Could the Fed Intervene to Weaken the USD?

It has been years since the Federal Reserve, at the behest of the US Treasury, has stepped into the FX markets to try influence the value of the USD specifically. President Trump’s recent comments on the exchange rate have renewed speculation that the FX intervention option could be activated again. We think the case for intervention is weak, however, meaning success is not guaranteed, and that the USD is poised to soften anyway.

It’s been years (decades) since the Federal Reserve intervened specifically to affect the value of the USD. The last “concerted” intervention occurred in 2011 when G7 central banks jointly intervened to stem JPY strength following Japan’s devastating tsunami in March of that year. Concerted intervention also occurred in late 2000 to support the weak EUR. The last time the Fed intervened on its own account on the USD was supportive intervention in the mid 1990s. The broad consensus across the G7 since the early 2000s has been that markets should determine exchange rates.

So consider a very brief recap of what US FX intervention policy is, as we know it. 1) The Treasury, usually in consultation with the Fed, is responsible for setting exchange rate policy. 2) US FX intervention is conducted by the NY Fed and has been traditionally followed, after a short delay, by a statement from the Treasury confirming the action and providing some context around the decision. Intervention affects price and market behavior by signaling a desired exchange rate movement; for that reason, 3) the Fed conducts buying or selling operations with a number of significant FX counterparties simultaneously. 4) Intervention action is usually “sterilized” so as not to affect the level of bank reserves in the system.

President Trump has expressed varying positions on the exchange rate since taking office. He noted last August that foreign investors were flocking to the US’ “cherished” dollar, appearing to equate USD strength with the performance of the US economy. But also last August, he complained that the EUR and CNY were being manipulated lower and took Fed Chairman Powell’s policy tightening moves to task. That all sounds familiar.

Nothing much came of the President’s protestations last year but now, with the US economy poised to slow, trade deals perhaps proving harder to nail down than the White House imagined and global central bank policy tilting back towards accommodation, speculation is rising that the US might break with convention that has dictated a “hands off” approach to exchange rates and step in to drive the USD lower.

We consider FX intervention to be a low risk probability at this point—but not one we would exclude entirely from the US policy arsenal. As we have pointed out previously, a key consideration from our perspective is that the USD exchange rate—broadly—does not appear to be misaligned.

Bloomberg Economics’ Fair Value estimate for the USD (real effective exchange rate—REER) is modestly undervalued relative to the OECD’s USD REER, for example. Individual currencies may display more or less misalignment but we think the primary candidates for misalignment (i.e., too “cheap”) really reside in the emerging market space. Our own estimate of the USD’s fair value versus the major currencies, based on regressions with (DXY-weighted) 2Y spreads, also suggests the USD is about where we would expect it to be (the $R^2$ on this model has weakened in the era of zero interest rates but remains around 0.65).

We think the absence of any really obvious USD misalignment within the G-10 space at least as well as the absence of any significant volatility in the USD exchange rate means that the case for intervention is quite weak.

Moreover, history suggests that FX intervention is more successful when a central bank “leans into” a move that is already developing rather than trying to lean against...
an established trend. Intervention against the prevailing run of play might have some initial success but if the USD is strong or strengthening because of relatively better fundamentals or higher relative yields, as has been the case in recent years, then it is quite possible that markets would eventually move to challenge the Fed and threaten its credibility. If the grounds for intervention are weak, the chances of success (beyond making a short-term splash) may be limited as well.

It is notable that the G-20 communique from Osaka last weekend reaffirmed “the exchange rate commitments made by our Finance Ministers and Central Bank Governors in March 2018”. The 2018 statement supported flexible exchange rates and pledged to refrain from competitive devaluations or the targeting of exchange rates for “competitive purposes”. If intervention was a serious consideration right now, the US delegation might have tried to water that commitment down.

We expect the US economy to slow to nearer potential in H2 and into 2020. Markets are discounting aggressive Fed rate cuts which are reducing the USD’s yield advantage. And the USD is nearing the point in the calendar year when it typically takes a bit of a dive. These factors suggest to US that the USD is poised to soften of its own accord in the coming months, obviating the need for the Fed to step in—but perhaps not stopping President Trump from commenting on FX matters.