Intervention: divine or comic?

If central banks are so reluctant to intervene in foreign-exchange markets, why do they still hold so many reserves?

THE clamour for the European Central Bank (ECB) to intervene to save the ailing euro is getting louder by the day. As the euro hit another new lifetime low of below 85 cents this week, Michael Mussa, the IMF’s chief economist, said that the ECB ought to think about intervening to stop the rot. The weak euro will be discussed at the G7 meeting of central bankers and finance ministers in Prague on September 23rd. Few traders expect the G7 to agree to co-ordinated intervention—giving them yet another reason to push the euro still lower.

For all that most European policymakers have been trying to make bullish noises about the euro, they are more than a little miffed about Mr Mussa’s comments. He comes, after all, not just from the IMF, but—quelle horreur!—from America: both man and institution should not poke their noses in where they are not wanted.

This is a bit odd. Last week the ECB itself triggered speculation that it was intervening when it announced that it was using euro2.5 billion ($2.1 billion) of interest income earned on its foreign-exchange reserves to buy euros. The ECB insisted that this was only a technical adjustment, not intervention, but the markets were not so sure. Yet whatever the ambiguities, the questions are straightforward enough. Does the ECB need to intervene, and even if it does, will it work?

Mr Mussa argued that the weak euro was no longer just an embarrassment, but a problem. In particular, he said, it could exacerbate trade imbalances and so boost protectionism. Almost everybody agrees that the euro is undervalued today. Yet as far as the ECB is concerned, a weak euro is only really a problem if it pushes up inflation; and at 2.3%, inflation in the euro zone is still rather modest. Nor is the euro anywhere near as weak as its constituent currencies were in early 1985. The D-mark is today about 50% stronger than it was then.

So the case for intervention to support the euro is far from proven. But even if it was, would intervening help to push up the beleaguered currency? There is, of course, intervention and intervention. In the “unsterilised” sort, a central bank allows its sales of foreign currency to reduce
the money supply; in the “sterilised” sort it neutralises any effect on the money supply. The former is really just a type of monetary policy, not a separate tool. So by “intervention” economists normally mean the sterilised variety.

Most studies suggest that such intervention rarely works. But it can sometimes, if two conditions are met. First, such intervention must be co-ordinated with other central banks. Second, it should be used to signal new information about future policy.

That last week’s intervention by the ECB (if intervention it was) failed to buoy the euro was therefore no surprise. To take the second point first, intervening whilst simultaneously denying it is not exactly a clear signal. And intervention by the ECB alone would also be pointless. Though Japan has made sympathetic noises, the ECB needs America’s help if intervention is to succeed. It is unlikely to get it. The Americans will not want to push the dollar down ahead of their election. That is especially true when inflation is rising: the strong dollar has helped to hold down America’s inflation rate over the past couple of years, despite a red-hot economy, and has made it easier to finance its burgeoning current-account deficit.

All of which might be true but, as Mr Mussa says of intervention, “If not now, when?” His question raises another, perhaps more fundamental one. If intervention works, why do central banks intervene so infrequently? If it does not, why are they sitting on mountains of reserves? Even excluding their vast gold holdings, the ECB and the euro area’s national central banks together hold $226 billion of foreign-exchange reserves. Central bankers and economists are now asking this question more often. It was discussed last month at the central bankers’ annual pow-wow in Jackson Hole, Wyoming.

**The squirrel’s nuts**

The idea of having masses of reserves is partly a hangover from the Bretton Woods system of pegged exchange rates. Governments were then obliged to defend their parities against the dollar through official intervention and so needed ample ammunition. Yet Bretton Woods broke down almost 30 years ago and fewer countries now peg their currencies. Nowadays most economists think that in a world of highly mobile capital, countries have two options. They must either fully fix their currency, to the dollar, say, through a currency board or dollarisation, or they must allow it to float freely. Any arrangement in between, such as the old European exchange-rate mechanism or the East Asian currencies’ pegs before 1997-98, will eventually come unstuck.

This shift to floating exchange rates should in theory have reduced the need to hold reserves. Yet global foreign-exchange reserves are at record levels, equivalent to 15 weeks of imports, more than twice as high as they were in the late 1960s under the Bretton Woods regime.

Some economists and central bankers think that central banks no longer need such massive war chests. Not only is there less need to hold reserves to defend a currency, especially if intervention is of dubious value, but the other main reason to hold reserves—as a safety cushion in times of war, a trade embargo or a banking crisis—also looks suspect. It is understandable that a country such as Taiwan, which worries about the risk of an attack by China, holds large reserves. But in most developed countries, the need for a safety net seems much less.

Large reserves are not just unnecessary, they are also costly. It is rather as though a household with lots of cash sitting idle in a low-interest bank account was at the same time paying a much higher interest rate on its debts. It would make more sense to repay some of that debt. For most countries, the interest cost of domestic borrowing is greater than the return on foreign reserves,
because reserve currencies tend to pay lower interest rates. So taxpayers lose out.

Moreover, if a central bank such as the ECB has huge reserves, but seldom uses them to intervene when its currency falls, its protestations that its currency is undervalued ring hollow. Investors reckon that if the ECB were really serious about wanting a strong euro, it would have intervened already and strongly. Central banks that are not prepared to intervene would be more credible with smaller reserves.

Of course, they still need some reserves, to smooth out temporary gaps in the demand and supply of foreign currency. But reserves equivalent to four weeks’ worth of imports would be more than enough. The euro zone currently has 13 weeks’ worth of reserves; Japan 48 weeks’ worth.

Then there is the question of what assets to invest reserves in. The dollar accounts for some two-thirds of global foreign-exchange reserves. Most of the money is plonked into government securities. Yet the government plans to repay its debt within 12 years, thus shrinking the bond market. The need of foreign central banks to replace maturing bonds is already distorting the market. Either central banks will have to buy something else or they will have to shrink their reserves.

And herein lies an irony. If countries in the euro zone started to run down their reserves, the impact might be the same as intervening: the ECB would have to sell dollars. Different starting point, same effect.