8-1-2008

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Economic Commentary

August 2008

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Recently, the U.S. Treasury announced a new, temporary insurance program for U.S. money-market mutual funds. To guarantee payment of these funds' liabilities, the Treasury will use the assets of its Exchange Stabilization Fund. Created in the 1930s to stabilize the exchange value of the dollar, it has been tapped on occasion to supply loans to foreign countries in financial distress. This latest use of ESF assets is unlike anything the Fund has been used for before.

The U.S. Treasury acted recently to preempt problems in another area of the financial system weakened by the current crisis—U.S. money-market mutual funds.

Money-market mutual funds invest in highly rated short-term securities, notably commercial paper, and allow investors to remove their funds quickly. Consequently, many investors have viewed the funds as essentially risk-free checking accounts. But lately, some of these mutual funds are finding the value of their assets below—or perilously close to—the value of their liabilities, a situation more worrisome in the current environment because investors' deposits are not insured.

Runs on money-market mutual funds could have far-reaching effects, particularly for the commercial paper market, where many corporations find operating funds. So in September 2008 the Treasury announced it would create a temporary insurance program for money-market mutual funds. The mutual funds can enter this insurance program for a fee.

The Treasury will use the near $50 billion worth of assets of a little-known agency within the department, the Exchange Stabilization Fund (ESF), to guarantee payments of money-market-mutual-fund liabilities for up to one year. The ESF is a small agency whose traditional activities have consisted of foreign-exchange intervention and temporary stabilization loans to developing countries. For most people who heard the Treasury's recent announcement, the fund's obscurity was its most distinguishing feature, but for those who study central banks and monetary economics, the ESF is better known—and rather controversial.

Details about the new insurance program are not yet available, but a look at the origin and history of the ESF reveals how different such a role is from any use the ESF has been put to before.

ESF Origins

The Roosevelt administration and the U.S. Congress created the ESF in 1934, capitalizing it with $2 billion derived from an increase in the official price of U.S. gold. Ostensibly, Congress established the ESF to stabilize the exchange value of the dollar by buying or selling foreign currencies and gold. At the time, the administration was worried that a similar British stabilization fund might attempt to manipulate exchange rates to its own advantage and wanted to throw a counter punch, if necessary.

Over the years, the ESF has intervened chiefly to influence the dollar's exchange rate against currencies of the major developed countries, primarily the German mark and Japanese yen. The ESF, however, also interpreted its directive—to stabilize the exchange rate value of the dollar—much more broadly, as I explain below.

Congress allowed the ESF to be self-financing and to exist outside of the annual appropriations process. Doing so guarded the agency's secrecy, a precious commodity when charged with fending off currency speculators. In a like vein, Congress gave the secretary of the treasury full control over ESF operations. Responding quickly is also essential for successful foreign-exchange operations. Aside from the president, no other officer of the U.S. government has authority to review the Treasury's decisions regarding ESF operations. Since the late 1970s, Congress has imposed some oversight on operations and on the financing of the ESF, but these are largely after-the-fact reporting requirements. Fund operations remain squarely within purview of the Treasury.

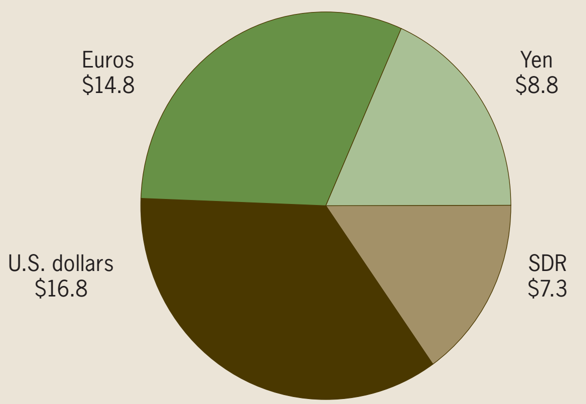
Foreign-Exchange Intervention

The Gold Reserve Act authorizes the ESF to stabilize dollar exchange rates. As Anna Schwartz details in her history of the ESF, the Fund's early foreign exchange operations were fairly limited. It truly became active in 1961 when it attempted to shore up the Bretton Woods system. The United States and other large industrial countries had fixed their exchange rates under the Bretton Woods Agreement Act in 1945, but the system did not become fully functional until the end of 1958. Shortly thereafter, the dollar faced fairly persistent downward pressures. The ESF acted in both the spot and forward exchange markets to stabilize the dollar, but the Fund quickly found its resources insufficient for the task. To alleviate the shortfall, the Federal Reserve System began to intervene along with the ESF in 1962. The Federal Reserve Bank of New York, which had always intervened as the agent of the ESF, now acted on behalf of both the ESF's account and the Fed's own account.

While the Federal Reserve and the ESF have separate legal authority to intervene, most observers recognize the Treasury as having primary responsibility for these operations. The Treasury probably cannot compel the Fed to intervene, but the Fed has only rarely refused. Appearing not to cooperate in a legitimate policy operation of the administration would raise market uncertainty about the operation and could sabotage its chances for success.

The Federal Reserve's decision to intervene on its own account raised some eyebrows in 1962, and it has occasionally done so ever since. For one thing, U.S. foreign-exchange operations, as routinely conducted, do not alter fundamental macroeconomic determinants of exchange rates, like U.S. bank reserves. Consequently, intervention cannot systematically influence exchange rates. At best, intervention seems to sometimes affect the market's perception of these fundamentals. This small, uncertain gain, however, may come at a cost.

1. Currency Denominations of ESF Assets



Notes: ESF assets are total assets and SDRs less SDR certificates, valued in billions of dollars, following Osterberg and Thomson (1999). SDRs are special drawing rights, an international reserve currency created by the International Monetary Fund.

Many wonder if it is appropriate for an independent central bank to act in concert with a government's fiscal authority in an action that may seem at odds with the goals of monetary policy. Often, during the 1980s and early 1990s, the dollar appreciated as the FOMC tightened monetary policy. The Treasury and the Fed then intervened to offset the dollar's appreciation by buying foreign exchange. While the operations did not directly interfere with monetary policy, many FOMC members felt that they created confusion in the markets about the Fed's near-term policy objectives and reduced the long-term credibility of monetary policy.

One specific aspect of this relationship, called warehousing, became a particular flashpoint. To understand the controversy, one needs first to understand what the ESF does besides directly intervening in the foreign-exchange market.

Stabilization Loans

In addition to foreign-exchange intervention, the ESF has provided temporary stabilization loans to select developing countries. Most of these have been Latin American countries, with Mexico being the most persistent recipient.

While these operations conform broadly to the ESF's directive of stabilizing dollar exchange rates—many of these countries pegged their currencies to the dollar—the recipients need not use these funds directly in their exchange markets. Some, for example, have dressed up their foreign exchange reserves on reporting dates. Consequently, the loans often have a distinct foreign-aid and foreign-policy flavor. In the summers of 1988 and 1990, for example, the ESF made temporary stabilization loans to Yugoslavia and to Hungary, respectively, whose currencies were of little economic importance to the United States, but the loans fostered foreign-policy objectives.

The ESF usually extends these stabilization loans by setting up a swap line. Swap lines are temporary facilities through which the ESF can "swap" U.S. dollars for the currency of a foreign country. Essentially, they are short-term loans in which the borrowing country's currency acts as collateral. Occasionally, as in the Mexican peso crisis of 1995, other collateral is required. The borrowing country gets to use the U.S. funds, and the lender automatically invests the foreign currency in an interest-earning asset.

Warehousing

The ESF's ability to acquire foreign exchange either through interventions or by extending swap loans to developing countries is limited by the amount of dollar-denominated assets in its portfolio. In August 2008, the ESF had nearly $50 billion in assets and $40 billion in capital (assets less liabilities). As figure 1 indicates, fewer than $17 billion of these assets are denominated in dollars.

The ESF currently holds $9.5 billion worth of Special Drawing Rights (SDRs). SDRs were created by the International Monetary Fund (IMF) in 1969 to serve as an international reserve asset. At the time, the world needed a reserve asset besides gold, the dollar, or some other national currency to sustain the Bretton Woods system, but by the time the IMF created the SDR, Bretton Woods was beyond repair. It collapsed in August 1971. Nevertheless, the SDR still exists as an international reserve asset.

The ESF can monetize—change into dollars—its SDRs. With the authorization of the treasury secretary, the ESF creates a "swap certificate," a liability on its balance sheet, and sells it to the Federal Reserve for dollars. The Federal Reserve is legally obliged to accept SDR certificates.

The ESF can also obtain dollars by warehousing foreign exchange with the Federal Reserve. Warehousing is a currency swap in which the Federal Reserve buys foreign currency from the ESF in a spot transaction and sells it back to the ESF in a forward transaction. The duration typically has been 12 months, but some unwound early and some rolled over. Because the Federal Reserve undertakes the spot and forward portions of these swaps at the same exchange rate, unanticipated exchange-rate movements have no financial consequences for the Fed. The Fed earns interest from any foreign-currency denominated assets that it holds as a consequence of the swap, but loses interest on the Treasury securities that it might have to sell to offset any monetary impacts from the ESF's dollar sales.

Many FOMC participants have viewed warehousing as a temporary loan from the Federal Reserve to the ESF, collateralized with foreign exchange. The Federal Reserve Act does not include such lending authority, and the Banking Act of 1935 prohibits the Federal Reserve from purchasing U.S. government obligations, except in the open (or secondary) market. The U.S. Congress granted the Federal Reserve authority to lend up to $5 billion to the Treasury for short durations in 1942, but this authority expired in 1981. Opponents of warehousing argue that in the absence of clear ongoing lending authority, the Fed should not warehouse currencies for the ESF, especially given the foreign-policy nature of many ESF stabilization loans.

Proponents view warehousing as a temporary exchange of assets—not as a loan. Moreover, because the Treasury does not issue German marks or Japanese yen—as it does U.S. government securities—the Treasury constitutes part of the open market for foreign exchange. They sometimes point to parallels between warehousing and the acceptance of SDR certificates. Hence, proponents contend warehousing foreign exchange is wholly acceptable.

The FOMC currently authorizes the Fed to warehouse up to $5 billion in foreign exchange for the ESF. During the Mexican peso crisis of 1995, the limit was increased to $20 billion. However, no funds have been warehoused since 1992.

No matter how one characterizes warehousing operations—as a loan or an asset exchange—opponents worry that it allows the Treasury to skirt the Congressional appropriations process. Of the original $2 billion appropriated by Congress to the ESF, all but $200 million was later used to pay the United States' subscription to the IMF. The ESF retains interest and capital gains on the domestic and foreign assets that it holds, but if it needs more funds for intervention or for lending, opponents of warehousing contend that the ESF should seek a Congressional appropriation.

New Avenues, Old Problems

The Treasury's surprising decision to offer insurance to money-market mutual funds through the ESF is clearly a broad extension of the Fund's traditional role, but one that Treasury could undertake quickly and easily in anxious times. The existence of this insurance—like insurance for bank deposits—should stem fears and prevent a run on money-market mutual funds. The ESF has nearly $17 billion in dollar-denominated assets readily available to backstop money-market mutual funds. Beyond that, the ESF would need to convert foreign-currency denominated assets into dollars, either by selling them to the market or foreign central banks or by exchanging them for dollars with the Federal Reserve System. The latter prospect risks awakening some long-dormant controversies.

Recommended Reading

"From Obscurity to Notoriety: A Biography of the Exchange Stabilization Fund," by Anna J. Schwartz. 1997. *Journal of Money, Credit, and Banking*, vol. 29, no. 2.

"The Exchange Stabilization Fund: How It Works," by William P. Osterberg and James B. Thomson. 1999. Federal Reserve Bank of Cleveland, *Economic Commentary*.

The Exchange Stabilization Fund: Slush Money or War Chest? By C. Randall Henning. 1999. Institute for International Economics: Washington, D.C.

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