## Chapter 1 : EconPapers: Exchange Rate Policy and Interdependence

*Exchange Rate Policy and Interdependence: Perspectives from the Pacific Basin 1st Edition. by Reuven Glick (Editor), Michael Hutchison (Editor) Be the first to review.*

Rogers Pennsylvania State University, University Park Preface The implications of different exchange rate policy arrangements have long been a central issue in international economic analysis. Because of the diversity of historical backgrounds, stages of economic development, and financial market environments among countries in the Pacific Basin, this region provides an ideal laboratory for a comparative study of exchange rate arrangements and their implications for monetary policy. Moreover, the Pacific Basin has become widely recognized as the most dynamic region in the world economy. Much attention has focused on issues related to international trade with Pacific Basin countries. Only recently have exchange rate and financial policy issues come to the forefront, as countries in the region have become more integrated with one another and with the rest of the world through international capital as well as trade movement. The conference brought together academics, central bankers, and other policymakers and researchers to review and compare the experiences of Pacific Basin countries. The essays in this volume provide a comprehensive analysis of the theoretical issues associated with exchange rate policies as well as the individual experiences of Pacific Basin countries. Since the program has promoted cooperation among central banks in the Pacific Basin and sponsored research on major monetary and economic policy issues in the region. The Center for Pacific Basin Monetary and Economic Studies was established by the Bank in to open the program to greater participation by visiting scholars. This book is the joint product of many people. Besides the authors of the chapters, special thanks are due to Ramon Moreno, who provided detailed comments on earlier drafts of several papers, and Mary Racine, for her work as production and copy editor. Finally, any opinions expressed in this volume are those of the respective authors and do not necessarily reflect the views of the organizations with which they are associated. Hutchison Since the collapse of the Bretton Woods system of fixed exchange rate parities in the early s, countries have been largely on their own in making choices about their exchange rate arrangements. Most countries have moved away from pegging to a single currency toward either pegging to a basket of currencies or adopting a more flexible arrangement under which the domestic currency is frequently adjusted. In large part this movement was prompted by a desire to liberalize financial markets, maintain some national autonomy over macroeconomic policy, and at the same time avoid the need for a system of widespread international capital controls. This is especially true among Pacific Basin countries, which in the past fifteen years have undertaken substantialfinancialreform, removing barriers to domestic and international capital flows. Under these circumstances, national economies have become increasingly influenced by foreign developments. Greater international interdependence has complicated the conduct of domestic monetary policy and led to greater exchange rate flexibility as individual countries have sought to insulate themselves from foreign disturbances. Because of the diversity of historical backgrounds, stages of economic development, andfinancialenvironments, the Pacific Basin region offers a wide variety of approaches to exchange rate policy. Some countries still peg their currency to a single foreign currency, while some peg to a basket of currencies. Other countries allow varying degrees of flexibility in their exchange rates. The Pacific Basin region thus provides a useful set of country experiences for a comparative study of exchange rate arrangements and their implications for the conduct of monetary policy. Why countries have adopted different exchange rate policies and how these different policy approaches have affected their national econ- 2 Reuven Glick and Michael M. Hutchison omies are questions of substantial interest to policymakers and researchers alike. The essays in this volume examine the conduct of exchange rate and monetary policy among Pacific Basin countries. They address four broad issues, with some essays focusing on the national experience of specific countries in the Pacific Basin and others adopting a cross-country comparison approach. First, how closely linked are financial markets in the Pacific Basin? The extent to which individual countries are linked to foreign economies and are able to insulate themselves from foreign disturbances is dependent upon the degree of international capital mobility. Three essays in the volume quantify the degree of capital mobility and asset market linkages among Pacific Basin countries. Chinn and Frankel focus on the interest rate linkages of financial assets and the relative importance of the U. Engel and Rogers examine the linkages in equity markets and the persistence of stock return differentials in the region. Dooley and Mathieson develop an alternative measure of capital mobility that does not depend on observed domestic interest rates. Second, what are the implications of choosing different exchange rate regimes? The optimal choice of exchange rate arrangements depends on a variety of factors. What is the experience of Pacific Basin countries? How have exchange rate policies influenced the dependence of these economies on developments abroad? Five essays in the volume look at these issues. Turnovsky provides an analytical overview of exchange rate theory and its policy implications from several theoretical perspectives. Moreno examines the link between exchange rate regimes and domestic insulation from external shocks for Korea and Taiwan. Pitchford considers the importance of the exchange rate regime for the transmission of trade price shocks in the case of Australia. Grimes and Wong consider the New Zealand experience and discuss how the exchange rate is used to guide monetary policymakers in achieving their ultimate objective of price stability. Popper and Lowell look at the experience of Australia, New Zealand, Canada, and the United States and infer the extent of concern by monetary authorities about the exchange rate by measuring the influence of foreign developments on domestic prices. Third, to what extent have countries been able to sterilize the effects of their exchange rate intervention policy on their monetary policy? Virtually all central banks in the Pacific Basin region have active inter- Overview 3 vention policies, in some cases designed to peg currency values and in others simply to moderate currency movements. How actively have central banks intervened in foreign exchange markets? What have been their objectives? What are the ultimate effects on the conduct of monetary policy? Three essays examine these issues. Watanabe analyzes how intervention operations by the Bank of Japan have acted as a signal about the future stance of monetary policy. Kwack examines the extent to which Korea was able to sterilize the effects on its money supply of large current account surpluses in the late s. Fourth, what are the prospects for a yen bloc? Two essays evaluate the prospects for a yen currency bloc among Pacific Basin countries. Ito discusses different interpretations of a yen bloc and examines the present overall international use of the yen, as well as the financial and trade relations of Japan with neighboring countries in the Pacific Basin. Melvin, Ormiston, and Peiers evaluate the portfolio demand for international currencies and assess the desirability of forming a yen currency area from the point of view of investors. Using this organizational framework, we turn to a discussion of the individual essays. Hong Kong and Singapore were the first to begin liberalizing their financial systems by removing or relaxing interest rate regulations and abolishing exchange rate controls in the mids. Significant financial reforms have been undertaken in Japan and Malaysia since the late s and in the Philippines, Australia, New Zealand, and Indonesia since the early s. More recent movements toward liberalization have occurred in Thailand, Korea, and Taiwan. Although the timing and the extent of liberalization steps have varied across countries, virtually all countries in the region have allowed domestic and foreign market forces to play a greater role in their financial markets. To what extent has this liberalization process increased the integration of financial markets and the international mobility of capital within the Pacific Basin? They find that though interest rate linkages with the United States have become stronger over the period , the region is still far from achieving complete financial integration, particularly in the lesser developed countries. For countries with well-developed forward markets, they attribute most of the remaining barriers to integration to currency factors. As local equity markets have grown in the region, the opportunities for international investors seeking higher return or diversification have expanded. Engel and Rogers in Chapter 3 explore the extent to which equity markets in the Pacific Basin have equalized real returns on investment opportunities using data on stock market indexes over the period  Consistent with the Chinn and Frankel work on interest rates, Engel and Rogers find substantial differences in real return prospects for equity investors across countries. They also ask whether real returns differ among countries because ex ante nominal rates of returns are different or because ex ante purchasing power parity fails to hold. They find that the real return differences are largely accounted for by nominal return differentials. Moreover, there does not appear to be any relation between the type of exchange rate arrangement and the relative magnitudes of nominal return differentials and purchasing power parity deviations. The authors suggest that the observation of real return differentials might be attributable to differences in the relative riskiness of equity investments. In light of prevailing implicit or explicit regulatory controls, Dooley and Mathieson Chapter 4 question the usefulness of observed domestic interest rates in measuring the degree of capital mobility and extent of international financial market linkages. They construct an alternative measure of capital mobility, not based on observed domestic interest rates, but derived instead from the response of money demand to private Overview 5 capital flows. This measure gives results that are sometimes counter to the conventional wisdom about which countries are more integrated with world capital markets. Dooley and Mathieson also discuss the implications of increased capital mobility for the choice of exchange rate arrangements and the conduct of monetary policy. They maintain that the choice of exchange rate arrangements is best viewed as a response by policymakers to their loss of control over growing private sector international arbitrage activity. To the extent that a country desires to maintain control over domestic monetary conditions, it must choose between permitting greater exchange rate flexibility and imposing increasingly restrictive controls on international capital flows. Moreover, changes in the degree of capital mobility have affected various monetary policy instruments. Which exchange rate regime best insulates an economy from foreign shocks? What form of exchange rate arrangement helps provide discipline to policymakers and perhaps lends credibility to announced policies? Some of the basic economic theory on these issues is addressed in Chapter 5 by Turnovsky. Surveying the theoretical literature on exchange rate management and implications for monetary policy, he classifies these models into four categories: Choosing to target the money growth rate implies a particular long-run domestic rate of inflation and, given the rate of inflation abroad, a corresponding long-run rate of exchange rate depreciation. If instead the monetary authorities choose to target a particular level or path for the exchange rate, this implies a corresponding money growth rate, and hence a loss of control over monetary policy. What are the advantages of choosing to peg the exchange rate as opposed to allowing the exchange rate to float? One of the strongest arguments for pegged exchange rates is that they enforce discipline on 6 Reuven Glick and Michael M. Hutchison domestic macroeconomic policies, which in turn may help to stabilize inflation expectations. Linking to a stable foreign currency limits the rate of domestic inflation, which in turn constrains monetary and fiscal policy. By "credibly" committing themselves to a fixed exchange rate arrangement, policymakers may hope to import some of the credibility for stable monetary control presumably associated with foreign policies. The disciplining effects of a currency peg may be small or absent in an already well-managed economy. In other cases, political pressures may make tighter monetary and fiscal policies infeasible and limit the ability of the government to commit credibly to a pegged exchange rate. With open capital markets, a more flexible exchange rate is often the only practical policy option, since attempts at fixing the exchange rate would inevitably invite speculative attacks on the rate. Thus, fixed exchange rates are consistent with a high degree of capital mobility only if domestic monetary policy objectives are sacrificed, a difficult political choice for many policymakers. The implications of new classical models are particularly rich for exchange rate policy. Whether economic disturbances are predominantly domestic or foreign, nominal or real, temporary or permanent, all influence the choice of exchange rate regime. A flexible exchange rate regime, for example, generally works better to insulate the domestic economy from foreign inflation than do fixed exchange rates by permitting the value of domestic currency to appreciate so as to limit the effect on domestic prices. Structural characteristics of the economy, such as the degree of international capital mobility and wage rate flexibility, also affect the insulating properties of the exchange rate regime. The less the degree of wage flexibility, for example, the greater the effect of a change in the nominal exchange rate on the real wage and thus on output, and hence the greater the desirability of exchange rate flexibility. An important result of the theoretical literature is that because of the diverse nature of shocks facing an economy, neither purely flexible nor perfectly fixed exchange rates are generally "optimal. The optimal degree to which exchange rates should be "managed" or "flexibly fixed" varies with changes in the nature of disturbances, economic structure, or political objectives. However, the practical problems involved in discerning the source of shocks and identifying the relevant structural characteristics make it difficult for policymakers to apply theoretical criteria for adjusting the exchange rate.

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## Chapter 2 : Exchange rate misalignments, interdependence, crises, and currency wars: an empirical asses

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International Finance Table of contents List of contributors; Preface; 1. Overview Reuven Glick and Michael M. International Financial Market Integration: Financial links around the Pacific Rim: Chinn and Jeffrey A. Exchange rate policy, international capital mobility and monetary policy instruments Michael P. Dooley and Donald J. Choice of Exchange Rate Regimes: Exchange rate policy and insulation from external shocks: Trade price shocks and insulation: Officially floating, implicitly targeted exchange rates: Intervention and Sterilization Policies: The signaling effect of foreign exchange intervention: Sterilization of the monetary effects of current account surpluses and its consequences: Korea, Sung Y. Prospects for a Yen Bloc: On the possibility of a yen bloc Takatoshi Ito;  Future research on exchange rate arrangements in the Pacific Basin should start by consulting this work. The contributors are effective researchers who employ sophisticated techniques. Students of international finance will find the essays provocative and potentially helpful in identifying research projects. Economists specializing in this area will admire the attention to detail, the emphasis on policy considerations, and the focus on a set of often-neglected countries.

# DOWNLOAD PDF EXCHANGE RATE POLICY AND INTERDEPENDENCE

## Chapter 3 : Exchange Rate Policy and Interdependence



Additional Information In lieu of an abstract, here is a brief excerpt of the content: Freed from the balance-of-payments read balance-of-trade equilibrium constraint, monetary policy could have been directed to the achievement of domestic objectives, most notably the desired degree of internal price stability, independent of that of the rest of the world. Greater autonomy in national monetary policies and less interdependence in inflation and perhaps output rates were expected to be the main benefits of more flexible exchange rates. Moving away from fixed exchange rates would not only have reduced the "common currency standard" characteristics of the Bretton Woods system and the strong economic interdependence implicit in it, but would also have lessened the policy conflicts arising from the perceived asymmetry in the sharing of adjustment burdens between balance of payments deficit-prone and surplus-prone countries. It would have, in addition, reduced the "exorbitant privilege" retained by the reserve issuing country the United States , whose degree of monetary autonomy was unparalleled within the system. It was also thought that the preservation of the liberal trade system developed in the post-World War II era would be made easier with a more automatic balance-of-trade adjustment mechanism in place. The opinions here expressed are those of the author and should not be attributed to the organizations with which he is currently affiliated. In fact, the degree of monetary interdependence, as exemplified by the increased correlation of price and interest-rate changes across countries, was greater in the s than in the s and has become even stronger in the s. Monetary authorities have faced different types of internal economic conflicts when they attempted to use monetary policy to attain domestic targets. When they tried to direct monetary policy against inflation , currencies tended to appreciate strongly, placing a large part of the burden of strong anti-inflation policies on those sectors of their economies most exposed to international competition. Given the divergence in the economic targets being pursued at times by the various members of the international monetary system and, more recently, the differences in their fiscal-monetary mixes, serious external policy conflicts also arose. Developing countries, for example, saw in the global deflationary bias of the anti-inflationary policies pursued by the major industrial countries in the main cause for the emergence of the debt crisis in  They contended that a collapse of world demand for their exports, coupled with high rates of interest, transformed a manageable medium-term problem into a near unmanageable short-term crisis, which required on their side unnecessarily high internal adjustment costs. Serious policy conflicts also arose between industrial countries. European governments saw the main cause for their monetary impotence in the monetary-fiscal mix pursued by the United States in the period. In their view, ever higher dollar values, the result of restrictive monetary and expansionary fiscal policies in the United States, prevented them from relaxing their monetary stance in the face of domestic economic stagnation and rising unemployment. The rest of the industrial world felt in those years that its policy options were constrained by the effects of policy initiatives of the largest member of the international monetary system, and the one whose currency continued to play in it a key role, not only as a generalized vehicle for real transactions, but also as an international asset. No exchange-rate system can You are not currently authenticated. View freely available titles:

## Chapter 4 : Exchange Rate Policy and Interdependence: Perspectives from the Pacific Basin - PDF Free D

*Why countries choose different exchange rate arrangements and how these arrangements affect domestic monetary policy control and macroeconomic stability are questions of substantial interest to policy makers and researchers alike. The countries of the Pacific Basin region offer a wide variety of.*

Abstract Why countries choose different exchange rate arrangements and how these arrangements affect domestic monetary policy control and macroeconomic stability are questions of substantial interest to policy makers and researchers alike. The countries of the Pacific Basin region offer a wide variety of examples for the comparative study of the implications of different exchange rate arrangements. The essays in this volume examine the degree of financial interdependence and the conduct of exchange rate and monetary policy among Pacific Basin countries. The essays address four broad issues: Some of the essays focus on the national experience of specific countries in the Pacific Basin; others adopt a cross-country comparison approach. 

## Chapter 5 : Project MUSE - International Monetary Policies, Interdependence, and Debt

*B.O.O.K Exchange Rate Policy and Interdependence Ebook Z. Aftab, AurangzebThe long-run and short-run impact of exchange rate devaluation on Pakistan's trade performance America shipped US$ trillion worth of goods around the globe in , down by -2% since but up by % from to*

Two different econometric approaches are used to achieve these goals. The study uses the algorithm suggested by Hendry and Krolzig The second strategy involves estimating long panel data with the real effective exchange rate and fundamentals for a group of countries and explicitly testing the interdependence hypothesis. The results suggest that the long-run exchange rate is mainly driven by its own fundamentals for most countries. The existence of interdependence is restricted to short-run dynamics. Large fluctuations of the exchange rate exacerbate debates regarding whether such movements are "excessive," reflect "fundamentals," or are "rational. Empirical strategies can be formulated based on models that use the doctrine of Purchasing Power Parity or an analysis based on fundamentals. From these models, I construct the estimates of exchange rate misalignment for each country and test whether there is interdependence between various currency misalignments. The remainder of this paper is organized in the following manner. In the second section, I discuss the importance of exchange misalignment. In the third section, I conduct a non-exhaustive review of existing literature. In the fourth section, I discuss the econometric methodology employed in greater detail. In the fifth section, I present the results and compare them with those of similar studies in existing literature. In the last section, I present some conclusions. Among other measures, the US authorities adopted an aggressive monetary policy with a strong reduction in nominal interest rates and monetary expansion. According to analysts, such measures generated strong pressure for US dollar depreciation against currencies of countries whose governments did not follow a similar monetary policy of lowering their domestic interest rates. If a country chooses not to follow such a reduction and opts to keep interest rates unchanged and accumulate reserves to prevent appreciation of its currency, it will eventually have to face inflation pressures. Some authors argue that the Federal Bank, after the sub-prime crisis, has been trying to use monetary policy to generate a depreciation of the dollar rate to create an aggregate demand stimulus to speed up economic recovery. This policy has generated worldwide repercussions, and the possible disadvantages of such effects are a subject of debate. One of the channels through which the monetary policy operates is real exchange rate depreciation. If the effect on other countries is deleterious, these countries could attempt to use available instruments to avoid the appreciation of their local currencies. This might configure a policy known in the literature as "beggar thy neighbor". For a small country, the strategy of attempting to retaliate is perhaps not the best as it is very difficult to cause significant damage to a leader country, thereby rendering such a policy ineffective. The main mechanism by which monetary policy would function is via devaluation of the exchange rate; however, for a small country, it would be difficult to counteract the effects of exchange rate appreciation by changing its own monetary policy. Turnovsky and Basar is an example of a study in which this strategic interaction is formally analyzed. An expansionary monetary policy operates via the mechanism of excessive depreciation of currency. The degree and persistence of exchange rate misalignment is the mechanism by which net exports react in the short term and generate an increase in aggregate demand and smooth output fluctuations around its potential level. Some empirical questions can be formulated in this regard: Reference to this theory can be found in classical economics. Recently, some studies have collected evidence in favor of the validity of PPP for tradable goods, although the adjustment toward equilibrium can be very slow Froot and K. Ahmad and Craighead analyzed monthly consumer price indexes for a secular American and British data set. The study showed strong evidence in favor of mean reversion, but with a high half-life. The economics of exchange rate misalignment There is a theoretical discussion on the variables that drive the exchange rate in the long run. Two old but very important references are Edwards and Dornbusch The first analyzes economic misalignment, its causes, and consequences. The second is the classical model of flexible exchange rates. They analyze how monetary policy shocks can cause deviations from long-term PPP and the phenomena of under and over shooting. Bilson and Mussa are also related classical studies. They are in keeping with the monetary approach to exchange rate. According to this approach, the exchange rate is linked primarily to the relative evolution of output and money supply among countries on the assumption that PPP and uncovered interest parity hold continuously and countries have stable money demand functions. However, Meese and Rogoff casts doubt on the explanatory power of this theory. The study showed that exchange rate forecasts that are constructed using this approach are not superior to a naive model such as a pure random walk with drift. According to the study, the equilibrium exchange rate level is determined at the point at which investment and savings generated by economic fundamentals are equal. A classical reference to exchange rate misalignment is made by Williamson He defines equilibrium exchange rate as the level at which the country is able to maintain a certain desired level of deficit or surplus seen as sustainable in its external accounts. This is called the fundamental approach of the real exchange rate FRER. Cline is another reference in this regard. One source of criticism comes from the fact that there is a high degree of arbitrariness in choosing the desirable level of external accounts. Another source of criticism comes from the focus of the approach on flows and not on stocks. Faruqee seeks to incorporate issues related to the evolution of stocks and builds a model in which there is an interaction between flows and stocks. Therefore, he shows that there must be a stable relationship between real exchange and the net foreign investment position between residents and non-residents. This is called the behavioral approach of the real exchange rate BRER. The model was extended by Alberola and Cervero Further, Kubota developed a model with intertemporal consumption choice and capital accumulation. The model suggests that the real exchange rate is a function of relative terms of trade, net external position, and relative productivity of tradable and nontradable sectors. This is the approach used in the current study. The advantage of this approach is the low degree of subjectivity in the exchange rate misalignment estimate. The model connects the level of real exchange rate to a group of fundamentals obtained from a theoretical model. This approach is empirically implemented using an econometric model to decompose the series of real exchange rates into permanent and transitory components. In order to this, two testing strategies are used. The general model is given by the following equation: Shocks are assumed to be uncorrelated in time and cross-sectional dimensions. In the general case, all the variables could cointegrate with each other, 4 but Larsson and Lyhagen , for example, restrict their analysis to the case in which there can be cointegration only between variables of the same country. It is precisely this possibility that makes this structure attractive for analyzing the problem considered in this work. For example, it is possible to test if the cointegration vector, which represents the fundamentals of a country e. This hypothesis could be tested under the null hypothesis that certain elements of matrix A are zero. Larsson and Lyhagen showed that after the rank of a long-run matrix is determined, the test can be implemented using a likelihood ratio test with an asymptotic chi-squared distribution. The authors also derived a test to determine the rank of cointegration; this test has no standard asymptotic distribution, and this distribution was tabulated. Among other interesting hypotheses, it is also possible to test jointly, for example, whether the net external investment position is one of the fundamentals for all analyzed countries. One limitation of this structure is the untested assumption that B is a diagonal matrix. Except for cases in which the temporal dimension of the database is sufficiently large, it is difficult to assess the validity of this hypothesis due to the curse of dimensionality. In order to circumvent this problem, we chose two different strategies. We estimated models with small sizes in relation to time and crosssectional dimensions. We decided to estimate models for all combinations of countries taken as pairs for a sample with data from to , and a model of higher dimension with five developed countries and Brazil using a larger sample beginning in The estimation of the model is done by using the algorithm of generalized reduced rank regression GRRR developed by Hansen All restrictions imposed on the general model can be tested using a likelihood ratio test with an asymptotic chi-squared distribution. The likelihood ratio procedure used in the study suffers from a serious size distortion. This encourages analysts to use a bootstrap technique to obtain appropriate critical values. Studies that discuss similar problems are Johansen , Johansen et alii , Gredenhoff and Jacobson , and Swensen We chose to perform a bootstrap to simulate the appropriate distribution for the test statistic. The results suggest that the size distortion is actually severe. Strategy 2 The second strategy for testing the existence of interdependence involves estimating multivariate models. First, a country-by-country analysis is done to obtain the long-term relationships that will be used as input for the construction of the exchange rate misalignment estimate. Then, the error correction mechanisms obtained for all countries are included in each individual country model. Thereafter, their relevance is tested using the algorithm suggested by Santos and Hendry and Hendry and Krolzig This procedure was implemented using software Oxmetrics. If the final selected model contains only the series of the individual country, it can be concluded that there is no evidence for the interdependence hypothesis, whereas in the event that the final country model contains variables related to other countries, it can be concluded that there is some degree of interdependence. The data generating process for a specific country is assumed to be a multivariate VECM model given by: Shocks are assumed to be uncorrelated in time. In general, the decomposition has the following form: However, this condition is not always satisfied. Johansen proposes that. This decomposition exists in the system since there are variables whose order of integration is at most 1. Kasa proposes that. Another possibility is to generate forecasts from the VECM estimated for each point. The values for which the series converge are the fundamentals. In this study, I use the decomposition given by Gonzalo and Granger See, for example, Alberola and Cervero Their decomposition can be easily adapted if the data generating process is given by 1.

## Chapter 6 : Exchange Rate Policy and Interdependence : Reuven Glick :

*Introduction I Exchange rates are a key macroeconomic variable I Policymakers, businesses, traders and academics all pay attention I Understandable since it a ects a number of macro variables.*

Interest groups across a wide range of industries in the US voiced concern regarding the competitive disadvantages they face as a result of a strong dollar. Many of these organizations argue that currency misalignments make it difficult, if not impossible, for US firms to effectively compete in domestic and foreign markets. And policymakers do not ignore these concerns. Members of Congress have begun introducing currency realignment legislation, and often manage to garner substantial levels of support. Many other legislators, however, have opposed the bills. In fact, even legislators who represent industries that we would expect to benefit from a weaker dollar â€" most notably manufacturing and agricultural interests â€" often opposed the legislation. What generated this opposition to currency legislation if dollar overvaluation harms these sectors? I show that political alignments on exchange rate legislation are shaped by the extensive and multidimensional interdependence between the US and its key economic partners, especially China. Many industries and legislators are concerned that an aggressive stance on the currency issue could lead to a broader economic conflict. This is a particularly important consideration in the context of exchange rate legislation, which is closely tied to other areas of international economic policy, such as trade policy. Additionally, beyond the measures imposed by the US, China could very well retaliate with changes to its own trade and investment policy. This would adversely affect industries that export to, invest in, or otherwise engage with the Chinese market. As a result of the mutual dependencies between the US and Chinese economies, many industries actively lobbied against the currency legislation. In fact, even sectors that might otherwise support the ostensible goals of realignment legislation obtaining a relatively weaker dollar often opposed the currency bills. I find that legislators who received contributions from US business interests that are economically dependent on China often withheld their support for the legislation; additionally, legislators from districts that export extensively to the Chinese market were far less likely to support the bills. The ongoing controversy surrounding currency legislation in the US Congress highlights several ways in which issue linkages and bilateral economic dependence drive political behavior. Despite the heated rhetoric suggesting that the US must take a hard line against China, many policymakers in the US recognized the risks involved with such an approach. After one currency bill was considered in Congress, President Obama suggested that the legislation might lead to Chinese retaliation. These results also raise several broader considerations. First, theoretical approaches and empirical analyses must recognize that political behavior in any issue area rarely takes place in an isolated arena. In the case of currency legislation, for instance, there are clear connections to trade and investment policy. In fact, if we were to rely entirely on standard models of trade preferences or standard models of exchange rate preferences in isolation, we would not get accurate predictions of the realized political alignments on currency legislation. These same concerns apply to other areas of international economic policy, where proposed legislation frequently implicates multiple policy areas. Second, political economy research must be careful to account for the role of interdependencies within the global economic environment. Interconnectedness creates a wide range of vulnerabilities that constrain political behavior. Research that fails to acknowledge these forces will provide incomplete at best explanations for political outcomes, and this may very well lead to short-sighted or suboptimal policy guidance.

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*An exchange rate policy implies a systematic effort by the monetary authorities to influence the level or rate of change of the exchange rate. A variety of policy instruments are potentially available to influence the exchange rate, including foreign exchange intervention, domestic monetary policy, various forms of controls on international.*