Recent Exchange Market Intervention

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

Follow this and additional works at: http://repository.cmu.edu/tepper
Part of the Economic Policy Commons, and the Industrial Organization Commons
It is a pleasure to appear again before this committee. Although the issues today appear to be narrow and technical, in my judgment, they are not. Today's hearing touches on basic issues in economics, public policy, accountability, and the use of public funds.

In the past two years, and particularly in 1989, the amount of exchange market intervention has increased substantially, and the balances held by the Treasury's Exchange Stabilization Fund and by the Federal Reserve have reached unprecedented levels. Part of the increase in the holdings of the Exchange Stabilization Fund has been financed by loans from the Federal Reserve. These loans are outside the budget process and have not been subject to review or Congressional authorization. Indeed, the business of intervention and its financing has, until today, proceeded without the benefit of Congressional authorization or oversight.

No public purpose has been achieved by recent exchange market intervention that could not be achieved otherwise. Studies of exchange market intervention by virtually all economists and analysts show that exchange market intervention has no effect on exchange rates unless accompanied by a change in monetary policy. This finding, replicated many times, has led analysts to distinguish between sterilized and unsterilized intervention. Sterilized intervention is simply an exchange of domestic for foreign assets on the Federal Reserve's balance sheet. Unsterilized intervention occurs if the central bank increases or decreases bank reserves and money as a consequence of its exchange market intervention.

The practical point to the distinction between sterilized and unsterilized intervention is this: The Federal Reserve can achieve in its ordinary operations whatever can be accomplished by foreign exchange market intervention. Unsterilized intervention differs insignificantly from domestic open market operations that change reserves and money; interest rates, exchange rates and money stock will not be noticeably different if the same volume of reserves is injected or removed by operations in the foreign
exchange market or in the domestic government securities market. The
operations in the exchange market are redundant for such goals of policy as
employment, output, or inflation. Nor does sterilized intervention alter our
balance of trade or payments with foreigners.

Sterilized intervention has been the normal pattern in 1988, 1989 and
1990. Monetary policy operations have produced a generally declining rate of
increase in all relevant measures of money growth. At the same time, the
Federal Reserve and the Exchange Stabilization Fund have increased the amount
of foreign currencies they hold from $6.6 billion at the end of 1984 to $17.3
billion at the end of 1988 and to more than $44.5 billion at the end of 1989.
Chart 1 shows the recent, large increase to the end of 1989. The amount held
increased further in the first months of 1990.

(Insert Chart 1 here)

Despite the relatively large increase in foreign exchange holdings in
1989, the weighted average exchange value of the dollar changed very little
over the year as a whole. In contrast, with much smaller accumulation of
foreign currencies, the dollar was devalued by almost 20% against a basket of
foreign currencies in 1986. The Federal Reserve and the Exchange
Stabilization Fund added $4.5 billion to their holdings in 1986, and $27.2
billion in 1989.

Why did the smaller net purchases in 1986 have a much larger effect on
the average value of the dollar? Part of the answer lies in other actions by
the Federal Reserve. In 1989 the Federal Reserve sterilized foreign exchange
purchases by selling more than $12 billion of government securities in the
open market. As a result of these and other offsetting actions, total bank
reserves declined by $0.5 billion in 1989 and the monetary base, bank reserves
and currency, rose by $17 billion. Foreign exchange operations in 1986 were,
on balance unsterilized. The Federal Reserve made net purchases of $30 billion
in the domestic securities market and increased total bank reserves and the
monetary base by $11 billion and $24 billion respectively.

The difference in the two periods illustrates three main points. First,
 intervention in the foreign exchange market achieves nothing that cannot be
achieved by domestic monetary operations. The monetary expansion that
contributed to the devaluation of the dollar in 1986 was achieved principally
by domestic operations. Second, the principal way in which foreign exchange
operations and domestic monetary operations change the value of the dollar is
TOTAL FOREIGN CURRENCY HELD BY THE US

CHART 1

(billions)

by changing the anticipated inflation rate. If market participants believe that U.S. monetary policy has become more inflationary relative to inflation in major countries, the dollar falls; if they believe that monetary policy has become less inflationary the dollar rises. Third, there is no close or reliable relationship between the size or frequency of foreign exchange operations and changes in the value of the dollar. The relatively large net foreign exchange purchases of 1989 had little effect on the dollar's external value; the much smaller net foreign exchange purchases of 1986 (or 1985) were accompanied by substantial dollar devaluation.

The Committee's letter of invitation asks a series of questions about the effect of currency intervention on employment, growth, the balance of trade and payments, inflation, and the standard of living of U.S. households. I have noted that inflation and the value of the currency are closely linked. It is not by chance that we find that high inflation and rapidly depreciating currency values occur together. Experience in Argentina, Brazil, Peru, Mexico and Bolivia give evidence of this well established relation. Nor is it by chance that we observe that countries with relatively low inflation such as Germany, Japan and Switzerland have had strong currencies, on average, during the postwar period as a whole and during the years since 1973 when exchange rates of principal currencies have fluctuated in value. What is true of these extremes is true of intermediate rates of inflation as well. The higher the rate of domestic inflation, compared to inflation abroad, the more rapidly the value of the currency declines. Unsterilized intervention can be used to change the actual and anticipated rates of inflation and the exchange value of the dollar, but most often inflation and devaluation are caused by domestic monetary expansion.

The Committee's letter asks whether intervention has raised or lowered the rate of inflation. My answer is that the excessive monetary growth of 1986, to reinforce the devaluation of the dollar begun by market forces in March 1985, is a leading cause of the higher inflation experienced in 1989 and 1990. The growth of money at first drove down the value of the dollar. With a lag, devaluation raised prices of imports and stimulated exports. With a lag, faster money growth encouraged domestic expansion also. Under the stimulus of monetary expansion and devaluation, growth of real output remained well above its trend rate of growth in 1987 and 1988. With a somewhat longer lag, monetary expansion and devaluation spilled over into a more rapid
increase in consumer prices and in unit labor costs in 1989 and early 1990.

The Federal Reserve responded to the excessive money growth, in a timely way, to avoid a return to a high inflation regime. Their actions have now brought the economy to the edge of recession and perhaps beyond.

The long-term effects of exchange rate changes on output, employment, standard of living and trade balance depend on whether the exchange rate change is monetary or real. Real exchange rate changes affect standards of living; a familiar example is the increase in the Japanese standard of living as their economy has grown and their exchange rate has appreciated. The rise in the real exchange rate permits Japanese consumers and producers to buy more real goods and services abroad. The long-term rise in Japan's real exchange rate is driven by the increased productivity and the real growth of the Japanese economy. Intervention and currency manipulation by central banks or governments can delay these changes or their effects. Exchange market intervention and earlier excessive monetary expansion were major factors depreciating the yen in the first months of this year. But if Japan's inflation is controlled and their faster productivity growth continues, sooner or later the real value of the yen will reflect the higher growth.

Treasury and Federal Reserve operations in the foreign exchange market would have no long term real effects, if inflation were always neutral. There are many reasons why inflation is not neutral in either the short- or long-term. Tax laws, such as the decision to index personal taxes but not business depreciation, permit inflation to reduce the real value of corporate assets and redistribute wealth and income away from industries and firms with relatively large capital stocks. Bondholders, mortgage holders, and other creditors lose if they fail to currently anticipate inflation; debtors gain. These are long-term, permanent effects. The short-term effects that occur are transitory; they reflect the fact that all prices and costs do not adjust instantly. Some contracts are fixed by law or by agreement and often do not correctly anticipate inflation. The alternating periods of expansion and contraction of the economy, though short-lived, are no less real. Once again, these real effects do not depend on (unsterilized) intervention. Unanticipated inflation or disinflation can be brought about by domestic operations. A well-designed monetary policy to achieve stable growth with low inflation would avoid such changes and their costs to the public.

The October 1987 stock market crash is another example of a short-term
real effect of unsterilized intervention and exchange rate policy on the
economy and the public. Under the so-called Louvre agreement, the governments
of major countries agreed to maintain an (unannounced) set of exchange
rates. The Federal Reserve, under the Humphrey-Hawkins law, announced growth
rates for principal monetary aggregates. By early fall, at the latest, it was
clear that the two targets were inconsistent; maintaining the exchange rate
target required growth rates of U.S. monetary aggregates below the announced
targets. The Federal Reserve held to the exchange rate target. This required
higher interest rates in the U.S. With interest rates rising, and money
growth low, investors and consumers revised their beliefs about the prospects
for the economy. Once again, it does not matter whether these adjustments
were brought about by domestic market or foreign exchange operations. The
effect of raising interest rates and reducing money growth does not depend on
how these changes are brought about. Once the stock market crashed, the
Federal Reserve gave up the exchange rate target, increased money growth and
lowered interest rates to prevent a crisis.

Exchange rate policy was not the sole cause of the stock market decline. I
doubt that anyone will identify all of the causes. But exchange rate policy
contributed importantly by creating conditions under which interest rates rose
and stock prices declined; these conditions could have been avoided by
permitting the exchange rate to adjust to market forces. Intervention did not
prevent the adjustment; it delayed it and increased the cost.

The 1987 experience produced a dramatic result. The main lesson should
not be lost. Attempts to control or influence exchange rates have been
costly.

The goal of relatively stable, non-inflationary growth does not require
exchange rate manipulation or foreign exchange intervention. No one knows the
level of the exchange rate that is consistent with non-inflationary growth.
Even if the rate were found, it would not remain constant. Intervention and
exchange rate manipulation can be costly, as the inflation of 1989 and the
1987 market break attest. Congress should eliminate, or severely restrict,
both intervention and efforts to control the exchange rate.

Questions 7 and 8 in the Committee's letter can be answered together.
The level of the foreign exchange rate depends on interest rates, anticipated
and actual rates of inflation, real growth of productivity and labor force,
tax rates, regulations, and tariffs at home and abroad. The exchange rate is
a price—the price of domestic money and other assets in terms of foreign money. In a free market economy, operating as our economy does, the current price is determined by the decisions of buyers and sellers acting in the market place. As I have indicated, there is not a single, unchanging correct price for our currency.

The historically high value of foreign currency holdings by the Treasury and the Federal Reserve -- $46 billion at the end of March -- will increase in value if the dollar declines and rise in value if the dollar appreciates. No one can predict reliably which of those two events is more likely. The Treasury and the Federal Reserve are in the same position as speculators who have invested heavily in foreign currencies; if the dollar appreciates, they lose. Unlike the speculator, however, the Treasury and the Federal Reserve do not bear any losses because they are speculating with the taxpayers' money. Treasury losses are an expense. Federal Reserve losses reduce profits of the Federal Reserve and their contribution to the budget.

The record of losses and gains is available from published reports of the realized and unrealized profits on foreign exchange operations. As holders of between $6 and $10 billion of foreign exchange from 1980 to early 1985, the Federal Reserve and Treasury lost money during the period of a rising dollar. The cumulative value of the loss reached about $1.5 billion, approximately 20% of the average holding. The depreciation of the dollar, beginning in 1985, first erased these losses, then produced a profit that reached $2 billion in 1987 on holdings of approximately $13 billion at the end of that year. Since 1987, reports have shown some quarters with realized and unrealized profits and others with losses. At the end of April 1990, the cumulative profit was $2.9 billion, the highest recorded. Early this year, depreciation of the yen cost the taxpayers more than $1 billion; this loss was offset by appreciation of the German mark, so it will not appear in the published record. A 6.5% appreciation of the dollar, given current holdings, would wipe out all of the recorded profit of $2.9 billion. I do not know any reason to expose taxpayers to the speculative losses (or gains) implied by the current $46 billion of foreign currency holdings. Congress should put a limit on foreign exchange holdings.

A large part of the recent buildup of foreign exchange balances at the Exchange Stabilization Fund has been financed by loans from the Federal Reserve. These loans are "off budget". They do not go through the
appropriation process. They have been made by an agreement between the Treasury and the Federal Reserve known as "warehousing". The Congress has not been asked whether it wishes to finance these operations of the Exchange Stabilization Fund, or whether it approves of the large increase in foreign exchange holdings and the risk inherent in the speculative position, or whether it wishes to permit warehousing.

In my opinion, the operations are unwise and unnecessary. I do not believe that any public purpose has been served by recent foreign exchange operations. Further, I believe it is unwise to permit the Federal Reserve to lend money to the Treasury. If the Treasury is to engage in foreign exchange market operations, expenditures for these operations should, like all other Treasury expenditures, be subject to standard Congressional appropriation procedures. Warehousing and any other direct financing of the Treasury should be barred.

Part B of the Committee's letter raises the relevant question of whether operations in the foreign exchange market should be conducted by both the Federal Reserve and the Treasury. In my opinion, it is wasteful for the Treasury to operate in the foreign exchange market while having the Federal Reserve offset the monetary effects by sterilizing the Treasury's action. And, it is wasteful for the Federal Reserve to buy or sell foreign exchange and offset the effect by selling or buying domestic securities. This merely churns the markets.

Authority for monetary policy has been delegated by Congress to the Federal Reserve. Decisions to intervene in the exchange market should be made a part of monetary policy and made a responsibility only of the Federal Reserve.

The Exchange Stabilization Fund is a relic of the interwar gold exchange standard. I recommend that the Exchange Stabilization Fund be closed and that decisions to intervene be made part of the regular monetary policy process. My preference would be to have foreign exchange intervention limited to those rare and infrequent occasions when there is turmoil in the foreign exchange market such as occurred following the illness, sudden death or attempted assassination of our Presidents. Even if that recommendation is not adopted, I believe that accountability and efficiency are enhanced by concentrating responsibility and authority in a single agency. Since the operations are part of monetary policy, the Federal Reserve is the appropriate agency.
The Committee's last question asks who should determine the value of the dollar. The value of the dollar is determined in the market place in response to information, including information about policies at home and abroad. The foreign exchange value of the dollar should not be a policy objective.

The Federal Reserve should concentrate on the one task for which monetary policy is best suited--maintaining the domestic purchasing power of the currency. If they succeed in that task, there is no reason to be concerned about the exchange rate. If, by inflating or deflating, the Federal Reserve does not maintain the domestic value of the currency, it will not maintain its foreign value. Operations in the foreign exchange market cannot prevent the consequences of mistaken policies from affecting the domestic and international value of the currency and the public's standard of living. Congress should restrict these operations and prohibit warehousing.