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U.S. Dollar Intervention: Options and Issues for Congress

After falling to its lowest value since the introduction of floating currencies in 1973, the U.S. dollar has appreciated by 25% between July 2011 and July 2019—its highest value since the early 2000s. President Trump and others have argued that the dollar's current relative strength is holding back growth since a strong dollar makes U.S. exports more expensive in foreign markets while at the same time making it difficult for domestic producers to compete with cheaper imports. This has raised questions about what policy options are available to potentially reduce the value of the dollar. Interventions are more likely to succeed if paired with fiscal or monetary policy changes and supported by major trading partners.

Historical Experience

In the flexible exchange rate period since the early 1970s, the dollar exchange rate has not typically been an explicit target of U.S. economic policy, with market forces determining the value of the dollar instead. Policymakers typically address concerns about the exchange rate by targeting underlying fundamental issues, such as the size of the budget deficit.

At various points over the past several decades, however, when the U.S. government and others agreed there were fundamental misalignments or an excessive amount of exchange rate volatility, action was taken to directly alter the exchange value of the dollar (see **Figure 1**). President Carter intervened to stem the decline of the dollar in 1978. The dollar subsequently appreciated sharply during President Reagan's presidency, leading to a group of major economies signing agreements in the mid-1980s to collectively intervene, first to weaken and then to stabilize the dollar. The United States stopped intervening, for the most part, in the mid-1990s. Since then, the United States, in coordination with other countries, has intervened on three isolated occasions—in 1998, 2000, and 2011.

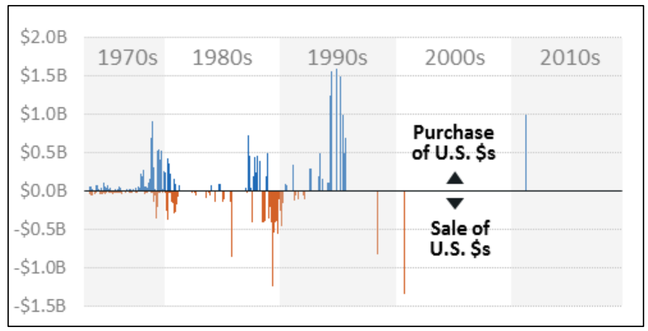
Policy Options

The U.S. government can intervene in foreign exchange (FX) markets in an effort to raise or lower the value of the dollar relative to foreign currencies (i.e., the exchange rate). If the government wishes to raise the value of the dollar, it buys dollars and sells its FX holdings. If it wishes to reduce the value of the dollar, it does the opposite.

The 1934 Gold Act assigned the Department of the Treasury the primary responsibility for FX policy. Both Treasury and the Federal Reserve (Fed), an independent agency, can intervene in FX markets. However, they have typically intervened jointly, with the Fed conducting operations on Treasury's and its own behalf.

The U.S. government's ability to intervene to increase or defend the value of the dollar is limited by its relatively modest FX reserves. Currently, the Fed holds $20.65 billion in foreign exchange reserves and the Treasury holds another $20.63 billion in the Exchange Stabilization Fund (ESF). By contrast, the government's ability to intervene to reduce the value of the dollar is limited only by the Fed's willingness to buy FX reserves.

Figure 1. U.S. Foreign Exchange Interventions
1973-2019



Source: Federal Reserve.

Exchange Stabilization Fund. Treasury can conduct currency intervention through the ESF. The ESF's initial objective was to stabilize the value of the dollar by buying and selling foreign currencies and gold. In 1973, with the demise of the Bretton Woods monetary system, where the dollar was pegged to gold and other countries were pegged to the dollar, the explicit purpose of stabilizing the exchange value of the dollar was stricken from the ESF's statute. In its place, the Treasury Secretary has broad authority: "Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the Secretary . . . with the approval of the President may deal in gold, FX, and other instruments of credit and securities."

In addition to its initial capitalization ($2 billion), Congress allowed the ESF to remain outside of annual appropriations. Instead, the ESF retains all of the earnings from its operations. The main limitation on the ESF's ability to intervene to reduce the value of the dollar is the amount of dollar-denominated assets in its portfolio, which are $22.48 billion as of March 2019. In order to secure more dollars for foreign exchange operations, Treasury could (1) seek an additional appropriation from Congress; (2) monetize its holdings of IMF special drawing rights (SDR, an international reserve asset), valued at $50 billion, by temporarily selling them to the Fed; or (3) engage in a currency swap arrangement called "warehousing," in which the ESF sells foreign currency to the Fed and agrees to repurchase it at a later date, during which the Fed credits dollar reserves to the ESF for the duration of the swap.

Federal Reserve. The Fed can also purchase foreign currencies to reduce the value of the dollar; but unlike the Treasury, it is not limited in how much it can purchase. Because the Fed controls the money supply, it has the option to create bank reserves as desired to purchase foreign currencies.

In addition to foreign exchange intervention, economic theory predicts that short-term interest rates, the Fed's main policy tool, also affect the value of the dollar. The value of the dollar is determined by the relative demand for U.S. goods and services and U.S. assets. In practice, capital flows dwarf trade flows, so the value of the dollar is particularly sensitive to interest rates in the United States relative to the rest of the world. Foreign capital can only flow into the country on net (i.e., when foreign purchases of U.S. securities or physical capital exceed U.S. purchases of foreign securities or capital) through the exchange of foreign currency for dollars. Theory predicts that if the Fed lowers interest rates relative to the rest of the world, it would reduce the demand for U.S. capital, thereby reducing the value of the dollar. This is one of the standard channels through which lower interest rates stimulate the economy. Although U.S. interest rates are currently low, they are even lower for many major trading partners.

Deficit Reduction. Congress also has a tool at its disposal if it wishes to reduce the value of the dollar—it can reduce the federal budget deficit. Economic theory predicts that, all else being equal, government budget deficits push up interest rates and the value of the dollar because the deficit is financed by selling debt to private investors. That debt competes with private investment for investors' finite pool of saving, pushing up interest rates on all securities. When the government reduces the deficit, there is less competition for that saving and interest rates fall. Lower interest rates make U.S. investment relatively less attractive, thereby reducing demand for the dollar and lowering its value.

Effectiveness: Sterilized vs. Unsterilized Intervention. According to the Fed, it routinely sterilizes foreign exchange interventions. Sterilized intervention is when the Fed takes offsetting steps to neutralize the impact of intervention, whether it be by the Fed or the ESF, on interest rates. Unsterilized intervention is when the Fed accommodates the decline in the dollar by lowering interest rates. As discussed above, lower interest rates would support the depreciation by reducing demand for the dollar.

Economic theory predicts that foreign exchange intervention only has a lasting effect on the dollar if it is "unsterilized." Economists debate whether sterilized intervention is ineffective in reality, with some evidence on both sides. For example, interventions in the 1970s to boost the value of the dollar were seen as ineffective because the Fed was not willing to simultaneously rein in inflation. By contrast, intervention set off a lasting decline in the dollar in the 1980s, although some economists question whether macroeconomic conditions were the true cause of the decline. In practice, sterilized intervention could be ineffective because the amounts involved are small relative to private trading volume (daily turnover for the dollar in foreign exchange markets was $4.4 trillion in 2016).

Intervention and Fed Independence. While the Fed has the more powerful tools to influence the value of the dollar, it defers to the Treasury in articulating the government's dollar policy. Yet the Fed's independence from the Administration means that Treasury cannot require the Fed to support its currency policy, which would be necessary if the intervention were to be unsterilized, conducted by the Fed, or involve the Fed buying SDRs from the ESF or warehousing the ESF's foreign exchange. The Fed's independence has already been put under a spotlight by the President's repeated calls for the Fed to lower interest rates. Arguably, the rarity of the Fed's foreign exchange interventions would highlight the implications for independence if it were called on to intervene.

Economic Effects

United States. If the government could successfully sustain a lower dollar policy, it would increase foreign demand for U.S. exports and increase U.S. demand for goods that compete with foreign imports. This would boost total spending in the economy, while making some groups worse off (e.g., it would reduce the purchasing power of U.S. consumers.) Whether this was positive or negative depends where the economy is operating relative to full employment. If the economy were operating below full employment, a boost in spending would be welcome, as it would help move the economy closer to full employment. But if the economy were at or above full employment, a boost in spending could be unwelcome, as it could push inflation higher. With the unemployment rate in 2019 at its lowest level since the 1960s, the economy appears to be very close to full employment. However, inflation has been persistently low despite low unemployment, so the risk of unwelcome inflation may currently be lower than typical.

Since, as discussed above, dollar interventions alone are typically not large enough to have a lasting impact, were a lower exchange rate sustained, it would likely be because of a change in fiscal or monetary policy or because private investors reduced their demand for U.S. assets. These developments would also have effects on the U.S. economy not captured in the analysis above.

Rest of the World. One theme of economic research on currency intervention is that efforts must be coordinated to be successful. For example, in the 1980s, there was broad concern among global powers about the strength of the U.S. dollar and its effect on the global economy. In contrast, current concerns are not shared by major trading partners, who largely view the dollar's strength as a result of the strength of the U.S. economy relative to the rest of the world and recent U.S. budget deficits. Such diverging views raise the prospect of tit-for-tat competitive devaluations if the United States were to pursue dollar devaluation on its own, which could negate any U.S. trade gains. It might also trigger financial market instability. Countries such as China and Japan have shown a willingness to engage in significant foreign exchange interventions in the past.

Marc Labonte, mlabonte@crs.loc.gov, 7-0640
Martin A. Weiss, mweiss@crs.loc.gov, 7-5407

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