2

Overview and Rationales

The principal activity of the ESF has been foreign exchange intervention, defined as the buying and selling of US dollars for foreign currency on the open market, which the Treasury Department has conducted in order to limit fluctuations in exchange rates. Historically, in terms of the frequency and the amounts involved in intervention, such operations have been by far the most important function of the ESF. Currency matters also have consumed the largest share of the time that Treasury officials have devoted to administering the account. Intervention responsibilities are shared with the Federal Reserve.[1]

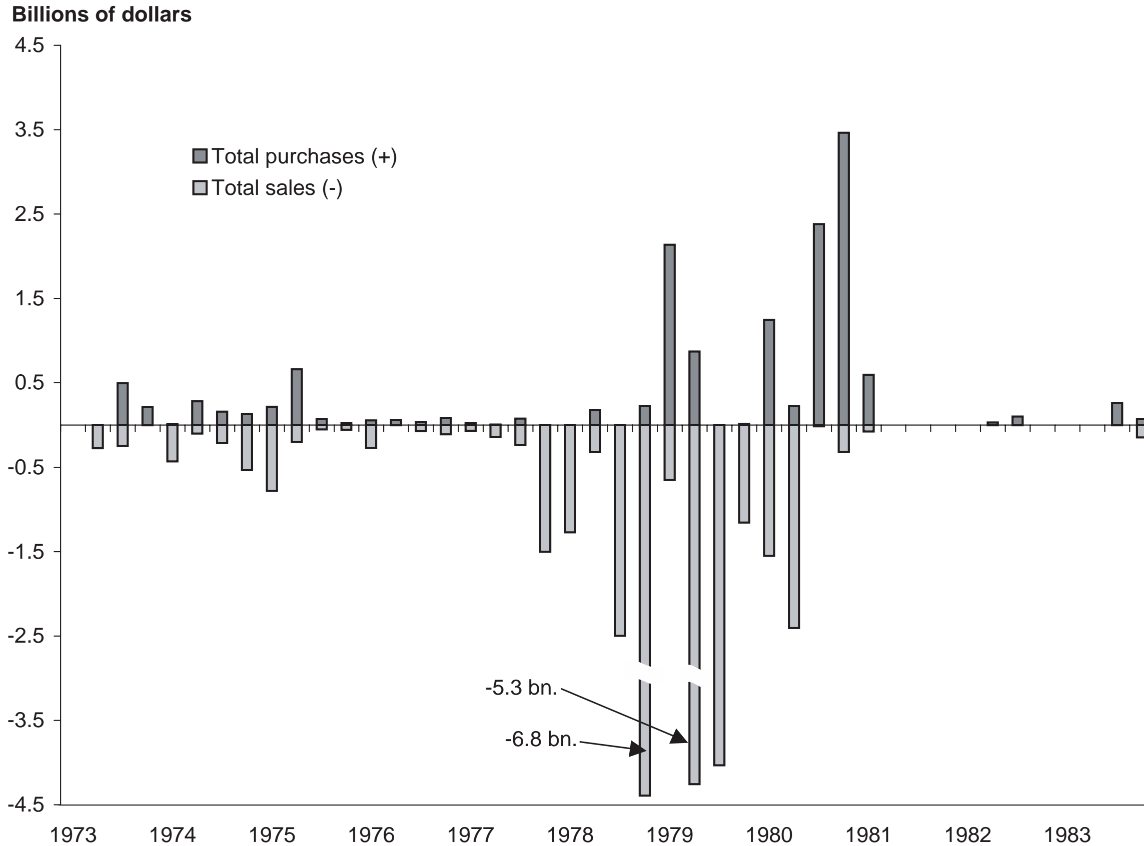
Figures 1 and 2 depict the amount of foreign exchange intervention on a quarterly basis since the introduction of floating exchange rates in the early 1970s. Figure 2, which covers the period of 1984-98, shows in addition the share of the ESF in intervention relative to that of the Federal Reserve—usually a roughly equal split. Intervention activity peaked during the Bush administration in 1989 when $20.7 billion was sold to cap the exchange rate of the dollar, $10.3 billion of which was from the ESF.

Providing stabilization loans is the second principal activity of the ESF. The Secretary of the Treasury occasionally lends from the ESF to enable foreign countries to smooth adjustments in their balance of payments under internationally monitored economic policy reform programs. The loan to Mexico in 1995 is the most salient example of such activity. Balance-

1. On the politics and institutions of US international monetary policy, and the relationship between the Treasury and the Federal Reserve specifically, see, among other works, Destler and Henning (1989) and Henning (1994).

Institute for International Economics | http://www.iie.com

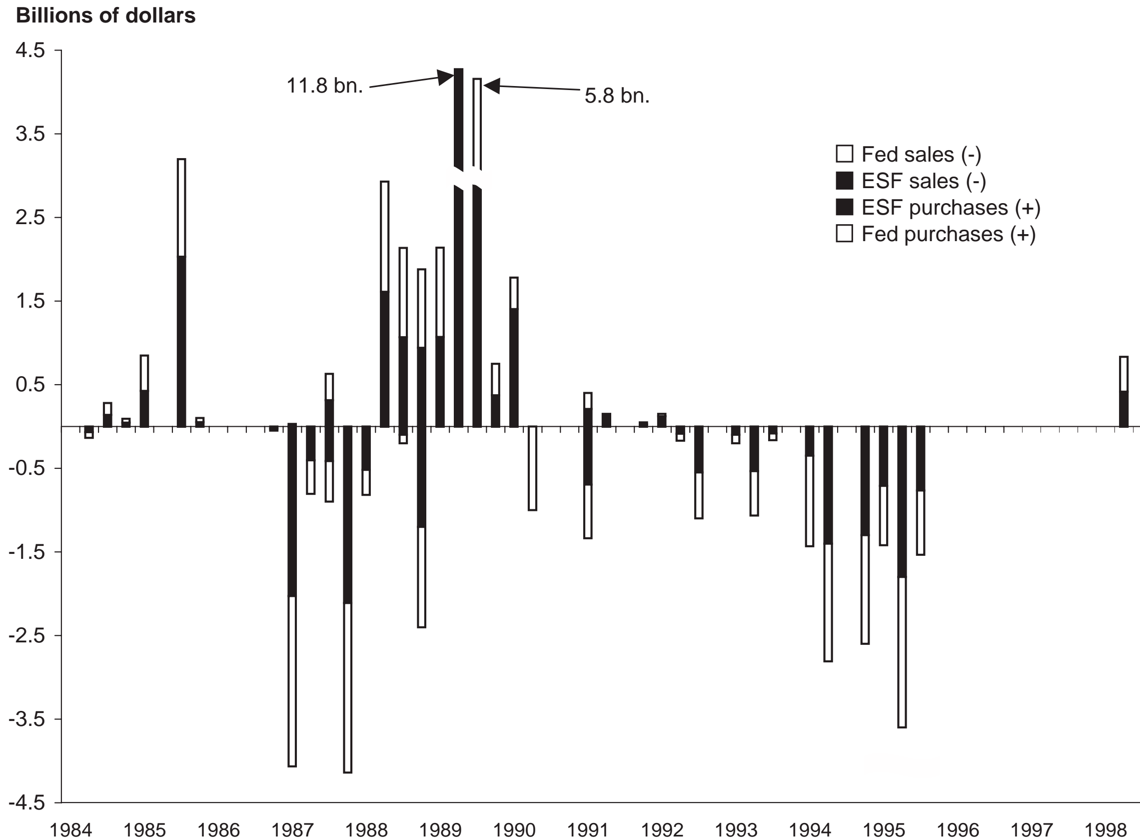
Figure 1 US foreign exchange intervention, 1973-83 (purchases and sales of foreign currency)



Note: Data are presented in three-month intervals, beginning with March-May 1973.

Source: Federal Reserve Board of Governors.

Figure 2 US foreign exchange intervention, 1984-98 (purchases and sales of foreign currency)



Note: Data are presented in three-month intervals, beginning with February-April 1984.

Source: Federal Reserve Bulletin, 1984-98.

of-payments lending is closely connected to currency stabilization: without such financing, other countries' currencies would depreciate more precipitously and much further than with ESF support. In recent years the stabilization lending activities of the ESF have become considerably more visible and publicized.

The basic rationales for government foreign exchange and financial intervention, and thus for maintaining the ESF, rest on imperfections in the currency and financial markets. If foreign exchange markets were perfect, currencies would converge toward and fluctuate around equilibrium exchange rates. Economic and policy shocks might perturb currencies periodically, and rapid adjustment of asset markets compared to goods markets might cause currencies to swing widely. In a perfect market, once the effects of shocks dissipate, the exchange rate would nonetheless stabilize.

The currency markets, however, are often driven by herd behavior rather than rational expectations and thus produce occasional speculative bubbles rather than exchange rate stability. Most participants in the currency markets hold either very soft views or no views at all on the longer-run equilibrium rate. The connection between exchange rates and the underlying economic fundamentals is correspondingly weak. In this environment, official intervention can signal changes in policy fundamentals or prick speculative bubbles, causing foreign exchange traders to revise their expectations and thus change market exchange rates.[2]

Perfect financial markets, similarly, would recognize worthy stabilization programs and finance transitional deficits in the current account. But these markets suffer from incomplete information, multiple equilibria, and problems of enforcement and coordination among lenders (see, for example, Masson and Mussa 1997). The creditworthiness of borrowers and the profitability of investments are difficult to foresee in the teeth of a crisis, when the coming postcrisis economic conditions are obscure. Bandwagoning is prevalent among international banks and investors. Masson and Mussa (1997, 24) summarize the effects of these imperfections:

> Market discipline generally speeds up the recognition of unsustainable policies and thereby brings about needed policy adjustments. However, the market does not always act on the basis of appropriate judgments or reflect socially optimal assessments. At times, markets continue to provide financing for unsustainable policies, delaying needed adjustment. When a belated recognition of problems occurs, the change in market sentiment can lead to a violent reversal of the capital inflows, causing a balance of payments crisis. Without official financing, the crisis would force on the authorities disruptive adjustment, with potentially high costs in terms of output and employment losses.

---

2. On the operation of currency markets and the case for foreign exchange intervention, see, among other works, Williamson (1999), Catte, Galli, and Rebecchini (1994), Dominguez and Frankel (1993), Kenen (1988) and (1994), Krugman (1989), and Frankel and Froot (1986).

Institute for International Economics | http://www.iie.com

In this process, exchange markets, generally adopting short-term time horizons, often overvalue currencies and then, with a precipitous change in sentiment, depreciate them to levels far below their optimal long-term equilibria, a pattern known as "overshooting."

With loans from the ESF, the US government can provide liquidity to borrowers that are fundamentally solvent, preventing excessive downward overshooting of their currencies, smoothing their balance of payments adjustment, and reducing output and employment losses. By doing so, US authorities also reduce the adverse shift in the US trade balance and associated output and employment losses in the United States. Currency stability and international liquidity foster open trade and investment policies around the globe, from which the United States and the rest of the international community benefit.

Some economists argue that the imperfections in these markets are insignificant, or that the government cannot know better than the market where the long-term equilibrium rate lies. However, given the manifest short-term perspectives of most participants in the currency market, substantial swings in exchange rates beyond economically justifiable limits, and superior knowledge on the part of officials of at least their own future policies, I believe that authorities have a constructive role to play in intervening at least occasionally. The suggestion that markets are sufficiently close to perfection and that foreign exchange intervention or stabilization lending would *never* be warranted strikes this author as clearly not justified.

The major issue examined in this study concerns the organization of such a capacity to intervene. Given the nature of international markets, and in particular the speed with which exchange rates shift and investors withdraw, the US government should be capable of intervening quickly. Because the markets are complex, the officials overseeing foreign currency operations or stabilization loans should have training and expertise. And, finally, because international coordination takes time and often requires compromises, the United States should retain a unilateral capacity to act. With these rationales in mind, the Congress decided in 1934 to create the ESF and to delegate authority over the account to the Secretary of the Treasury.

Institute for International Economics | http://www.iie.com