Divine intervention

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Under the right conditions, currency intervention can work. So is it time to support the dollar?

THE dollar's steep drop this year has triggered speculation that central banks may soon intervene in the foreign-exchange markets to prop up the sickly currency. It will surely be discussed, if *sotto voce*, at the next G7 meeting on April 11th. Policymakers have already embarked on verbal intervention. Jean-Claude Trichet, the president of the European Central Bank (ECB), has said he is “concerned" by the euro's climb against the dollar; European Union leaders at a summit in Brussels on March 14th said “disorderly” currency moves are “unwelcome”; and Fukushiro Nukaga, Japan's finance minister, has called the dollar's decline “excessive”. Such talk has helped the greenback to rebound from a 12-year low of ¥96 and an all-time low of $1.59 to the euro on March 17th. But can policymakers put their money where their mouths are?

Many academic economists remain sceptical that when central banks buy or sell currencies they can influence exchange rates. After all, their operations are a drop in the ocean compared with the trillions of dollars traded in the markets every day. History is littered with failed interventions—think only of Britain's failure to keep the pound in Europe's exchange-rate mechanism in 1992. However, co-ordinated intervention involving several central banks has had much more success.

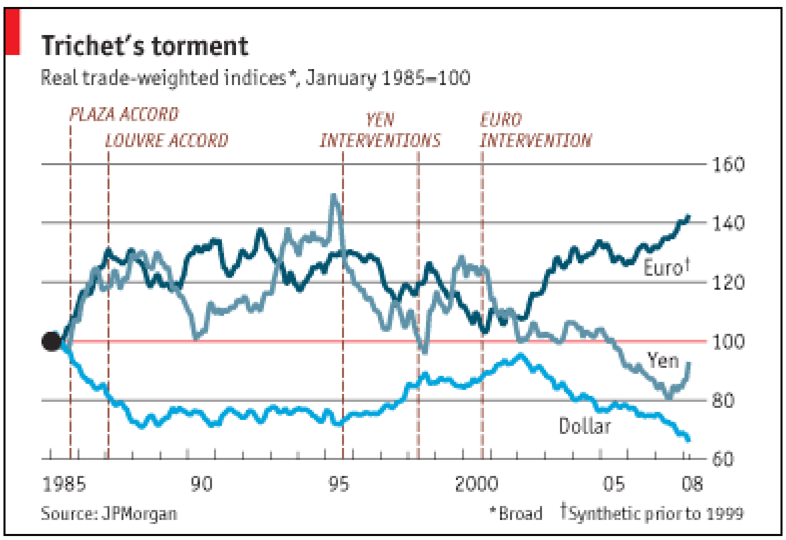
Group therapy

Stephen Jen, Morgan Stanley's chief currency economist, claims that joint interventions by the G7 have had a “near perfect record” in turning currencies around. Since 1985 there have been five big examples of co-ordinated action: the Plaza Accord of 1985 to pull the dollar down; the Louvre Accord of 1987 to halt the dollar's slide; the joint intervention by America and Japan to halt the dollar's fall against the yen in 1995; and then to support the yen in 1998; and G7 action to support the euro in 2000. Often intervention did not succeed immediately but, with the exception of the Louvre Accord, later proved to be turning-points, says Mr Jen. This does not mean that co-ordinated intervention is all-powerful; but in the correct circumstances, it is a powerful signalling device for private-sector capital flows.

What is true is that almost all previous joint interventions in currency markets were accompanied by changes in monetary policy relative to other countries. These were consistent with the goal of altering the exchange rate. In the campaign to support the euro in 2000, for example, interest rates in the euro area fell more slowly than elsewhere, causing interest-rate differences to move in favour of the euro. Thus the fact that the Fed is easing does not mean it cannot intervene to support the dollar. It does suggest, however, that this will not work unless the ECB also starts cutting rates. With the interest-rate paths of the two central banks going in different directions, rescue efforts are doomed.

Indeed, the main cause of the dollar's recent slide has been the ECB's refusal to cut interest rates (because of its inflation concerns) while the Fed is slashing rates to support growth. Or to put it another way, the weak dollar is consistent with the economic fundamentals, namely that America is in recession whereas the euro zone is still growing. The ECB will want to see inflation easing and more evidence that growth is slowing before it cuts rates. There is also little chance right now that the American government would join in any action to push up the dollar, because the cheap currency is giving a helpful boost to exports.

On the other hand, the euro is now looking extremely over-valued—and thus ripe for intervention (see chart). Its real trade-weighted exchange rate (the best measure of competitiveness) is at its highest for 35 years. In contrast, the yen still looks cheap. It has gained much more against the dollar this year than has the euro, because increased global risk aversion has reduced the attractiveness of carry trades. But the yen's real trade-weighted exchange rate remains historically weak. It is 40% below its level in 1995, the last time central banks intervened to support the dollar against the yen.



Mr Jen reckons that the probability of co-ordinated intervention has increased as the dollar's depreciation has gained speed. The orderly correction in the currency is in danger of degenerating into a more violent adjustment as dwindling investor confidence in dollar assets creates a vicious circle of capital flows out of the dollar. But until the monetary policies of America and Europe start converging, there is no point in intervention. This implies that the dollar could yet fall further.

Another complication is that since central banks staged their last co-ordinated currency attack in September 2000 the world has changed. Today, almost four-fifths of the globe's dollar reserves are held not by G7 central banks but by emerging economies, notably China and oil producers such as Saudi Arabia. For intervention to be successful, the G7 will probably need their blessing. After years of telling China to stop meddling in the foreign-exchange market, the G7 could find it embarrassing to admit that its members want to intervene themselves.

QUESTIONS:

1. Why is a currency intervention by a single central bank less likely to succeed than a coordinated intervention by several central banks? (Hint: Think it through the share of the intervention to the overall currency market)
2. How would a coordinated intervention by the FED, the ECB, and the Bank of Japan to support the US dollar affect the capital flows in the world?
3. What is the main reason for the sharp depreciation of the US dollar in the last year?
4. Why have interest rates been diverging in the US and in the Eurozone?
5. What are the consequences of a weak US dollar / strong Euro for the US and European manufacturers?
6. What are the short-term prospects for the US dollar?
7. When will a coordinated intervention to support the US dollar work?
8. How has the foreign exchange market changed since the last coordinated intervention?
9. What risks does this change present to the success of an eventual supporting operation in favor of the US dollar?