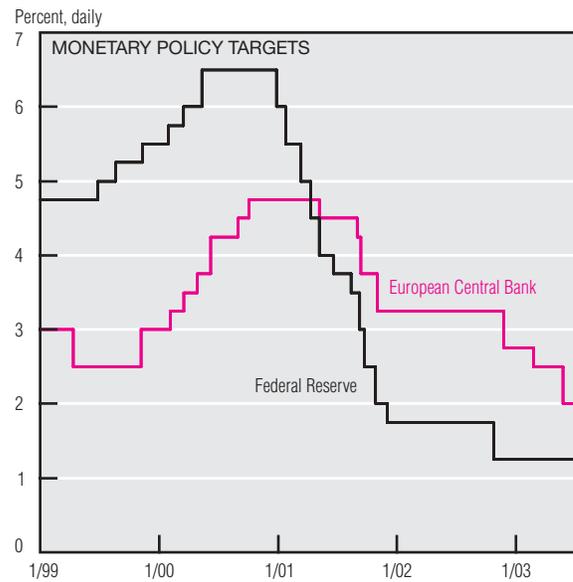
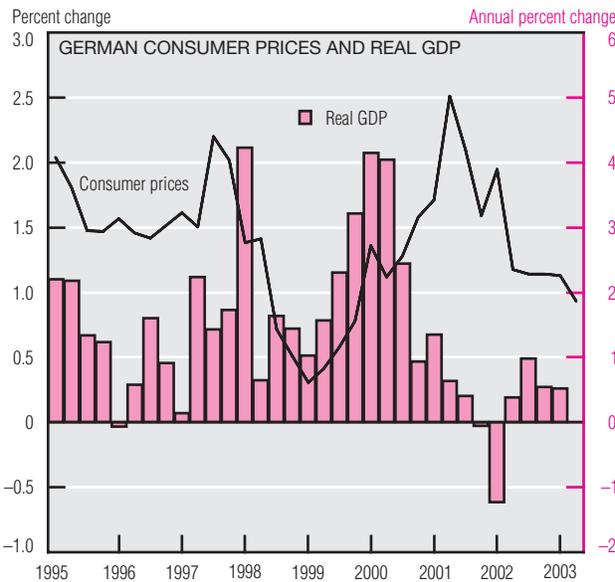
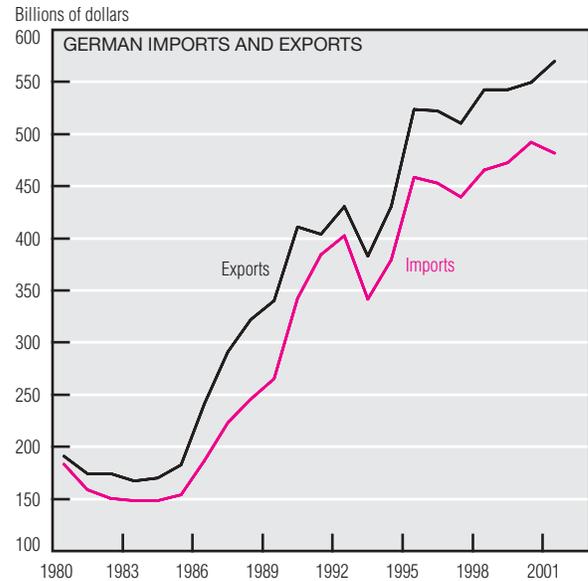
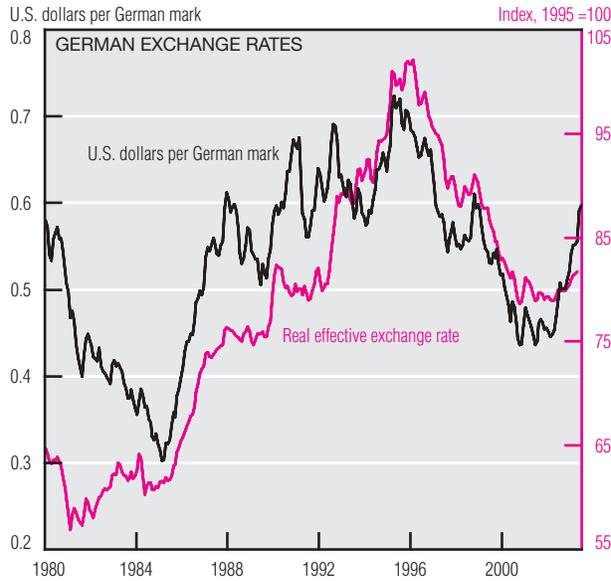


Euro Intervention



a. Federal Reserve: federal funds target rate; European Central Bank: two-week repo rate.

SOURCES: Board of Governors of the Federal Reserve System; International Monetary Fund, *International Financial Statistics*; Deutsche Bundesbank; and European Central Bank.

Prompted by the euro's sharp appreciation against the dollar, German chancellor Gerhard Schröder recently suggested that the European Central Bank intervene in the foreign exchange market to "maintain the competitiveness of exports from Europe." The chancellor wants to encourage Germany's expanding trade surplus, a source of growth for the country's otherwise lackluster economic outlook. Unfortunately, he is counting on a rather ineffective policy lever.

On those rare occasions when exchange markets briefly become

unsettled, intervention can sometimes dampen exchange rate movements. Beyond these infrequent and fleeting effects, however, intervention is useless because it does not alter exchange rate fundamentals. The European Central Bank (ECB) will not allow interventions, which are similar to open-market operations, to interfere with the overnight interest-rate target that it uses to guide monetary policy. Buying dollars injects euro reserves into the European banking system, which—other things being equal—would

lower overnight interest rates. The ECB, however, will make any necessary adjustments to its normal reserve operations to maintain the targeted interest rate. On balance, then, interventions have no effect on the key mechanism through which they might alter exchange rates—money.

The ECB could foster a euro depreciation through a sufficiently large easing of monetary policy. This might expand Germany's trade surplus temporarily, but eventually a higher rate of inflation would neutralize any exchange rate gains.