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Intervention In The Foreign Exchange Markets: How Effective Is It?

Betty A. Herre

INTERVENTION

IN THE

FOREIGN EXCHANGE MARKETS:

HOW EFFECTIVE IS IT?

by

Betty A. Herre
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Texas Tech University, 1973

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Dr. Orville Goulet
Faculty Advisor

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TABLE OF CONTENTS

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ABSTRACT

Intervention in the Foreign Exchange Markets:
How Effective Is It?

Betty A. Herre

The University of North Dakota Graduate Center, 1989

Faculty Advisor: Dr. Orville Goulet

Intervention in the foreign-exchange markets by the central banks of the major industrial nations has been the norm for a little over 40 years. The level of intervention exercised by these central banks during these 40 years has ranged from very heavy to very light. At one extreme was the Bretton Woods period which was characterized by extensive, cooperative intervention among central banks to maintain fixed exchange rates between currencies. At the other extreme were periods like the early to mid-1970's and the early to mid-1980's which were characterized by the use of only occasional intervention. The most recent round of extensive interventions took place from 1985 through early 1988. These recent interventions represented a concerted effort by the United States, Great Britain, West Germany, France, and Japan (the G-5) to force the U.S. dollar down more rapidly than the foreign-exchange market was driving it down. Subsequently, the dollar's fall required further interventions by the G-5 to maintain the dollar in a certain target zone. The entire effort by the G-5 was initiated to aid the United States in correcting its massive trade deficit. This effort was unsuccessful in reaching its goal. While the United States' trade deficit with the other countries

of the G-5 and the countries of the European Economic Community did improve, the U.S. trade deficit with many of the countries whose currencies were tied to the U.S. dollar did not improve. The United States continued to run a massive trade deficit. Despite this huge trade deficit, the dollar began to rise again on the foreign-exchange markets in the spring of 1989. A currency, such as the U.S. dollar, which rises in value when the country is experiencing a huge trade deficit is not following the "rules" of the basic monetary systems. Possible reasons for the dollar's ability to break the "rules" include that the U.S. dollar is a reserve currency for the rest of the world and that the United States is a profitable and safe place to invest. The existence of these reasons and the unlikelihood that they will be removed indicate that intervention on behalf of the U.S. dollar will not be very effective.

CHAPTER I

INTRODUCTION TO INTERVENTION IN THE FOREIGN-EXCHANGE MARKETS

On September 22, 1985, top central bank and other economic officials from the United States, Japan, West Germany, France, and Great Britain (the Group of Five) held a press conference to announce that they intended to work together to drive down the value of the United States dollar.[1] This event ushered in the latest attempt by the world economic community to manipulate exchange rates between currencies using cooperative intervention by central banks.

To better understand the significance of this event, it is necessary to have some understanding of the three basic types of monetary systems. These three systems are the pure gold standard, flexible or floating exchange rates, and the various systems of managed exchange rates.

The first basic monetary system is the pure gold standard. Under a pure gold standard, each currency has a fixed price in gold. Because each currency is fixed in relation to gold, each currency also has a fixed price in relation to all other currencies. When an excess demand for another currency occurs in one country, gold will flow from the country which has the excess demand to the country that has the desired currency. This outflow of gold will reduce the money supply in the country experiencing the outflow and will reduce the price

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[1] Michael Salter et al., "Planning the Dollar's Fall," Maclean's, 7 October 1985, 38.

levels and employment in that country. This, in turn, will reduce the demand for imports in the country experiencing the outflow of gold and make its goods more attractively priced for export. The country experiencing the inflow of gold will be confronted with a larger money supply, higher price levels, and greater levels of employment within the country. This will lead to a greater demand for imports in that country and a lower demand for exports from that country and thus lead to greater demand for the currencies of other countries by that country.[2] While the use of the gold standard nearly by definition precludes extended periods of imbalance between imports and exports, it does this at the possible cost of "violent domestic inflations and deflations."[3]

The second of the basic monetary systems is the system of flexible or floating exchange rates. Under a truly flexible exchange rate system, the price of a country's currency fluctuates when there are changes in the supply of and demand for that currency internationally. Basically, the exchange rate adjusts to eliminate any excess demand. When demand for the currency in the international marketplace is high, its price will rise, making items exported from that country cost more in other countries. This, in turn, will lead

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[2] Peter B. Kenen, International Economics (Englewood Cliffs, N.J.: Prentice-Hall, 1964), 58.

[3] Sir Maurice Parsons, "Stabilizing the Present International Payments System," in The International Adjustment Mechanism: Proceedings of the Monetary Conference in Melvin Village, New Hampshire, October 8-10, 1969 by the Federal Reserve Bank of Boston (Boston: The Federal Reserve Bank of Boston, 1970), 42.

to a reduction in the demand for that currency.[4] Conversely, if more of a country's currency is available than is demanded in the international marketplace, the price of that currency will decline. Imports will begin to cost more in that country; therefore, fewer imports will be purchased there. However, exports from the country whose currency has declined in value will be less expensive in other countries, and the demand for its exports will rise, thus increasing the demand for that currency. As Daniel Pope summarized it:

> Thus, under floating exchange rates, the adjustment process occurs in the international sphere, with only an indirect effect on domestic prices and incomes....In other words, under a floating rate system, it should not be necessary to impose a recession in order to alleviate a trade deficit.[5]

The third basic type of monetary system includes the various systems of managed exchange rates. Under managed exchange rate systems, exchange rates are stabilized by official intervention in the foreign exchange markets, usually by central banks.[6] This intervention can be used either only occasionally to smooth out bumpy changes in a currency's exchange rate or it can be used extensively to support or force down a currency. The central banks of various countries can intervene individually or cooperatively. With a managed exchange rate system, there may be no direct link between the monetary situation within the country and the foreign exchange market.[7] This

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[4] Kenen, 58.

[5] Daniel Pope, "The United Kingdom and the Gold Standard: 1925," in Macroeconomic Decision Making in the World Economy, ed. Michael G. Rukstad (New York: The Dryden Press, 1986), 389.

[6] Kenen, 58.

[7] Ibid.

is because, using the United States as an example, the Federal Reserve Banks can hold assets other than gold such as government securities against their monetary liabilities, so that the money supply is not directly tied to the supply of gold.[8] Using government securities as assets to back the money supply allows the Federal Reserve Banks to either buy govenment securites on the open market to build American bank reserves and stop a contraction in deposits and lending because gold has flowed out of the country or to sell government securities to reduce bank reserves and stop an increase in lending and deposits because gold has flowed into the country.[9] Thus the inflow or outflow of gold can be counteracted by the buying or selling of government securities, and the money supply can be effectively insulated in a managed exchange rate system.

Throughout this century, exchange rates have run the gamut from being fixed in relation to the price of gold to being allowed to freely float against one another. The occurrence of these two extremes has been very rare, however, with varying levels of central bank intervention being the norm. Extensive use of cooperative intervention in the exchange markets to manipulate the value of currencies also occurred earlier this century in the form of the Bretton Woods Agreement. Since the monetary system established by the Bretton Woods Agreement was considered a fixed exchange rate system, this latest attempt by the Group of Five to cooperatively manipulate

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[8] Ibid., 69.

[9] Ibid., 71.

exchange rates by central bank intervention represents a movement toward more fixed exchange rates.

In view of the fact that our economy is becoming an increasingly global one, which of these three monetary systems is being used is of great importance to businesses and consumers. The exchange rates between various currencies determine to a large extent the profitability of international trade for businesses as well as the cost of maintaining the quality of life to which consumers have become accustomed. The domestic policies required by the monetary system in use also affect both businesses and consumers. Since the monetary system in use is most likely some form of managed exchange rate system, the level of intervention being used becomes the important issue. Therefore, the efficacy of intervention in the exchange markets is an issue of great importance to both the United States and the world business communities.

Since the perfect monetary system is something even economists cannot agree upon, this paper will be limited to looking at how effective intervention in the exchange markets has been. In order to explore this question, recent periodical articles as well as books and articles written about the Bretton Woods period and other time periods during this century will be used to examine how exchange rates have been determined and what effect intervention has had on factors such as the trade deficit.

CHAPTER II

EXCHANGE RATE SYSTEMS THROUGH WORLD WAR II

To better judge how well intervention has worked, it will be helpful to review how well the world's economy performed under the two extreme monetary systems -- the gold standard and freely floating exchange rates. Basically, the world came closest to experiencing both a pure gold standard and a freely floating exchange rate system in the years before World War II.

The World on the Gold Standard

"The world's monetary system was most like the gold standard during the 40 years before the First World War. By the mid-1870's, each major country had connected its currency to gold, establishing a fixed exchange rate between its own currency and all the others."[10] The basic parities between currencies remained fairly constant until 1914.[11]

Even during this time period, however, the monetary system was not a perfect example of the gold standard. The United States issued paper money against its holdings of government securities as well as against its holdings of gold. While Great Britain did not follow the practice of using government securities as backing for newly issued money as the United States did, Britain did sell commercial bills and

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[10] Ibid., 77.

[11] Ibid., 78.

government securities to ease or tighten credit. Nevertheless, many countries did try to use domestic monetary policy to reinforce the impact of gold flows rather than to offset their impact.[12]

The system had some problems, too. Some of the major countries manipulated their output and employment rather than allowing prices to adjust. Often countries at the periphery of the monetary system, such as the raw materials producers of the Western Hemisphere, were forced to bear the brunt of adjustments. These countries were forced to change their exchange rates often and had to drop away from the gold standard during payments crises.[13]

After World War I, an attempt was made to return to the gold standard. Great Britain re-established the gold standard in May 1925, but was obviously having trouble maintaining its pre-World War I gold parity in 1927. The United States was forced to have higher inflation rates and lower interest rates than Great Britain throughout this period in order to maintain the pound at its pre-World War I parity with the dollar.[14] With the United States intervening by manipulating its domestic policies, the "return to the gold standard" of the 1920's was even less a true gold standard than that before 1914. The death knells for the ill-conceived post-World War I return to the gold

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[12] Ibid.

[13] Ibid.

[14] Daniel Pope, "The U.S. Financial Crisis of 1931," in Macro-economic Decision Making in the World Economy, ed. Michael G. Rukstad (New York: The Dryden Press, 1986), 66.

standard were heard when Great Britain withdrew from the gold standard in 1931.[15]

There were a number of reasons for the failure of the post-World War I gold standard. Among these are the fact that even before World War I the gold standard was not strictly adhered to since gold was not the only backing for the U.S. dollar and the British bank rate was sometimes used to counteract the effect of gold flows. Additionally, after World War I, more inter-government debt existed, higher tariffs and wider use of import quotas existed, and farm output had expanded tremendously. New political parties had been formed in many of the major industrial countries to appeal to urban workers, and the power these new parties wielded made it difficult for governments to allow unemployment to occur as it often must under a true gold standard. New central banks had been created in several countries, and all central banks were finding ways around the rules imposed by a strict gold standard. Finally, because many central banks were holding dollars and pounds sterling as well as gold to back their money, the new monetary system was really a gold-exchange standard and not a pure gold standard. In addition to all these complicating factors faced by most nations, Great Britain faced some special problems which made it even more difficult for it to maintain the gold standard. Great Britain's major exports of textiles and coal were meeting stiff competition throughout the international marketplace unlike any ex-

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[15] Ibid., 68.

perienced in the past, and Great Britain had lost its preeminence in the financial markets as well.[16]

A Period of Monetary Chaos

As a result of Great Britain's withdrawal from the gold standard, a gold outflow of crisis proportions began for the United States in late 1931. Rather than responding to this gold outflow by intervening via open market securities operations as most central banks would do under a managed exchange rate system, the Federal Reserve Board responded by raising discount and acceptance rates.[17] The central banks of many other nations were unwilling or unable to intervene to stabilize their currencies either. The world monetary system came as close as it has in this century to experiencing freely floating exchange rates. The result was that "the 1930's saw complete monetary chaos."[18] The currencies of many small countries fluctuated wildly in foreign exchange markets due to economic conditions within the countries and waves of speculation. The United States left the gold standard in 1933, returning at a lower parity in 1934. Countries, like France and Italy who remained on the gold standard, established trade barriers to protect their currencies and their economies. Exchange rates did not settle down again until 1936 when the gold-bloc countries adjusted their gold parities and made a "stand-still"

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[16] Kenen, 78-79.

[17] Pope, "Crisis of 1931," 69.

[18] Kenen, 79.

agreement with Great Britain and the United States.[19] "When the exchange rates had finally settled down, they were not much different from what they had been before 1931."[20]

Despite the fact that exchange rates settled to nearly the same levels after the upheaval, five years of chaos convinced the world economic community that they could not handle the uncertainty of freely floating exchange rates. To at least one observer of the 1920's and 1930's, a system of floating exchange rates had at least three major problems:

> They create an element of risk which tends to discourage international trade,..exchange fluctuations involve constant shifts of labour and other resources between production for the home market and production for export,..[and]..any considerable or continuous movement of the exchange rate is liable to generate anticipations of a further movement in the same direction, thus giving rise to speculative capital transfers of a disequilibrating kind.[21]

Views such as these were held by many and greatly influenced the monetary system which came into being after World War II.

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[19] Ibid., 79-80.

[20] Ibid., 80.

[21] Ragnar Nurskse, International Currency Experience (Geneva: League of Nations, 1944), 210-211, quoted in Peter B. Kenen, International Economics (Englewood Cliffs, N.J.: Prentice-Hall, 1964), 80.

CHAPTER III

THE BRETTON WOODS SYSTEM

After World War II, the major countries resolved not to make the same mistakes which had been made after World War I. The problems with maintaining the gold standard had become all too apparent in the 1920's and 1930's. The chaos created by the use of floating exchange rates in the late 1930's also made a floating exchange rate system seem unacceptable. Instead, a compromise between a true gold standard and freely floating exchange rates was settled upon.

The Bretton Woods Agreement

The exchange rate system established after World War II became known as the Bretton Woods System and was established by the Bretton Woods Agreement of 1944. Under this agreement only the United States was required to fix the value of its currency in relation to gold and to guarantee convertibility initially. The other governments who signed the agreement agreed only to peg their currencies to the U.S. dollar or to gold.[22] A maximum limit of 1 percent of fluctuation on each side of the parities so established was allowed under the agreement. If this 1 percent was exceeded, the central bank of the country involved would be forced to intervene.[23] After a transition

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[22] Kenen, 81.

[23] Paul Einzig, The Case Against Floating Exchanges (New York: St. Martin's Press, 1970), 13.

period, the other signatories were to make their currencies convertible to gold and to other currencies. Additionally, rules governing exchange rate changes were established. A government could alter the par value of its currency by up to 10 percent without approval of the International Monetary Fund (IMF) which was also set up in the agreement, but had to have prior approval of the IMF for larger changes in value. This approval for larger changes would only be granted in cases of "fundamental disequilibrium" in a country's international accounts.[24] Because under the Bretton Woods Agreement currencies were pegged to the U.S. dollar but could also be altered by up to 10 percent, the Bretton Woods System was sometimes referred to as an adjustable peg system.[25] Essentially, then, the Bretton Woods System was an attempt to set up a somewhat flexible system initially which would ultimately allow the establishment of a fixed exchange rate system once the world economy was recovered sufficiently for convertibility of all currencies to be restored. One deference to flexibility was to be retained after convertibility was restored -- the adjustable peg mechanism was to be left in place.

An explanation of the role of the International Monetary Fund (IMF) is relevant at this point. The IMF was part of "the framework for post-war monetary cooperation" set up by the Bretton Woods Agreement.[26] As described by Kenen, the IMF:

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[24] Kenen, 81.

[25] Richard E. Caves, "Discussion," in The International Adjustment Mechanism: Proceedings of the Monetary Conference in Melvin Village, New Hampshire, October 8-10, 1969 by the Federal Reserve Bank of Boston (Boston: The Federal Reserve Bank of Boston, 1970), 135.

[26] Kenen, 81.

> is a pool of currencies and gold furnished by its 76 member governments. When a country joins the IMF, it is assigned a quota which governs the size of its cash subscription, its voting power, and its drawing rights....When a country encounters a payments deficit and does not have sufficient reserves to cope with the problem, it can buy foreign currency from the IMF in exchange for its own currency, but it must repurchase its own currency within 5 years. A member of the IMF can always buy foreign currency equal in value to a quarter of its quota (the equivalent of its initial gold subscription). To make a larger purchase, it must satisfy the Fund that it is trying to solve its payments problem, as by controlling domestic inflation.[27]

The establishment of the IMF, it was hoped, would ensure that external exchange rates would have some effect on the internal domestic policies of those countries experiencing a deficit.

In addition to establishing the IMF and setting up limits within which a currency could be revalued, the Bretton Woods System also encompassed the General Agreement on Tariffs and Trade (GATT) which was signed in 1947. GATT was intended to encourage low tariffs and promote non-discrimination among countries. The intent of the entire Bretton Woods System was to prevent beggar-thy-neighbor trade and exchange policies like those which had engulfed the world economic community in the 1930's while allowing some autonomy for the signatories in monetary and fiscal matters.[28]

A Dollar Shortage

The dollar was chosen to be the basis for the Bretton Woods System because one of the major concerns of America's trading partners

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[27] Ibid., 89.

[28] Richard N. Cooper, "Flexing the International Monetary System: The Case for Gliding Parities," in The International Adjustment Mechanism: Proceedings of the Monetary Conference in Melvin Village, New Hampshire, October 8-10, 1969 by the Federal Reserve Bank of Boston (Boston: The Federal Reserve Bank of Boston, 1970), 141.

at that time was a shortage of dollars. This fear was exacerbated by the U.S. military, economic, and overseas aid programs which appeared after World War II. The United States held nearly 57 percent of the total reserves of all the members of the IMF as late as 1949. Due to the comparative productive strength of the U.S. economy, other major industrial nations feared U.S. gold reserves would just continue to increase during the post-war period so these recovering countries established systems of import quotas and exchange restrictions to guarantee that their imports from the United States did not exceed their supply of dollars. Even with these quotas and restrictions, the dollar shortage persisted and had to be handled through Marshall Plan aid and by heavy borrowings from the International Monetary Fund in the late 1940's.[29]

In 1949 the United States "forced devaluations of the European and Japanese currencies against the dollar," causing the Japanese yen to be devalued by 98 percent.[30] The British pound was devalued by more than 30 percent and the Deutsche mark by more than 20 percent against the U.S. dollar. This made goods exported by these countries more competitive against U.S. goods, but the earlier fears of a dollar shortage persisted.[31] "Until the late 1950's, foreign monetary

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[29] Vincent G. Massaro, Transnational Money Management: Issues and Practices (New York: The Conference Board, 1978), 1-2.

[30] David B. Yoffie, "Kennedy and the Balance of Payments," in Macroeconomic Decision Making in the World Economy, ed. Michael G. Rukstad (New York: The Dryden Press, 1986), 414.

[31] Massaro, 2.

authorities were far more anxious to obtain dollars than exchange dollars for gold."[32]

The Gold Drain Begins

It began to be apparent that a dollar shortage was no longer to be feared in 1958. In that year, U.S. exports fell by over $3 billion from the prior year while U.S. imports dropped by less than $300 million.[33] In addition to the problems with the U.S. current account balance, "an increase in U.S. foreign investment in Europe and growing dollar reserves overseas reduced the incentive for foreign governments to hold U.S. currency."[34] By the end of 1958, "convertibility of the currencies of the major industrial countries into other currencies for nonresidents was restored by 14 European countries."[35] With the return of convertibility and the formation of the European Economic Community (EEC), the Europeans had less need for U.S. currency. The dollar shortage of the post-war years turned into a dollar glut. Foreign central banks began to demand gold for dollars, and the gold drain began.[36] It became necessary for central banks to support the U.S. dollar as was proved when:

> On October 20, 1960, the British stopped supporting the price of gold on the London Exchange, causing the price to shoot up to $40 per ounce. The price was quickly reduced to official levels when the United States provided Britain with new gold reserves. Yet

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[32] Yoffie, 414.

[33] Massaro, 2.

[34] Yoffie, 415.

[35] Massaro, 2.

[36] Yoffie, 415.

the psychological impact of breaking the official price, even for one day, was dramatic.[37]

Throughout the 1960's, the United States was plagued by an outflow of dollars. This was of major concern since the dollar was backed by gold, and dollar holdings had to be converted to gold upon request of foreign governments under the Bretton Woods Agreement. In 1961 and 1962, the Kennedy Administration launched Operation Twist in an attempt to promote faster domestic growth by keeping long-term interest rates low to encourage more domestic investment and raising short-term interest rates to limit the outflow of capital to other countries. An additional measure, which it was hoped would further halt the outflow of funds that resulted from the use of U.S. capital markets by foreigners, was the interest equalization tax (IET) enacted by Congress in 1963. The IET was supposed to increase the interest cost to foreigners on securities sold to U.S. investors and thus prompt the development of alternative capital markets. Even with these measures in place, the outflow of dollars continued. The Board of Governors of the Federal Reserve System issued guidelines in early 1965 which requested that banks hold credit extended to foreign concerns to 105 percent of the amount of such credit at the end of 1964. Foreign Direct Investment Regulations also went into effect in 1965 which limited the transfer of U.S. funds from U.S. parent companies to their overseas affiliates.[38]

All these restrictions and regulations failed to halt the outflow of dollars completely. Additionally, they led to the establishment of

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[37] Ibid.

[38] Massaro, 3-4.

the Eurodollar and Eurobond markets. As Massaro explained it:

> The early development of the Eurodollar market, for instance, resulted from the attempt of some Eastern European countries that placed dollars with banks in Western Europe to avoid a possible blockage or confiscation of funds in the United States.....The Eurodollar market grew from $10 billion at the end of 1965 to $46 billion at the end of 1970.[39]

Because of restrictions on amounts which could be loaned in the United States, U.S. companies and their affiliates were responsible for much of the expansion.[40]

The Eurobond market, the market for longer term issues denominated in dollars and other currencies, also grew by leaps and bounds during the same period. Its value went from $100 million in 1963 to an annual average of more than $4 billion from 1968 to 1970. Approximately half of that activity was attributed to borrowings by U.S. companies and their affiliates.[41]

All these outflows of dollars wreaked havoc on the United States' IMF reserve levels. By late 1968, U.S. reserves had dropped to only 20 percent of the reserves of all Fund member countries from 39 percent in late 1958.[42] "The bulk of the shift in reserve assets ...[was] due to substantial increases in the reserves of other countries, and especially in their holdings of U.S. dollars."[43] The reduction in the United States' IMF reserves throughout the 1960's and

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[39] Ibid., 4.

[40] Ibid.

[41] Ibid.

[42] Ibid., 2.

[43] Ibid.

early 1970's had much to do with the collapse of the Bretton Woods System in 1973.

The Call for a Change Begins

In the late 1960's it became fashionable for economists to blast the Bretton Woods System. Few, if any, supporters of the system could be found. Several alternative approaches to handling the management of exchange rates were advanced. Among these alternative approaches were a crawling peg, wider bands, gliding parities, and freely floating exchange rates. Some economists supported various combinations of these alternatives. All seemed to be in agreement that the Bretton Woods System was flawed.

Milton Friedman, a proponent of floating exchange rates, cited as one of the major problems with the Bretton Woods System its abrupt rather than gradual changes in exchange rates.[44] He pointed out that of the 21 more-developed countries, only 3 had not experienced a depreciation of their currency with respect to the dollar under the Bretton Woods System. Of the 18 which had experienced depreciation, "6 had a depreciation of less than 30 percent, and 12....had a depreciation of more than 30 percent."[45] The abrupt changes due to these large depreciations showed that just as much uncertainty exists under fixed rates as under floating exchange rates. As Friedman maintained:

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[44] Milton Friedman, "Panel," in The International Adjustment Mechanism: Proceedings of the Monetary Conference in Melvin Village, New Hampshire, October 8-10, 1969 by the Federal Reserve Bank of Boston (Boston: The Federal Reserve Bank of Boston, 1970), 19.

[45] Ibid., 17.

> The difference is that if you have flexible rates, the uncertainty manifests itself in changes in the price of exchange. It manifests itself promptly but gradually, in a way to which people can adjust promptly. When you have fixed rates, the uncertainty manifests itself in exchange and trade controls, in restrictions on what you can do, in large discontinuous changes in exchange rates from time to time.[46]

Gottfried Haberler agreed with Friedman on the need for a smoother adjustment mechanism. He found the adjustable peg system established by the Bretton Woods Agreement:

> unsatisfactory, because it leads necessarily to large capital flows before and after each depreciation or appreciation. As time goes on, more and more people catch on to the pattern and the speculative flows tend to become larger from one crisis to the next.[47]

Haberler supported greater flexibility in exchange rate management as a means of smoothing exchange rates changes. For him, this greater flexibility did not necessarily mean that every currency in the world would float against every other currency. He envisioned that "many small countries will prefer to peg their currencies to that of a large country and groups of countries may well join in fixed currency blocs."[48]

Robert Solomon also found fault with the adjustment mechanism provided for in the Bretton Woods Agreement. The major shortcoming of the adjustable peg system, as Solomon saw it, was that there was "a

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[46] Milton Friedman, "Discussion," in The International Adjustment Mechanism: Proceedings of the Monetary Conference in Melvin Village, New Hampshire, October 8-10, 1969 by the Federal Reserve Bank of Boston (Boston: The Federal Reserve Bank of Boston, 1970), 115.

[47] Gottfried Haberler, "Panel," in The International Adjustment Mechanism: Proceedings of the Monetary Conference in Melvin Village, New Hampshire, October 8-10, 1969 by the Federal Reserve Bank of Boston (Boston: The Federal Reserve Bank of Boston, 1970), 32.

[48] Ibid.

tendency for those who devalue to devalue excessively and when an occasional revaluation does occur, it tends to be deficient."[49] To correct this, he saw a need for a bias toward revaluation and felt an upward crawling peg might be a feasible solution.[50]

Sir Maurice Parsons came closer than most economists of the late 1960's to supporting the Bretton Woods System. He especially questioned the proposed crawling peg mechanism of limiting adjustments to plus or minus 2 percent per year. He did this on the grounds that it was so difficult to determine if a currency was under- or over-valued by 10 percent or more. He felt that by the time the evidence of under- or over-valuation was strong, the 2 percent limit would prove inadequate to correct the misalignment. Because of this, he felt a crawling peg would increase speculative pressure on currencies even more than the Bretton Woods System of relatively fixed exchange rates.[51] Parsons also applauded the introduction of Special Drawing Rights (SDR) which were:

> a form of international currency issued by the International Monetary Fund and used only by governments in place of gold as a monetary reserve...[they were] established in July 1969 by the Group of Ten, linked to gold, and set equal to $1/SDR.[52]

The Group of Ten were Belgium, Canada, France, Italy, Japan, the

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[49] Robert Solomon, "Panel," in The International Adjustment Mechanism: Proceedings of the Monetary Conference in Melvin Village, New Hampshire, October 8-10, 1969 by the Federal Reserve Bank of Boston (Boston: The Federal Reserve Bank of Boston, 1970), 36.

[50] Ibid., 37-38.

[51] Parsons, 50.

[52] Michael G. Rukstad, Macroeconomic Decision Making in the World Ecomony (New York: The Dryden Press, 1986), 580.

Netherlands, Sweden, the United Kingdom, the United States, and West Germany.[53] Parsons felt SDR's would help offset the damage caused by the inefficiencies of the adjustment mechanism under Bretton Woods.[54]

George N. Halm advocated the use of a widened band which he acknowledged could vary from a very limited system of floating rates to a fixed par-value system with widened gold points. According to Halm:

> Whether this compromise favors discipline or freedom depends on the chosen width of the band in conjunction with the supply of international liquidity reserves....If international liquidity reserves and widened bands are considered trade-offs, the latter have the advantage that exchange-rate variations produce real adjustments while the larger reserves only help postpone adjustments.[55]

In addition to widening the band, Halm recognized that if the exchange rates remained at the support points for a period of time, flexibility would be lost, so he suggested combining the wider bands with a crawling peg of perhaps 2 percent per year.[56]

Richard N. Cooper argued instead for a gliding parity system. Under his proposal:

> A country would be expected to change its exchange parity weekly whenever its payments position warranted a change. The weekly change in parity would be fixed at .05 percent...A change in parity would be triggered by a movement in the country's

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[53] Massaro, 45.

[54] Parsons, 52.

[55] George N. Halm, "Widening the Band for Permissable Exchange Rate Fluctuations," in The International Adjustment Mechanism: Proceedings of the Monetary Conference in Melvin Village, New Hampshire, October 8-10, 1969 by the Federal Reserve Bank of Boston (Boston: The Federal Reserve Bank of Boston, 1970), 127.

[56] Ibid., 130.

> international reserve position....A country that failed to alter its parity when an alteration was indicated would be required to explain and justify its decisions before other trading nations, which would meet on a regular basis several times each year to review international monetary developments. Any country that systematically ignored the presumptive rules and offered an unacceptable justification would be open to sanctions.[57]

Cooper felt this gliding parity system would provide both a long-term gradual adjustment mechanism plus a means of imposing external discipline on domestic policies.[58]

As can be seen, economists were virtually all in agreement that the Bretton Woods System had become unworkable. Its lack of smooth adjustments in exchange rates troubled all of them, but they could not agree on the degree of flexibility which needed to be added to the system to smooth such adjustments. It is also interesting to note the ideas advanced by these economists in the late 1960's because several have come up as proposals for the management of exchange rates since 1985.

The Collapse of the Bretton Woods System

The whole Bretton Woods System rested on confidence in the dollar. Obviously, confidence in the dollar became more shakey throughout the 1960's as the outflow of capital from the United States continued. The large external deficits run by the United States during this period led many countries to convert their dollar holdings into gold. This outflow of gold caused the United States to officially close the gold window on August 15, 1971, when it was

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[57] Cooper, 146-147.

[58] Ibid., 146.

announced by President Nixon that the United States "would no longer allow conversion of foreign official holdings of dollars into gold."[59]

In an attempt to maintain a more flexible version of the Bretton Woods System, the Group of Ten countries signed the Smithsonian Agreement on December 18, 1971.[60] This agreement provided for a devaluation of the dollar by about 8 percent against gold and certain other currencies. It also widened the ranges within which the exchange rates of countries could vary about their fixed parity point from the plus or minus 1 percent of the Bretton Woods Agreement to plus or minus 2.25 percent.[61]

The Smithsonian Agreement lasted only until February 1973 when the dollar again had to be devalued. This marked the end of the Bretton Woods System.[62] Instead of this devaluation restoring confidence in the dollar, however, it:

> led to even greater turbulence and to the official closing of foreign-exchange markets for more than two weeks in March, 1973. Since the reopening of exchange markets on March 19, 1973, the international monetary system has been one of floating exchange rates with different degrees of intervention by the various central banks.[63]

How Well Did Intervention Work During Bretton Woods?

Looking back on the Bretton Woods period, heavy cooperative intervention worked fairly well to get the world's economy back on its

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[59] Massaro, 6.

[60] Ibid.

[61] Rukstad, 580.

[62] Massaro, 6.

[63] Ibid.

feet again after World War II. The devaluations which the United States forced on Japan and several of the European nations in 1949 led to these nations becoming more competitive internationally. This, however, led to the dollar's decline as our trade surplus deteriorated into a trade deficit. As dollars flowed out of the United States, so too did gold under Bretton Woods. Our IMF reserves, likewise, were greatly diminished. It could be argued that some of this was a good and necessary thing since the imbalance in favor of the United States at the end of World War II was not a good thing when looking at the entire international economy. Basically, the way the Bretton Woods System was set up led to its demise. It was set up based on an extremely strong dollar backed by huge reserve surpluses and equally large trade surpluses, but by the System's very design it was intended to diminish these reserve and trade surpluses in favor of the recovering countries of Japan and Western Europe. As could be expected, the Bretton Woods System of fixed exchange rates eventually collapsed as the other currencies gained strength in relation to the U.S. dollar. Continued cooperative intervention could have maintained the System possibly, but the intervention would have needed to affect domestic policies within the U.S. and other countries much more than was politically acceptable in the late twentieth century.

CHAPTER IV

FLOATING EXCHANGE RATES -- 1973 TO 1985

With the collapse of the Bretton Woods System in 1973, the world entered another period of floating exchange rates. Unlike the floating exchange rate period of the late 1930's, however, central banks practiced a lot more intervention in the foreign-exchange markets during this period of "floating" exchange rates. Some countries responded to the collapse of the fixed exchange rate system by connecting the value of their currencies to the currency of other nations. Throughout this twelve year period, exchange rate stability varied with conditions, and the use of intervention varied from infrequent to extensive.

The European "Snake"

In an effort to maintain some stability within the floating monetary system, five of the six countries in the European Economic Community -- Belgium, the Federal Republic of Germany, Italy, Luxembourg, and the Netherlands[64] -- banded with Norway and Sweden to form the so-called snake arrangement in 1973.[65] Under this arrangement, these countries agreed to "keep their own exchange rates in a narrow band with one another but to float their currencies

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[64] Yoffie, 413.

[65] Massaro, 6.

jointly against other currencies."[66] The various currencies of those in this arrangement were pegged to the Deutsche mark initially.[67]

Floating Rates: 1973 - 1976

A number of shocks hit the world economic community during the years of 1973 through 1976. In late 1973, petroleum prices were increased fourfold by the OPEC cartel. At nearly the same time, there was a rapid rise in agricultural and raw material prices. Inflation became a serious problem for the industrialized nations, and because of this, leaders of these nations chose not to pursue expansionary fiscal and monetary policies. By 1974, real gross national product (GNP) in the capitalist industrialized nations had begun to fall, and by early 1975, the world had slid into the worst recession since the 1930's.[68]

Despite all these problems, the floating exchange rate system was performing much better than expected. There had been much speculation that such conditions under a floating exchange rate regime would lead to competitive depreciations of currencies and erection of protectionist barriers to trade as had occurred under the last floating rate regime in the 1930's. These responses did not occur. The dollar performed fairly well also. When the dollar dipped in the summer of 1973 during a period of high inflation rates in the United

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[66] Ibid.

[67] Ibid.

[68] Daniel Pope, "The Decline of the Dollar: 1978," in Macroeconomic Decision Making in the World Economy, ed. Michael G. Rukstad (New York: The Dryden Press, 1986), 454.

States and upheaval over the Watergate affair, the United States and other nations intervened in the foreign-exchange markets by purchasing dollars with other currencies. The dollar responded by rising in value in the latter half of 1973. From late 1975 through late 1977, the dollar remained within only a few percentage points of the value which had been set for it in the Smithsonian Accord of 1971. Because the United States was less reliant on imported oil than Japan and many of the European countries, the United States ran a current account surplus from 1973 through 1976. This current account surplus was probably partially responsible for the stability of the dollar during this time period.[69]

Other currencies performed reasonably well during this stressful period also. Only the pound sterling required a large loan from the IMF to offset a rapid decline in its value in 1976.[70] As noted by Daniel Pope:

> Fluctuations in exchange rates were becoming more moderate and were apparently fulfilling their prescribed function. When a nation's currency depreciated, its international competitive position generally improved and its payments deficit shrank. Similarly, as strong currencies rose in value, their payments surpluses tended to diminish.[71]

Some disturbing problems surfaced which indicated there could be flaws in this floating exchange rate system characterized by only occasional intervention. The recession of this time period occurred for all the industrialized nations almost simultaneously. The various nations did not recover from the recession at the same time or rate,

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[69] Ibid., 454-455.

[70] Ibid., 455.

[71] Ibid.

however. The United States recovered more rapidly and more vigorously than did West Germany or Japan. This, unfortunately, led to a rapid rise in prices for Americans and took its toll on the U.S. balance of payments as well.[72]

The Dollar's Decline: 1977-1978

In 1977, the current account for the United States experienced a $15.3 billion deficit. Additionally, the capital account experienced a deficit of $13.4 billion. Because of these deficits, official dollar holdings in West Germany, Japan, and the OPEC countries rose.[73] As could be expected, this surplus of dollars in the international marketplace began to take its toll on the value of the dollar internationally.

The exchange rate of the U.S. dollar began its descent slowly, showing little movement as late as the end of 1977 from the level it had been at when floating rates first went into effect in March 1973. Between March 1973 and the end of 1977, the dollar appreciated 9.4 percent against the Canadian dollar and 34.8 percent against the pound sterling. The dollar did, however, decline drastically against several other currencies -- 25.5 percent against the West German mark, 10.5 percent against the Japanese yen, and 37.9 percent against the Swiss franc during the same time period.[74]

The Japanese and West Germans were the major beneficiaries of the

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[72] Ibid.

[73] Ibid., 455-456.

[74] Ibid., 456.

U.S. trade deficit with both countries running substantial trade surpluses. The Carter administration hoped the declining dollar would correct this situation, but the dollar's decline was slow to help. The Japanese were thought to be using a "dirty float" -- selling yen and buying dollars to prevent the yen from rising so high that Japanese export competiveness would be threatened. Unfortunately, because of such interventions and because of the "J-curve" effect, the U.S. deficit situation did not improve rapidly. The "J-curve" effect refers to the fact that in the short run, import and export commitments do not change but depreciation means more dollars are required to pay for the same volume of imports while export revenues remain stable.[75]

Recognizing the fact that central bank intervention in the exchange markets could "do no more than slow down -- at a high cost -- the underlying movement" of a currency, intervention by the Federal Reserve had been limited to counteracting "short-run 'disorderly market conditions', not longer-term trends" from 1973 through 1977.[76] The Carter administration began to reverse this policy in January of 1978 by adding a "swap line" between the Federal Reserve and the German Bundesbank to other existing swap arrangements. Under the terms of these swap arrangements, each nation had a standby line of credit in its partners' currencies. By borrowing foreign currencies on these lines of credit and then selling these currencies to buy its own

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[75] Ibid., 456-458.

[76] Ibid., 458.

currency, a country could raise or support the exchange rate for its own currency. The new swap arrangement with the Germans was put to use immediately. The mere announcement that such intervention would be used caused the German mark to fall 4 percent and the Swiss franc to fall 6 percent against the U.S. dollar. Despite these interventions, the dollar began to slip again as time passed. The Carter administration responded by selling gold each month to raise the value of dollars in relation to gold. Carter's Federal Reserve responded by tightening credit.[77] The use of these two measures failed to halt the fall of the dollar.

By the fall of 1978, it became apparent that stronger measures were needed to stop the dollar's fall. The Carter administration responded in November of 1978:

> The Treasury and the Fed[eral Reserve] extended their swap arrangements with the German, Swiss and Japanese monetary authorities by $7.6 billion. This more than doubled the swap lines with these three strong currencies (from $7.4 billion to $15 billion). Total swap line limits reached $30 billion. In early November, the Fed[eral Reserve] used these resources energetically. Between August 1, 1978 and January 31, 1979, American official foreign exchange sales (designed to support the dollar) came to $9,359.1 million. (Of this, $8,122.9 million was in marks.) The intervention level was more than six times as high as in the previous half year and was most active in the early days of November.[78]

Three billion dollars of additional funds earmarked for intervention on behalf of the dollar were obtained by a withdrawal from the U.S. reserve account at the IMF. Another two billion dollars

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[77] Ibid., 459.

[78] Daniel Pope, "The Decline of the Dollar: 1978 -- Supplement," Harvard Business School teaching note 9-384-172 (Boston: HBS Case Services, 1984), 356.

were made available for intervention by selling American-owned SDR's at the IMF to Germany, Japan and Switzerland. Still another ten billion dollars could be raised by the sale of U.S. Treasury securities denominated in strong foreign currencies overseas.[79]

In addition to preparing for strong intervention in the foreign exchange markets, the Federal Reserve, with the support of the Carter administration, raised the discount rate. In a final move:

> the Treasury raised the level of gold sales to at least 1.5 million ounces monthly, a fivefold increase. The foreign exchange markets perceived these actions as being exceptionally strong measures. The intervention succeeded in halting the decline of the dollar through late 1978 until mid-1980.[80]

The European Response to Floating Rates in the Late 1970's

The European "snake" arrangement of the early 1970's evolved into the European Monetary System (EMS) in the late 1970's. The EMS represented to its member countries a way to fix exchange rates among themselves in order to "avoid price-level instability from occurring in response to transitory monetary disturbances reflected in exchange-rate fluctuations."[81] Exchange rates among these countries were fixed in two respects:

> First, an absolute limit of 2.25 per cent divergence from central rates (except for Italian lira, which has a limit of 6 per cent); and second, a limit for each currency against the ecu, which itself is based on a basket of EEC currencies. When either of these limits is crossed, the country of the currency concerned is expected to take corrective action.[82]

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[79] Ibid., 356-357.

[80] Ibid., 357.

[81] Jaleel Ahmad, Floating Exchange Rates and World Inflation (New York: St. Martin's Press, 1984), 211.

[82] Ibid., 99.

Just how effective this exchange rate fixing mechanism was can be seen from the experience of the EMS countries between March 1979 and September 1980 when the average change in EMS exchange rates against the ecu was only 1.3 per cent.[83] The success of the EMS at maintaining its member currencies in such a narrow band at a time when the U.S. was required to engage in heavy intervention to prop the U.S. dollar's "floating" rate cast fixed rates in a more favorable light. Even if the intervention levels required to maintain this narrow band were high for the EMS countries, their exchange rates were certainly far less volatile than the dollar's during this time period.

Floating Rates in the Early 1980's

From March 1980 through February 1981, heavy intervention in the foreign-exchange markets by the United States continued. The dollar responded:

> In March 1980, the Carter administration, under the Credit Control Act of 1969, imposed credit controls. The tightening of monetary policy and the sharp rise in U.S. interest rates resulted in an initial dollar appreciation.[84]

Due to a recession in 1980 which did not lower inflationary expectations and the Federal Reserve's continued policy of restricting the growth of reserves and raising interest rates, further appreciation of the dollar occurred. By February 1981, the dollar had risen 6.4 percent on a trade-weighted basis from its March 1980 level.

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[83] Ibid., 94.

[84] Michael L. Bagshaw and Owen F. Humpage, "Intervention, Exchange-Rate Volatility, and the Stable Paretian Distribution," Working Paper 8606 (Cleveland: The Federal Reserve Bank of Cleveland, 1986), 4.

Gross intervention transactions had totalled approximately $14 billion. The majority of the dollar purchases occurred in April, May, and June of 1980.[85]

During the period from April 1981 through March 1982, the United States did not intervene on behalf of the dollar, although foreign central banks increased their dollar interventions. U.S interest rates remained high while weak economic activity abroad kept interest rates abroad from rising. The United States began to get inflation under control, and the U.S. current account improved relative to the current accounts of many European countries. The dollar depreciated some in relation to other currencies in the late summer of 1981 as U.S. economic activity slowed, U.S. interest rates were expected to decline, and foreign interest rates began to rise. By late 1981, however, the dollar began to rally again. This rally occurred because, despite the declining U.S. interest rates, international interest rate spreads still favored investments in dollars. Additionally, European economic activity was still sluggish.[86] "On balance, the trade-weighted dollar appreciated 13.8 percent between April 1981 and March 1982."[87] Credit for part of the appreciation in the value of dollar which began in 1981 is attributed to the shift from the restrictive monetary policy under Carter and Volcker to the more expansionary fiscal policy under President Reagan.[88]

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[85] Ibid., 5.

[86] Ibid., 5-6.

[87] Ibid., 6.

[88] Pope, "Supplement," 357.

Reagan's expansionary policies caused the U.S. economy to boom and the dollar to rise in the mid-eighties:

> The Reagan policy mix of large tax cuts coupled with tight money pushed up interest rates in the U.S. That drew in foreign capital, thereby making the U.S. a big international borrower. The capital inflows, in turn, pushed up the value of the dollar.[89]

Because of the low inflation rates and relatively high interest rates in the United States, the dollar continued to rise until it peaked in February of 1985.[90] The strong dollar led to huge trade deficits as could be expected. The U.S. merchandise trade deficit reached $60 billion in 1983 and $110 billion in 1984.[91] Support for protectionism was definitely gaining momentum.[92] The Administration and the Federal Reserve were reluctant to intervene in the exchange markets to drive the dollar down because they were afraid such a move "would dry up the huge inflow of foreign capital that [had] helped finance the U.S. budget deficit."[93]

How Effective Was Intervention Between 1973 and 1985?

Technically, this question should not even be asked since, under pure floating rates, intervention should not be occurring. As can be seen from this period, a truly floating exchange rate is nearly

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[89] Alan S. Blinder, "Reaganomics Made the Trade Gap Inevitable," Business Week, 20 May 1985, 42.

[90] Barbara Rudolph, "Dropping the Other Shoe," Time, 9 September 1985, 55.

[91] "Slowing Imports," Fortune, 4 March 1985, 43.

[92] Rudolph, 54.

[93] Edward Mervosh and Karen Pennar, "Yes, the Dollar Is Down. No, It Won't Do Much Good," Business Week, 19 August 1985, 53.

impossible in our current world. The governments of the world and their respective central banks cannot seem to let go and let the market determine the value of their respective currencies.

During the period from the re-opening of the foreign-exchange markets in March 1973 until the end of 1977, intervention was used, but only occasionally. Floating rates, after their initial chaotic introduction in early 1973, seemed to be functioning in nearly a textbook fashion. Despite the oil crunch, the world economy responded well to floating rates. However, the western industrialized nations went into recession simultaneously in 1975, and the world reached a low in economic activity not quite as severe as in the 1930's. Those who distrusted floating exchange rates were probably ready to point to the lack of stability in exchange rates as the cause for the slump. Before this could happen, though, the United States began to pull out of the recession.

Unfortunately, acting as the "locomotive" for the world economy caused a repetition of the same problems that had led to the demise of the Bretton Woods System. The United States began to experience trade deficits and with them a drain on reserves. The dollar began to fall in late 1977. In response to this fall of the dollar, the United States entered a period of heavy intervention to prop the dollar which began in 1978 and continued until just after Reagan entered office in 1981. A recession, restrictive domestic monetary policies, and massive interventions in the foreign-exchange markets by the Federal Reserve in cooperation with foreign central banks via "swap lines" were all necessary to stop the dollar's fall. This heavy use of intervention belied the description of "floating" attached to the

monetary regime during this time period. All these interventions finally paid off by stopping the drop of the dollar by early 1981.

Because of inflation, the Carter administration had engaged in restrictive domestic policies. With inflation somewhat under control because interest rates remained high, the Reagan administration chose to engage in more expansionary domestic policies like tax cuts and increased military spending. The high interest rates attracted foreign capital so that according to one economist, "foreign investment in the U.S. made possible the non-inflationary boom of 1983 and early 1984."[94] Since the dollar was rising and the economy was growing without a recurrence of inflation, intervention was not deemed necessary during this period by the United States. Intervention was only considered after the huge trade deficit, which the strong dollar had created, prompted a rise in protectionist sentiment.

Based on the experience of these twelve years under a floating exchange rate system, it appeared that countries were likely to intervene very little when their currencies were stable or rising, but were likely to intervene heavily when their currencies were falling. Interventions, when they were used to counteract strong market trends, tended to be massive and required the assistance of domestic policy interventions to gain the desired effect. The benefit that adjustments should occur in the international sphere under a floating exchange rate system was lost when heavy intervention took place because domestic policies had to be adjusted.

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[94] C. Fred Bergsten, "The Trade Deficit Could Be Ruinous," Fortune, 5 August 1985, 106.

CHAPTER V

THE GROUP OF FIVE AND THE EXCHANGE MARKETS

In the summer of 1985, the United States was experiencing a rising sentiment of protectionism. After over 12 years of floating exchange rates with varying levels of intervention by central banks, the dollar was near a post-war high. The merchandise trade deficit was projected to be $150 billion by year's end. The Japanese were still resisting the abolishment of their trade barriers to United States goods and services.[95] It was estimated by Data Resources, Inc. that the strong dollar and resulting trade imbalance had cost 1.5 million manufacturing jobs in the United States.[96] In addition, agricultural exports were in a slump.[97]

Group of Five Exchange Rate Intervention Begins

The Reagan administration knew some action would have to be taken or a new trade war, spurred on by protectionist legislation, might begin. This action came when:

> On Sunday, Sept. 22, [1985] top central bank and economic officials from the Group of Five -- the United States, Japan, Germany, France and Great Britain -- held a press conference in New York City's Plaza Hotel. There they announced that in order

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[95] Lee Walczak et al., "The New Trade Strategy," Business Week, 7 October 1985, 92.

[96] Eric Gelman et al., "Tremors of a Trade War," Newsweek, 9 September 1985, 67.

[97] Walczak, 92.

> to avoid an international trade war they intended to act in concert to drive down the value of the U.S. dollar.[98]

With obvious forethought, the announcement was made by the Group of Five (G-5) the day before President Reagan announced his new "fair trade" program calling for:

> government-initiated complaints against unfair trade practices; speeded-up processing of 'injury' claims by domestic industries; tighter rules against copyrighting and counterfeiting; a $300 million war chest to allow the Export-Import Bank to counter foreign subsidies; and a push to convene a new round of trade talks under the General Agreement on Tariffs & Trade (GATT).[99]

This two-pronged approach was deemed necessary to sustain President Reagan's veto on some of the major trade bills before Congress in September of 1985. It was hoped that the devaluation of the dollar would cause the United States' trade deficit to drop to a much lower level in the latter part of the 1980's. Only a drastic reduction of the trade deficit was thought able to permanently put out the protectionist fires.

The dollar responded dramatically. "Pushed by heavy central-bank intervention, the greenback plunged by more than 5% against major foreign currencies the day after the dollar announcement."[100] By mid-January of 1986 when the Group of Five met again in London, the dollar had fallen 19% against the Japanese yen and 17% against the West German mark. Members of the Group of Five seemed satisfied with the progress made up to that point. Leonhard Gleske, a director of

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[98] Michael Salter et al., "Planning the Dollar's Fall," Maclean's, 7 October 1985, 38.

[99] Walczak, 92-93.

[100] Ibid., 90.

the Bundesbank, expressed the belief that Germany would do no more at that time to cause a further decline of the dollar.[101]

The Need for Further Intervention

The dollar did, however, continue its decline against the yen and the mark. The Japanese especially began to worry that the dollar had fallen far enough and intervened in the exchange markets in the spring of 1986 to try to maintain the dollar at 180 yen. Several important meetings involving top finance ministers and central bankers took place in this time frame -- an April 7-11 meeting of the International Monetary Fund (IMF) in Washington, D.C.; an April 16-17 meeting of the Organization for Economic Cooperation and Development in Paris; and a May 4-6 meeting of the Group of Five with representatives from Canada and Italy in Tokyo. On the agenda at all these meetings was the concept of "target zones" for the various currencies.[102] The Tokyo summit, which ended with an agreement among the seven major industrial powers to move toward the concept of target zones for currency valuation, was hailed as a success for Baker and the Reagan administration.[103] The plan, presented at the Tokyo summit by Treasury Secretary Baker, suggested the use of a group of key economic indicators including inflation and growth rates, trade and budget

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101 Edward Boyer, "The Attack on the Dollar Is Over," Fortune, 3 March 1986, 65.

102 Blanca Riemer, "Now, a Real Global Try at Stable Currencies," Business Week, 14 April 1986, 42.

103 Richard Fly et al., "Reagan Scores Big at the Summit," Business Week, 19 May 1986, 42.

deficits, and currency values to determine if exchange rates were within their target zones. Experts at the International Monetary Fund were to study which of these indicators would be most effective and present the results of their study at the September meeting of the International Monetary Fund.[104]

At the September meeting of the International Monetary Fund in Washington, D.C., however, talks between the members of the International Monetary Fund deteriorated as the Reagan administration waffled on the budget deficit issue and European and Japanese allies bickered over lowering interest rates in their countries.[105] His failure to make progress toward the use of target zones at the International Monetary Fund meeting led a determined Treasury Secretary Baker to begin "backroom dealing." Baker met with success on October 31, 1986, when "in return for a U.S. pledge to stop driving down the dollar, export-dependent Japan reduced interest rates and agreed to adopt new tax cuts."[106] The Baker-Miyazawa pact put Baker in the position to pressure West Germany to get its economy moving faster or face an alliance between Japan and the United States.[107] All these actions were aimed at increasing demand for American exports in a

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[104] Blanca Riemer, "Where's the Beef in Baker's Tokyo 'Triumph'?" Business Week, 30 June 1986, 47.

[105] Blanca Riemer and William Glasgall, "A Standoff at the IMF," Business Week, 13 October 1986, 42.

[106] Sarah Miller, Terri Thompson, and Douglas F. Graham, "Jim Baker Tries to Back Bonn into a Corner," Business Week, 17 November 1986, 70.

[107] Ibid.

faster growing Japan and West Germany. This, in turn, it was hoped would reduce the United States trade deficit. The Germans refused to be moved, however.

The Dollar's Fall Becomes a Weapon

Even with the Baker-Miyazawa pact, the dollar continued its decline. The Japanese accused the United States of not keeping its end of the bargain by allowing the dollar to fall from 164 yen to 154 yen, and the United States accused the Japanese of offsetting most of the effect of the income tax cut they had agreed to by imposing a value-added tax at the same time.[108] With the breakdown of the Baker-Miyazawa pact obvious by January 1987, the Reagan Administration seemed willing to let the dollar continue its descent against the yen and mark to get the message through to Japan and Germany that they must stimulate their economies or face the consequences of a much lower American dollar. The tactic worked:

> Two days after the dollar skidded to a postwar low of 149.98 yen in Tokyo, Japanese Finance Minister Kiichi Miyazawa jetted to Washington for emergency talks with Baker...A cut of half a percentage point in the Bank of Japan's discount rate, to 2.5%, was widely expected to result from the conference.[109]

Even the Germans seemed to be touched. "Germany's 18-member Bundesbank Council prepared to meet amid expectations that the central bank would reluctantly reduce the German discount rate from 3.5% to 3%."[110] The Germans, however, to show their resentment at the pressure

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[108] Blanca Riemer and William Glasgall, "The Risks of a Free-Fall," Business Week, 2 February 1987, 29.

[109] Ibid., 28.

[110] Ibid.

the United States was putting on them, also increased the reserve requirements of their banks, thereby reducing the amount the banks could lend to corporations.[111]

Another Attempt at Target Zones

Using the threat of further devaluation of the dollar, Baker approached the February 1987 meeting of the Group of Five nations from what he hoped was a position of power. His aim was to get a firm commitment from the Group of Five finance ministers and central bankers to the idea of target zones for currency valuation which had been advanced at the Tokyo summit of May 1986.[112] Baker's hopes for adoption of a system of target or "reference zones in which currency values would be allowed to fluctuate only within determined limits" were dashed again.[113] All the Group of Five agreed to in the Louvre Accord was a temporary pledge to defend the dollar if it slipped below 1.75 marks or 145 yen. Additionally, a few limited stimulative measures were promised by Germany and Japan.[114] In their official statement, the Group of Five allowed that:

> Further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate

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[111] Rich Thomas, "Double-Talk on the Dollar," Newsweek, 2 February 1987, 45.

[112] Michael Meyer and Rich Thomas, "Taming the Wild Buck," Newsweek, 2 March 1987, 53.

[113] Blanca Riemer et al., "The Paris Pact May Not Buoy the Dollar for Long," Business Week, 9 March 1987, 40.

[114] Ibid., 41.

closely to foster stability to exchange rates around current levels.[115]

The "in current circumstances" points out that no new long term agreement on currency stability resulted from the February 1987 Paris meeting.

The Louvre Accord Falls Apart

Exchange rates remained relatively stable through spring and early summer of 1987 as foreign central banks intervened to keep the dollar from falling. It is estimated that West Germany, Japan, and Great Britain spent from $52 to $100 billion by October 1987 intervening in the currency markets. These interventions hurt their economies by creating inflationary pressure because of the increase in domestic money supplies and the loss on investment as the dollar declined in value anyway.[116]

With the stock market crash of October 19, 1987, all attempts at holding to the Louvre Accord ceased. Federal Reserve Chairman Alan Greenspan was compelled to boost the money supply which in turn lowered interest rates by 1.5 percentage points and put downward pressure on the dollar.[117] "Less than two weeks later the president of Germany's central bank, Karl Otto Poehl, pronounced rate pegging more or less officially dead in a New York speech that virtually ridiculed

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[115] "Finance Ministers Meet on Exchange Rates," Department of State Bulletin (April 1987): 32.

[116] Robert E. Norton, "The Dollar: How Low Should It Go?" Fortune, 7 December 1987, 39.

[117] Ibid., 39-40.

James Baker."[118] In addition, Poehl denounced Baker's idea to tie the value of currencies to the price of a market basket of commodities, including gold.[119] The other members of the Group of Five joined West Germany in ignoring the Louvre Accord. Without the intervention of the Group of Five, the dollar fell drastically, settling at a low of 1.57 marks and 121 yen to the dollar by the end of 1987.[120]

The Dollar Recovers

As a result of coordinated central bank intervention at the beginning of 1988 and two months of better American trade figures, the dollar rose sharply against both the yen and the mark to 131 yen and 1.71 marks in February of 1988.[121] At the end of March, however, the dollar fell nearly 5% again.[122] America's major allies seemed to have tired of propping up the dollar time and time again. British Chancellor of the Exchequer Nigel Lawson suggested that Washington had "to be prepared to use interest rates to back up the sort of stability you want to see."[123] Likewise, the German Bundesbank "has signaled that it isn't likely to intervene unless the dollar's value falls to

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[118] Ibid., 40.

[119] Ibid.

[120] "The Dollar's Leap Year," The Economist (20 February 1988): 87.

[121] Ibid.

[122] William Glasgall et al., "Won't Anybody Help the Dollar?" Business Week, 11 April 1988, 56.

[123] Ibid., 57.

1.60 marks."[124] The Bank of Japan also was not terribly firm about intervening further to support the dollar.[125]

The Group of Seven, as the Group of Five became known after the addition of Canada and Italy, met again in April 1988 and reaffirmed their desire to stabilize currency markets.[126] When the February 1988 trade figures were released in late April, the Group of Seven had to put their words into action by once again intervening in the foreign exchange markets. Their intervention only slowed the decline of the dollar.[127] In spite of these ups and downs and interventions, however, Business Week reported in July that the dollar had actually been "remarkably stable" since early January. It also noted that "the Finance Ministers from the seven largest industrial nations who gathered at the Toronto summit were spared the familiar worries over the dollar that had marked earlier meetings."[128]

Has This Latest Intervention Reduced the Value of the Dollar?

Whether an intervention is perceived to have worked depends on the effect sought. Obviously, the latest interventions to drive the dollar down worked against the mark and yen -- perhaps too well. The subsequent interventions to prop the dollar up by the Japanese and German central banks attest to that. Later interventions to

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[124] Ibid.

[125] Ibid.

[126] Barbara Rudolph, "Punch in the Eye," Time, 25 April 1988, 59.

[127] Ibid.

[128] Mike McNamee, "Oh, Dear, Where Should the Dollar Be?" Business Week, 4 July 1988, 117.

stabilize the dollar were not so successful. The dollar continued to fall against the mark and yen despite numerous heavy interventions by central banks.

Another problem with determining the effectiveness of intervention is that the decreases in the dollar's value are measured by traditional indexes such as the Federal Reserve Board's daily index of the dollar versus ten major currencies which is based heavily on the mark and the yen. These indexes largely ignore Canada, Mexico, South Korea, Taiwan, Hong Kong, and Singapore.[129] Additionally, "the old indexes are weighted according to trade patterns of the mid- to late 1970s and also according to the importance of each currency in total world trade."[130] The problem with this weighting is that Canada is not a big player in world trade but is the United States' biggest trading partner.[131] To solve these problems, several new indexes have been developed based on more current trading patterns. These show a somewhat different picture of how much the dollar has declined. In February of 1987 when the Federal Reserve Board index showed the dollar as having declined by 40 percent from its peak in February 1985, the index prepared by Jeffrey A. Rosensweig, an economist with the Federal Reserve Bank of Atlanta, showed that the dollar had declined only 22 percent from its peak. Rosensweig's index includes currencies of 18 countries rather than 10 -- among these 18 are Hong

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[129] "Measuring the Dollar," Fortune, 10 November 1986, 52.

[130] Ibid.

[131] Ibid.

Kong, Singapore, South Korea, Taiwan, Australia, Canada, Saudi Arabia, and nine European nations.[132] Still another index has been developed by W. Michael Cox, an economist at the Federal Reserve Bank of Dallas. Cox's index includes all 131 countries that trade with the United States. In February 1987 Cox's index showed the dollar had fallen only 3 percent from its peak in early 1985.[133] Therefore, the answer to the question of whether or not this latest round of intervention has really worked even to reduce the value of the dollar cannot be clearly answered. It does appear intervention can affect the dollar's value against specific currencies but it cannot cause the dollar to be universally devalued.

Has the Dollar's Recent Decline Affected the Trade Deficit?

Perhaps a more fruitful approach to answering the question of whether or not this latest round of interventions has accomplished its intent is to look at its effect on the United States' trade deficit. Trade deficit statistics must be viewed with some caution. Wall Street generally follows and reacts to the monthly trade figures. There are a number of problems with that approach. For one thing, the monthly trade figures released by the Census Bureau are not seasonally adjusted. Likewise, the monthly figures often do not include up to 15% or more of a given month's imports. Therefore, the seasonally adjusted quarterly figures provided by the Bureau of Economic Analysis

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[132] Roger Thompson, "Rise and Fall of the Dollar," Nation's Business (February 1987): 9.

[133] Ibid.

are a more reliable source than either the preliminary or the revised monthly trade figures.[134]

For the year ended 1985, the merchandise trade deficit was $148.5 billion.[135] It was the threat of this huge trade deficit and the rising protectionist sentiment in the United States that prompted the action taken by the Group of Five to drive the dollar down in September of 1985. It was hoped that a cheaper dollar would drastically improve the trade deficit by increasing exports from the United States and decreasing imports to the United States. Economists warned that, even though the dollar had begun to depreciate during the fourth quarter of 1985, the effects of that depreciation would not show up in a reduction of the trade deficit before 12 to 18 months. This was because of an economic theory explained earlier in this paper and known as the J-curve. Simply stated, the J-curve theory said that because import prices would rise quickly but consumers would not change their buying habits as quickly, the trade deficit would widen before it improved.[136] Therefore, the fourth quarter statistics for 1986 were the first ones which should have shown some improvement in the trade deficit.

When the fourth quarter trade figures for 1986 became available, they showed real export volume had increased by an annual rate of 16%

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[134] Edwin A. Finn Jr., "Of Apples, Oranges, and Toyotas," Forbes (26 January 1987): 34.

[135] Clayton Yeutter, "U.S. Trade Policy and the Trade Deficit," Department of State Bulletin (April 1987): 23.

[136] Joan Berger, "The Falling Dollar Has Thrown the Trade Deficit a Curve," Business Week, 11 May 1987, 68.

in the fourth quarter, up from an annual rate of increase of 13% in the third quarter. During the first half of 1986, however, export volume had fallen.[137] The improvements in the export figures came in the time frame predicted by the J-curve. Imports, however, did not fit the J-curve theory. Instead, imports rose during the fourth quarter of 1986 but it was not possible to tell whether that was caused by price increases brought about by the dollar's devaluation or by a higher volume of imports purchased.[138] The final figure for the merchandise trade deficit in 1986 was $170 billion.[139] Obviously, the trade deficit had not staged a decisive turnaround after 15 months of a cheaper dollar. The overall trade gap had, in fact, worsened. It was hoped that the $170 billion trade deficit represented the bottom of the J-curve.

In the first quarter of 1987, however, imports declined at an annual rate of 8.8%.[140] "Prices of imports other than petroleum rose at a 10% pace in the first quarter. That means the shrinkage, in real terms, was much greater than the drop in dollar value."[141] The decline in imports was greatest for those items from Western Europe and Japan, while imports of items from such countries as South Korea, Taiwan, and

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[137] James C. Cooper, "Some Trade Numbers Are Looking Good -- For Now," Business Week, 16 February 1987, 25.

[138] Ibid.

[139] "One Month of Trade: A Sampler of U.S. Exports and Imports," Fortune, 27 April 1987, 220.

[140] William B. Franklin and James C. Cooper, "The Falling Dollar Is Improving the Trade Picture," Business Week, 1 June 1987, 39.

[141] Ibid.

Hong Kong actually increased.[142] Exports performed poorly. The value of exports to Western Europe and Japan fell compared to the fourth quarter of 1986 while the value of exports to the rest of the world remained constant.[143] The fall of the dollar was helping, but only in the import situation with the Western Europeans and Japanese. Since the dollar had not fallen against the currencies of the Pacific Rim nations of Hong Kong, Taiwan, and South Korea, the United States trade situation with them remained virtually unchanged with large trade deficits the rule. It seemed that the United States could not have both an increase in exports and a decrease in imports all in the same quarter.

That pattern continued to show up in the second quarter of 1987 when the real volume of imports remained high, "particularly from those countries where the dollar's value has not fallen substantially."[144] Imports from Western Europe and Japan barely grew during the second quarter, and exports did poorly which is normal for the second quarter.[145] The improvements in the trade deficit appeared to be small at best considering the dollar had already fallen about 40% according to the Federal Reserve's index.[146]

Finally, in 1988 the trade figures began to improve. The trade

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[142] Ibid.

[143] Ibid.

[144] William B. Franklin and James C. Cooper, "That Flood of Imports," Business Week, 26 October 1987, 25.

[145] Ibid., 26.

[146] Thompson, 9.

deficit shrank "from a monthly average of $14.9 billion in late 1987 to an $11 billion average for the three months ended in May of this year [1988]."[147] Richard B. Hoey, an economist with Drexel Burnham Lambert Inc., predicted the deficit would stabilize at a range of $10.5 billion to $11 billion per month.[148] Hoey hit the preliminary figure for September 1988 right on the head at $10.5 billion. Including the unrevised September figures, the trade deficit was running at an annual rate of $137.2 billion for 1988.[149] In September, the trade gap with Western European countries fell by $500 million to $880 million, the trade gap with the Pacific Rim countries fell by $250 million to $3.1 billion, and the trade gap with Japan fell by $700 million to $4.1 billion.[150]

The final trade deficit figures for 1988 which were released in February 1989 showed a annual deficit of $137.34 billion, the first annual decline in these figures since 1980. Exports rose to $322.22 billion, approximately 26.8 percent higher than in 1987, thanks to growing sales of American-manufacured products and farm goods. This gain in exports was large enough to more than offset an 8.3 percent increase in imports.[151] As could be expected:

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[147] Kathleen Madigan, "How Long Can the Trade Deficit Keep Shrinking?" Business Week, 22 August 1988, 20.

[148] Ibid.

[149] "Trade Deficit Falls, But So Does Dollar," Minot Daily News, 16 November 1988, p. A1.

[150] Ibid., p. A11.

[151] "Trade Deficit Declines for First Time Since 1980," Minot Daily News, 17 February 1989, p. A8.

> America's largest trade imbalance was with Japan, a deficit of $55.4 billion, down 7.3 percent from the all-time high set in 1987. The deficit with the 12-member European Economic Community was down even more sharply, falling 47.2 percent to $12.8 billion for 1988. The deficit with Canada, the largest U.S. trading partner, declined by 9.6 percent to $10.6 billion.[152]

A little over three years after the Group of Five met at the Plaza Hotel in New York and agreed to force the dollar down against the major European and Japanese currencies, the trade deficit has narrowed a little. The U.S. trade deficits with those countries, against whose currencies the dollar has fallen most, have improved. The trade deficits with those countries, against whose currencies the dollar has fallen little, remain basically unchanged. Only with the United States' closest trading partner, Canada, has the trade deficit shown a percentage decline that is close to the percentage decline of the dollar in relation to their currency. Americans still continue to import more than they export even with higher prices for imports. It appears that reducing the value of the dollar in relation to the currency of another country does have some effect on the amount of goods imported from that country, but the effect is usually less than the amount of the devaluation.

This latest use of intervention to reduce the value of the dollar has not been effective in solving the trade deficit problems of the United States. The United States is still running a massive trade deficit. According to the monetary theories behind exchange rate systems, the existence of this massive trade deficit should continue to force the dollar down in the foreign-exchange markets whether the

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[152] Ibid.

United States and other countries intervene or not. According to the latest figures, this has not been happening. In the spring of 1989, the dollar began to rise again. Since April 21, 1989, "the dollar has climbed nearly 5% against its West German counterpart and about 4% against the Japanese and British currencies."[153] Attempts by central banks to halt the dollar's rise have been ineffective through mid-May 1989.[154] It appears that the behavior of the dollar in the foreign-exchange markets is not easily explained by the standard monetary theories and that, therefore, intervention in the exchange markets to alter the value of the dollar cannot be particularly effective.

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[153] Michael R. Sesit, "Dollar Jumps to Its Highest in 29 Months," Wall Street Journal, 16 May 1989, p. C1, col. 3.

[154] Ibid.

CHAPTER VI

SUMMARY AND CONCLUSIONS

Intervention by central banks in the foreign-exchange markets has become a fact of life in the latter half of the twentieth century. With the rise of labor unions and the unacceptability of the use of violent contractions and expansions of the domestic economy to correct trade imbalances, a return to the gold standard seems an unlikely option. With the presence of central banks and the unwillingness of governments to allow drastic fluctuations in the value of their currencies on the foreign-exchange markets like those experienced in the late 1930's, a return to true floating rates seems unlikely as well. For these reasons, some form of managed exchange rate system, characterized by some degree of central bank intervention, has become the option of choice.

The world economic community has experimented with varying levels of intervention in the years since World War II. During the Bretton Woods years, the world attempted to establish a system of fixed exchange rates. Intervention was required by the terms of the Bretton Woods Agreement in order to maintain fixed parities, but a small amount of flexibility was built into the system. It became obvious as the world recovered from the after-effects of World War II that large devaluations and revaluations would be necessary. Eventually, the recovery was so complete that the dollar's value fell out of line with that of the other major currencies. Of all the major currencies, the dollar was the only one which could not be devalued under the Bretton

Woods System because the dollar had joined gold in the capacity of backing the currencies of other countries. Despite the dollar's position as a reserve currency, it became necessary to devalue the dollar and reach a new agreement. This devaluation proved insufficient, and the Bretton Woods System collapsed when its signatories refused to intervene to the extent necessary to support the value of the dollar.

The world economic community then experimented with a managed floating rate system. After a chaotic introduction which caused the foreign-exchange markets to be closed for several weeks in March of 1973, floating exchange rates performed reasonably well for over 4 years with only occasional intervention. Then the dollar began to fall and massive intervention to support it was deemed necessary. After nearly four years of increasing levels of intervention, which ultimately involved the domestic economy as well as the international sphere, the dollar began a recovery. With Reagan's expansionary policies, the dollar's strength grew and intervention was avoided since a strong dollar suited the political agenda of the administration. Finally, after huge trade deficits became the rule and support for protectionism had grown, the United States agreed to work cooperatively with Great Britain, France, Germany and Japan to drive the dollar down by intervention.

Intervention to drive a currency down to improve the country's competitiveness worked well for Japan and several European countries under the Bretton Woods System. Ultimately, all these currencies increased in value again as the countries involved moved from having a trade deficit to having a trade surplus. The Group of Five

intervention to drive the dollar down has not worked nearly so well. The initial drive to force the dollar down was successful against the currencies of Great Britain, France, Germany, and Japan. It was so successful, in fact, that the dollar fell further and faster than the G-5 desired. Efforts to prop the dollar back up failed miserably perhaps because, by the very action of intervention, the G-5 destroyed confidence in the dollar and also created a feeling of expectancy among speculators that further such interventions would occur. To further complicate the discussion on the efficacy of intervention, there were many currencies whose values were tied to that of the dollar, and U.S. trade deficits with those countries were unaffected by the dollar's devaluation against the G-5 currencies. After all the intervention by the G-5, the United States is still running a huge trade deficit. In addition, the dollar has begun to rise in value again in the spring of 1989 despite continuing huge trade deficits for the United States. This just highlights the fact that the U.S. trade deficit is somewhat different than a trade deficit for a non-reserve currency country.

The fact that the dollar is used as a reserve currency allows the value of the dollar to "break" the rules established by the three basic monetary systems. With the huge trade deficits the United States has been experiencing throughout most of the 1980's, the dollar should have fallen drastically in value. The fall in the dollar's value should not have stopped until the trade deficit was corrected. The dollar has not obeyed these rules, however. This is because other countries hold dollar reserves to back their currencies. Since these foreign-held dollar reserves increase each year, the United

States is forced to run a chronic 'balance-of-payments deficit.'[155]

As explained by John Mueller:

> It is probably no coincidence that the official 'net debtor' position of the U.S. ($368 billion at the end of 1987, and about $500 billion today) approximately equals the dollar assets of foreign central banks. This implies that, apart from the U.S. government and foreign central banks, Americans' books are still roughly balanced with the rest of the world.[156]

In other words, as long as the dollar is held as a backing for other currencies throughout the world, U.S. trade deficits are likely to continue into the foreseeable future.[157] As long as trade deficits for the United States are caused in part by the U.S. dollar serving as a reserve currency, it is difficult or impossible to know exactly when the dollar is under- or over-valued. Therefore, intervention on behalf of the dollar can be questioned on the grounds that, to be effective, the correct valuation for the dollar must be known.

Herbert Stein suggests another very feasible reason for both the trade deficit and the recent increase in the value of the dollar:

> The U.S. has a trade deficit because people in the rest of the world invest their savings here. This inflow of capital is voluntary on both sides -- foreigners are seeking the best place to put their money and American governments and companies are seeking the best place to obtain money. Foreigners seeking to invest here have to obtain dollars. Their demand for dollars keep (sic) the exchange rate of the dollar at a level where U.S. imports exceed U.S. exports.[158]

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[155] John Mueller, "CPI at 7%? Bet Your Reserve Dollar," Wall Street Journal, 24 February 1989, p. A16, col. 4, 5.

[156] Ibid.

[157] Ibid.

[158] Herbert Stein, "Don't Worry About the Trade Deficit," Wall Street Journal, 16 May, 1989, p. A14, col. 3-5.

Therefore, another way to make the dollar "obey" the rules so intervention will be effective is to make the United States a less profitable and safe place for foreigners to invest. Since it is unlikely that actions which would make the United States less of a desirable place for foreigners to invest will be taken, intervention cannot be used effectively to correct the trade deficit nor will forcing the dollar down necessarily be successful.

In conclusion, then, intervention on behalf of the dollar is not very effective. It is not effective both because the dollar is a reserve currency for the rest of the world and because the United States has traditionally been and still remains a safe and profitable place for foreigners to invest. Unless these two conditions change, intervention to change or maintain the value of the dollar is likely to be less effective than desired. Changing these two conditions would have more undesirable consequences for both the U.S. and world economies than living with massive U.S. trade deficits.

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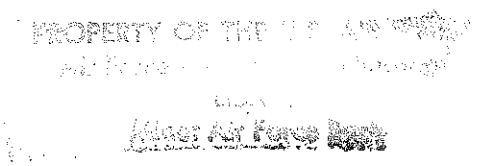

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332
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