Foreign Exchange Intervention

Pro: The ECB should intervene to support the Euro

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Over the first 22 months since the launch of the euro the currency has depreciated by about 30% against the US dollar and by more than 20% in effective rate terms. This contrasts sharply with the perception in Europe two years ago that the currency was then at a broadly appropriate level – and even more with the expectations of many European academics and officials at the time that it was likely to appreciate, because of lower inflation than in the United States and significant improvements in financial competitiveness of the euro-area relative to that of fragmented national financial markets prior to 1999.

Market participants have disagreed and popular explanations of the divergence are not in short supply. Growth surprises in the United States have been almost continuous until recently, overshadowing those in the euro-area. The expectation that a slowdown in relative US growth would lead to lower real interest rates in the United States was accordingly sharply revised soon after the launch of the euro. Surprisingly strong productivity growth relative to the euro has inspired large inflows of long-term capital into US markets, financing an important part of what had looked like an unsustainable current account deficit. When these explanations seemed to fade away, the blame was put on poor communication skills in the ECB and on the ambiguities in the Treaty as to the division of responsibility for the external value of the euro between the monetary and the political authorities. The continuing search for new fundamentals to explain the steady depreciation of the euro may itself have injected negative dynamics to the evolution of the exchange rate, as recently argued by de Grauwe , making the fall of the euro still harder to explain.

European policy makers have become increasingly concerned for both economic and political reasons. The euro-area trades some 16–17% of its GDP with countries outside, a higher degree of openness than observed in either the United States or Japan. Depreciation therefore adds considerably to inflation. Furthermore, exchange rate uncertainty dampens investment and employment, probably by more than in the United States because employment practices are more rigid in the euro-area. Euro depreciation initially offered the attraction of stimulating activity which was welcome in helping European exports at a time of slow recovery. But it has since become very difficult to argue that such help remains essential. The artificially comfortable external environment may well have slowed some of the more structural reforms that the euro needs. Politically euro depreciation has become an embarrassment vis-à-vis an increasingly critical domestic public and because of the inevitable *schadenfreude* which it has triggered in the United States where major reservations about the whole project had survived the launching of the euro. Finally, excessive depreciation has hardly engendered a positive attitude in the three EU countries outside the euro-area to adopting the new currency.

In view of these considerations it is surprising that it took the authorities of the euro-area so long to announce exchange-market interventions in favour of the euro. One major reason was that it was seen as essential to the success of the intervention that it was a joint initiative by the G7 countries, or at least with the United States. It proved difficult to bring about co-ordination at a time when the strength of the dollar was seen in Washington as economically useful to dampen overheating and as politically helpful in providing a sign of external confidence in the US economy. Available research suggests that intervention is more likely to have a significant impact when the action is joint, but it

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does not conclude that unilateral intervention is effective. Recent studies by Ramaswamy and Samici and by Fatum find a number of examples of effective unilateral intervention in both the USD/JPY and USD/DEM markets over the past decade and a half.

The G7 countries did announce on 22 September that they were intervening jointly to support the euro. But the amounts were small. The weekly consolidated statement of the Eurosystem published on 28 September suggests a sum of just over EUR 3 billion, while Federal Reserve data of the same date put US intervention at $ 1.5 billion. The Bank of England also intervened, but reportedly reversed its transaction later the same day. Altogether the effort appears to merit the label of half-hearted, and it is not surprising that markets were unimpressed, pushing the euro below the level at which intervention had taken place.

Both before and after 22 September the ECB has sold dollars on a number of occasions as can be inferred from the weekly statements. At one point, earlier in September, the ECB pointed out that it was making “routine sales of foreign exchange income”, a technique often used by central banks without drawing attention to it. Around 1 November the ECB indicated over a couple of days that it had intervened, again without any major impact on exchange rates. There is no way of knowing where the rate would have been in the absence of published and unpublished intervention efforts, but the experience has been taken as confirmation that intervention is not, even in the short term, a reliable tool. But that seems a premature judgement.

The Eurosystem has at its disposal foreign-exchange resources of more than EUR 250 billion. 50 billion is pooled in the ECB with the rest remaining with the participating central banks. However, in May the Finance Ministers authorised the ECB to call up more reserves centrally if necessary. Having seen that using a very small fraction of these resources did not significantly affect the exchange rate, the obvious conclusion would have been to announce gradual sales of a substantial part of the dollars held by the Eurosystem. When the euro was launched, concern was voiced that the central banks in the euro-area would wish to dispose of what now had become excess reserves, putting pressure on the euro to appreciate. If the European authorities are not prepared to dispose of these now when they rightly say they consider the euro to be significantly undervalued, there is an understandable perception in the financial markets of a lack of credibility.

Much has been made in the public debate of the argument that the euro-area is faced with long-term outflows of equity and portfolio capital rather than short-term outflows, the containment of which is the normal purpose of interventions. But in 2000 long-term outflows have slowed to EUR 8-10 billion a month. Even if they were to continue at that rate (which looks unlikely) it would be well within the resources of the euro-area authorities to sustain such an outflow by dollar sales out of their reserves for a couple of years. Announcing such a strategy would – as argued recently by Gros – send a strong signal to private investors and third-country monetary authorities that the downward pressure on the euro has come to an end.