Foreign exchange intervention in Argentina: motives, techniques and implications

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1. Introduction

Finding the optimal degree of exchange rate flexibility is difficult. To a great extent this is because the optimal degree of exchange rate flexibility is quite idiosyncratic and depends on a number of country-specific characteristics that might include the degree of openness, the degree of price and wage stickiness, the degree of short- and medium-term exchange rate pass-through to prices, the degree of substitutability between domestic and imported goods, the state of the banking system and the amount and nature of financial dollarisation.

Argentina's monetary and exchange rate policy is currently in a state of transition to an inflation targeting approach from the very particular mix of policies that helped to manage the severe crises of 2001 and 2002. After the devaluation, it was necessary to anchor expectations that were, in some circles, running wild, so much so that some commentators were predicting a hyperinflation. Continuing capital outflows had to be stemmed by the use of severe, albeit transitory, capital controls. In addition, the central bank had lost the monopoly of issuing money and 15 provinces were issuing their own quasi-monies that circulated abundantly within (and, in a couple of cases, beyond) their borders. The technique of projecting bands for the path of the broad monetary base (which includes the quasi-monies) proved to be an effective way of coping with adverse expectations. Foreign exchange sales were used initially to stem the possibility of an even greater real exchange rate overshooting than that which occurred.

One of the distinguishing features of the post-crisis period has been the low degree of exchange rate pass-through to domestic prices experienced after the very substantial nominal depreciation of the peso. Both a very negative initial output gap and sound monetary policies have been responsible for the low degree of inflationary pressures.

Since the initial post-crisis phase, the quasi-monies have been eliminated, capital controls have been almost completely eradicated, private capital outflows have stopped and the economy has been recovering briskly. Consequently, the central bank has introduced a number of changes in its policies and procedures, including foreign exchange market intervention and sterilisation policies, as well as an international reserves accumulation policy, always within the constraints imposed by the central bank's essential mission, which is fighting inflation. These changes are presented below.

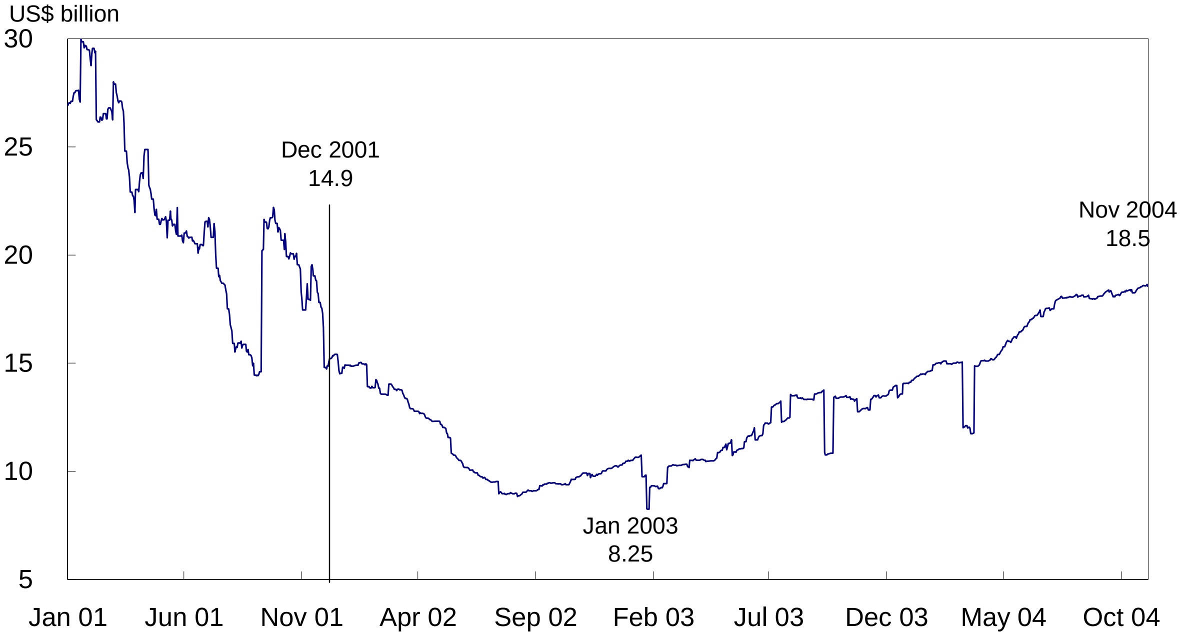
2. Motives

The reasons for and methods of the central bank (BCRA) interventions in the foreign exchange market have changed substantially over the last five years. Up to December 2001, Argentina used a currency board system and the role of the central bank was to exchange, without restriction, pesos and US dollars for each other, one to one. With a run on the banking system, the chaotic ending of the currency board and the default on a part of the government's foreign currency-denominated debt, the central bank faced a number of problems. First, it needed to control foreign exchange outflow and the exchange rate overshooting. During 2001, honouring the currency board programme meant that international reserves had declined from US$ 34.5 billion toUS$ 19.7 billion for the system as a whole, and from US$ 27 billion to US$ 19.4 billion for the BCRA. The central bank's international reserves reached a low of US$ 8.25 billion in January 2003. The government first restricted deposit withdrawals from the banking system and later decreed the forced conversion of US dollar-denominated deposits in the banking system into pesos at an exchange rate substantially lower than that prevailing in the market. Beginning in early 2002, restrictions were imposed on capital outflows. Limits were placed on the amounts of monthly exchange transactions allowed per person (which generated a secondary demand for individuals to use their identity number for transactions for others) and traditional exporters were required to convert their earnings into pesos through the central bank.

Beginning in May 2002, in a bid to forestall the increasing dollarisation of the economy, the central bank started issuing its own debt instrument (Central Bank Notes) as a means of providing the domestic financial market with a peso-denominated asset that could be an alternative to the US dollar and dollar-denominated securities. These notes initially had a maturity of one week, but as the instrument gradually evolved into a tool of domestic liquidity management, maturities have increased and now range from one month to three years.[1] Annual interest rates on these securities rose to a peak of around 120% in pesos (in the middle of 2002) and have fallen gradually over the past three years so that they are now in the 3 to 7% range. During this time, the restrictions on private purchases of foreign exchange have been gradually relaxed and most of the restrictions that remain involve reporting and are not quantity restrictions. The BCRA has intervened in the exchange market regularly in order to reduce the volatility of the exchange rate and to replenish the central bank's international reserves while monetising a rapidly growing economy according to the monetary programme.

Figure 1

BCRA´s international reserves



Source: BCRA

Since January 2003, the BCRA has accumulated international reserves equal to US$ 10.3 billion, mostly in dollars, through regular interventions in the local market so that as of 4 November 2004, gross international reserves reached US$ 18.5 billion. The rebuilding of the stock of international reserves was the welcome corollary of a very successful monetisation strategy. The strategy consists of monetising the economy (growing at an average rate of 8%) through the most liquid market available, that is the foreign exchange market, given that the other sources of variation of money supply are actually acting as sources of contraction. The three exogenous sources of contraction of money supply are: the financial system, by paying back the loans granted by the central bank as lender of last resort during the crises; the government, applying a fraction of the fiscal surplus to payments to International Financial Institutions (IFIs); and the BCRA itself, through the issuance of Central Bank Notes in order to establish a reference rate for the money market. It is the policy of the central bank to accumulate an adequate cushion of international reserves, which plays a critical role in granting needed flexibility throughout the government debt restructuring process, during which there are substantial debt amortisations with the IFIs. Although Argentina has introduced a great deal of

[1] Letras del Banco Central (LEBAC) are notes with maturities shorter than one year, and Notas del Banco Central (NOBAC) have maturities longer than a year. LEBACs are issued in pesos, pesos indexed by CER and in US dollars. NOBACs are issued in pesos and pesos adjusted by CER.

exchange rate flexibility, a substantial cushion of reserves is viewed as providing protection against a number of shocks, including changes in capital flows (sudden stops), changes in international market conditions for Argentina's exports and imports, and for managing shocks that could come be related to problems with foreign exchange denominated debt (both public and private).

The optimal composition and investment strategy of international reserves is currently under study. Recently, the amount of reserves held as gold has been increased to serve as insurance against catastrophic international events (of which there is a small probability), and as part of an investment strategy.

A number of times over the last few years, foreign exchange reserves have been lent to the central government to cover short term timing mismatches in the payments required by international financial agencies (such as the IMF) and later disbursements to Argentina by these same agencies or other payments by the central government.

3. Governance, accounting, relations with the government and communication

Argentina's international reserves belong to the central bank and their evolution is reflected in the balance sheet of this institution. In addition, the central bank determines the composition of international reserves, both in terms of the money in which it is held and the investment policy. Recently, reserves investment policy has aimed to maintain high levels of liquidity while at the same time minimising the potential effects of price changes. Argentina is currently negotiating the restructuring of its defaulted sovereign debt, and reserve investment policies could change once this is completed.

The central bank has full legal powers for taking decisions on interventions in the foreign exchange market. Intervention and sterilisation operations are jointly designed to meet quantitative targets of the monetary programme, as described in the section above. Daily intervention decisions are made by the central bank's president after consulting with the bank's technical staff, in a manner consistent with the current monetary programme. Interventions take place in the (wholesale) spot market, which is by far the most developed and liquid in Argentina. The costs of intervention are borne by the central bank (to whom profits accrue). Changes in valuation are shown in the balances under "International Reserves" with the impact in the item "Net Equity - Net Income". International reserves are reported on a gross basis for domestic purposes, but are reported to international financial agencies as net of outstanding debt to the IMF, as agreed upon. Profits or losses from operations in international reserves are reflected in the item, "Difference in Market Price of Gold, Currency and Government Securities - Income (Loss)".

There is no policy of official announcement of changes in intervention strategy and the quarterly Inflation Report describes intervention actions during the quarter it surveys. The amounts of realised interventions are announced weekly through press communications that are also published on the central bank's web page.

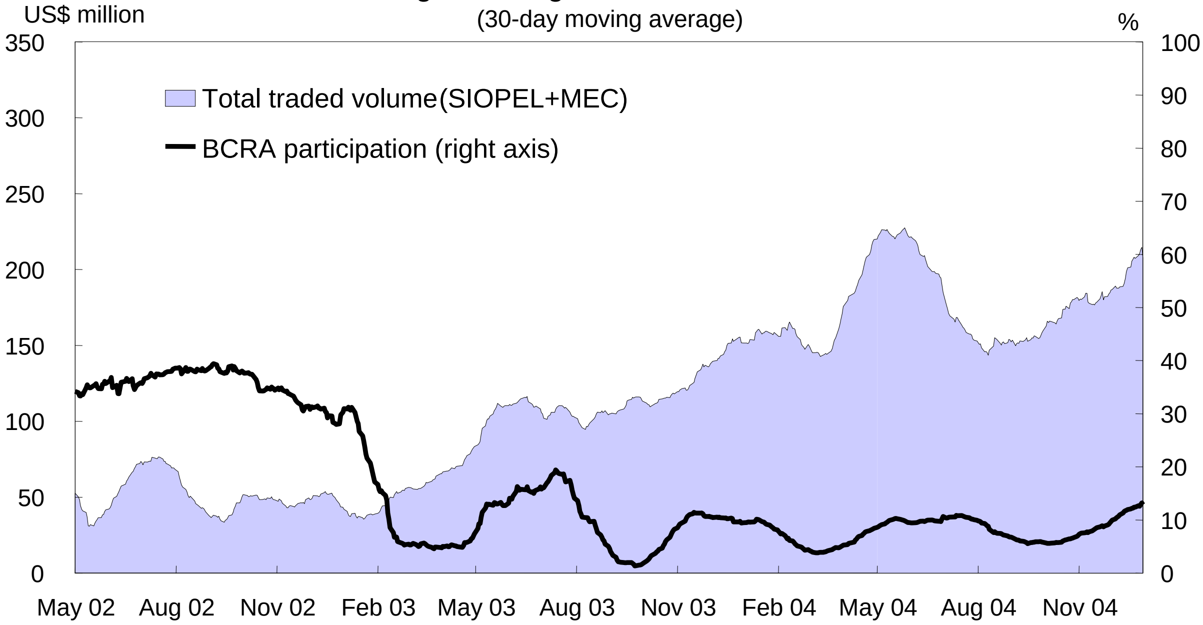
4. Techniques and tactics

The central bank's foreign exchange transactions take place during normal business hours via direct trading in the wholesale spot market. The results of these transactions are published via a daily press release which states that an intervention has occurred and gives information about its size. These daily press releases are summarised in the regular weekly Exchange Report, which comes out with a minimum lag and describes the dates and size of interventions. This policy of quickly providing full ex-post information to the market contrasts with the practices of most central banks, which tend to tactically use secrecy in their foreign exchange interventions. However, Argentina has a long history of monetary instability, and the BCRA needs to build and maintain its reputation as the manager of an independent monetary policy not bound by the straitjacket of a currency board. In that context, this transparency policy has been useful by allowing continuous market supervision over the central bank's progress in the implementation of the monetary programme.

Figure 2:

Foreign exchange market traded volume

(30-day moving average)



Source: BCRA and MAE

The foreign exchange market in which the BCRA operates has been growing steadily during the past two years. With the controls imposed just after the crisis, exporters were obliged to surrender their US dollars to the central bank so that the BCRA was initially always selling dollars. When the exchange rate overshooting relaxed, the Central Bank began purchasing dollars and its interventions were often as much as 50% of the market. Both the relative and absolute size of interventions have declined and interventions now account for approximately 7% of the market.

5. External Aspects

Since the end of the currency board regime in the beginning of 2002, the central bank has intervened regularly in the exchange market with the objective of stabilising the exchange rate and reducing its volatility while monetising a growing economy. Intervention has been regular and quite predictable, with the central bank intervening on approximately 90% of the days that the market has been open. As a result, intervention has had both a short term and a sustained effect on volatility and monetisation. The sustained effect has been achieved by the continuous process of interventions, which is also needed to compensate for the monetary base contraction caused by the government and banking sector transactions, as already discussed. Almost all interventions in the last two years have been central bank purchases of foreign currency, whereas most interventions during the first half of 2002 were sales.

With the crisis at the beginning of 2002, exchange rate interventions were accompanied by an increasing array of exchange controls, regulations and information requirements. In addition, exporters faced surrender requirements with the central bank. As mentioned above, these restrictions have been gradually reduced and currently are not really binding.

Dollarisation does not now present much of a problem in terms of exchange rate interventions because the forced pesoisation of much of the financial system after the devaluation in 2002 has left the financial system with a very low level of dollarisation. The relatively high current level of reserves has an expectations effect since they permit the central bank to respond in a positive and controlled manner to sudden reversals of capital flows. This high level of reserves has resulted in an increased credit rating from a major rating agency.

6. The domestic implications

The interventions of the central bank since the middle of 2002 have allowed it to provide the Argentine economy with an adequate level of liquidity and to meet the quantity targets of the monetary programme while keeping the inflation rate within its forecast band. Additionally, these operations have permitted the central bank to control excessive volatility in the exchange rate that might have been harmful to economic activity.

Argentina entered in partial default on its sovereign debt in 2002 and, due to the magnitude and complexity of the operation, is still negotiating the restructuring of this debt. As already mentioned, initially the central bank had no instrument for intervention in the monetary market. For this reason, it began issuing its own instruments, (the Central Bank Notes described above). These instruments were rapidly accepted by the financial community and their interest rates serve as a reference rate for the system. Recently, the Central Bank has begun to trade in the inter-bank repo market with seven day instruments backed by LEBACs and has been using this to influence the short-term interest rate. The fact that these Central Bank Notes are of various maturities has provided the financial system with a reference yield curve, facilitating the reconstruction of longer-term private lending.

Even though there is much to be done, the experience acquired by the central bank during the years that followed the crisis was proved to be very useful for conducting monetary policy under a floating exchange rate regime in an emerging economy. We expect to continue improving our communication strategy to appear as transparent as possible to the markets in order to continue building up the stock of credibility that every central bank needs to conduct monetary policy in a successful way.