Foreign exchange market intervention in emerging market economies: an overview

On 2 and 3 December 2004, the BIS hosted a meeting of Deputy Governors of central banks from major emerging market economies to discuss foreign exchange market intervention. While few developed countries have actively intervened within the last decade, the outstanding exception being Japan, intervention has been commonplace in the emerging market community.

There are several reasons why developed countries no longer actively intervene. One is that research and experience suggest that the instrument is only effective (at least beyond the very short term) if seen as foreshadowing interest rate or other policy adjustments. Without a durable and independent impact on the nominal exchange rate, intervention is seen as having no lasting power to influence the real exchange rate and thus competitive conditions for the tradable sector. A second reason is that large-scale intervention can undermine the stance of monetary policy. A third reason is that private financial markets have enough capacity to absorb and manage shocks - so that there is no need to "guide" the exchange rate.

Yet emerging market countries do intervene - presumably because they believe the instrument to be an effective tool in the circumstances and for the situations they face. The difference in view is brought home by the unprecedented scale of foreign exchange reserve accumulation by the emerging market group in recent years. Between the end of 2001 and the end of 2004, global foreign exchange reserves grew by over US$ 1600 billion, reflecting reserve accumulation by emerging market economies in Asia. Many observers from developed economies have publicly attributed the comparatively weak appreciation of Asian currencies against a rapidly depreciating US dollar to such intervention. Hence there does seem to be a common belief that intervention by emerging market economies has significantly altered the path of the *real* exchange rate for long enough to matter - even if such a view runs counter to received wisdom about intervention in the markets for major currencies.

This meeting threw some new light on these issues. Some flavour of the discussion can be gleaned from the central bank papers reproduced in this volume, along with overview papers prepared by BIS staff. Four central questions are outlined below; it will be clear that many important issues remain to be resolved.

Is intervention more effective in emerging markets?

The wide range of different objectives behind intervention in practice makes assessment difficult - especially empirical assessment that uses data from different episodes and different countries where policy objectives may vary. In flexible exchange rate cases, the objectives of intervention are particularly varied, a point which emerges clearly from the Moreno paper and the individual country papers in this volume. Reasons for intervention cited by central banks that do not target the exchange rate include: to slow the rate of change of the exchange rate; to dampen exchange rate volatility (in some cases to satisfy an inflation target); to supply liquidity to the forex market; or to influence the level of foreign reserves. The paper from South Africa provides an example of objectives that are both subsidiary to the main objective and conditional on prevailing circumstances (in this case, the process of reserve accumulation being used to help dampen volatility when that is convenient). Other country papers show that varying mixtures of objectives are quite commonplace.

Many central banks would argue that their main aim is to limit exchange rate *volatility* rather than to meet a specific target for the *level* of the exchange rate. Yet others would counter that it is better to abstain from intervention in the foreign exchange market: such a stance would, they contend, make investors more aware of the need to hedge their own exposures, and this would help the market in hedging instruments to develop. The papers from Israel, Mexico, Poland and Thailand are particularly relevant in this regard. There is indeed some evidence that exchange rate volatility has fallen a lot in some countries where the central bank has not intervened in recent years. The papers from Korea and Peru highlight the existence of a policy trade-off where there are reasons to intervene to dampen volatility yet intervention may involve moral hazard with respect to market development.

The survey reported in Mihaljek's paper shows that many emerging market central banks view intervention as effective in influencing the exchange rate consistent with their objectives. Part of this may be attributable to cases in which fixed or targeted exchange rate regimes are in place: under such a regime, monetary policy actions are primarily dictated by what is needed to achieve and maintain the exchange rate target, intervention in the foreign exchange market is automatic or nearly so, and the exchange rate peg has proved reasonably durable. The papers from Hong Kong SAR and Saudi Arabia illustrate the point.

Formal econometric research has usually thrown doubt on the conclusion of effectiveness of intervention in flexible exchange rate cases although, as noted, such research often conflates interventions for different purposes. In addition, the effectiveness of intervention is likely to depend on the specific circumstances - studies of effectiveness on average do not answer the question of when intervention is likely to be successful.

Disyatat and Galati's paper surveys the available empirical evidence, and presents new evidence for the Czech koruna (the methodology requires detailed daily data on intervention and option prices, which were only available for the Czech Republic). The authors' new estimates tentatively suggest the existence of a cumulative effect from repeated intervention (although the mechanism is not clear). In the group of countries surveyed, there are several examples of repeated interventions over lengthy periods. In this connection, the paper from Venezuela makes the interesting point that intervention might have diminishing power with repetition.

It remains possible that greater apparent effectiveness of intervention in emerging market cases simply reflects different structural characteristics. Emerging market economies tend to have less substitutability of assets across currency boundaries, and the authorities tend to have greater financial - and certainly regulatory - weight relative to their private markets. Mihaljek's paper shows clearly that emerging market economies typically hold very large reserves compared with market turnover (see Table A2), even if interventions are not in general large relative to turnover. And several of the country papers describe the application of regulatory measures to obtain influence over the exchange rate.

How much transparency is desirable in forex intervention?

Typically, exchange rate and intervention policy involves some consultation between the government and the central bank. But there is no simple rule for allocating responsibilities between these two entities. As the paper by Moser-Boehm makes clear, views of central banks also differ about transparency. Transparency is seen as needed for accountability, which is more important the more autonomous the central bank. In some cases, high levels of transparency have also been used as a means of reinforcing a break from past exchange rate regimes and as part of an attempt to rebuild credibility. The papers from Argentina, Chile and Turkey all make such a point.

Many favour transparency regarding the intervention framework ex ante, and transparency about actual intervention operations ex post. For tactical reasons, however, silence regarding the timing and precise nature and size of specific operations ex ante is generally thought to be desirable (one exception is Hong Kong, where operations are revealed in real time). Intervention is sometimes kept secret so that the market has no target to attack - the paper from Hungary provides an account of open interventions attracting destabilising speculation - or has no idea of how much intervention has taken place so that credibility is not threatened by the perception that the central bank has failed. Some argue that markets eventually find out and secret intervention of this type is undesirable.

Have intervention tactics improved?

Central banks have probably improved their intervention techniques in recent years. They now devote greater resources to "reading" the market than in the past. But it is unclear whether central banks have become more effective as a result, because the sophistication of market participants has also risen and because the knowledge of what drives the exchange rate is still very imperfect. The paper by Archer examines tactical issues in some depth.

The outcome of various intervention tactics depends on the situation, and tactics evolve as part of an ongoing trial-and-error process reflecting uncertainty about what works. Few felt that "clever" use of market dynamics (eg entering the market when it is known to be illiquid) to leverage the influence of interventions would be useful in practice. Most have an aversion to volatility, and would not like to add to it. Some would not like to be visible in the market at all, and the central bank's presence is harder to hide when operating in thin markets. Others felt that having a large effect in a peripheral part of the market would be unlikely to generate useful results in the main (spot, wholesale, onshore) market. In any case, if a central bank wants to be effective in the main market, it should intervene in that market for reasons of credibility.

The idea that intervention might work by “coordinating” otherwise dispersed or fragile views about the exchange rate outlook is also discussed in the paper by Archer. If that coordination channel is operating, it seems likely that actions rather than words are the main coordinating vehicle, given that only a small minority of participating central banks reported actively using “open mouth operations”. However, the papers from Chile and Indonesia provide interesting counter-examples where open mouth operations of quite different forms have been seen to be successful in influencing exchange rate behaviour.

How decisive are adverse domestic spillovers?

Resisting currency appreciation through large-scale and prolonged sterilised intervention creates several major challenges - for the stance of monetary policy; for the financing costs of the authorities; and for exposures in both financial markets and the public sector’s balance sheet. Possible adverse spillovers are addressed in the paper by Mohanty and Turner and by a number of the contributed papers (see especially the discussions of the relationship between foreign exchange market intervention and inflation targeting in the papers from Brazil, Colombia, the Czech Republic and New Zealand).

Such domestic spillovers seem likely to make intervention harder and harder to sustain. Seeking to *both* prevent currency appreciation *and* hold up domestic money market rates (for monetary policy reasons) perpetuates the initial interest rate differential and can lead to continuous capital inflows. There is a risk of significant balance sheet mismatches for central banks, which could face losses due to carrying costs (if local interest rates were above foreign levels) or to their exposure to large currency appreciation. But although the factors that could at some point undermine the sustainability of intervention are clear, there are few signs at present that these adverse consequences have actually materialised.

A number of features of the current situation thus seem new, with interesting implications. Large-scale sterilisation operations are clearly much less hampered by financial market underdevelopment than was the case just a few years ago. And even with incomplete sterilisation, the relative lack of adverse consequences raises the distinct possibility of longer-lasting real exchange rate effects of intervention than conventional wisdom thought likely. Just how long-lasting such effects really are cannot be known until the present episode has run its course.