

Scharrer, Hans-Eckart

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Successful Exchange Market Interventions?

The combined impact of rumours about an alleged secret agreement between central banks to support the dollar and massive foreign exchange market interventions by monetary authorities helped the dollar at the beginning of 1988 to overcome its record low of DM 1.5680 and Yen 120.45. Many observers felt that this was the first sign of an about-turn in the development of the dollar exchange rate. However, this hope seems premature.

At present, the portfolio decisions of international investors are primarily orientated towards the expected development of two variables, which thus have a considerable bearing on the development of the dollar exchange rate: the development of current accounts and interest rate differentials of the USA vis-à-vis Japan/Federal Republic of Germany (Europe). As regards the balances on current account, the American trading position has improved markedly in real terms, whereas there are signs of a gradual reduction of surpluses in Japan and the Federal Republic of Germany. However, the nine-month "stabilisation" of the dollar at around DM 1.80 as a result of the Louvre Accord of February 22nd, 1987, was not enough to also reflect the process of external economic adjustment in nominal terms. Furthermore, the basis for this process of adjustment is a narrow one: substantial sections of US as well as West German and European foreign trade are by and large insulated from the effects of exchange rate changes. In addition, as a consequence of the rapidly growing external debt of the USA the traditional American surplus in investment income has diminished substantially; a deficit is expected in 1988 – at the expense of future current account development.

If, accordingly, the current account figures will continue in future to pull down the dollar the question arises whether the interest rate differentials between dollar, yen and D-mark investments will be sufficient to counteract this declining trend. This was obviously not the case last year. The buying up of probably more than US \$ 100 billion by monetary authorities demonstrated that, in view of existing interest and exchange rates, private investors were not willing to finance the American current account and budget deficits. Via their interventions, therefore, the non-American monetary authorities in effect provided the USA with an interest subsidy. It seems rather doubtful that the interest rate differential will increase to an adequate extent in 1988 to stabilise the dollar exchange rate at its current level in view of continuing external economic imbalances. Not only the election year, but also concern about a renewed stockmarket crash stand in the way of a clearly more restrictive monetary policy course in the USA. The dollar exchange rate, therefore, can be expected to fall even further during the course of the year.

Another reason for the lack of jubilation over the recently administered exchange rate increase is the fact that there are growing doubts over whether the conceptual fixation of central banks on the dollar exchange rate is the right approach. The dollar exchange rate is undeniably an important economic variable and the risk of a further decline in its value is bound to have an adverse effect on the willingness of many businesses to invest (more) in Europe. It is also true that due to their extremely short-term time horizon foreign exchange market participants repeatedly subject the industrial sector to serious shocks, which the latter can only cushion to a limited extent on account of its long-term (real) capital tie-up. Interventions by monetary authorities, therefore, are often justified by referring to the argument that central banks have to play the part of a counterspeculator with a medium-term orientation.

The question is, however, whether the results of the dollar policy so far justify the effort. The influence of the monetary authorities on the course of exchange rate development during the last decade was in fact pretty limited despite numerous tactical victories over the "speculators". Interventions by the Deutsche Bundesbank of DM 24 billion in 1978 and DM 19 billion in summer 1979 were unable at the time to prevent the dollar from declining at an accelerated pace; the exchange rate trend only changed following the transition to a new monetary policy in the USA. Nor was success any greater in the years 1981-85: although the Bundesbank injected billions of dollars into the market and ran the risk of triggering a recession via a markedly restrictive monetary policy which contradicted the needs of the domestic economy the dollar rose to DM 3.47. Although the interventions in the wake of the 1987 Louvre Accord managed to temporarily check the dollar's slide a high price was paid: businesses were given false market signals and the monetary growth target in the Federal Republic of Germany was exceeded to such an extent that doubts grew with regard to its justification. In the end, the accumulated need for a change in exchange rates was so great that it burst all barriers. On the whole, by defending a rigid exchange rate level which did not conform with market forces the monetary authorities probably contributed more towards destabilising than consolidating international financial markets and economic expectations in 1987 – "Black Monday" (October 19th, 1987) was also the price which had to be paid for the incompatibility between the dollar exchange rate and interest rate differentials.

The monetary authorities of industrialised countries have, on the whole, lost credibility during recent years due to their repeated inability to achieve both exchange rate policy and monetary policy objectives. Indeed, the managed floating regime, as practised so far, combines the weaknesses of the Bretton Woods system (lack of control over the money supply) with those of a "pure" system of flexible exchange rates (lack of control over the exchange rate).

Some fundamental rethinking about the dollar policy approach seems necessary. The first element of a comprehensive adjustment strategy in Europe is the renunciation of all efforts via wordy communiqués, foreign exchange market interventions or interest rate policy measures to push through a rigid dollar exchange rate target against the market. Past experience shows that this tends to do more harm than good, all the more so as it is not based on a fundamental economic policy consensus with the USA. Instead, the monetary authorities should seek first and foremost to achieve continuity in their monetary policies and restore their credibility. For the Federal Republic of Germany this means that the Deutsche Bundesbank should adhere to its recently announced money supply target for 1988.

A second essential element of a new approach is a fairer distribution of the burden of adjustment between individual countries, branches of industry and businesses. By linking their currencies with the D-mark many of Germany's partner countries in the European Monetary System (EMS) have had to accept currency appreciations against the dollar which were not justified in terms of their own external economic position. At the same time, there was a further increase in the German current account surplus vis-à-vis the countries of the European Community last year, a development which runs contrary to the necessary reduction of the Federal Republic of Germany's aggregate current account surplus. A realignment within the EMS taking these developments into account, therefore, would be an appropriate move. A fairer distribution of the burden of adjustments must also include exposing those branches of industry and businesses protected via subsidies from the effects of exchange rate changes – ranging from the aircraft industry (Airbus) to the agricultural sector – to the same international competitive conditions as the other sections of the economy, at the expense of which the former are living.

The third element of a positive adjustment policy would be a cooperative strategy – including the bringing in of the latest Japanese experience – to accelerate economic growth, promote the process of innovation and create new jobs in competitive businesses and branches of industry. The weak dollar is not just a matter of concern for monetary authorities. Governments as well as unions and employers are called upon to help solve the problems this causes.

Hans-Eckart Scharrer