Contra: There's No Point in Intervention to Support the Euro

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Intervention in support of a floating currency always means sterilized intervention. If it did not, the central bank in question would simply move domestic interest rates in the desired direction. Yet, if a central bank does not move interest rates, exchange rate intervention is likely pointless (as shown in numerous empirical studies). There are two channels through which intervention theoretically could have an effect: via supply of currency in the market; and via exchange rate expectations.

On the first count, that of supply, for major currencies like the euro and the dollar, there simply is too much currency in play everyday for even massive (relative to reserves) central bank intervention to move the markets. As one senior participant in such operations has observed, "By the time the market commentary is speculating whether the intervention was large enough, you have already lost the battle."

On the second count, that of expectations, the claim is often made that intervention provides information to the foreign exchange markets – but what kind of information? If it is supposed to be information about the state of the economy, that means that the central bank has already failed to be persuasive through data release and communication. Since communication is more specifically to the point of where the central bank believes the markets are wrong in their assessment, and commits the central bank to its assessment more explicitly than vaguely motivated intervention, there is no reason to think that intervention will be more persuasive.

If the intervention is supposed to convey information about central bank intentions, that information is only credible if it is backed up by monetary policy moves. Otherwise, the markets can correctly assume that the central bank is unwilling to give up domestic policy goals for the sake of a particular value of the exchange rate. If the exchange rate movement is likely to have significant pass-through effects on inflation, it is consistent for the central bank to offset how that would lead inflation to deviate from its inflation goal. If the exchange rate move is a one-time or temporary shift which is likely to have minimal pass-through, the central bank should be able to anchor inflation expectations and publicly state that it will ignore that fluctuation.

This is why the last concerted intervention in support of the euro in September 2000 failed, and the previous concerted intervention in support of the Japanese yen in June 1998 succeeded. In the case of the euro, there was no credible belief that the ECB would was truly concerned with the inflationary effects of the euro's fall if it was only intervening; meanwhile, any tightening of policy would widen the gap between U.S. and euro-11 growth rates, putting further pressure downwards on the euro. In the case of the yen, the intervention with U.S. agreement was seen as a signal that the Japanese government was about to change mistaken macroeconomic policy, which it did in July 1998, and that such policy would reduce the growth gap, which it did by year's end.

The only way for the ECB to support the euro is either to reduce uncertainty about its policies, or to somehow avoid shutting off euro-zone recovery before the growth gap with the U.S. shrinks (as it has and will). Both of these would best be served by discarding intervention. The euro-zone national governments confuse ECB communications when it comes to exchange rate policy. The inflationary effect on the euro-zone economies of a declining euro is smaller than before EMU, so it is a less sustainable and credible monetary policy to respond to any temporary price effect.

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