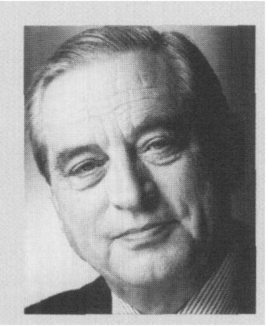
A SYMPOSIUM OF VIEWS

At The Dawn Of The Twenty-First Century, Is Currency Intervention Dead As A Policy Tool?

Have global financial markets become too large, moving electronically at too great a speed, for finance ministries and central banks to make much of a difference? Have intervention exercises actually become a sign of weakness to markets, a powerful "flash light" of desperation that at times proves to be completely counterproductive? Assuming global trade continues to expand, will the stabilizing role of central banks diminish even more? Or are today's policymakers creative enough to construct the proper "theatrics" to allow for a convincing statement of policy resolve? Is there a need for more of an institutional structure in this regard?

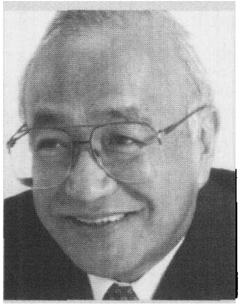


No, and as far as the ECB is concerned, the room for maneuver is even larger.

KARL OTTO PÖHL

Partner, Sal. Oppenheim Jr. & Cie., former President, Deutsche Bundesbank, 1980-91.

My answer to the headline question is clear: NO. Interventions in the currency markets by central banks have always been a policy tool. Remember the Louvre Agreement! That will not change in the future. As far as the ECB is concerned, the room for maneuver has become even larger. Purchases and sales of foreign currency — i.e., the U.S. dollar — will create less problems for monetary policy, liquidity, and price stability in the eurozone than it did in the past for the Bundesbank, due largely to the bigger size of the euro area. The ECB and the Fed are responsible for the two most important currencies in the world. They should not exclude any investment which could help stabilize exchange markets. I believe, however, that target zones or new institutional arrangements for that purpose are unrealistic and should not be considered. Moreover, interventions are no substitute for fiscal and monetary discipline. Stability begins at home!



On the contrary, the birth of the euro and the internationalization of the yen have opened a new era in global coordination.

MAKOTO UTSUMI

Professor, Keio University, former Japanese Vice Minister of Finance for International Affairs, 1989-1991.

Let me address the question with three points.

1. Since the 1980s, we have observed that markets can be mislead for an extended period of time. The emergence of a very strong U.S. dollar in the first half of the 1980s offers one example. This strengthening came to an end with the Plaza Accord and the joint intervention by G5 monetary authorities.

The excessively strong yen after 1993 was led by the market's belief that the U.S. was using a "strong yen card" as the weapon to pressure Japan. But after the spring of 1994, the U.S. Administration completely abandoned this strategy. Only the markets did not recognize it. So the joint intervention by the U.S. and Japan shocked the market and triggered a change of tide: The exchange rate began to line up with the fundamentals.

2. The globalization of the financial markets tends to orient markets toward herding, since quickly digesting an overabundance of real-on-time information can be quite difficult.

Here, currency intervention can yield surprising effectiveness by sending signals to the market.

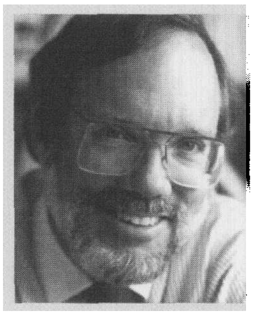
So on the contrary, the role of intervention by monetary authorities is hardly diminishing in the twenty-first century.

3. The twenty-first century starts with the euro becoming a key currency which can compete with the dollar. It opens a new dimension in the history of world financial markets. Consider several aspects of this development.

First, the U.S. will not be allowed to continue a policy of "benign neglect" toward the value of its currency much longer.

Second, a structural change of currency negotiations will inevitably take place. In the past, currency interventions were discussed either between the U.S. and Japan or the U.S. and Germany. Almost no discussion occurred between Japan and Germany (or Europe). The Bundesbank did not like intervention exercises between the DM and third currencies, like the yen. Yet the new European Central Bank wants the euro to become a central international currency. Most likely it will eventually be ready to discuss how to stabilize the euro and the yen with their Japanese counterparts, including the possibility of joint intervention. If Europe and Japan eventually agree to stabilize the euro and the yen within a certain range, will the U.S. be able to just sit out of the euro-Japan agreement?

The birth of the euro and the internationalization of the yen are opening up new perspectives and new strategies in the global financial market.



No way! When done skillfully, the record is extremely positive.

C. FRED BERGSTEN

Director of the Institute for International Economics, former Assistant Secretary of the Treasury for International Affairs.

Currency intervention remains a powerful tool of official policy. The United States and Japan intervened successfully to stop the excessive appreciation of the yen in the spring and summer of 1995. They did so again to stop its excessive depreciation in the middle of 1998.

Indeed, the record of intervention in support of equilibrium exchange rates by G7 officials since the Plaza Accord is extremely positive. They helped bring the dollar down from its grossly overvalued peak of 1985, which had threatened the continued openness of the global trading system because of the enormous protectionism that it generated in the United States.

They smoothed the dollar's descent in 1987 and early 1988 when it threatened to trigger the feared "hard landing." Comprehensive studies, by both the Banca d'Italia and by Jeffrey Frankel and Kathryn Dominquez for the Institute for International Economics, demonstrated that intervention has worked very successfully over the past fifteen years. To do so, intervention must be conducted skillfully. It must respect and promote underlying economic fundamentals — even, or especially, when the markets are ignoring those factors, as they occasionally do. It must be conducted jointly by the countries whose currencies are involved. And it must be impressive enough to sway the markets.

The actual amounts required are often surprisingly small, as in both dollar-yen cases cited above; officials need not fear "being swamped by private capital flows" when they do it right. Moreover, virtually all cases of successful intervention have been sterilized with respect to their domestic monetary impact; officials need not fear "distortion of domestic policy objectives."

Problems arise in two cases. First, intervention obviously cannot and should not try to preserve misaligned exchange pegs, like sterling and the lira in 1992, the Mexican peso in 1994, or the Thai baht and Brazilian real in 1997-99. Efforts to do so give a good policy instrument a bad name. Second, official timidity to deploy intervention permits markets to push currencies too far from their equilibrium levels. The yen should never have been permitted to rise as far as 79 to 1 against the dollar in 1995, nor fall as far as 145 to 1 in 1998.

Governments and central banks need to admit publicly what they recognize in practice: sterilized intervention, skillfully deployed, represents an effective additional policy instrument. It can logically and legitimately be used to pursue the additional policy target of currency equilibrium. This means that the current debate on reforming the international financial architecture can quite feasibly include the adoption of target zones or other variants of "controlled flexibility," as advocated by Japan and all three continental European members of the G7, to manage the basic system of floating rates in a manner that will protect the world against the huge misalignments that periodically create severe economic distortions, protectionist trade pressures, and the inevitable sharp currency reversals that threaten global financial stability.

On this question, the answer is to listen to Bob Rubin.

STEVE H. HANKE
Vice Chairman, Friedberg Mercantile Group, Inc., New York, Professor of Applied Economics, The Johns Hopkins University.

The decade of the 1990s has witnessed more than its share of dramatic currency crises. Volatile hot money flows have battered the European Exchange Rate Mechanism (1992-93), the CFA franc (1994), the Mexican peso (1994-95), the Thai baht and several other Asian currencies (1997-98), the Russian ruble (1998), and the Brazilian real (1999). All of these crises have one thing in common: pegged exchange rate regimes.

There are three types of exchange-rate regimes: floating, fixed, and pegged rates. Although floating and fixed rates appear to be dissimilar, they are members of the same family and function without official intervention in currency markets. With a floating rate, a monetary authority sets a monetary policy but has no exchange-rate policy — the exchange rate is on autopilot. With a fixed rate, a monetary authority sets the exchange rate but has no monetary policy — monetary policy is on autopilot. In both instances, however, there cannot be conflicts between exchange-rate and monetary policies and, consequently, balance of payment crises cannot occur. Under floating and fixed-rate regimes, market forces automatically rebalance financial flows and avert balance of payments crises.

While both floating and fixed-rate regimes are equally desirable in principle, it must be stressed that floating rates, unlike fixed rates, do not perform well in developing countries because these countries usually have weak monetary authorities and histories of monetary instability. Indeed, currencies in developing countries rarely float on a sea of tranquility.

Fixed and pegged rates appear to be the same. But they are fundamentally different. Pegged rates require a monetary authority to manage both the exchange rate and monetary policy. Unlike floating and fixed rates, pegged rates invariably result in conflicts between exchange rate and monetary policies. When this occurs, it's only a matter of time before currency speculators spot the contradictions and force a devaluation.

On April 21, 1999, then-U.S. Treasury Secretary Robert Rubin delivered an important policy speech on exchange rates. Mr. Rubin concluded that freely floating and fixed exchange rates were acceptable, and that anything in-between (adjustable pegs, bands, managed floats and so on) were undesirable. After almost sounding like a broken record on these issues, I was delighted to hear an echo.

If Mr. Rubin's vision is adopted in the twenty-first century, hot money and currency crises will be thrown into the proverbial dust bin. And that's not all. By foregoing intervention in foreign exchange markets, monetary authorities will no longer be able to force taxpayers to involuntarily bear exchange-rate risks that they were unwilling to take on in private markets.

A number of factors have contributed to the obsolescence of intervention.

HELMUT SCHIEBER
Member of the Directorate, Deutsche Bundesbank

All signs indicated that central bank intervention in foreign exchange markets has been decreasing for some time and especially in the recent past. This certainly holds true for the major international currencies such as the U.S. dollar, the yen, the D-Mark and the euro. But the currencies of emerging and other industrial countries have also undergone numerous developments that have contributed to decreasing intervention or even its complete abandonment.

Around the world today, turnover on foreign exchange markets and the potential for further growth have been expanding much more rapidly than the central banks' monetary reserves, as have the instruments and techniques available in the financial markets, as have the integration of national markets to form a single global financial market. This means the balance of power between markets and central banks has clearly shifted in favor of markets, which has made central banks cautious about doing battle with markets. But there has also been less cause for such battles.

There have been no pronounced or clear misalignments between the three global currencies comparable, for example, to the misalignments of the eighties. Nor has there been, thanks to the convergence progress achieved in the European Union, such serious attacks on currencies as in 1992-3.

Additionally, many countries in Asia, the former Soviet Union, and Latin America changed over to floating exchange rates after bitter experiences with fixed exchange rates and large-scale but ultimately unsuccessful interventions. These changeovers alone reduced the incentive to intervene for a large number of countries, to say nothing of the losses incurred by monetary reserves before switching regimes.

In Europe, ten national currencies, and hence the respective causes and possibilities of intervention, have disappeared with the introduction of the euro. Euroland as a whole has become less susceptible to foreign exchange movements, reducing the tendency to intervene still further.

Furthermore, a growing number of central banks around the world are moving toward greater independence, allowing them to focus their efforts on combating inflation which they regard as their core responsibility. Apart from a few exceptional cases of small, open economies where an exchange rate anchor might possibly be used, an uncompromising anti-inflation policy is not consistent with exchange rate targets and frequent interventions.

Thus, a number of factors, some globally relevant and some locally relevant, have contributed to the obsolescence of intervention. Although forecasting fashions requires caution, nothing suggests a renaissance of intervention will occur anytime soon.

In the wake of several years of currency peg failures — often with serious consequences — and the general shift of foreign exchange rate power from central banks to foreign exchange markets, a revival of intervention is barely conceivable, notwithstanding the political rescue actions of the recent past. Naturally, intervention cannot be ruled out in isolated cases — for example, in the event of severe misalignments or uncertainty in the foreign exchange markets — but its heyday is certainly over. Yet is anybody mourning its passing?

Friedman was right. Exchange rate schemes are unsustainable.

ALLAN H. MELTZER

Allan H. Meltzer University Professor of Political Economy, Carnegie Mellon University, Visiting Scholar, American Enterprise Institute.

More than forty years ago, Milton Friedman taught us that there are only two viable exchange rate systems: fixed and floating. Fixed means permanently fixed, as in Hong Kong, Argentina, Panama, or between New York and the other forty-nine states. Countries or regions with fixed exchange rates accept inflation or deflation to adjust their prices as required. Floating means that the market sets the exchange rate; the government and central bank take what the market gives.

Pegged, target, or managed exchange rates are an unstable mix of the other two. Governments and central banks intervene in currency markets to adjust exchange rates to meet their often changing objectives.

Friedman predicted that all such systems would fail. Recent research by Kenneth Rogoff at Princeton and others shows that the life of pegged exchange rate systems has been short. Once again, Friedman was right.

Why do they fail? Their very existence encourages the expectations that the exchange rate can change — that the government will not accept as much inflation or deflation as necessary to maintain a permanently fixed exchange rate. The peg also encourages speculation by giving speculators a one-way bet and limiting their potential losses. That's why speculators like pegged rates and exchange market intervention.

Economists find it useful to distinguish between sterilized and unsterilized intervention. Sterilized intervention changes the mix of central bank assets but does not change its monetary liabilities — the monetary base. Unsterilized intervention is what countries do when they "defend" pegged or target rates. Unsterilized intervention notifies the market that the country is willing to spend money, for example, to hold its exchange rate fixed. If the market perceives that the exchange rate is misaligned, intervention often invites increased speculation against a pegged rate.

The size of capital movements and the openness of markets have speeded the process, but Friedman's prediction antedates these changes. The lesson: Exchange rates are relative prices. So are the prices or costs of goods and services in one country relative to all others. Countries must let one or the other adjust. Where exchange rates are misaligned, the only choice is between adjusting the exchange rate (floating) or letting price level adjust (fixed). ◆