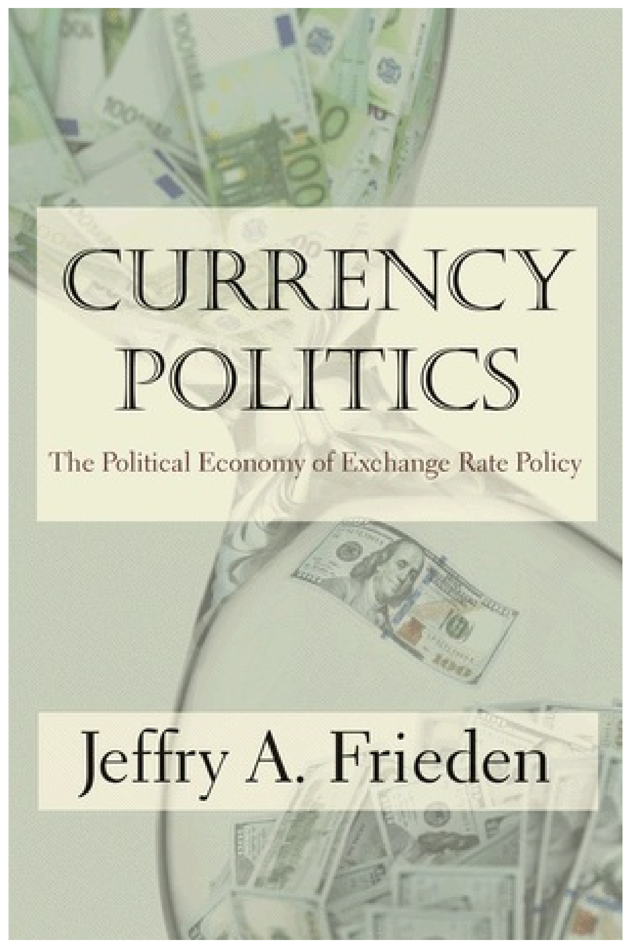
Book Review: Currency Politics: The Political Economy of Exchange Rate Policy by Jeffry A. Frieden

Exchange rates are vital to the functioning of an economy, so what determines the currency policies that governments choose to pursue? In **Currency Politics: The Political Economy of Exchange Rate Policy***,* **Jeffry A. Frieden** *draws upon a range of historical examples and case studies from Europe, North America and Latin America to offer an analysis of the politics of exchange rate policy. While often a challenging read, this book is worth the effort for those looking to understand how national politics shape currency policy and the possible future of international currency regimes, writes* **Jenny McArthur***.*

If you are interested in this review, you may also like to listen to **a podcast** *of Professor Frieden's LSE public lecture, 'Lessons for the Euro from America's Past', recorded on 19 January 2016.*

***Currency Politics: The Political Economy of Exchange Rate Policy.* Jeffry A. Frieden. Princeton University Press. 2016.**



Currency Politics: The Political Economy of Exchange Rate Policy makes a considered and compelling case for the relevance of political economy to explaining currency policy. Monetary economics, which deals with money supply and the choice of exchange rate policy, is typically dominated by analysis using economic factors only. *Currency Politics* weaves together political economy theory, robust econometrics and historical analysis to explain the development of monetary policy using national political factors and the shifting global economic and political order.

The appeal of this text to economists and political scientists alike is obvious; however, it also explains monetary economics with such clarity that it is unusually accessible – at least for the field of economics – to a more general audience. Think of it as occupying the middle ground between pop economics titles, like *Freakonomics*, and more formidable volumes, such as Thomas Piketty's *Capital in the Twenty-First Century*.

The first chapters introduce basic policy choices for managing the monetary system: exchange rate regimes, either fixed, floating or pegged to another currency, and a currency's price level. The choice of regime depends on competing demands for stability and flexibility, while the price level is held in tension between supporting price competitiveness for exporters and the purchasing power of consumers.

The goals of monetary policy form an 'impossible trinity', with unavoidable trade-offs between financial integration, stability of exchange rates and monetary independence. Since these trade-offs impact unevenly across the economy, political conflicts arise over the choice of policy settings. Jeffry A. Frieden's theories hinge on the uneven impacts of these policy settings, and how they shape the political dimension of currency policy decisions. Currency policy is perceived to be more politically contentious for open economies where international trade is subject to uncertain fluctuations in international capital flows. Manufacturers and exporters prefer a lower price level to be competitive in global markets, while a higher price level improves the relative purchasing power of consumers. Preferences for a particular exchange rate regime can be explained by a firm's 'exposure to exchange rate volatility' – that is, the risk of losing money due to fluctuations in the exchange rate, depending on the nature and conditions of trading contracts with other countries. The extent to which firms have debts in foreign currencies is also relevant, as is potential 'pass-through' – how much the cost of currency fluctuations can be passed on to customers.

Image Credit: Exchange Rates (Debs (ò_ó)♪)

With this framework in place, a set of case studies is used to test the relevance of political economy to currency policy at various stages in history: namely, the United States during the transition to the gold standard (1862-96); European monetary integration between 1973-94; and Latin American policy between 1970-2010. The individual elements of Frieden's theories are tested empirically to understand how important the political economy of currency policy is to explain voting patterns and government policy choices.

Regression analysis of voting data and proxy variables for political interests largely substantiate Frieden's theories in the selected cases, particularly the preference of manufacturers and exporters for a flexible regime and lower price level. International financial intermediaries, who have historically lobbied for a more stable regime, contest these policy settings. There is also evidence that populist politicians may inflate the price level to boost the purchasing power of consumers, particularly in the Latin American context.

In the use of case studies and the inclusion of historical and contextual factors, *Currency Politics* introduces a meaningful narrative to the analysis. Pure economic analysis is typically deterministic and struggles to account for contingent factors. By considering social, institutional and historical aspects, the text succeeds in treating the economy for what it really is: a complex and interdependent phenomenon.

The chapters on currency policy in nineteenth-century USA are particularly illustrative: large-scale infrastructure investment acted as a catalyst for economic growth and geographical expansion across the new continent, leading to the emergence of two competing political blocs in the agricultural hinterland and urban centres of industry and finance. Railroad magnates funded new railways using foreign-denominated debt and had strong interest in moving away from gold to a floating exchange rate. Farmers and mining firms shared this interest and voted for lower price levels along with a floating exchange rate to guarantee competitiveness in export markets. Manufacturers went against expected behaviour for two reasons: import tariffs were relatively high, particularly after the Civil War, and the US was geographically distant from potential competitors. With high transport costs protecting firms from competition with European counterparts, they could easily pass-through the costs of currency fluctuations to consumers. The Latin American analysis conversely brings to light a tendency for currencies to appreciate in the lead-up to an election, boosting the purchasing power of consumers to support re-election for the incumbent government, but in some cases creating unsustainable price levels and precipitating a currency crisis.

The initial building blocks of the political economy of currency policy are intuitive, and there is little groundbreaking in the idea that people will lobby or vote for a policy setting that benefits them most. However, each case study builds on these foundations to develop interesting insights into the interplay of currency policy and the broader global economic and political order. By using a wide range of cases, alongside robust treatment of the contextual and historical factors, the text shows how the nuances of different regions' political regimes shape the political dimensions of currency policy. The political power of urban consumers in Latin America led incumbent governments to carefully time devaluations around the electoral cycle, letting the currency appreciate to boost domestic purchasing power. In contrast, the diminished political power of workers in the early US economy where labour organisation was at a low level, and likewise under the authoritarian Chinese government, enabled both countries to maintain a low price level to boost international competitiveness.

The field of currency policy is increasingly important as the global economy becomes ever more integrated; however, it is poorly understood by the general public and often forgotten until a crisis arises. The influence of contingent political factors on the ability of governments to change their monetary policy is shown to be profound. Frieden makes his research accessible to a broader audience through *Currency Politics*; it is a challenging read in parts, but worth the effort to understand how national politics shape currency policy and the possible future of international currency regimes.

Jenny McArthur is a PhD candidate at University College London. Her research focuses on the relationship between infrastructure investment, urban growth and liveability. Jenny has a background in civil engineering and economics. Twitter @jen_m_mcarthur. Read more reviews by Jenny McArthur.

Note: This review gives the views of the author, and not the position of the LSE Review of Books blog, or of the London School of Economics.

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