Conclusion

Most analysts believe that growing U.S. trade deficits cannot continue. As our international indebtedness grows, foreigners will become increasingly reluctant to acquire additional dollar-denominated assets. This will initiate adjustments in many economic variables, including exchange rates and interest rates, to bring the international economy back into balance. How and how quickly these adjustments take place depends in large part on how rapidly the market decides to adjust its holdings of dollar-denominated assets.\(^3\)

Depreciation of the dollar can contribute to the adjustment process by increasing the competitiveness of U.S. goods and services in world markets. Nevertheless, economists have long realized that the ability of an economy to meet increased demands for its goods and services limits the contribution of a currency depreciation to improving its trade balance. If the economy is operating at full capacity, the appreciation will not generate much improvement in the trade balance. Ultimately a reduction in the trade deficit requires that the United States reduce its budget deficit, that it promotes savings, and that it encourages production of tradable goods and services.

Exchange-market participants understand these relationships and look for compatible developments in U.S. economic policies. If they believe that the United States is attempting to force a dollar depreciation through an inflationary increase in money growth or that the United States is not taking credible steps to reduce its budget deficit, international investors, who have played an important role in helping finance U.S. credit demands, could shift large amounts of dollars into assets denominated in other currencies. Under such circumstances, no amount of exchange-market intervention could supplant appropriate monetary or fiscal policies.

If, on the other hand, monetary and fiscal policy are consistent with a reduction in the trade deficit and an orderly depreciation of the dollar, then intervention can play a useful role in reinforcing the intention of policy should market uncertainty arise. Policymakers should clearly state the objectives of such policies. Under these circumstances, monetary and fiscal policies will help minimize market uncertainty and, hence, the need for intervention.

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ECONOMIC COMMENTARY

The Group of Five countries (France, Germany, Japan, the United Kingdom and the United States), plus Canada, met in Paris on February 21 and 22, seeking ways to eliminate huge trade imbalances in the United States, Japan and Germany, to encourage greater exchange-market stability, and to thwart growing protectionism.

The recent rapid depreciation of the dollar, which poses major problems both for the United States and for our major trading partners, prompted the Paris meeting. As the dollar depreciates relative to other currencies, foreign exporters find it difficult to compete against U.S. goods in world markets. The dollar depreciation already has contributed to a sharp slowdown in Japan’s economic growth. For the United States, fear of continued rapid dollar depreciation increases the risk that international investors will shift funds out of dollar-denominated assets and, thereby, force up U.S. interest rates. Federal Reserve Chairman Paul A. Volcker repeatedly has cautioned about this possible effect.

The depreciation also will contribute to higher prices in the United States. Although vague on the issue, the Paris meeting increased speculation that the participating countries would intervene more forcefully in an attempt to limit movements in key exchange rates. As newspapers recently have reported, Japan, and to a lesser extent, Germany have committed large sums to exchange-market intervention. In contrast, however, the United States has been reluctant to intervene in the exchange market, believing that nations conduct intervention independent of their monetary policies it has, at best, a limited influence on exchange rates.

This Economic Commentary discusses the U.S. reluctance to intervene in exchange markets. We present three theoretical channels through which exchange-market intervention could influence exchange rates: the monetary channel, the portfolio-adjustment channel, and the expectations channel.\(^2\)

A Definition

Exchange-market intervention refers to official purchases and sales of foreign exchange, which nations undertake to influence the exchange value of their currencies. Although nations have many ways to influence their exchange rate—such as using monetary and fiscal policy, capital controls and trade barriers—exchange-market intervention seems the most direct and most flexible method.

Many nations, therefore, frequently resort to intervention. Members of the European Monetary System, for example, routinely intervene to keep their exchange rates within narrow margins. Much of the recent interest in intervention stems from the belief that intervention enables nations to influence their exchange rates without altering monetary and fiscal policies.

To understand this, we first must distinguish between sterilized and nonsterilized intervention. When a country undertakes sterilized intervention, it engages in other transactions to prevent either the purchase or sale of foreign currency from influencing its money-supply growth. In contrast, nonsterilized intervention can alter a country’s money supply.

An example can help clarify the important distinction between sterilized and nonsterilized intervention. Suppose the United States wants to slow a depreciation of the dollar relative to the German mark. At the direction of the Treasury Department, the Federal Reserve System would buy dollars with German marks through its foreign-exchange desk in New York.

Because this transaction reduces the supply of dollars in the foreign-exchange market, the dollar should then appreciate relative to the German mark. The foreign-exchange desks’ purchase of dollars, however, also contracts the money supply in the United States. At this point, the intervention transaction is nonsterilized.

The reduction in the money supply resulting from intervention might be inconsistent with the domestic objectives of monetary policy. Consequently, the Federal Reserve then might wish to offset the impact of the intervention purchases of dollars by purchasing Treasury bills through the System’s open-market desk at the Federal Reserve Bank of New York. The purchase of Treasury bills supplies reserves to the banking system and increases the money supply. Thus, by coordinating the activities of the foreign-exchange and open-market desks, the Federal Reserve can offset, or sterilize, the monetary impact of its exchange-market activities.

Should We Intervene in Exchange Markets?

by Owen F. Humpage

1. This article was revised and published after the February Group of Five meeting and has been backdated in order to maintain the continuity of the Economic Commentary series - editor.


3. The United States intervened quite frequently during most of the 1970s, but has intervened relatively infrequently in the 1980s.

Address Correction Requested: Please send corrected mailing label to the Federal Reserve Bank of Cleveland, Research Department, PO. Box 6387, Cleveland, OH 44101.
4. The purchase of dollars with marks also will alter the relative prices and thus alter the demand for inflation in the United States. But, prices typically adjust more slowly than interest rates. Thus, the effect of a small decrease in inflation in Germany will be relatively small. The dollar will continue to appreciate until the public has fully adjusted to the change in interest rates. A change in the dollar's real exchange value will change the price of oil in dollars. Consequently, the real exchange value of the dollar has an important effect on the dollar's nominal exchange value.

5. The purchase of Mark Lender securities to the market.

6. The nominal exchange rate is the rate that is used to convert one currency into another. The nominal exchange rate is equal to the nominal exchange rate adjusted for inflation rate differentials between two countries.

7. This description ignores the important contribution of expectations. Expectation, however, will not alter the outcome of a decrease in the rate of growth in the dollar's real exchange value. If the Federal Reserve decreases the target for the growth in the money supply, the dollar's real exchange value will decline. But, even if the relevant bonds are imperfect substitutes, it appears that the response to small changes in the rate of inflation in the United States is quite low.

8. Exchange risk is the uncertainty associated with unanticipated exchange rate movements. A country with a high exchange risk premium will be unwilling to hold assets issued by other countries, but the public and the governments will impose capital controls.

