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IN THIS EDITION:

ARE COVERT OPERATIONS UNDERWAY IN THE GLOBAL CURRENCY WARS?

In an age of economic policy activism, including widespread quantitative easing and associated purchases of bonds and other assets, it is perhaps easy to forget that foreign exchange intervention has always been and remains an important economic policy tool. Recently, for example, Japan, Switzerland and New Zealand have openly intervened to weaken their currencies and several other countries have expressed a desire for some degree of currency weakness. In this report, I consider the goals and methods of foreign exchange intervention and place today's policies in their historical context. Also, I examine the evidence of where covert intervention—quite common historically—might possibly be taking place: Perhaps where you would least expect it.

ANOTHER TOOL IN THE TOOLKIT

Over two decades ago, when I was a graduate student of international economics in the US, I had the good fortune to take a course in international economic policy from a former US Treasury official who had worked in the International Affairs division during the 1980s.

Some readers might recall that the 1980s were the decade of the Plaza and Louvre Accords, so named after their respective locations, as the Bretton-Woods arrangements had also so been. This former official had thus been involved in negotiating these historic currency agreements to first weaken and then support the US dollar, respectively. One evening in 1991, while preparing for our final exam in his course, some fellow students and I hosted him for dinner.

Although the primary goal of the wine-laden dinner was to try and glean from our esteemed guest clues as to the questions on the exam, once we collectively relented in that unsuccessful effort, the discussion turned to his experiences at the New York Plaza hotel in 1985 and subsequently at the Paris Louvre in 1987. This became one of the more eye-opening conversations of my life as a student and practisioner of international finance. What follows is my best effort to recall and to paraphrase:

"Were they effective?" asked a fellow student. "Did the Accords accomplish their objectives?"

"Please define what you mean by 'effective'."

"Well, other than moving the exchange rates, what were the policy goals?"

"Ah, the goals!" he replied. "Well as you know the strong dollar of the early 1980s was a product of Fed Chairman Volcker's dramatic tightening of US monetary policy. This caused a recession in the US but don't forget it also had global effects, putting a strain on some other major economies. The strong dollar helped their exports but then on the other hand it led to higher inflation. By 1985 much of Europe had a serious inflation problem and the strong dollar was viewed as part of the cause.

"After Reagan was re-elected in late 1984 the US and Europeans had a common incentive to weaken the strong dollar and help rebalance growth. As a quid pro quo the US expected European assistance in pressuring Japan to relent in its assault on the US auto industry. Japan had been growing rapidly for years and had little negotiating leverage in any case, so when everyone gathered in New York in 1985 a deal was fairly easy to reach and as the coordinated interventions took place, the dollar declined steadily versus both European currencies and the yen.

"By 1987, however, the dollar had weakened dramatically. Global economic growth was generally strong, however, and inflationary pressures were building. This was particularly true in the US, due to dollar weakness. And so in that year, the same parties came to the table and agreed that the dollar had declined sufficiently; healthy, balanced growth had generally been restored; and it was time to end the dollar's long decline.

"There was a fly in the ointment, however. The German Bundesbank was particularly concerned about the buildup of inflationary pressure and was signalling an imminent rise in interest rates. This went directly against the Louvre Accord, as these were meant to support the dollar, not the German mark. But the Bundesbank was proudly independent of the German government and prioritised its domestic goals over the Louvre Accords and thus prepared to raise interest rates anyway. This greatly increased pressure on the US Fed to follow along and many believe that fears of a reciprocal Fed policy tightening—required to stabilise the dollar—triggered the October 1987 stock market crash.

"That crash led Greenspan to slash interest rates in order to prevent a sharp economic downturn. In time this contributed to a sharp pickup in inflation and by 1990 CPI was back to 1970s levels at over 6% y/y. The Greenspan Fed then determined that in order to avoid a 1970s repeat interest rates had to rise sharply. They did, and the US fell into a recession nearly as deep as that of the early 1980s.

"So were the Plaza and Louvre Accords effective? Hard to say. You could certainly argue that some of their effects were desirable from the domestic perspectives of certain actors, in particular the US and some weaker European economies. But did they serve the political or economic interests of Germany or Japan? That is less clear.

"What of the intervention itself? How did it take place? Is there an optimal way in which countries can intervene in the FX markets?" asked another student.

"Well it is certainly optimal from the policymakers' perspective if countries on both sides of an exchange rate can agree to cooperate. This was the case with both Plaza and Louvre, at least initially. With both sides publicly cooperating, and executing their intervention in coordinated fashion, it is the rare, brave, one might say foolhardy speculator who will dare to take the other side.

"More difficult is when a country intervenes unilaterally, especially if they are trying to defend their currency from speculative attack. That is ultimately futile, although if you have some accumulated FX reserves and are clever how you go about it you can nevertheless accomplish quite a bit."

"But reserves are limited, are they not? Once markets sense that a country is running out of ammo, don't they become emboldened to attack more aggressively, forcing the issue?" the student pressed.

"Oh of course there is a limit. We have seen this countless times throughout history. Reserves dwindle, the attack intensifies and all of a sudden in some midnight meeting the government in question gives up and just devalues, either all in one go or in a handful of stages. In my view, once you determine the dam is breaking it is best just to let it break, face the consequences and move on. But that is just my opinion and I suppose if I were facing such pressures myself I don't really know exactly how I would act.

"But I will tell you this: If you are going to intervene from a position of weakness, you had better do everything in your power to burn the speculators. That is what buys you time and that's precisely what you need to defend against the attack: time. When you go into the market, you go in big. You go in when liquidity is low. You go in when people don't expect it. And the moment they come back to attack anew, you go in even bigger. You force the price hard over a short time, ensuring that distinctive chart patterns emerge and on high volume. Speculators will read those charts, assume the trend has reversed, and you will win some of them over to your side, at least for a period of time. That is the way to do it."

"But if the speculators know that is the game plan, will they take the charts seriously?" asked another. "Won't they see that it is all artificial price action, not indicative of anything other than a desperate government exhausting its scarce reserves?"

"Well, you must…" The professor paused for a moment. You could tell he wanted to say something but was unsure how best to say it. Then he continued: "As a good poker player, you must be careful to play your cards close to the vest. Don't show the speculators your hand if you can help it. In fact, consider keeping the intervention secret if you can. Some might figure out what is going on but many won't and they will just assume that the trend is reversing due to natural market causes. It helps if you have friends at the major dealers who owe you a favour or two or at a minimum understand and support the reasons behind the policy."

"Are you saying that covert intervention occurs frequently?" asked another student in astonishment.

"I have no privileged information to that effect. Certainly when I was at Treasury we did no such thing. But then we had no reason to because we had our allies on side and we desired to show our intentions to the markets to get them to do our work for us. But I suspect other countries in a more difficult position have operated in this covert way on occasion and perhaps the US has done so as well in the past, for example to manage the markets as Bretton-Woods was breaking down. I can only speculate.

I forget the remaining details of that evening, other than a humorous discussion of some of the professor's misadventures when he was a young Foreign Service officer posted to various countries in the 1970s. He certainly did have a good sense of humour and he was also remarkably forthcoming in his discussion of US international economic policy.

Recall that this conversation took place in 1991, the year prior to the 1992 European Exchange Rate Mechanism (ERM) crises that rocked the foreign exchange world and threatened the process of European integration, by then already long underway. Another, less-severe ERM crisis would hit in 1995. A rash of Asian currency crises arrived in 1997, followed by a near-collapse of the Russian rouble in 1998, precipitating a US financial crisis via the now-notorious hedge fund Long-Term Capital Management (LTCM). In all cases, policymakers were active in trying to prevent, manage and clean up after the respective crises. In some cases their actions were out in the open; in others, less so. In still others, their specific actions and interventions behind the scenes probably remain secret to this day.

A CURIOUS PAPER ON COVERT INTERVENTION

Back in 2001, some prominent economists wrote a paper, published in the American Economic Association's prestigious *Journal of Economic Literature*, titled "Official Intervention in the Foreign

Exchange Market." In this paper, the authors discuss the efficacy of foreign exchange intervention and, perhaps surprisingly, they include a brief section on covert intervention specifically, of which the following is an excerpt:

> ***Most actual intervention operations in the foreign exchange market have been—and still are—largely secret, not publicly announced by monetary authorities****…*
>
> *The traditional relevant literature identifies three types of arguments in favor of secrecy of official intervention: arguments based on the central bank's desire to minimize the effects of an unwanted intervention operation (for example because the decision has been taken outside the central bank, e.g. by the Treasury), arguments based on the perceived risk and volatility in the foreign exchange market which might be exacerbated by an announcement of official intervention, and portfolio adjustment arguments. A further explanation may be that* ***although monetary authorities intervene in order to target the value of a foreign currency, since the fundamentals of the foreign currency are not necessarily equal to this objective, the monetary authorities do not have an incentive to reveal their intervention operations as no announcement on their activities will be credible … [S]ecrecy of intervention may be an attempt to affect the exchange rate … without triggering a self-fulfilling attack on the currency.*** *(Emphasis added.)* [1]

Now it is not exactly common for published academic journals to contain a discussion of covert activities. How did the authors conduct their research? Who were their sources? Why did the editors allow such opaque, unsubstantiated material to be published without appropriate verification?

Small clues are provided in the authors' respective backgrounds and also in the article acknowledgements: Both authors studied at the University of Warwick in Britain. At time of writing, one worked at the US Federal Reserve and one for the World Bank in Washington DC. The acknowledgements thank a number of prominent fellow academics for their assistance but also mention *three anonymous referees*.

It is therefore not much of a stretch to surmise that sitting economic policymakers, perhaps on both sides of the Atlantic, provided the source material for the section on covert FX intervention discussed above. As for exactly who they might have been, the short list would certainly include those officials working at the time at the US Treasury's International Affairs Division or at the US Federal Reserve on the one side; and at one or more European finance ministries or central banks on the other.

[1] *Sarno, Lucio and Taylor, Mark P., "Official Intervention in the Foreign Exchange Market,"* Journal of Economic Literature *vol. 39 (September 2001). The link is here.*

FOREIGN EXCHANGE INTERVENTION AND THE GLOBAL FINANCIAL CRISIS

Returning now to our discussion of the history of foreign exchange intervention, as it happened, the Europeans managed to hold integration together through the 1990s. In 1999, against the expectations of many, the euro currency was launched and the leaders of the time hoped that, stronger together than apart, European financial crises would become a thing of the past.

Of course we now know that financial crises are not a thing of the past but the present, and not only in Europe. All major developed economies have been embroiled in protracted financial crises since 2008. Yes, there have been tentative signs of a recovery at times, including recently, and stock markets in the US, Europe and Japan have all risen dramatically of late. The fact remains, however, that policymakers are holding interest rates on the floor while running huge fiscal deficits in a blatant, neo-Keynesian effort to stimulate aggregate demand in the hope that this will lead to an economic normalisation in time.

Well good luck with that. Readers of this report will know that I don't believe that financial market manipulation of interest rates, currencies, stock markets, commodities or anything else for that matter diminishes the need for natural economic deleveraging following a boom-bust cycle. Indeed, manipulations are ultimately counterproductive as they misallocate resources. This misallocation may go unseen for a sustained period but, as Frederic Bastiat explained so eloquently in the 19th century, that doesn't make it any less real or harmful.

As one tool among many, foreign exchange intervention has continued to be publicly and actively used as a policy tool, most recently in Japan, China, Brazil, Switzerland, New Zealand and a handful of other countries. In all of these cases, however, it has been used to prevent or limit currency strength rather than to defend against weakness.

Based on the academic paper cited above, the authorities in these countries have had no need to employ covert intervention tactics as they have not sought to disguise eroding currency credibility and have been accumulating rather than depleting their foreign reserves. Indeed, the Bank of Japan, for example, plans to double the size of its balance sheet as an instrument of policy.

However, as all major economies seem to prefer currency weakness to strength at present, the world appears to be in the midst of a so-called 'currency war'. The term 'war' implies that countries are failing to cooperate with one another. This in turn suggests that there might indeed be an incentive at present for covert operations of some sort to weaken currencies without other countries noticing. Might covert FX intervention be taking place for this reason?

Let's consider the evidence. As the professor explained in his comments, covert, non-coordinated interventions would probably leave a 'footprint', that is, they would take place at times of low market liquidity and tend to continue until an important chart pattern has emerged that encourages speculators to reverse the previous market trend, thereby initiating a new one in line with the intervention's objectives.

Looking around various FX rates, there is some evidence that covert intervention has been taking place in Asia. Occasional, sharp overnight moves on unusually high volume have taken place in the Korean won, Taiwan dollar, Indonesian rupiah, Malaysian ringitt and Vietnamese dong. This is of course only circumstantial evidence but it would be odd were profit-maximising economic agents to behave in this way. Given that the authorities in question have the means and quite possibly the motive, and the price action is suggestive, it is entirely reasonable to surmise that some covert intervention has been taking place in the region.

THE FUTURE OF COVERT FX INTERVENTION

If the currency wars continue to escalate as they have of late, it seems reasonable to expect that covert interventions will grow in size, scope and frequency. As it is impossible for all countries to devalue against all others, however, this just raises the stakes in what is, at best, a zero-sum game. At worst, as countries begin to accuse one another of covert currency manipulation, the currency wars will morph into damaging trade wars with tariffs, taxes, quotas, regulations and all manner of restrictive trade practices that, collectively, could slam the brakes on what little global economic momentum remains.

There is one country in particular, however, that has a particularly keen interest in avoiding this: the United States. As the issuer of the world's reserve currency and the world's largest foreign-held public debt, the US wants to ensure that foreigners continue to absorb dollars as reserves. If their preferences were to change in favour of other assets, this would place upward pressure on US interest rates, greatly complicating the Fed's efforts to stimulate domestic growth and reduce unemployment.

Worse, if an outright trade war breaks out, the US will quickly become mired in a severe stagflation, the result of higher import costs, strangled global trade, far fewer dollars being absorbed abroad and associated upward pressure on dollar interest rates. The US would have to make some tough choices.

Many argue that, absent a trade war, foreigners' appetite for dollar assets will not diminish. History suggests otherwise. Central banks actively diversified reserves out of dollars in the 1970s, following the US decision in 1971 to renege on the Bretton-Woods promise to redeem foreign official dollar holdings in gold. By the early 1980s, the dollar share of reserves had fallen dramatically as other currencies and gold took a growing share.

The same has happened in recent years and at an accelerating rate. Central bank gold purchases rose to a post-Bretton-Woods record last year and are continuing at a rapid clip so far in 2013. Private investors also continue to diversify out of dollars.

The US Federal Reserve has been absorbing roughly half of all new US Treasury bond issuance, which has prevented a material rise in interest rates, but the pressure is building. Were foreigners to dramatically accelerate their diversification out of dollars and into other currencies and gold, the US would face a dilemma: Allow interest rates to rise to stabilise the dollar, triggering a recession and a huge deterioration in government finances; or continue to suppress interest rates but watch the dollar fall sharply, triggering far higher inflation and general economic and possibly also political instability.[2]

There is a third option, however. The US could try to have its cake and eat it too. It could continue to suppress interest rates through QE but it could also covertly intervene to support the dollar in the foreign exchange markets. To do so publicly would be a short-lived, probably disastrous exercise as the US possesses little in the way of foreign currency reserves. Speculators would almost certainly see this as a historic opportunity to force through a major devaluation, reaping potentially huge profits in the process. Thus I consider this highly unlikely.

But consider: the US may have little in the way of FX reserves but it has a huge pile of gold reserves—the world's largest in fact. If the US were to set about covertly intervening to support the dollar amid artificially low interest rates, therefore, it would make far more sense to do through covert intervention in the gold market. Should they follow my former professor's advice, they would sell gold into the market at relatively illiquid times for maximum price effect. They would do so repeatedly until certain technical chart patterns turned in favour of the dollar and against gold, establishing a new trend. And if they succeeded, no one need ever know.

So do I think they will try it? Perhaps. Desperate policymakers sometimes do desperate things. And history is sometimes stranger than fiction.

A FEW WORDS ABOUT THE AMPHORA REPORT

As I indicated last month, I have begun the process of transforming the *Amphora Report* into a low-cost subscription service. If you would like to continue receiving the report, please send me your details and I will place you on the list of interested parties. Once available I will send through detailed subscription information. In any case, thanks again for your interest in these pages. I do hope they have been enjoyable, informative and educational.

Best Regards,
John Butler
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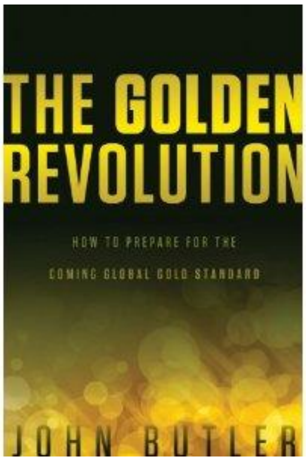
[2] I wrote about this policy dilemma in much more detail back in 2011. Please see IT'S THE END OF THE DOLLAR AS WE KNOW IT (DO WE FEEL FINE?), Amphora Report vol. 2 (April 2011). Link here.



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"John Butler provides much illuminating detail on how the world's monetary system got into its present mess. And if you're wondering what comes next, this is the book to read."
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More Praise for *THE GOLDEN REVOLUTION*:

"John Butler has written an indispensable reference on the subject of gold as money. His book is a combination of history, analysis, and economics that the reader will find useful in understanding the use and misuse of gold standards over the past century. He breaks the book into a long series of essays on particular aspects of gold that the reader can take as a whole or in small bites. It is technical yet accessible at the same time. The Golden Revolution is a useful and timely contribution to the growing literature on gold and gold standards in monetary systems. I highly recommend it."
—James Rickards, author of the *New York Times* bestseller *Currency Wars: The Making of the Next Global Crisis*

"In The Golden Revolution, John Butler makes a powerful case for a return to the gold standard and offers a plausible path for our nation to get there. Enlightened investors who blaze the trail will likely reap the greatest reward. For those still wandering in the dark, this book provides necessary light to keep you headed in the right direction."
—Peter Schiff, CEO, Euro Pacific Precious Metals; host of The Peter Schiff Show; and author of *The Real Crash: America's Coming Bankruptcy—How to Save Yourself and Your Country*

"John Butler's historical treasure trove empowers the reader to understand, prepare, and act. To have a chance to emerge unscathed from financial turmoil, join the Golden Revolution. I have."
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—Ned Naylor–Leyland, Investment Director MCSI, Cheviot Asset Management

"Ex scientia pecuniae libertas (out of knowledge of money comes freedom).John has used his exemplary knowledge of money to lay out a cogent framework for the transition of society based on fiat money to a more honest society forged by gold. He has taken complexity and given us simplicity. Monetary economics and its interrelationship with geopolitics, finance and society is extraordinarily complex, but he has managed to assimilate a vast array of information and distill it in a simple and thoughtful framework. That is an art many academic writers never achieve."
—Ben Davies, cofounder and CEO, Hinde Capital

AMPHORA: A ceramic vase used for the storage and intermodal transport of various liquid and dry commodities in the ancient Mediterranean.

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John Butler has 19 years' experience in the global financial industry, having worked for European and US investment banks in London, New York and Germany. Prior to founding Amphora Capital he was Managing Director and Head of the Index Strategies Group at Deutsche Bank in London, where he was responsible for the development and marketing of proprietary, quantitative strategies. Prior to joining DB in 2007, John was Managing Director and Head of Interest Rate Strategy at Lehman Brothers in London, where he and his team were voted #1 in the Institutional Investor research survey. He is the author of *The Golden Revolution* (John Wiley and Sons, 2012), a regular contributor to various financial publications and websites and also an occasional speaker at major investment conferences.