Foreign exchange intervention by emerging market economies: issues and implications

Saif Hadef Al Shamsi[1]

Abstract

The UAE's Union Law 10 of 1980 stresses that one of the major tasks of the Central Bank of the United Arab Emirates is to "support the currency, maintain its stability and ensure its free convertibility into foreign currencies". In practice, this has translated into the adoption of a fixed dollar/dirham exchange rate, which essentially implies a passive approach to foreign exchange intervention. Liquidity is balanced through the use of tools such as Certificates of Deposit (CDs), both conventional and Islamic, as well as dollar/dirham swaps. These tools help to sterilise excess liquidity and to provide liquidity during times of market stress. Recent experiences and challenges suggest that these tools have served the UAE well, but as debt and trade flows enlarge, a more proactive approach may be required in regulating liquidity within the UAE financial system.

Keywords: monetary policy, central banking, the supply of money and credit

JEL classification: E5

[1] Assistant Governor, Monetary Policy and Financial Stability Department, Central Bank of the UAE.

The topic for discussion for this meeting is "FX intervention by Emerging Market Economies: Issues and Implications". At the Central Bank of the UAE, we do not intervene in FX markets in a direct and active manner. Therefore, we thought that it would not be advisable for us to fill in the tables that were sent to us by the BIS, as the data we fill in could give the readers an incorrect impression that we intervene in markets in a conventional way, whereas we have a different approach to the subject. This short paper is an effort to present that approach in a short and concise way.

The UAE's Union Law 10 of 1980, which established the Central Bank of the UAE (CBUAE), stresses that one of the major tasks of the CBUAE, is "to support the currency, maintain its stability internally and externally, and ensure its free convertibility into foreign currencies".

The UAE dirham was launched in 1973 and has been pegged to the US dollar since 1980. The resultant stability of the dirham that has followed from the fixed exchange rate has served the UAE economy well – a fact which has been noted by the International Monetary Fund.

Indeed, reducing currency risk has benefited the UAE's open economy, which has gained from its geo-strategic location between the East and the West. This locational advantage has been further enhanced by the modern infrastructure that has been built in the country, making the UAE an important travel and logistics hub.

The commitment that the country and its monetary authority have shown to the fixed peg regime has enhanced business continuity and stability. Meanwhile, the Central Bank of the UAE has followed a passive but highly effective policy in preserving the peg. We fully recognize that in a pegged regime the market cannot have an iota of doubt over the central bank's commitment to the exchange rate policy.

It is to back this commitment that we are always on either side of the market during our working hours. Therefore, any bank licensed by the CBUAE and operating in the country can approach the CBUAE to buy/sell the dirham, without any limit, at the exchange rate of 3.6720 to 3.6730 dirhams per US dollar. This is our bid/offer spread, and we are committed to it during our business hours.

The narrowness of the peg has had its consequences in the form of limiting FX market activity, ***but it has been highly effective in maintaining FX stability and balancing market liquidity***. It is not the policy of the CBUAE to actively intervene in markets, but given our policy stance, we are available for market players to access the dollar/dirham window throughout the day.

The government in the UAE is the major supplier of dollars, since the UAE is an oil producing country and oil exports are denominated in US dollars. It has also been noticed that at times of market stress, as has been the case with recent bouts of the European debt crisis, the appetite for dollars goes up when dollar supply from the global interbank market dries up.

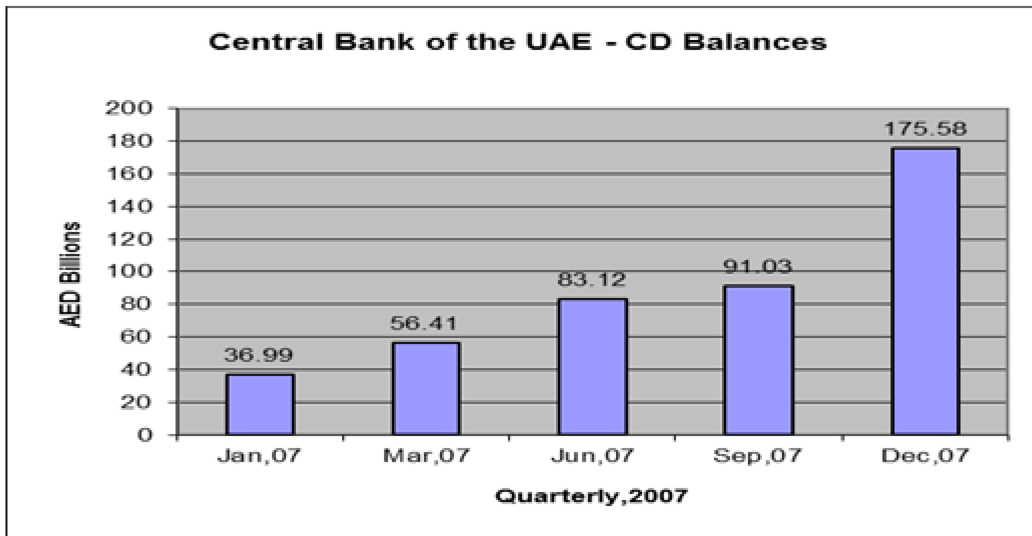
The need to provide an almost unlimited amount of US dollars to back up any demand against the UAE dirham is therefore a major monetary policy goal. Hence, the focus of our reserves management strategy is on liquidity and capital preservation.

Apart from the dollar/dirham window, we offer banks the ability to manage their dirham liquidity via two other programs – the dollar/dirham swaps and the Certificate of Deposit (CD) program. Both these programs have been in place for a

long period, although they have undergone significant changes in their scope and execution over time.

The dollar/dirham swap was a limited program till December 2008, but since then it has been expanded in terms of eligibility, tenor and amounts.

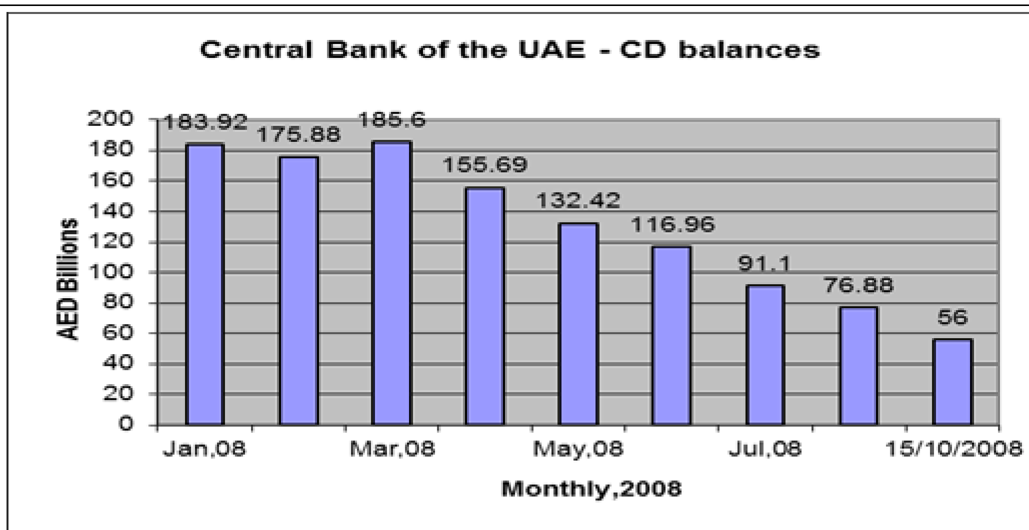
Outstanding CDs at the CBUAE – 2007 Figure 1.1



Source: Central Bank of the UAE

Similarly, our CDs program was reviewed in 2007 as a result of the speculation on dirham revaluation during the years 2007–2008. This was a time when fiscal policy was very expansionary in the UAE, and high GDP growth, with rising inflation, led the market to speculate on a dirham revaluation against the dollar. These flows were, to a great extent, sterilized via the CDs program (see Figures 1.1 and 1.2).

Outstanding CDs at the CBUAE – 2008 Figure 1.2



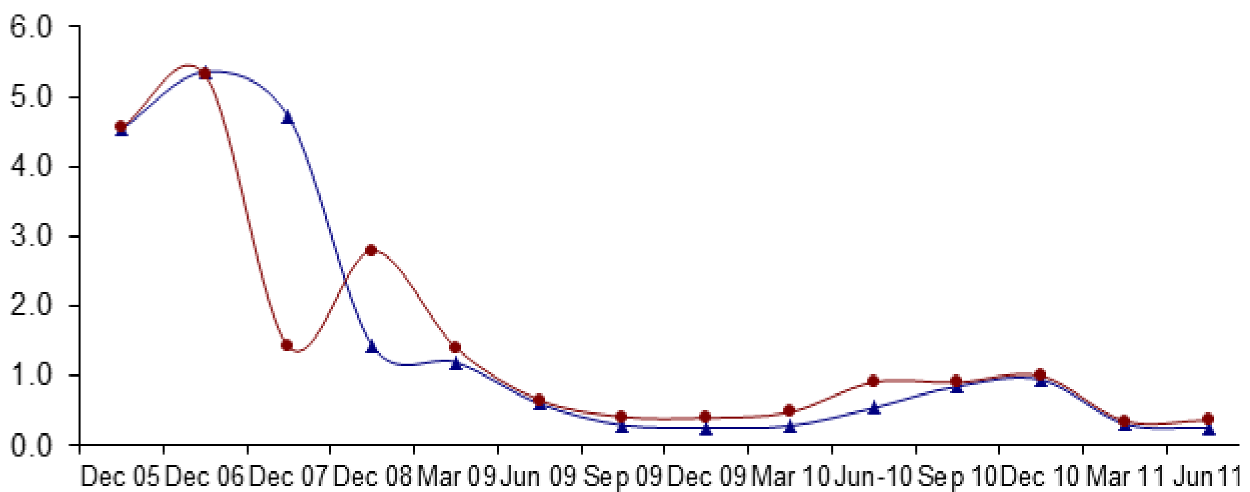
Source: Central Bank of the UAE

These large flows led us to readjust the CDs program from a passive program, where issuance was up to the banks, to an auction-based program where the cut-off rates would be decided by the CBUAE. Previously, CDs were issued at fixed rates closely aligned to the US Libor rates. Consequent on the adjustment, the new rates were gradually aligned with rates prevailing in the domestic interbank dirham market and those derived from the dollar/dirham swap curve. As a result, the coupons paid on CDs collapsed from around 4.5% to close to 1%, in line with the prevailing market rates, both in the deposit market and forward markets, at that time.

The changes had their impact on the inflows, which peaked in early 2008 and gradually reversed over time, till the CD rates, dirham swap implied rates and dollar Libor all came in line over the course of time (Figure 2).

The CDs program has been a very useful tool for sterilizing market liquidity. The outstanding amount of CDs has always risen or fallen in line with market liquidity. The CDs program has also been able to add to market liquidity at times of shortages, as banks can borrow both dirhams and dollars via CD repos at very reasonable rates for periods varying from overnight to 3 months.

AED swap implied rates and Libor rates — Figure 2



$ Libor AED swap implied rates

Source: Bloomberg and Central Bank of the UAE

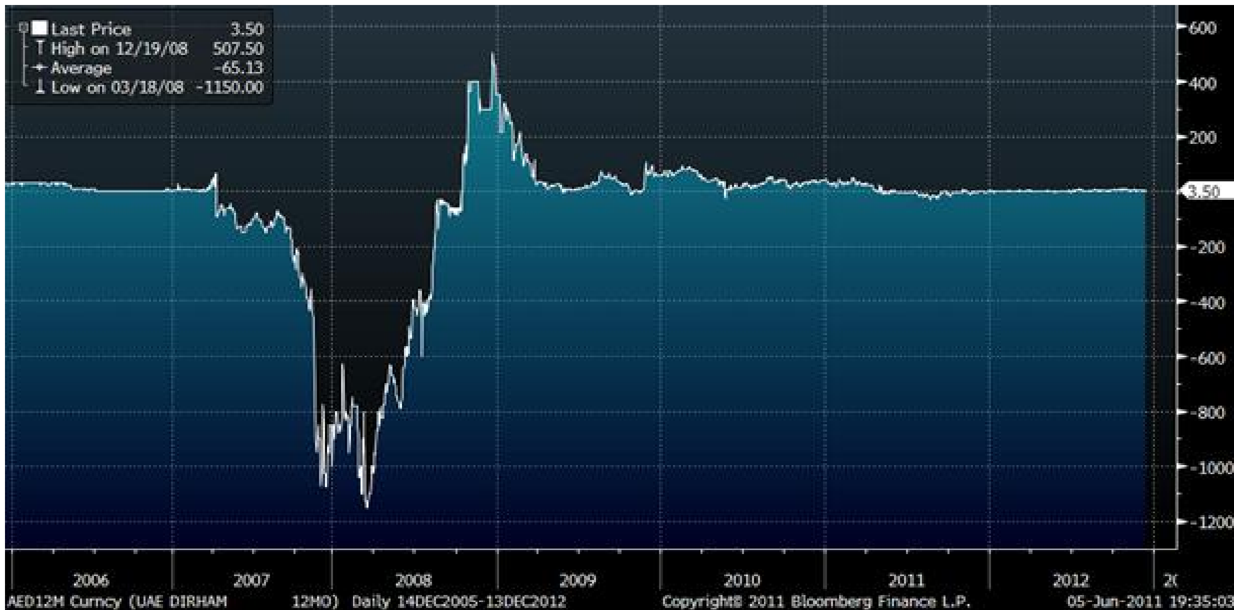
The narrow band of FX volatility in both spot and 12-month forward markets (Figure 3 below) has largely resulted from the commitment of the CBUAE to buy and sell unlimited amounts of USD, spot as well as forward, at the pegged rate during the official working hours of the Central Bank.

Figure 3 shows large variations in the 12-month USD/AED forward rates during the 2007/2008 period – this was the time when there was speculation on dirham revaluation and during this period money market rates diverged from the Central Bank's CDs rates. From March 2008, forward rates surged higher as the global crisis began and local banks, trying to fund their dollar assets, now pushed the rates in the opposite direction. This is when we introduced dollar funding (against CD

collateral) and expanded the dollar swap program, which normalized the forward curve to its natural levels.

USD/AED 12-month forwards

Figure 3



Source: Bloomberg

But inevitably, as markets grow and debt and trade flows enlarge, we will need to be more proactive in regulating liquidity within the financial system. To provide an enabling environment to encourage banks to buy UAE government securities, the CBUAE will be launching a discount window facility called the Marginal Lending Facility (MLF) in the next 18–24 months.

Through the MLF, banks will be able to borrow intra-day and overnight funds to tide them over sudden short term liquidity shortfalls. Currently, there is a lack of eligible government securities, but it is to be hoped that over time we will be able to redress this situation.

It is our understanding that the pegged exchange rate regime guarantees the stability of the UAE economy and has served our interests well in the past. Hence, we intend to continue with the pegged regime, but are moving towards creating an infrastructure which further strengthens our monetary policy environment. This will involve closer monitoring of liquidity within the banking system and provide support in events of excesses or shortages of liquidity. Naturally, events of shortages are more devastating than periods of excess. With the benefit of hindsight, however, one can say that both shortages and excesses have negative fallout and central banks should guard against them by closely regulating liquidity within the banking system.