Will dollar strength trigger intervention in 2017?

By Carmen Reinhart
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Only a small group of central banks refrain from intervening in the foreign-exchange market to stabilize their currencies' exchange rate or coax it in the desired direction. Even when they do not intervene directly, their interest-rate policies are often formulated to be compatible with exchange-rate objectives. As a result, freely floating currencies are comparatively rare. This has important implications for the United States authorities as they confront a sharp rise in the dollar's exchange rate.

When a potential or actual loss of confidence in the currency threatens to bring about large capital outflows, intervention usually takes the form of sales of foreign-exchange reserves to mitigate the magnitude or speed of depreciation. The People's Bank of China's ongoing reserve losses are a salient recent example. The most recent US intervention in foreign-exchange markets (which has been rare in general) to support a weak dollar dates back to 1992-1995.

At the other end of the spectrum, concerns about lower international competitiveness as a result of significant currency appreciation may be even more common among policymakers and export-oriented firms. Worries about overvalued currencies permeated policy discussions in many emerging markets as recently as 2013, and sustained efforts to lean against the wind of appreciation resulted in record reserve accumulation for many central banks.

Fears of a strong currency are by no means limited to emerging economies. As the recent crisis in the eurozone periphery deepened and the euro's value plunged relative to the Swiss franc, Switzerland's central bank, citing the strong franc's threat to the economy, introduced a *de facto* exchange-rate peg in September 2011. The policy capped the Swiss franc's appreciation against the euro, because the central bank stood ready to buy foreign exchange in whatever quantities were necessary. After a spectacular increase in reserves, the cap was eventually lifted in December 2014 and replaced with a policy of negative interest rates.

The US has not been exempt from such concerns. In the first half of the 1980s, following the Federal Reserve's record interest-rate hikes, the dollar appreciated by almost 45% against other major currencies. As a result of the strong dollar, the US lost international competitiveness and the trade balance sank to record lows in 1985.

These developments set the stage for the Plaza Accord, which my colleague Jeffrey Frankel has described as probably the most dramatic policy initiative in the foreign-exchange market since President Richard M Nixon floated the dollar in 1973. At New York City's Plaza Hotel on September 22, 1985, US officials and their counterparts from the world's leading economies agreed to take concerted action to halt and reverse the dollar's appreciation. It was an accord precisely because it involved international policy coordination among the major players, whose public statements were coupled with organized market intervention (selling US dollars).

The dollar did indeed depreciate, though the extent to which this can be attributed to the Plaza Accord remains a source of some debate. What is certain is the relevance of that debate today.

The dollar has appreciated by more than 35% against a basket of currencies since its low point in July 2011. While the dollar's climb has been attributed partly to Donald Trump's

unexpected victory in the US presidential election, it also reflects the fact that US monetary policy is set to tighten against a backdrop of continued monetary stimulus in the eurozone and Japan.

President-elect Trump campaigned on a promise to bring back US manufacturing, even if doing so requires imposing tariffs and dismantling existing trade arrangements. Yet a strong dollar is a major obstacle to fulfilling his promise. Perhaps financial markets will begin to perceive the dollar as currently overvalued and retrench. If not, will it be time for another Plaza-style accord? More important, who would be willing to cooperate?

Apart from the significant cumulative appreciation of the US dollar, there are scant similarities between the current environment and 1985. Back then, Japanese real GDP growth topped 6%. Today, sustained appreciation of the yen would probably derail the modest progress forged by the Bank of Japan in raising inflation and inflation expectations. With the ratio of public debt to GDP at around 250%, higher inflation is likely to be part of the solution to Japan's debt overhang.

On the other hand, Germany, with its record-high current-account surpluses (exceeding 8% of GDP) could withstand an appreciation. But, unlike 1985, in a scenario where the euro survives its current challenges, it will not be the Bundesbank that sits at the table in 2017. From the vantage point of the European Central Bank, which is coping with another round of distress in the periphery (primarily in Italy, where the frailty of the banking system is fueling capital outflows), the euro's weakness is a godsend.

That leaves China, now the world's second-largest economy, which was not an integral part of the 1985 agreement, to bear the burden of dollar depreciation. But China's recent tightening of capital controls underscores the challenge it already faces in preventing the renminbi from depreciating further. Moreover, given the negative impact of the strong post-Plaza yen on Japan's subsequent economic performance, it is unclear why China would consider a stronger renminbi to be worth the risk.

In other words, while it is quite plausible to expect that Trump's Treasury will want to reverse the dollar's climb, it is equally plausible that no other major economy will help. If the strong dollar prompts intervention in currency markets in 2017, the most likely scenario is one in which the US intervenes alone.

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