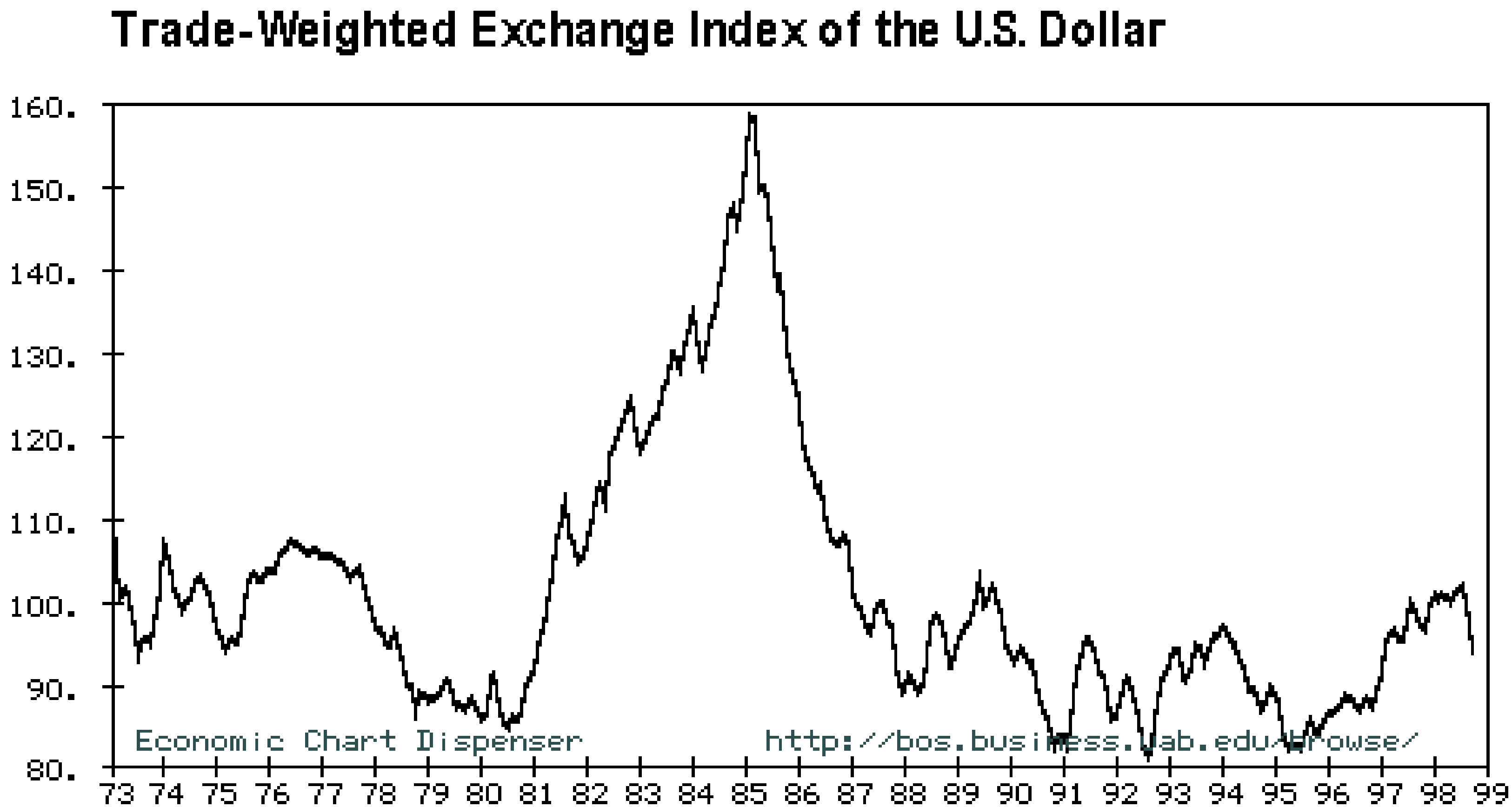
Exchange-Rate Policymaking in the US

•The exchange-rate of the dollar has been extremely <u>volatile</u> since the end of Bretton Woods in 1973. The US$ depreciated 13% between 1974-79, then appreciated 63% from 1979-85, then fell 62% between 1985-90.



The Exchange-Rate as a Policy Variable

- **Instruments of exchange-rate policymaking.** While market forces are the fundamental determinates of exchange rates, the demand and supply of currencies is subject *to some degree* to the will and actions of governments.

1. "Direct" policies

– Foreign exchange intervention by central banks and Treasuries.

– Multilateral intervention (coordinated with other governments).

– "Jawboning": Talking the dollar up or down.

2. "Indirect" policies that bear on exchange rates

– Unilateral adjustment of monetary and/or fiscal policy.

– Multilateral adjustment of monetary and/or fiscal policy.

Structure of US Exchange-Rate Policymaking

- **Who controls direct and indirect instruments of policy?** Just as with trade policy, how policy is made can shape the content and direction of policy. But unlike trade policy:

  - Exchange-rate policymaking, both direct and indirect, is a *very closed process* removed from societal and congressional pressures.

  - Process has remained largely unchanged for most of the century.

- **"Direct" exchange-rate policymaking**
  - Decisions to intervene or jawbone in FOREX markets are made by Treasury Dept and the Federal Reserve. The Fed is the junior partner.
  - Treasury controls the Exchange Stabilization Fund (ESF) which is a pool of foreign exchange used for intervention. ESF operations are conducted through the Federal Reserve Bank of New York.

US Policymaking Institutions, cont.

- **Direct exchange-rate policymaking (cont.)**
  - The Fed also holds reserves of foreign currencies and can intervene at its own discretion. In practice, virtually no intervention or jawboning takes place without mutual consent and conflicts between the Treasury and the Fed are rare.
- **Indirect policymaking**
  - Domestic Monetary Policy is the domain of the Federal Reserve, the most independent of all American political institutions, short of the Supreme Court.
  - The Fed's independence from politics and Congress is a function of the long tenure of Fed officials (14 years) and the Fed's budgetary autonomy (it's self-financed).
  - The Fed's primary mandate is to fight inflation, but because int'l financial markets are tightly integrated today, there is a much stronger link between domestic monetary policy and the exchange rate.

US Policymaking Institutions, cont.

- The exchange-rate is one of the primary "channels" by which monetary policy affects the economy. For example:

$$M\downarrow \;\Rightarrow\; i\uparrow \;\Rightarrow\; E\uparrow \;\Rightarrow\; NX\downarrow \;\Rightarrow\; Y\downarrow$$

  where M is the money supply, *i* is the real interest rate, *E* is the value of the dollar, *NX* is net exports (exports minus imports) and Y is aggregate output (GDP).

- **Fiscal policymaking**, by contrast, is open, inclusive, and resistant to sudden change. The president proposes the budget, Congress weighs in on virtually even line (with interest groups and pork barrel projects in mind). This is a slow moving and very political process.
  - –Fiscal policy can have a dramatic impact on exchange rates (as in large budget deficits of the 1980s) but it is indirect as fiscal policy rarely gives much precedence to the exchange rate.
  - –Fiscal policy choices are not determined by external, exchange rate considerations.