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# Discretion Is The Point:
# The Misunderstood Legal Bounds of the ESF

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## Introduction

We recently released a proposal advocating for the creation of a Supply Insurance and Acceleration Program through the Exchange Stabilization Fund ("ESF"). The ESF allows the Secretary of Treasury to purchase "instruments of credit or other securities" in a manner "consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates."

Despite this facially mundane purpose, and the fact that it has been used by both Republican and Democratic presidents to address a variety of economic challenges, the ESF has been subject to considerable controversy. The enabling statute affords the Secretary of Treasury significant authority and discretion over considerable resources (the most recent balance sheet statement was $221bn), invocations of which have given rise to efforts to curtail it.

With this in mind, it is imperative that any case for using the ESF have strong legal justification and appropriate constraints to limit political pushback. Given the discretion afforded the Secretary in utilizing the ESF, and the strong correlation between commodity price volatility and exchange rate volatility, the Secretary has the authority to establish a Supply Insurance and Acceleration Program for key commodities.

## Background

The ESF was established in 1934, to stabilize the exchange value of the U.S. dollar. The demise of the gold standard together with the advent of a floating exchange rate system necessitated reform. In 1976, the purpose of the fund was modified, striking "stabilizing the exchange value of the dollar" and allowing actions "consistent with the obligations of the Government in the International Monetary Fund." Since that time, the fund has been used to provide loans to Mexico during the "Tequila Crisis" of 1994-95, to support money market funds during the Great Recession, and to support Federal Reserve facilities during the COVID-19 pandemic.

The scope of Treasury's authority has never been litigated, but it has been subject to political controversy driven by misunderstandings on the limits that bind the Secretary's legal authority.

In 1995, following a failed attempt to seek congressional approval for a loan package for Mexico, President Clinton resorted to his Plan B and used the ESF to provide the support necessary to prevent a default. His decision garnered substantial pushback. As captured by the Peterson Institute for International Economics:

> *"Congressional committees held numerous hearings…the atmosphere was contentious and the exchanges often sharp, demonstrating a substantial breakdown in congressional-executive relations over the substance and execution of the rescue…Senators and representatives… questioned in many instances the ability of the President and the Secretary to act with ESF funds."*

Congress ultimately passed legislation requiring regular disclosure of the fund's activities with respect to the Mexican package–but did not meaningfully limit the Secretary's discretionary powers.

In 2008, at the onset of the Global Financial Crisis, the Treasury Department utilized the ESF to establish the Temporary Guarantee Program for Money Market Funds ("TGPMMF"). It was the first time that ESF funds had been used to support domestic entities. Although it was a novel use of the ESF, Treasury officials justified it on the basis that "the runs were threatening to spread the destabilizing stresses on the financial system beyond the United States," and that "forcing fire sales of assets by money funds to meet the demands of investors would cause a further deterioration of the U.S. economy and declines in the dollar's value."

In spite of the success of the program, Congress again protested. It passed a narrow (but impactful) limitation on the ESF, prohibiting it from ever using it again to support Money Market Mutual Funds (it later suspended the limitation during the 2020 COVID-19 pandemic). Additionally, the Congressional Oversight Panel, charged with oversight and accountability of the measures taken to respond to the crisis, questioned whether the ESF had legal authority to support money market funds in the first place, and put forth a narrow interpretation of the ESF's allowable uses.

These episodes demonstrate the central challenge for using the ESF: economic crises require a high degree of discretion and flexibility, but often give rise to imperfect solutions–inciting backlash from Congress, which then attempts to limit the Secretary's future discretion. Despite these backlashes, a central fact remains unchanged: **the text of the statute affords significant discretion to the Secretary of Treasury to use ESF funds to support exchange rate stability.**

## Discretion is Paramount: A Fair Reading of the Statute

31 U.S.C. 5302 establishes the stabilization fund and reads the following (irrelevant reporting and accounting subsections have been omitted):

*(a) (1) The Department of the Treasury has a stabilization fund. The fund is available to carry out this section, section 18 of the Bretton Woods Agreement Act (22 U.S.C. 286e–3), section 3 of the Special Drawing Rights Act (22 U.S.C. 286o), and the Coronavirus Economic Stabilization Act of 2020, and for investing in obligations of the United States Government those amounts in the fund the Secretary of the Treasury, with the approval of the President, decides are not required at the time to carry out this section. Proceeds of sales and investments, earnings, and interest shall be paid into the fund and are available to carry out this section. However, the fund is not available to pay administrative expenses.*

*(2)* ***Subject to approval by the President, the fund is under the exclusive control of the Secretary,*** *and may not be used in a way that direct control and custody pass from the President and the Secretary.* ***Decisions of the Secretary are final and may not be reviewed by another officer or employee of the Government.***

*(b)* ***"Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates,*** *the Secretary or an agency designated by the Secretary, with the approval of the President,* ***may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary.*** *However, a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in any 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months." (emphasis added).*

Any fair reading of the statute must conclude that Congress intended to give the Secretary of Treasury considerable discretion to use the ESF. It placed the fund under the "exclusive control of the Secretary," subject only to presidential approval. It prohibited review by other agencies or officials of decisions made by the Secretary. And it provided the Secretary explicit authority to determine what "instruments of credit and securities" would be necessary to deal in a manner "consistent with the obligations of the Government in the International Monetary Fund."

As Edward Knight, former General Counsel of the Department of Treasury, concluded in 1995:

> *"Given the purpose of the ESF as a means of maintaining order in exchange markets and its genesis as a tool for counteracting similar funds held by other countries, it is entirely reasonable that Congress has vested complete discretion in the Secretary of the Treasury and the President for the operation of the Fund. As the chief financial policy official of the U.S. Government, the Secretary of the Treasury is uniquely situated in the Government to make the complex judgments necessary to determine the need for intervention in currency markets at any particular time."*

The discretion provided in the text supports the following generalized, restated rule: **the Secretary has the authority to use ESF funds to engage in transactions or activities she deems necessary to support the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates.**

This principle runs contrary to how many would define the bounds of the ESF, as illustrated most recently in the Congressional Oversight Panel's report overseeing the response to the 2008 Global Financial Crisis.

The Treasury Department relied on the ESF's wide authority to justify the use of ESF funds in setting up the Temporary Guarantee Program for Money Market Funds ("TGPMMF"). The facility guaranteed "the share price of any publicly offered eligible money market mutual fund – both retail and institutional – that applies for and pays a fee to participate in the program." The program was intended to "address temporary dislocations in credit markets," and President Bush approved Secretary Paulson's use of the ESF to make those guarantees.

The TGPMMF was a marked departure from prior uses. It was the first time that the ESF supported domestic counterparties. In the operation's announcement, Treasury made no reference to exchange rate stabilization, and stated the purpose of the ESF was to "promote international financial stability." At the time, no further legal justification was provided or released.

Although the facility played an important role in stabilizing international financial markets and limiting the fallout from the global recession—the politics of "bailouts for Wall Street" bred controversy and opposition. The panel was highly skeptical of the Treasury's use of the ESF to guarantee money market funds. Although Treasury never released a formal legal justification, they provided the panel with the following justification:

> *"The IMF obligations referenced in this provision link orderly exchange arrangements to the stability and health of the global financial and economic system. Because the extreme demand for redemptions facing money market funds at the time the [TGPMMF] was initiated had magnified liquidity strains in global funding markets and greatly exacerbated global financial instability, the [TGPMMF] was expected to counter such instability and help restore financial equilibrium. This objective was consistent with the terms of the statute"*

The panel responded to this claim stating, "while one could argue that the distress in the MMF market had—and the prospect of a prolonged run on the markets would have had—serious consequences for international financial stability, Treasury's position raises the prospect of using the ESF for other domestic activities that can be plausibly linked to ensuring international financial stability." It went even further, suggesting that the text and legislative history indicated that the fund was "primarily intended" to provide loans to foreign countries on a short-term basis.

This limited interpretation is simply not grounded in reality, as made clear by both the legislative history and any rigorous textual analysis. As the late legal giant Walter Dellinger, who authored a 1995 Office of Legal Counsel (OLC) opinion on the ESF, concluded, the legislative history "reflects the judgment of Congress that the President and the Secretary should retain the flexibility to use the ESF, as they consider necessary, to respond promptly to sudden and unexpected international financial crises that undermine the global currency exchange system and jeopardize vital U.S. economic interests."

Furthermore, the claim that the fund was only intended to provide short-term credit to foreign countries does not stand up to basic principles of statutory interpretation. For one, the text explicitly contemplates a distinction between support for a "foreign entity" and for a "government of a foreign country."

Under the "whole text canon" the law should be read in a manner where each clause helps to interpret the other. The statute requires only that loans or credits to foreign entities or countries be accompanied by a written justification to Congress. The fact that it is limited to "a loan or credit," even though another part of the law allows other types of dealings (in gold, foreign exchange or securities), is direct evidence that it is meant to be a limitation on a specific class of a broader set of transactions, rather than apply to the whole. Suggesting that the narrow limitation applies to the entire paragraph would be an exercise in "unwarranted superfluousness."

The narrow reading also fails under the presumption against surplusage, as the limitation would be unnecessary if it applied to the entire paragraph. The presumption requires that "every word and every provision is to be given effect.... None should needlessly be given an interpretation that causes it to duplicate another provision or to have no consequence." Under that presumption, the foreign nation or entity requirement can only be limited to the sentence containing it. An interpretation that the limitation applied to the entire paragraph would result in the actual reference to foreign entities or nations having no consequence. Essentially, if the limitation to foreign entities applied to the entire paragraph, the fourth element could easily read "However, a loan or credit may be made for more than 6 months... only if..." The existence of the limitation therefore strongly supports the contention that the text allows usage beyond just support for foreign nations.

The evidence is even more damning after examining the structure of other contemporary stabilization programs administered through the Department of Treasury. For example, the State and Local Fiscal Assistance Act, first passed in 1972 (and extended by the same Congress that amended the Exchange Stabilization Fund) established a revenue sharing program to "make payments to States and to local governments to coordinate budget-related actions by such governments with Federal Government efforts to stimulate economic recovery." But that program included a complex allocation formula, authorized appropriations only during periods of high unemployment, and limited the use of such payments to "the maintenance of basic services customarily provided to persons in that State or in the area under the jurisdiction of that local government, as the case may be." In short, Congress set clear boundaries and limitations on a stabilization program administered by the Department of Treasury. That it declined to set such boundaries on the Exchange Stabilization Fund is further evidence that Congress intended a considerable degree of authority and latitude to determine when and how the fund should be administered.

The strict reading limiting the ESF's primary use to loans for foreign nations simply does not pass muster. The text authorizes support for domestic entities. There are no meaningful limitations on eligible entities, types of transactions, time horizons for transactions, except for those explicitly defined in the text.

In spite of this, we do not posit that the text places no bounds on the Secretary's authority. The text of the statute offers a clear boundary–authorizing dealings that are consistent with the goals of exchange rate stability.

## Exchange Rate Stability: A Real Boundary on Using the ESF

The 2008 experience demonstrates the care and attention required to demonstrate the legality of an ESF facility—particularly when providing support to American businesses. So how can one demonstrate a strong legal justification for an ESF facility? By rooting interventions firmly in the goal of furthering exchange rate stability.

The statute essentially sets four elements to determine legality of an action:

> (1) whether the use would be consistent with the government's obligations in the IMF on orderly exchange arrangements and a stable system of exchange rates;
>
> (2) whether the President has provided approval;
>
> (3) whether the transaction is in gold, foreign exchange instruments, or other instruments of credit and securities; and
>
> (4) if a loan or credit is to a foreign entity for a period of more than six months, whether a written justification of unique or emergency circumstances has been provided to Congress.

The second, third, and fourth elements are relatively clear. The key boundary is the first, which is open to interpretation, and importantly, has opened the door to wider uses and policy responses in crises. Nonetheless, the importance of exchange rate stability should be clear. 31 U.S.C. 5302 itself references an "orderly exchange arrangements and a stable system of exchange rates." The "obligations of the Government in the International Monetary Fund" directs us to Article IV of the IMF's Articles of Agreement, which governs obligations regarding exchange rates, and requires members to "work with the Fund and other members to assure orderly exchange arrangements and promote a stable system of exchange rates."

However, Article IV describes policy goals beyond exchange rate stability. Section 1 includes the following obligations for member nations:

> *"Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of*

*exchange rates. In particular, each member shall:*

> *i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;*
>
> *(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;*

Though the language of the agreement is certainly oriented around exchange rate stability, the broad obligations in subparagraphs (i) and (ii) could authorize activity with a much more attenuated relationship to exchange rate stability. Policies with even the most tangential relationship to "orderly economic growth with price stability," "orderly economic and financial conditions" or a "monetary system that does not tend to produce erratic disruptions," could be justified, especially given the highly integrated nature of global financial markets.

Given the considerable discretion afforded the Treasury Secretary, to minimize political controversy and limit legal vulnerability, the Treasury Department should ensure that ESF actions are consistent with promoting exchange rate stability. Uses that make no effort to ground their reasoning in exchange rate stability will draw more scrutiny—and ones that are more clearly linked to limiting exchange rate volatility should garner support. We make no judgment about what is more appropriate or whether one is more likely to survive judicial scrutiny. But a strong legal, and political case for that matter, will rest on an argument that is least attenuated from stabilizing exchange rates.

## How Commodity Price Volatility Stokes Exchange Rate Volatility

With that in mind, how would we justify the use of the ESF to support commodity production? Ultimately, it comes back to our overall goal—guarding against the kind of commodity price volatility that has historically proven relevant to exchange rate dynamics.

This starts with a recognition that to meet the basic needs of a nation's population, demand for certain commodities is particularly inelastic to price increases. If you are highly import-dependent for fuel or wheat, sharp increases in prices deplete foreign currency reserves, (the same is true for export-reliant countries when prices decrease sharply), which can ultimately stoke a foreign exchange crisis. The consequences can exacerbate political and social unrest– perversely encouraging the further flight of foreign capital and reserves.

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There is considerable evidence that the commodities supercycle contributed considerably to currency crises. As a 2012 IMF publication put it, "commodity price volatility matters particularly for low-income countries. These countries are hit by large terms of trade shocks almost six times more often than advanced economies, reflecting in part LICs' dependence on primary commodities. And the consequences of commodity price shocks are typically far more severe for LICs." It continued later on that "commodity price shocks put policymakers in the difficult position of having to choose between accommodating higher domestic inflation, potentially undermining central bank credibility, and tightening policies, which could exacerbate the negative economic impact of the price shock." A 2021 IMF working paper found that "the severe terms of trade shock associated with collapsing commodity prices in 2014-2016 precipitated a sharp deterioration in economic performance, underscoring the policy challenges commodity exporters can face. The countries saw a steep fall in economic growth, increased unemployment, deterioration in their fiscal, trade and current account balances, particularly under pegged exchange rate regimes, a significant loss of foreign reserves, rising public debt, and a sharp exchange rate depreciation (under flexible exchange rates)."

Countries' exchange rates can be very sensitive to their terms of trade (price of exports relative to price of imports) and expected capital flows that stem from commodity investment opportunities. In the context of oil, net exporters can see their currencies depreciate when oil prices decline (2014-16), while net importers are more vulnerable to depreciation when oil prices rise substantially (2007-08, 2009-11). Oil price spikes can be especially damaging for countries with limited reserves of "hard" currency (dollars usually) to satisfy inelastic domestic demand for imported commodities (energy usually, but food as well).

Our current moment demonstrates just how painful commodity swings and price surges can be to nations' balance of payments, and the threat this poses to global financial and economic stability. Sharp increases in the prices of food and fuel have stoked exchange rate crises around the world including in Lebanon, Laos, Sri Lanka, and Pakistan. With the supply effects from the Russian invasion of Ukraine not yet fully reflected in prices, even more nations will be at risk in the coming months. Across commodities (but particularly for critical ones like food and fuel), prices are already at a historically elevated range and with inventories low and still declining, demand continues to outstrip supply. Without an appropriate production response, upside risks for prices remain, elevating the possibility of more currency crises spreading. The central role that commodity prices play in exchange rate stability provides clear authority to the Secretary to use the ESF.

## Conclusion

Recent ESF interventions have engendered considerable opposition from members of Congress. Although some of these criticisms are not rooted in the intent of Congress, as demonstrated by the text of the statute, it is important that any considered ESF use offer a rigorous case demonstrating the linkage between the intervention and exchange rate stabilization.

Incentivizing commodity production may not seem like the most obvious way to minimize exchange rate volatility, but as the preceding analysis demonstrates, commodity volatility inherently fuels exchange rate volatility. At the current juncture, the commodity price fallout from the attempted Russian invasion is likely to be a root cause for dislocations in balance of payments and exchange rates for many economies. Action through the Exchange Stabilization Fund is particularly useful given how many currencies can be impacted by oil and food price volatility, including major allies and trading partners. Given this–it is paramount that the administration utilize the Exchange Stabilization Fund to establish a Supply Insurance and Acceleration Program.