

18 Globalization and exchange rate policy

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Exchange rates powerfully affect cross-border economic transactions. Trade, investment, finance, tourism, migration, and more are all profoundly influenced by international monetary policies. Many developing-country governments have searched for alternatives to the uncertainty that can prevail on international currency markets. Policy entrepreneurs have rushed to peddle currency nostrums, urging a turn toward dollarization, managed floating, nominal anchors, target bands, or other options.

There are both theoretical and empirical reasons to expect globalization to heighten the importance of the exchange rate. Theoretically, open-economy macroeconomic principles imply that capital mobility profoundly affects exchange rate policy choices. As Robert Mundell showed more than forty years ago, the government of a financially integrated economy faces a choice between monetary policy autonomy and a fixed exchange rate (Mundell 1963). If the government opts for a fixed rate, capital mobility makes impossible a monetary stance different from that of the anchor currency; alternatively, if the government opts to sustain an independent monetary policy, it must allow the currency to move. These constraints mean that the economics and politics of monetary and exchange rate policy are likely to be very different in an economy that is financially open than in an economy that is not. By the same token, inasmuch as international economic integration involves increased exposure to international financial and commercial flows, it heightens the concerns of those involved in or exposed to international trade and finance. In a relatively closed economy, few economic actors care about currency movements. But as economies become “globalized” more firms, investors, and workers find their fortunes linked to the exchange rate, and to its impact on trade and financial flows. This concentrates attention on the exchange rate.

Empirically, the impact of “globalization” on exchange rate politics can be seen both over time and across countries. The exchange rate was an important policy problem in the previous era of high globalization. Between 1870 and 1914, the gold standard was one of the major political controversies of the era. In the economies that first approximated globalized conditions today—the small open economies of Western Europe—the exchange rate was so prominent an issue that monetary unification became the top priority of

many Europeans over a twenty-year period. And, in the many economies that have now liberalized commercial and financial relations with the rest of the world, currency policy has similarly become central.

The policy advice that governments receive on exchange rates has typically been presented as technical solutions to technical economic problems. Yet exchange rate policy is highly political. It is chosen by policy-makers often concerned about the impact of currency policy on electoral conditions, and pressures from special interests and mass public opinion can affect its course profoundly. The gap between exchange-rate policy advice and the actual policy environment resembles the gap often found in discussions of policy towards the rule of law, investor protection, and corruption: the recommendations assume away interest groups, mass public opinion, and electoral coalitions—in a word, politics. And this is more than an academic concern. Recommendations that ignore the political economy of policy implementation can have disastrous outcomes. A first-best policy whose implementation is subverted by political realities may well be far worse than a feasible second-best solution.

In this chapter, I set out a rudimentary picture of the political economy of exchange-rate policy in developing countries.¹ I start by outlining prevailing approaches to the analysis of currency policy, highlighting the argument that ignoring politics leads to poor policy advice. I then discuss the choices policy-makers face with regard to exchange rate regimes and exchange rate levels, and the tradeoffs among different values that these choices entail. I analyze the political-economy pressures—special-interest, mass political, electoral—faced by policy-makers, with evidence drawn from recent Latin American experiences, before reaching my conclusion.

Politics and the exchange rate

The events of the past twenty years demonstrate the importance of understanding the political economy of currency policy. The European Monetary Union, debates over dollarization in Latin America, currency crises in Mexico, East Asia, Russia, Brazil, Turkey, and Argentina—all are impossible to understand without incorporating the role of pressures from interest groups, from mass publics, and from politicians concerned about their re-election. (The same, of course, is true of the gold standard in the nineteenth and early twentieth centuries.)

Currency policy is made in an intensely political environment. Even apparently apolitical observations often embody political assumptions or assertions. For example, allusions to the unsustainability of a particular exchange rate must be based on some model of political constraints on policy. Technically, no exchange rate is unsustainable; the real economy can be made to fit any nominal exchange rate.² Analysts who refer to an unsustainable exchange rate must have in mind that local political conditions will not allow the government to defend the level of the currency. These conditions might

include opposition from exporters or import competitors clamoring for a devaluation, or more general concern that a devaluation might reduce local purchasing power in unpopular ways. Whatever the reality, allegations of unsustainability presume something about the political system and the structure of interests within it.

These presumptions are worth making explicit. Yet prevailing analyses of currency policy largely ignore politics, with the result that practical policy discussions tend to abstract from the real and powerful pressures that are brought to bear on exchange rate policy choices.

Two common explanations of exchange rate policy choice focus on optimal currency area criteria and on the currency as an anchor for inflation expectations. The former approach goes back to the work of Mundell (1961) and others, and its arguments are well known: currency union between two countries is welfare-improving where factors are mobile between them, or when the countries are subject to correlated exogenous shocks, or when their economic structures are very similar. This reasoning has been extended to explain the choice of a fixed exchange rate, on the principle that currency union is simply an extreme form of fixing.

The second broad category of currency policy explanations emphasizes the use of the exchange rate as a way of overcoming the time-inconsistency of monetary authorities' anti-inflationary commitments.³ A government attempting to signal its seriousness about non-inflationary policy can peg the exchange rate to a nominal anchor currency.⁴ When a government commits to a peg it makes an easily verifiable promise: either it follows macroeconomic policies consistent with the peg, or it does not, in which case the peg collapses. Most contemporary supporters of fixed rates, including dollarization, point to the disciplining characteristics of this policy stance as its main attraction.

There are both theoretical and empirical problems with these two approaches. Theoretically, they presuppose that policy is made on welfare grounds. A welfare-driven policy could be the result of many things, such as that:

- policy-makers do not depend on support from domestic political actors;
- the relevant political pressures are for improvements in aggregate social welfare; or that
- domestic political actors do not have preferences over exchange rate policies other than that they enhance aggregate social welfare.

Needless to say, these theoretical propositions are at odds with decades of theoretical work in political economy.

There is also little or no empirical support for the supposition that policy follows normative welfare principles. For example, there is little evidence that existing currency unions—from Europe's Economic and Monetary Union to dollarized countries—met optimal currency area criteria when they were created. And most empirical work indicates that, except in the extreme

case of hyperinflation, it is rare for countries to use nominal anchors for anti-inflationary credibility.

Exchange rate policy motivates the same sorts of special and mass, particularistic and electoral, interests that are to be found in every other realm of economic policy. Recent analyses incorporate the role of interest group and partisan pressures, political institutions, and the electoral incentives of politicians.⁵

Choices and tradeoffs

The first analytical task is to understand the tradeoffs faced by politicians and their constituents as they consider national currency policies. Governments making currency policy face decisions on two basic dimensions: on the *regime* by which the currency is managed (fixed or floating, for example), and on the *level* of the currency (strong or weak). In the first instance, policy-makers have to decide whether to float or fix the exchange rate—and if to float, in which of the many possible ways.⁶ In the second instance, assuming the currency is not fixed, they need to determine what the preferred level of the exchange rate is.⁷ They can, of course, decide to let the currency float completely freely, but in developing countries policy-makers have shown themselves reluctant to do this. Policy-makers often act to avoid a substantial appreciation or depreciation of the currency, which implies that they have preferences over the currency's level.

Regime

Fixed or floating: stability and credibility or policy flexibility?

The traditional case for stable exchange rates hinges on the benefits of economic integration. In an open economy, the main advantage of a fixed rate regime is to lower exchange rate risk and transaction costs that can impede international trade and investment.⁸ Volatile exchange rates create uncertainty about international transactions, adding a risk premium to the costs of goods and assets traded across borders. By stabilizing the currency, a government can encourage greater trade and investment. More recent analyses emphasize the possibility that an exchange rate peg can enhance monetary-policy credibility, as mentioned above. Both theory and evidence suggest that fixing the exchange rate to the currency of a low-inflation country both promotes international trade and investment and disciplines monetary policy by providing an observable nominal anchor.⁹

But fixing the exchange rate has costs. To gain the benefits of greater economic integration through fixing, governments must sacrifice their capacity to run an independent monetary policy. The “impossible trinity” principle explains that governments must choose two of three goals: capital mobility, exchange rate stability, or monetary independence (Mundell 1962,

1963). In a financially integrated economy, domestic interest rates cannot long differ from world interest rates (capital flows induced by arbitrage opportunities quickly eliminate the differential). There is strong evidence that financial integration has progressed so far that capital mobility can be taken more or less as given—which reduces the choice to sacrificing exchange rate stability versus sacrificing monetary independence. Fixed rates require the subordination of domestic monetary policy to currency and balance of payments considerations.

A floating exchange rate, on the other hand, has the great advantage of allowing a government to pursue its own independent monetary policy. This independence is valuable because it provides flexibility to accommodate foreign and domestic shocks, including changes in the terms of trade and world financial conditions. Floating allows the exchange rate to be used as a policy tool: for example, policy-makers can adjust the nominal exchange rate to affect the competitiveness of the tradeable goods sector. In some countries, especially those with a history of high and variable inflation, policy-makers may place an overriding value on monetary stability. But for other countries, achieving monetary stability at the cost of flexibility may involve too great a sacrifice; an autonomous monetary policy might be the best way to cope with the external shocks they face.

In an open economy, then, policy-makers face a tradeoff between two competing sets of values. On the one hand, a fixed rate brings *stability and credibility*; on the other hand, it sacrifices *flexibility*. A fixed rate makes for more currency and monetary stability; a floating rate makes for more policy flexibility. Each set of values is desirable; obtaining each requires forgoing at least some of the other.

Level

High or low: consumers or producers?

Policy-makers face another set of tradeoffs, and that is on the *level* of the exchange rate. The level of the real exchange rate affects the relative price of traded goods in both local and foreign markets. There is no clear economic-efficiency argument for or against any particular level. A strong (appreciated) currency gives residents greater purchasing power, but the fact that it makes foreign products relatively cheaper also subjects national producers of tradeable products to more foreign competition. When a real appreciation makes domestic goods more expensive relative to foreign, consumers of imports benefit while producers of goods that compete with imports (and exporters) lose. The result is a loss of competitiveness for tradeables producers.

A real depreciation has the opposite effects: it stimulates demand for locally produced tradeable products, which is good for their producers; but it makes consumers worse off by raising the prices they pay for foreign goods and services. In broader macroeconomic terms, a real depreciation can

encourage exports, switch expenditures away from imports into domestic goods, invigorate the tradable sectors of the economy, and boost aggregate output. But a real depreciation can also be contractionary, because real money balances shrink as the result of the higher price level. And if a nation relies on imports for many vital items, such as oil, food, or capital goods, depreciation can reduce living standards, retard economic growth, and increase inflation.

Thus, the level of the exchange rate confronts policy-makers with two desirable but mutually exclusive goals—stimulating local tradeables producers, and raising local purchasing power. The benefit of increasing the competitiveness of national producers comes at the cost of reducing the real income of national consumers, and vice versa. To paraphrase Abraham Lincoln, you cannot please all of the people all of the time.

In some instances, especially in developing countries, the tradeoffs discussed above can be collapsed into one dimension. The strongest supporters of exchange rate flexibility and a depreciated currency are typically those producers concerned about their competitiveness in import and export markets. The strongest supporters of a fixed exchange rate are typically those concerned about currency stability and monetary credibility. So in many cases, the principal conflict can be expressed as one between *competitiveness* and *credibility*.

Political factors in the determination of currency policy

Selecting an exchange rate regime is a highly political decision: governments must make tradeoffs among values that are given different importance by different sociopolitical actors. With regard to the regime (fixed or floating), the choice is monetary stability and credibility versus monetary flexibility. With regard to the level (depreciated or appreciated), the choice is between competitiveness and purchasing power. Governments must weigh the relative importance of the stability of nominal macroeconomic variables, the competitiveness of producers of tradable products, and the purchasing power of consumers.

The decisions they make have domestic distributional consequences—a fact that is not lost on interest groups or electorates at large. Governments face pressures:

- for reduced volatility, from those who are internationally exposed, including export producers and those with foreign exchange liabilities, such as firms with dollar debts (suggesting a desire for a fixed exchange rate);
- for favorable relative price effects, especially from tradeables producers (suggesting a desire for a depreciated currency, hence floating);
- for purchasing power, from consumers (suggesting a desire for an appreciated currency).

Below I discuss the pressures exacted by interest groups and by electorates

with regard to currency policy, and offer some evidence from Latin America about how governments have responded.

Special interest groups

As regards the *exchange rate regime*, we can array groups along a continuum that measures the extent to which they are involved in international or domestic economic activity (Frieden 1991; Hefeker 1997). Groups who are heavily involved in foreign trade and investment—typically including the commercial and financial sectors and foreign currency debtors—should favor exchange rate stability, since currency volatility is an everyday concern that makes their business riskier and more costly. By the same token, these groups care less about a loss of national monetary autonomy, since they typically do business in several countries, and can shift their business or assets abroad if domestic conditions become unfavorable.

By contrast, groups whose economic activity is confined to the domestic economy benefit from a floating regime. The nontradeables sector (for example, services, construction, transport) and import-competing producers of tradeable goods belong in this camp. They are not required to deal in foreign exchange and so are free of the risks and costs of currency volatility. They are highly sensitive to domestic macroeconomic conditions and thus favor the national autonomy made possible by floating.

Tradeables producers are also likely to oppose a fixed rate, for two reasons. First, the adoption of a fixed rate in inflationary conditions—such as have characterized much of Latin America—usually leads to a transitional real appreciation, with detrimental effects on tradeables producers. This has been the experience of most exchange-rate-based stabilization programs. Second, a fixed rate eliminates the possibility of a depreciation to maintain or restore the competitiveness of tradeables producers.

The domestic interest group politics of the *level of the exchange rate* can also be represented simply, separating exporting and import-competing industries that lose, on the one hand, from domestically oriented (nontradeable) industries that gain from a currency appreciation, on the other (Frieden 1991). Domestic consumers also gain from an appreciation as the domestic currency prices of imported goods fall, lowering the cost of living. Currency depreciations have the opposite effects, helping exporting and import-competing industries at the expense of domestic consumers and producers of nontraded goods and services.

Among tradeables producers, the degree of concern about currency movements depends upon how directly they are affected by changes in the exchange rate. If import-competing firms that face an appreciation of the home currency are able to keep their prices high—as will happen if foreign producers do not pass the expected price decline through to local consumers—they will be less concerned about the appreciation.¹⁰ Generally, tradeables industries with high pass-through are more sensitive to the relative price effects of currency

movements than those with low pass-through, since their prices respond more directly to changes in exchange rates. And by extension, the level of the exchange rate is likely to be more politicized in developing than in developed countries, since the former tend to produce standardized goods and primary commodities, for which pass-through is high. Capturing an industry's sensitivity to exchange rate changes involves measuring the extent to which it sells products to foreign markets, uses foreign-made inputs, and, more directly, competes with foreign manufacturers on the basis of price (Frieden 1991).

The considerable variation of currency regimes in Latin America provides opportunities for at least a preliminary investigation of interest-group pressures. Given the characteristics described above, it seems likely that the manufacturing sector will prefer more flexible currency regimes in order to maintain the competitiveness of locally produced tradeables. In empirical work reported in Frieden, Ghezzi, and Stein (2001), we found that economies with larger manufacturing sectors were more prone to adopt either floating regimes or backward-looking crawling pegs, both of which tend to deliver more competitive exchange rates. This can be seen in Table 18.1, which shows that countries with larger manufacturing sectors are less likely to have fixed exchange rates (a lower number in the table is associated with a more fixed rate).

Table 18.1 Exchange rate regimes are affected by the size of the manufacturing sector, Latin America, 1972–94

<i>Smaller manufacturing sectors</i>			<i>Larger manufacturing sectors</i>		
	<i>Man/GDP</i>	<i>Scale of fixed/floating</i>		<i>Man/GDP</i>	<i>Scale of fixed/floating</i>
Haiti	8.87	3.19	Dom Republic	17.33	.96
Panama	9.33	0.00	Venezuela	17.42	2.85
Barbados	10.12	0.00	Ecuador	19.37	2.35
Guyana	12.39	5.08	El Salvador	19.48	1.24
Trinidad and Tobago	12.61	2.73	Nicaragua	19.86	1.16
Suriname	13.82	2.08	Colombia	20.31	6.75
Guatemala	15.18	3.58	Chile	21.39	5.79
Honduras	15.24	2.86	Mexico	21.85	6.04
Paraguay	15.71	3.34	Costa Rica	22.83	4.29
Bolivia	16.03	4.80	Peru	23.47	5.79
Belize	16.65	0.00	Uruguay	23.66	6.09
Jamaica	17.22	4.50	Brazil	28.63	7.06
			Argentina	29.35	2.74
Average	13.60	2.68		22.30	4.35

Scale of Fixed/Floating is a 10 point scale with 0 = Fixed for every period, 10 = Floating for every period.

Source: Frieden, Ghezzi, and Stein (2001).

The data can be examined more systematically, controlling for a wide variety of other economic factors (details are available in Frieden, Ghezzi, and Stein 2001). Table 18.2, derived from this more systematic empirical analysis, presents estimates of the impact of openness (exports plus imports as a share of GDP) and the size of the manufacturing sector on the likelihood of fixed and flexible exchange rate regimes. The more open the economy is—and thus the more important are internationally oriented economic actors—the more likely is the government to maintain a fixed rate. Specifically, a one standard-deviation increase in openness, centered on the mean—that is, a rise in a country's exports plus imports from 47 to 86 percent of GDP—is associated with a 25 percent increase in the probability that the government will adopt a fixed exchange rate.

Similarly, the larger the manufacturing sector is—indicating greater sensitivity to the competitive effects of currency movements—the less likely is a fixed rate. A one standard-deviation increase in the size of the manufacturing sector—that is, a 5.5 percent increase in a country's manufacturing/GDP ratio—is associated with an 11.3 percent *reduction* in the probability that the government will adopt a fixed exchange rate. This implies that each percentage point increase in the share of manufacturing in GDP reduces the probability of fixing by around 2 percentage points. In the closed economies of the import-substitution period, where manufacturers were mostly protected from foreign competition, this relationship was weaker or absent (see also the country studies in Frieden and Stein 2001).

It can also be seen that hyperinflationary episodes are associated with the use of a currency peg for credibility-enhancing purposes, whereas episodes of moderate inflation are not. Table 18.2 (column 1) shows that having inflation greater than 1,000 percent increases the probability of adopting a fixed rate regime by nearly 21 percentage points.

Electoral considerations

Elections are of recurrent importance in exchange rate policy-making. They may affect exchange rate policy for several reasons. As described in Frieden and Stein (2001), the income effect associated with depreciation reduces the

Table 18.2 Sources of choice of exchange rate regime, Latin America, 1972–94

	<i>Hyper-inflation</i>	<i>Openness</i>	<i>Manufacturing/ GDP</i>
Mean of variable	0.0254	0.665	0.1857
One standard-deviation change in variable	1.000	0.396	0.0553
Δp (fixed)	0.2076	0.250	-0.1129
Δp (flexible)	-0.1016	-0.120	0.0547

Source: Frieden, Ghezzi, and Stein (2001).

purchasing power of the population; it can make depreciation unpopular and therefore politicians may want to avoid it at election time. Devaluations may also be unpopular because they generate inflation. On the other hand, a real appreciation can deliver an electorally popular reduction in inflation and an increase in purchasing power. In line with this, governments show a strong tendency to allow or engineer a real appreciation in the run-up to elections, which is then reversed after the government changes hands (Klein and Marion 1997; Leblang 2000). An exchange rate electoral cycle boosts voters' incomes in the run-up to the election and imposes costs on voters only after the new government is in office. The delay results in a depreciation that is more costly than if it had occurred immediately, but newly elected governments appear to follow the rule of "Devalue immediately and blame it on your predecessors" (Edwards 1994).

Evidence for Latin America, from individual country studies and a cross-country study, is generally consistent with these arguments (Frieden and Stein 2001). A cross-country study reported in Frieden, Ghezzi, and Stein (2001) examines the behavior of exchange rates before and after elections. Looking at 86 episodes of electoral changes in government, we found that the real exchange rate appreciated nearly 3.5 percent in the months leading to an election and depreciated on average 6 percent during the following four months (Figure 18.1).¹¹

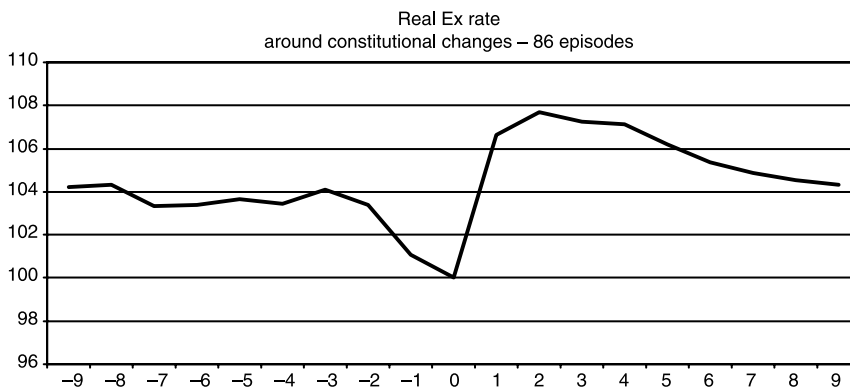


Figure 18.1. Real exchange rate movements around elections, Latin America, 1972–94.

Note: All episodes in the database are pulled together. For each a 19-month window is considered: month 0 corresponds to the month of the change in government, month –1 is the month prior to the change in government, and so on. The rate of depreciation across all episodes is then averaged for each of the 19 months in the window (–9 through 9). The authors use geometric rather than arithmetic averages in order to lessen the effects of outliers. To make the level of the exchange rate comparable across countries, the real exchange rate in each country is normalized so that the geometric average would be 100, and for purposes of this figure the month-by-month averages are normalized so that they would be 100 at time 0 (the time of the change in government). “Constitutional changes” are electoral changes in government (i.e. not including military coups), and occur at different times after the actual elections depending on national practice.

Source: Frieden, Ghezzi, and Stein (2001).

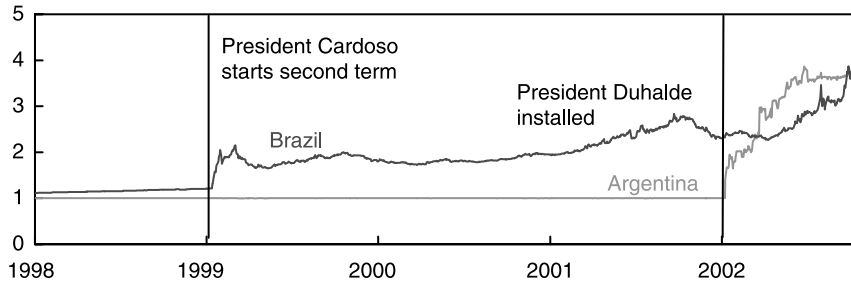


Figure 18.2. Exchange rates in Argentina and Brazil (*pesos* and *reals* per US\$).

At a more anecdotal level, Latin America is a rich repository of experiences in which governments delayed devaluations until after elections: Mexico's ruling PRI party did so with some regularity between 1970 and 1994. More recent Argentine and Brazilian experiences are also expressive. As shown in Figure 18.2, each government held the exchange rate more or less constant until right after a new president (in the Brazilian case, a re-elected incumbent) took office. In pre-election months, both currencies appreciated substantially in real terms, with a powerful positive impact on the purchasing power of local residents. Immediately after taking office, each government let the currency float—more accurately, sink—to a substantially depreciated level.

The political economy of exchange rate policy is not only important for developing countries. For over thirty years the member states of the European Union have attempted, with varying degrees of success, to stabilize their currencies against one another. The eventual creation of the euro, and the continuing question of whether, when, and how other countries in and around Europe will join the euro zone, certainly respond to powerful domestic and international political pressures (see, for example, Eichengreen and Frieden 2001, 2002).

Exchange rates are critical in a wide variety of other settings in the context of an integrated world economy. Commercial and financial relations between the United States and East Asia, for example, have long implicated currency policies, sometimes sparking political conflict. In the early stages of their respective export drives, East Asian nations—first Japan, then South Korea and Taiwan, now China—have typically kept their exchange rates very weak to spur manufactured exports. The results often provoke protests from American manufacturers who press the US government to insist that East Asian governments allow or force their currencies to appreciate.

Conflict over the trade effects of currency values has most recently been played out between the United States and China. The issue has been complicated by the fact that—as was true in the early 1980s when the American target was Japan—the weakness of East Asian currencies is matched by

the strength of the US dollar, which itself is in large part due to America's own fiscal policy and the resulting capital inflow. Whatever the ultimate resolution of these "global imbalances"—East Asian trade surpluses and American trade and fiscal deficits—there is little question that highly politicized currency policies played an important role in creating and propagating them. There is also little question that the unwinding of these imbalances will itself provoke political conflict over exchange rates and their effects.

Conclusion

Exchange rates are political. They affect the interests of powerful groups and of consumers. They affect elections, and are affected by them. International economic integration only heightens their impact and their political prominence. As the world economy has become more open—and especially as developing countries have become more open—exchange rates have become even more highly politicized, more controversial, and more subject to mass and special-interest political pressures.

Those who ignore the political economy of currency policy will make mistakes in developing feasible exchange rate policies. Both analysts and policy-makers would be well advised to pay concentrated attention to political economy factors in exchange rate policy-making.

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Notes

- 1 For more detailed analysis, the reader is referred to Broz and Frieden (2001); Frieden, Ghezzi, and Stein (2001); and Frieden and Stein (2001).
- 2 This is not simply a theoretical possibility: under the classical gold standard, it was common for countries to respond to a substantial real appreciation with a substantial real adjustment in prices and wages. The United States government pursued policies to put the dollar back on to gold after the Civil War, which led prices to decline by about 40 percent between 1865 and 1870, and then a further 30 percent between 1870 and 1879.
- 3 Kydland and Prescott (1977); Barro and Gordon (1983).
- 4 Giavazzi and Pagano (1988); Canavan and Tommasi (1997).
- 5 See, for example, Bernhard and Leblang (1999); Blomberg and Hess (1997); Eichengreen (1995); Frieden (1994, 1998); Hefeker (1997); Collins (1996); Edwards (1999); Klein and Marion (1997); Gavin and Perotti (1997); Stein and Streb (1999).
- 6 Obviously policy-makers have a wide choice of regime, ranging from a completely free float to a variety of managed floats, degrees of fixity ranging from a target zone to a peg, and a currency board of dollarization. This discussion focuses on the extreme—hard pegs and pure floats—however, because the analysis of intermediate cases flows from the extremes, and the tradeoffs described apply to the intermediate choices, albeit never as starkly as to the extremes.
- 7 Under most regimes a government must decide whether it prefers a relatively appreciated or relatively depreciated currency. Free floats are rare, and by the same token, countries that opt for a pegged regime always have the choice of abandoning the peg.
- 8 Mundell (1961), McKinnon (1962), Kenen (1969); a more recent survey is Tavlas (1994).
- 9 See, for example, the empirical results in Frankel (1995), Rose (2000), Vegh (1992), and Ghosh *et al.* (1997).
- 10 This is often the case in markets for highly specialized differentiated products such as automobiles.
- 11 See also Blomberg, Frieden, and Stein (2005).