged at great economic and political cost.

POLITICAL ECONOMY LESSONS OF THE MEXICAN CRISIS

Without repeating too much of what has come before, several potential lessons of the Mexican experience (and of others like it) can be suggested. I restrict myself to the exchange rate and other closely related spheres, but many of these points could be made more generally.

1. A focus on macroeconomic fundamentals is insufficient and may be misleading. The fundamentals are crucially important, of course. But their impact on currency policy is and can only be mediated through national political and policy-making structures. In

some countries, high levels of unemployment would translate directly and immediately into pressure on the exchange rate; in others, they would be irrelevant.

2. Explicit attention must be paid to the political constraints on policy. Economic and other technical features of policy and of the environment within which policy is made are important, and they typically get plenty of attention. But it is much less common for analysts, observers, and market operators to incorporate political considerations systematically into their evaluations of policy. This is a grave mistake and leads to poor understanding, bad explanations, and poorly devised forecasts.

3. Political constraints are both general and specific. In the monetary sphere, policy-makers have to balance the specific concerns of those most directly affected by currency policy against the policy's broad political (including electoral) implications. This is a difficult task to carry out, and a difficult one to analyze. But such factors as the role and influence of particularistic interest groups, the timing of elections, and features of the electoral system are crucially important to determining the range of maneuver available to policy-makers.

4. A policy without a political base of support will not long be policy. One often hears assertions to the effect that a particular strategy is likely to succeed because it is technically well designed, or because its authors are well trained, or because policy-makers have a good academic background in economics. Certainly all these are better than their opposites, but in the final analysis it is more important that policy-makers understand and be able to work with the political constraints on them than that they have particular expertise (which, after all, is readily available at a reasonable price). A good technician may well be able to design the socially optimal policy but have no chance of getting it adopted. A better result would be obtained by a seasoned politician willing and able to guide society toward a welfare improvement. Policy proposals, including those for optimal policies, are irrelevant unless they are politically feasible.

5. Politicians do have room for maneuver. Indeed, their job is largely to understand the constraints on them, to operate within these constraints, and to test their outer limits. Nothing discussed above should be understood to mean that politicians are impotent (just as new and improved theories of industrial organization do not make managers obsolete). Indeed, it leads to a healthy respect for

politicians, who are pursuing their own comparative advantage in getting things done.

6. There is no magic source of credibility. While it may be fashionable to refer to an exchange rate peg as a commitment technology, this is misleading if it is meant to imply that one needs only to plug the technology in to have it work. A currency peg, like other commitment technologies, can help resolve some informational ambiguities. It cannot eliminate the requirements that policies find a base of political support and that underlying macroeconomic policies be coherent and consistent.

This insistence on the importance of politics to monetary policy may appear obvious. But it seems to bear repeating, for most analyses of international and domestic monetary affairs slide over political considerations quickly and haphazardly. Political constraints are decisive and unavoidable determinants of policies and outcomes, and they deserve to be incorporated systematically into our analyses.

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