

# **The Federal Reserve Engages the World (1970-2000)**

## The Federal Reserve's Role in the Global Economy

Federal Reserve Bank of Dallas

September 18, 2014

Edwin M. Truman, Senior Fellow

# Federal Reserve $\approx$ Global Central Bank

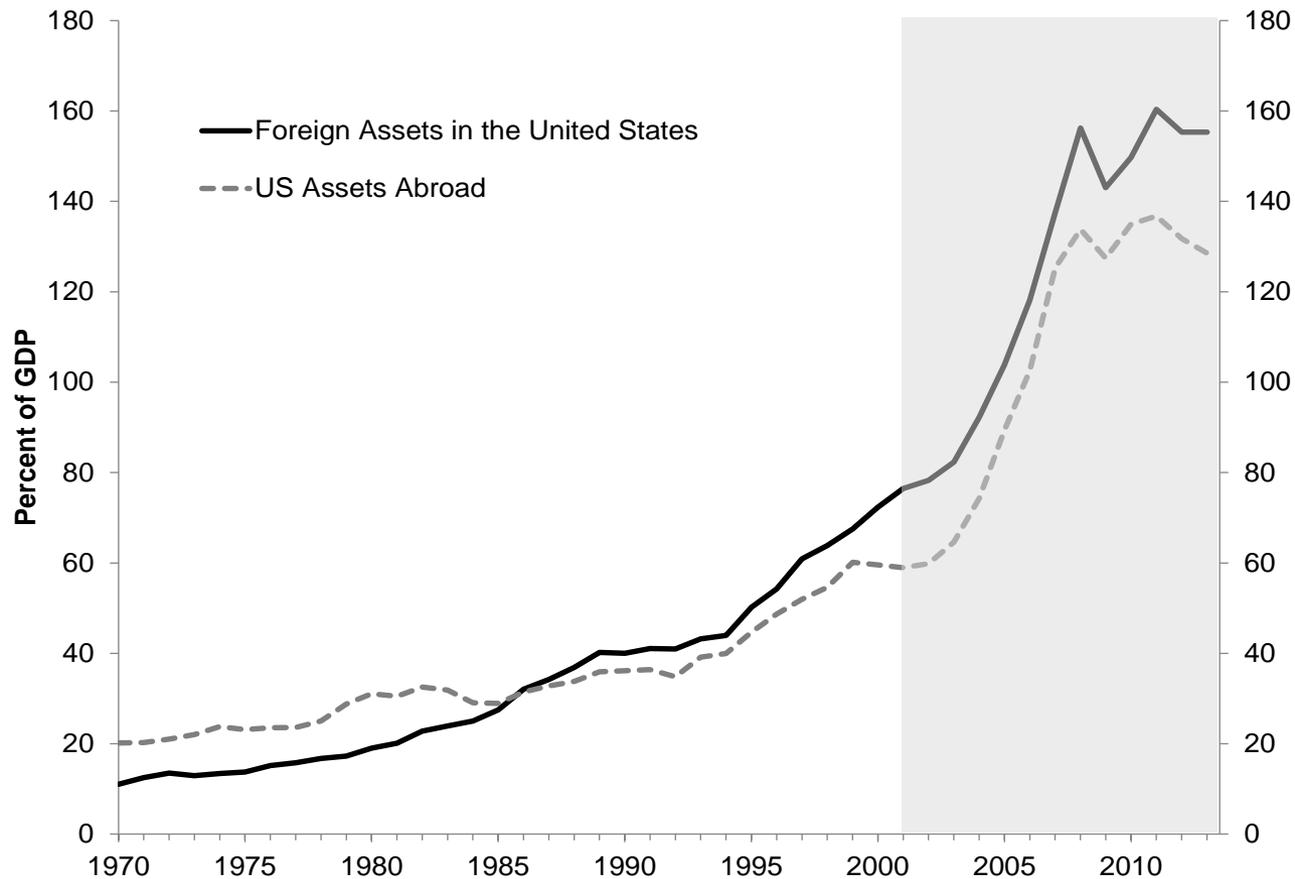
The last three decades of the 20<sup>th</sup> century witnessed the emergence of the Federal Reserve as the closest the world had to a global central bank

- Source of internal discomfort and controversy
- By 2000, Federal Reserve monetary policy and other activities had become unavoidably embedded in an increasingly globalized economic and financial system

# Globalization of the US economy



# Growing US financial integration



## Paper traces the evolution of these trends in four interrelated areas

1. Prospects for **US external accounts** were a continuing preoccupation; somewhat reduced by 2000 only to emerge again
2. The **foreign exchange** value of the dollar and the Fed's role in managing it were a focus of analysis and ultimately diminished controversy
3. Diagnosis of the **Great Inflation** took time but finally was recognized as largely home grown
4. The management and prevention of the **external financial crises** involved the Fed in a growing list of countries and topics of importance

# No effort to weigh international considerations in policy

I do identify 14 specific impacts of three types

**Type A** -- Developments in the **global economy impacted Federal Reserve** actions

**Type B** -- Federal Reserve activities were undertaken **primarily to assist other countries** but also to the benefit of the United States

**Type C** -- Cooperative **win-win impacts** combining **Types A and B**

# Distribution of IFDPs (percent)

Decade	External Accounts	US Dollar and Policy	Inflation	Financial Crises	Modeling	Countries	Other	Total (number)
1970s	16	15	4	3	11	6	44	171
1980s	13	18	1	8	4	14	42	222
1990s	9	13	3	14	1	14	45	302
1971 to 2000	12	15	3	9	5	12	44	695

# External Accounts and Sustainability

# The BWS was undermined by developments in US external accounts

- US monetary policy was not liberated by the demise of the Bretton Woods system
- US international economic policy was directed at restoring a sufficient current account surplus to support US net private capital outflows
- Result: a second dollar devaluation in February 1973 followed in March by generalized floating and a third dollar decline

# Increases in oil prices in 1973

- Undermined the achievement of a US current account surplus as well as reform of the international monetary system
- Federal Reserve policy floundered under this **Type A impact** of the global economy
  - Initial response in September 1973 was to ease to counter effects on real output and employment
  - Replaced in March 1974 by an abrupt shift in policy to counter effects on inflation in the context of an emerging US and global recession

# Continuing concerns about the US external accounts

- Contributed to perceived “benign neglect” and “talking down” of the dollar in the 1977-78 period
- Concerns about the US external accounts and the threat of US protectionism motivated the Plaza agreement in 1985 at which the Fed was a nervous by-stander  
(Next area covers in more detail)

# The Fed (Volcker) endorsed

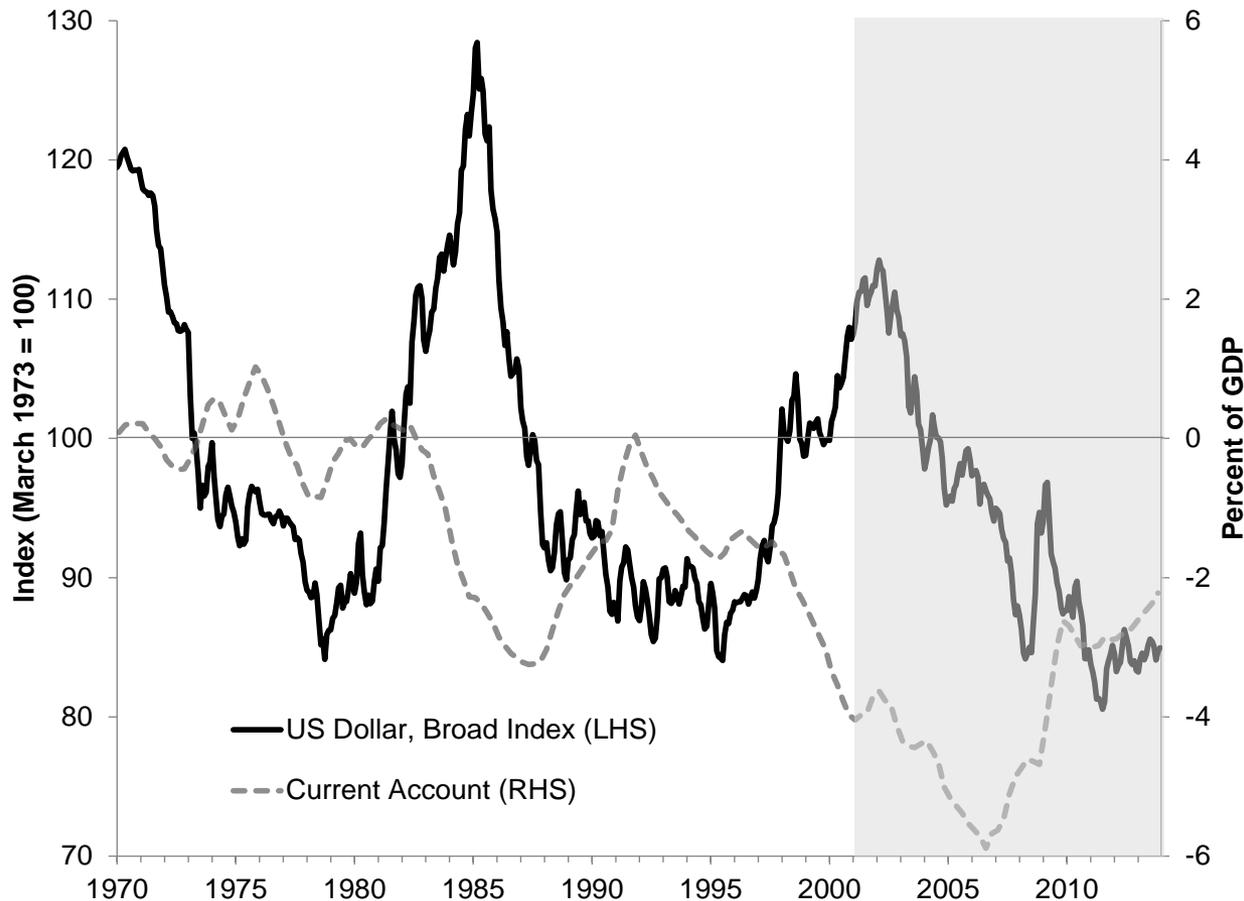
- The February 1987 Louvre accord to promote global growth
  - **Type B impact** which occurred
    - Against the advice of staff who argued correctly that the accord would not hold
    - The depreciation to date would not “correct” the US current account deficit, which ultimately moved toward surplus in 1990
- In the late 1990s, Fed staff attention shifted to the sustainability of the US international debt position and whether adjustments would or should be (fiscal) policy or market induced
- By 2000, the US external accounts were not receiving the priority policy attention they did in 1980s or were to receive a few years later

# Exchange Rates and Policy

# Multiple aspects of exchange-rate analysis and operations

1. Measurement issues
  - a. The “right” exchange rate
  - b. Effects on inflation and the trade balance
  - c. Definition of intervention
2. Exchange rate determination and forecasting (Messe-Rogoff)
3. Effectiveness of intervention operations
4. Role of the Federal Reserve in US operations

# Basic view: the “dollar” is loosely linked to the current account & vice versa



# US foreign exchange operations

- In the 1970s were conducted by the Desk at the FRBNY largely for System account via drawings on swap lines
- Under Treasury guidance, the Desk withdrew from the market in 1971, reentered in 1972, withdrew and reentered again in 1973
- The new IMF Article IV led in 1976 to a simplified FOMC Directive to guide Federal Reserve foreign exchange operations: “to counter disorderly market conditions” in “close and continuous consultation and cooperation” – not collaboration – with the US Treasury
- The new Procedural Instructions were designed to limit the discretion of the Desk, while preserving the discretion of the chairman

# Dollar depreciation

- Was seen by many as a major exogenous source of US inflation, along with prices of oil and commodities
- This view contributed to the November 1978 dollar rescue package
  - Mostly about mobilizing resources for US intervention (Carter Bonds etc.)
  - But package also contained a major monetary policy component insisted upon by the Bundesbank, a dramatic demonstration of external discipline unlike anything under Bretton Woods – **Type A impact**
- Decisive turn in the dollar did not come until the end of 1980

# The Regan-Sprinkel Treasury

- Adopted a minimalist approach to US foreign exchange operations
- As the dollar soared, other countries clamored for the United States to resist to help fight their inflation
- At Versailles summit in 1982, Regan agreed to an international study of experience under floating rates and of the effectiveness of intervention
  - Federal Reserve staff made major substantive contributions to this multilateral effort
  - The working group concluded that sterilized intervention did not have a lasting effect but could be useful as a supplementary policy tool
  - G7 ministers and governors were more positive about coordinated intervention, but Regan said that their qualified embrace of the intervention tool would not have an effect on US policy

# US policy began to change in 1985

- Baker replaced Regan at Treasury
- By March 1985 the dollar was 45 percent above its level in July 1980
- The Federal Reserve had little or no role in designing the resulting Plaza agreement
- Volcker opined in private that “one could have too much of a good thing”

# February 1986

- As noted, IF staff did not favor the Louvre accord, which Volcker embraced to support global growth and stability
- Volcker's concerns led him initially to be outvoted on a cut in the discount rate –  
**Type A impact**
- The Board's disagreement was covered over

# The dollar continued to decline

- During the balance of 1987
- The Federal Reserve under Greenspan hiked the federal funds rate in September – **Type A impact**
- The October stock market crash followed accompanied by a further dollar slide as the Federal Reserve led other central banks in easing policy
- Greenspan was a major participant in the budget summit whose modest but positive outcome was a precondition for a December G-7 statement reiterating support for the dollar – **Type A impact**

# The dollar began to recover in early 1988

- The Treasury wanted to resist its rise to preserve US trade gains
- The resulting heavy joint Fed-Treasury intervention in 1989 and build up in balances of foreign exchange as US inflation edged up and the FOMC was raising the funds rate became highly controversial – **Type A impact**
- The Federal Reserve's advice shifted from encouragement to restraint

# In response to FOMC questions and concerns

- Cross and I proposed in July 1989 a comprehensive review of System foreign currency operations from an institutional and historical perspective
- The study was presented to the FOMC in March 1990
  - It may have cleared the air a bit
  - But three members dissented from the increase in the System's "warehousing" facility for the Treasury and its exchange stabilization fund (ESF)

# Upward pressure on the dollar

- Eased after May 1990
- US intervention operations became less frequent in 1991-92.
- The incoming Clinton administration was greeted by a weakening dollar
- US foreign exchange operations resumed but were more often coordinated and on a larger scale

# In July 1994

- Greenspan, acting in cooperation with the Treasury, said “Any evidences of weakness in [the dollar] are neither good for the international financial system nor good for the American economy”
- Summers the next day said “The administration believes that a strengthening of the dollar against the yen and the mark would have important economic benefits for the United States”
- Thus was born what is now known as the “strong dollar policy” that has lasted for 20 years – **Type C impact**

# End of the era of US active intervention

- The Bentsen-Rubin-Summers Treasury operated with the Federal Reserve sporadically (but usually in scale) through August 1995
- In the following five-plus years, the US intervened only twice: in 1998 (yen purchases) and 2000 (euro purchases) -- arguably a **Type B impact**

# Retrospective on US intervention

- By 1996, US foreign exchange market intervention had largely become a non-issue in the FOMC
- The Federal Reserve had played a major role on the evolution of US policy
  - Leaning against extremes of policies of successive Treasuries
  - Participating in the Jurgensen report in 1982-83
  - Counseling patience and clarity in tactics and objectives
- The evolution was based primarily on pragmatic considerations not on philosophical arguments about Fed independence

# Swap Network

- The swap network was a residual, continuing point of FOMC controversy
- It was regarded by some as a danger to Fed independence
- And by many as an anachronism
- In July 1996, the Committee reached a consensus to seek agreement to dismantle the network

# Dismantling of the Swap Network

- Was achieved at the end of 1998 with the advent of the euro
  - Except for the swap agreements with Mexico and Canada, which were embedded in the North American Framework Agreement
- Some participants in the FOMC debates about the swap network anticipated its potential use by the Fed in this century as a tool to provide international-lender-of-last-resort liquidity support to international financial markets

# The Great Inflation

# The principal causes of the Great Inflation

- Were not external or exogenous in origin
- It took the Federal Reserve some time to reach that conclusion
- The Whip Inflation Now program of 1974, the failed initiative on wage and price guidelines in October 1978, and the dollar rescue package in November 1998 were attempts to treat the symptoms rather than the underlying cause

# It was necessary to try all other policies and have them fail

- Before the Federal Reserve, and in particular the administration, would embrace the experiment of the new operating procedures (NOP) in October 1979 – **Type A impact**
- Implementation of the NOP was not smooth, did not bring quick results, and spawned criticism of the Federal Reserve from multiple perspectives
- Response: Axilrod-coordinated System study of the NOP with two international chapters

# The date of the end of the Great Inflation

- Is a matter of debate
- Whatever the date, after the 1970s international considerations did not play much of a role in policy discussions of inflation
- Except, possibly, in setting an example that led to the FOMC's adoption of a medium-term inflation objective in 2012

# Management and Prevention of External Financial Crises

# The Federal Reserve's involvement in the external financial crises of other countries

- Dates back to the 1970s and access to the swap network by the central banks of Italy, the United Kingdom, and Mexico conditioned on their adopting IMF programs -- arguably a **Type B impact**
- Burns took a great interest in such matters
  - “Trouble Spots” reports were initiated
  - The Interagency Country Exposure Review Committee (ICERC) was established
  - US international banking data were substantially improved

# The Federal Reserve's 1979-1982 attack on inflation

- Had dramatic negative repercussions on global economy (recession) and contributed to the third world debt crises of the 1980s
- The relaxation of the US monetary brakes in second half of 1982 was substantially motivated by associated concerns about the global economy – **Type B impact**

# The Volcker plan was applied to

- Mexico, Brazil, Argentina, the Philippines, and Yugoslavia as well as other countries
- It was largely a Federal Reserve construct – **Type B impact**
- Federal Reserve also played a substantive role in shaping the 1983 IMF legislation including provisions
  - Reforms in international lending practices
  - Promoting negotiations resulting in the Basel capital accord
- Federal Reserve's role in the design and implementation of the subsequent Baker and Brady plans was secondary but not insignificant

# The 1994-95 Mexican crisis

- Was controversial, including within the Federal Reserve, but as in 1982 not a surprise to the FOMC
- Over the course of 1994, the Federal Reserve helped to coax Mexico to embrace an IMF program
- The Federal Reserve's contributions to the case for Plan A (loan guarantees) and facilitating Plan B (expanded use of ESF via warehousing) were substantial, consequential, and contentious –  
**Type C impact**

# Asian financial crises

- Involved the Federal Reserve to a lesser extent except in diagnosing the macroeconomic impacts on the US economy
- The Fed did play a major role in the design and execution of the Korean bank debt rollovers and re-profiling – **Type B impact**
- In September 1998, Greenspan’s “oasis of prosperity statement” and FOMC follow-up easing actions helped to defuse the aftermath of the Russian default -- **Type C impact**

# The Federal Reserve broadened its engagement in the global system

- Opened relations with People's Bank of China in 1980
- Was substantially involved in Russia and establishing central banks in the former Soviet Union
- Promoted international transparency reforms
- Took up its seat on the Board of the BIS and pushed for expanded BIS membership
- Supplied chairs of Basel Committee, FSF, GFSF, and Committee on Payment and Settlement Systems (Payments and Market Infrastructures)

# Concluding Observations

1. By 2000, the Federal Reserve had become deeply enmeshed in an economically and financially globalized world
2. The Federal Reserve could run from global economic, financial, and political developments, but it could no longer hide
3. One need not buy each of my 14-plus instances of a significant impact of international considerations on and of Federal Reserve policy during these three decades
4. Obviously, I believe they are sufficient to support my thesis that by 2000 the Federal Reserve was the closest the world had to a global central bank, as demonstrated by subsequent events

5. In discharging its global role, I am not fundamentally concerned about the scope of the Federal Reserve's mandate or a threat to its independence
  - a. The Federal Reserve can and should interpret its mandate broadly
  - b. It need not sacrifice underlying US interests to be effective
  - c. See the July 2014 US-China Factsheet "The Federal Reserve is sensitive to the effects of its policies on the international financial system. A key goal of the Federal Reserve is to maintain financial stability domestically and internationally."

6. Bottom line: The Federal Reserve should continue to deploy its intellectual and other resources to contribute to better US and global economic and financial policies even when those activities do not lie narrowly within the Federal Reserve's mandate

# Thank You