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CURRENCY POLITICS IN THE DEVELOPING WORLD

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The exchange rate is often said to be the most important price in any economy, for it affects all other prices. Americans are not used to thinking in these terms, in part because the US economy is relatively closed, and in part because the dollar is the world's principal reserve currency. Nonetheless, a country's exchange rate has a powerful impact on its economic activity, and this is especially true for developing countries. Because currency policy structures a country's economic relations with the rest of the world, it can be crucial in determining a poor country's developmental prospects.

Currency politics has been in the news lately: the travails of the Eurozone, US complaints about alleged Chinese currency undervaluation, and currency crises in Latin America and elsewhere have all focused attention on the exchange rate as a tool of economic policy. For developing countries, exchange rate policy is both crucially important and daunting. It is crucially important because it affects how the national economy interacts with the rest of the world economy. It is daunting because currency policy involves a series of difficult trade-offs, which force governments to make difficult choices. This can be seen by examining the two principal goals of exchange rate policy.

Regulating the Relationship Between Foreign and Domestic Prices

A country's exchange rate determines how international prices are translated into local and domestic prices, and vice versa. A strong or appreciated currency is one whose value is high relative to foreign currencies. So if the Mexican peso or Chinese renminbi is strong (appreciated), Mexican and Chinese citizens find the rest of the world's goods more affordable. This is, of course, a good thing; it means that nationals have greater purchasing power. This effect is known in macroeconomics as the income effect, as a stronger currency raises the real income of national residents.

However, a strong national currency means that domestic goods are expensive to foreigners. If the peso or renminbi are strong, Mexican and Chinese goods cost more in dollars and other foreign currency. This harms domestic producers of goods that enter into international trade, for they will find it harder to compete with foreign producers. By the same token, a relatively weak (or depreciated) currency makes national goods relatively inexpensive to foreigners, and foreign goods more costly at home. This helps domestic producers by giving them a competitive edge against foreign products. This effect is known as the substitution effect, as a weaker currency leads foreign and domestic consumers to substitute away from foreign goods and toward domestic goods.

The tradeoff here, then, is between competitiveness and purchasing power. A weak currency makes domestic manufacturers and farmers more competitive in both foreign and domestic markets. But it makes domestic consumers poorer, less able to buy goods. There is no way for a government to avoid this difficult choice: strengthening the currency helps consumers but hurts producers, and vice versa.

Most analysts of development think that, other things equal, keeping a poor country's currency relatively weak is a good idea. It protects domestic producers from foreign competition, and stimulates them to produce for and sell to world markets. In today's environment, most poor countries need to encourage domestic production of goods that can be sold abroad. Access to the world's markets has in fact been crucial to such earlier developmental successes as South Korea and Taiwan, and to such contemporary successes as China. In all these cases, the push to produce for export was crucially assisted by government policies that kept the national currency weak. Certainly this favors exporters at the expense of domestic consumers, but it seems to have generally positive effects on the prospects for economic development.

However, there is another problem with a relatively weak currency, apart from the fact that it makes national consumers poorer: it can create tension with a country's trading partners. A government that purposely keeps its currency weak is often seen as gaining an unfair competitive advantage against others, and its partners criticize its exchange rate for being purposely undervalued. This has been the crux of the difficult currency relationship between the United States and China. For over 15 years, many US manufacturers have complained that the renminbi is kept artificially weak by the Chinese government, giving Chinese manufacturers an artificial advantage in the US and other markets. The United States has threatened to declare China a 'currency manipulator,' which under US law could allow the United States to impose retaliatory trade sanctions.

Nonetheless, this last problem is primarily relevant for large countries—those large enough, that is, to attract the concern of producers in North America and Europe. Countries like Cambodia or Costa Rica are unlikely to draw much American or European attention if their currencies are substantially undervalued. And that is probably as it should be, for their currency policies have little impact on anything other than their own economies. But it may well be appropriate for large developing countries—China, India, Brazil—to be called to task for exchange rate policies that have a broader impact. Unlike Costa Rica, China's policies can have an impact on the rest of the world economy, and so China has to take that impact into account.

In any case, developing country governments face a major choice when it comes to the level of their exchange rate—and whatever choice they make will have both positive and negative consequences. A weak currency helps domestic producers compete with foreigners, but it impoverishes domestic consumers, and it may enrage foreign competitors. A strong currency makes domestic consumers better off, but puts major competitive pressure on domestic producers. What a government decides to do depends largely on how it weighs the relative importance of these contending interests.

Stabilizing International and Domestic Monetary Conditions

In addition to the strength or weakness of the currency, governments make decisions about how much they are willing to let their exchange rate move around. Many developing countries have found that allowing the value of their currencies to fluctuate tends to dampen incentives to engage in international trade and investment. Volatile exchange rates can make it hard for firms to plan, and can limit the extent to which a country's producers can take advantage of international economic opportunities.

For this reason, some developing country governments have chosen to strictly limit how much they will allow their currencies' values to fluctuate. At one extreme, governments can peg their currencies to that of another country, usually the US dollar or the euro. Some even give up their national currencies and adopt another, such as Ecuador and El Salvador have done by adopting the dollar. And among developed countries, of course, many of the members of the European Union have chosen to give up their national monies and create a common currency, the euro. There is in fact substantial evidence that stabilizing the currency encourages trade, investment, finance, travel, and other economic activities that can be important contributions to economic development.

Another important reason to keep the currency stable is that governments and companies of developing countries typically borrow heavily internationally, usually in dollars, euro, or other foreign currencies. Developing countries are chronically short of capital—they have massive investment needs that they cannot finance with their own resources and borrowing abroad is an important potential contribution to development, so long as the money is used well. But a change in the exchange rate, in particular, a devaluation, would increase the real burden of the foreign debt. If, say, the peso was ten to the dollar, a government or private company that borrowed a billion dollars would have a debt of ten billion pesos. If, as is not uncommon, the currency was devalued by 50 percent, so that it was now 15 to the dollar, the debt would now be 15 billion pesos. In fact, this sort of process—a devaluation of the currency that increases the local-currency equivalent of the foreign debt—has been responsible for many of the most debilitating crises in the history of developing countries. So a stable currency can be important for a country to be able to borrow internationally without getting into serious trouble with its foreign debts.

Yet another valuable effect of a fixed, or at least stable, exchange rate is that it helps to promote domestic monetary stability—that is, low inflation. Many developing countries have long histories of very high inflation, and even hyperinflation with prices increasing by thousands of percent a year. High inflation and hyperinflation can disrupt normal economic activity and retard economic growth, especially by creating great uncertainty about the future. When a currency is fixed to a low-inflation anchor—for example, when a Latin American currency is fixed to the dollar—it effectively 'imports' low inflation. Domestic goods prices are held down because any increase would lead to imports from the rest of the world. Over the past 30 years, dozens of countries around the world have used this strategy of fixing the exchange rate to successfully reduce disabling rates of inflation.

Despite all these attractive features of a stable currency, there are significant costs. The most important is that stabilizing the exchange rate means giving up one of the most powerful tools of macroeconomic policy. In today's world, in which money can flow more or less freely around the world, fixing the exchange rate against, say, the dollar means that a country has given up national monetary policy.

The Mundell-Fleming conditions—sometimes also called the trilemma—explain why, given an open economy, a government that fixes the currency against an anchor currency is also giving up its monetary policy independence. To understand this, imagine that Mexico fixes the peso against the dollar. If interest rates in the United States are three percent, then they have to be three percent in Mexico. If interest rates in Mexico were lower, money would flood out of Mexico to get the higher interest rate in the United States; if interest rates in Mexico were higher, money would flood into Mexico. Either way, the Mexican interest rate would be driven back to the US rate. This means that whatever interest rate is set by the US central bank, the Federal Reserve, will have to be the policy rate for Mexico as well. This may seem unimportant, but as the world has found in the aftermath of the global financial crisis that began in 2008, monetary policy is a powerful tool to combat recession and depression. For example, if the US economy is booming while the Mexican economy is in recession, a fixed peso would mean that the Mexican government would lose the ability to combat the recession with more stimulative monetary policy.

Again, there is a serious trade-off here. A government can choose to stabilize its currency in order to promote the country's international economic ties, reduce the costs of trade, facilitate foreign borrowing and investment, and restrain inflation—all things likely to stimulate economic growth. But if it does this, the country gives up the ability to adopt policies to soften the blows of macroeconomic disturbances, as it loses its monetary policy independence. Both are things of value; the government has to choose between them.

Exchange rate policy is inherently political. A currency's value and degree of stability are set, or at least strongly influenced, by the government. And the government faces serious choices, involving real trade-offs, in trying to decide what policy to adopt. Different choices have different effects on groups in society, on the state of the local economy, and on the relationship between the national economy and the rest of the international economy.

In fact, a government's currency policy can give us important insights into the political economy of the country more generally. This is true both of its general orientation toward economic policy, and the social groups to which it pays the most attention. A government that aims to encourage the country's participation in the world economy—one that has, so to speak, embraced globalization—is more likely to focus on keeping the currency stable to facilitate cross-border trade, investment, and finance. If the government is particularly interested in promoting exports as a path to economic growth, it is likely to try to keep its exchange rate weak. On the other hand, a government that is more concerned about the state of the domestic economy may allow the currency to fluctuate more widely, and might be less interested in an artificially weak currency. The government's attitude toward the exchange rate can tell us a lot about their more general views on the world economy, and on their own domestic political economy.

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To some extent, these choices are dictated by size and geography. A very small country near a large one—say, the Bahamas—depends almost completely on its economic ties with its neighbor, and has little hope of pursuing a fully autonomous monetary policy. So in general, small open economies are quite likely to fix their exchange rates to those of their large neighbors. Most small countries in and around the Caribbean fix their currencies to the US dollar; the smaller European countries have been eager to adopt the euro. On the other hand, larger countries have both a greater ability to pursue independent policies, and a less immediate concern about their neighbors. So large countries, such as India and Brazil, have tended to allow their exchange rates to vary in line with the perceived needs of their domestic economies. Sometimes longstanding colonial and post-colonial ties play a role. Many of the former French colonies in central and western Africa maintained a currency peg to the French franc, and now peg their currencies to the euro.

Exchange rate policy also responds to domestic politics, for different policies benefit different groups in society. A government that tries to keep its exchange rate especially weak is, as noted, helping producers at the expense of consumers. East Asian countries—first Japan, then South Korea and Taiwan, now China and other countries in the region—have typically pursued this policy. On the other hand, Latin American countries have much more often had relatively strong exchange rates, which helps consumers at the expense of export producers. This makes sense on two dimensions. First, East Asian countries have typically adopted development strategies that rely on promoting manufactured exports as an engine of growth, while Latin American countries have tended to be more inward-looking, with their manufacturing industries more oriented to the domestic market. Second, East Asian countries have quite often been authoritarian, while Latin American countries are more commonly democratic, and it stands to reason that democracies are likely to be more responsive to consumers than authoritarian regimes. Some combination of these factors, along with others, probably helps explain why the two regions' currency policies have differed so much.

Exchange rate policy may seem like a technical, arcane subject. But in much of the developing world, it is a topic of active debate. The kind of exchange rate policy a government adopts will have a major impact on how the country's economy interacts with the world economy. It will also affect the structure of the domestic economy, and the relative fortunes of important groups in society. Given the centrality of this policy, and the powerful impact it can have on socioeconomic groups, it is not surprising that currency policy has been politically controversial. As more developing countries are drawn into the world economy and have to make difficult decisions about their exchange rates, currency politics is certain to be an important source of controversy. HIR