

Exchange-Rate Policy: What the Treasury Secretary Should Say About the Dollar

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John Snow, the US Treasury secretary, appears to be facing a fate similar to that of his most immediate predecessor, Paul O'Neill. Because he is not one of their own, financial market participants and commentators are looking for reasons to criticize him.

They took their chance when Mr. Snow was so bold as to utter a public comment on US dollar policy. Instead of sticking zealously to the "strong dollar" policy of Robert Rubin, the former Treasury secretary, Mr. Snow talked of people having "confidence" in the currency. The reaction was contempt. The "strong dollar" has become the "confident dollar". Traders were not impressed and down the dollar went, continuing the decline that followed Mr. O'Neill's earlier remarks.

The criticisms are unfair. Being in charge of exchange rate policy, the Treasury secretary has little choice but to comment on the dollar. But there is not much the Treasury can actually do about currency fluctuations. Mr. Snow's and Mr. O'Neill's comments are no more responsible for the fall in the dollar than Mr. Rubin's were for its earlier rise. So what should Treasury officials be thinking and saying about the dollar? To answer that question, we must look at what does affect exchange rates. Modern economic textbooks agree on one basic principle: a country cannot be open to international capital flows and control both its exchange rate and its interest rate. This is one of the very few immutable laws of economics - one that has been validated repeatedly in many financial crises.

It is fairly simple to grasp why, in a world of capital mobility, policymakers must choose between controlling interest rates and exchange rates. Open financial markets require investors to be indifferent between the purchase of bonds in different countries, so interest rate differentials must equal expected exchange rate changes. If a country's interest rate is relatively high, its exchange rate is likely to appreciate.

Since central banks such as the US Federal Reserve, the European Central Bank and the Bank of England control domestic interest rates, they have implicitly decided to let their exchange rate fluctuate. The implication is that direct exchange rate interventions will be ineffective: decisions to buy or sell currency that leave domestic interest rates unchanged will have no impact on the exchange rate.

To see why this must be so, consider what intervention does to the central bank's balance sheet. In order to control interest rates, policymakers manipulate the size of their liabilities - the level of reserves in the banking system. Foreign exchange intervention that leaves reserves unchanged affects only the asset side of the balance sheet. Intervention by a modern central bank

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simply exchanges securities denominated in domestic currency for securities denominated in foreign currency.

Most Fed and Treasury officials know this, and act accordingly. Mr. Rubin told anyone who would listen that "a strong dollar is in the interest of the US" but rarely intervened to try to influence its level. After his first year in office, he intervened only once - in June 1998 - and that was to try to weaken the dollar. Since then, the US has intervened only once more, again to weaken the dollar. So Mr. Rubin's strong dollar policy did not imply any active attempt at raising its value.

Although interest rate changes have a direct impact on exchange rates, Federal Reserve officials always emphasize that the Treasury secretary has formal responsibility for dollar policy and decides when to intervene. He or she has responsibility without power. But unlike Alan Greenspan and his Fed colleagues, the Treasury secretary cannot refuse to answer questions about the dollar. What should Mr. Snow say?

Any answer must be clear that exchange rate policy is designed to achieve two long-run goals: first, keeping the dollar as the pre-eminent global currency; and second, maintaining economic policy that ensures high, stable real economic growth and high, steady investment returns. If these objectives are achieved, it will, in Mr. Snow's words, make people confident in the dollar. A stable economy will bring a stable dollar, which is what is wanted.

It is essential that Treasury officials are clear that they are going to let financial markets determine the dollar's day-to-day value. They are unable to do anything about currency trends, even over several years, and intervention in currency markets can be an emergency measure only.

So the next time Mr. Snow is asked about the dollar policy - which he will be - this is what he should say: "Day-to-day fluctuations in the value of the dollar are determined in financial markets. Our goal is to implement policies that ensure high and stable growth, so that the US economy continues to be the best place in the world to invest and the dollar remains the pre-eminent currency."

If Mr. Snow and Mr. O'Neill had been saying this for the past two years, would it have made any difference? Would the dollar still have depreciated by 25 per cent against the euro? The answer is probably yes. The dollar's decline is a result of economics, not rhetoric. Mr. Snow is clearly right. What the US needs is a fiscal policy that inspires investor confidence. When the country gets it, it will also get a stable dollar.