Session II: FX interventions: objectives, strategies, and tactics

XII BIS–CEMLA Roundtable: Reserve management and FX intervention

Introduction

- Reserve accumulation and interventions extensively used in EMEs and the region…
  - in spite of, in many cases, monetary policy regimes defined as inflation targets and flexible exchange rates.
  - used as monetary policy, macroprudential tool.

- FX intervention goals, strategies and tactics:
  - Main goals and intermediate objectives
  - Transmission channels and effectiveness
  - Methods and techniques
  - Strategies and tactics (communication and sterilization)

- BIS survey of 13 Latin America and the Caribbean countries and 16 other emerging market economies.

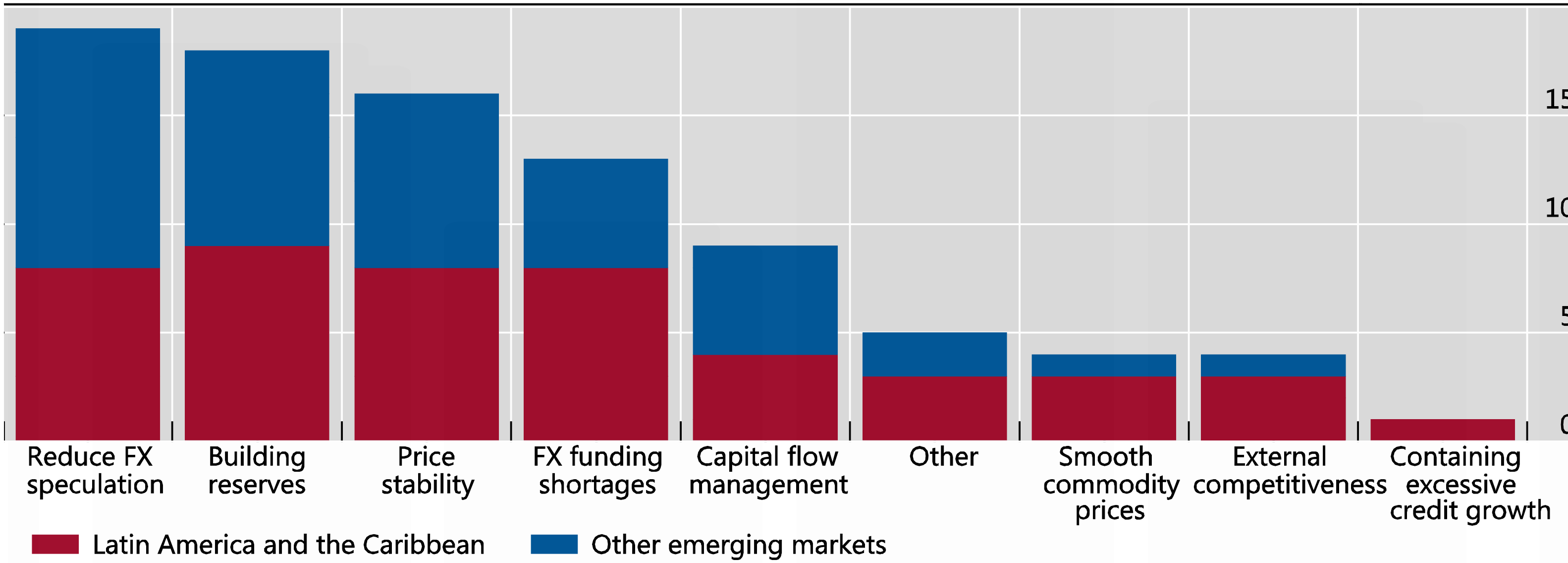
Goals and intermediate objectives

- **Goals** refers to the ultimate purposes of the intervention.
  - Intervention often responds to unwelcome financial developments that give rise to destabilizing exchange rate dynamics.

Curbing FX speculation and building reserves are key concerns for central banks

Number of countries

Graph 1



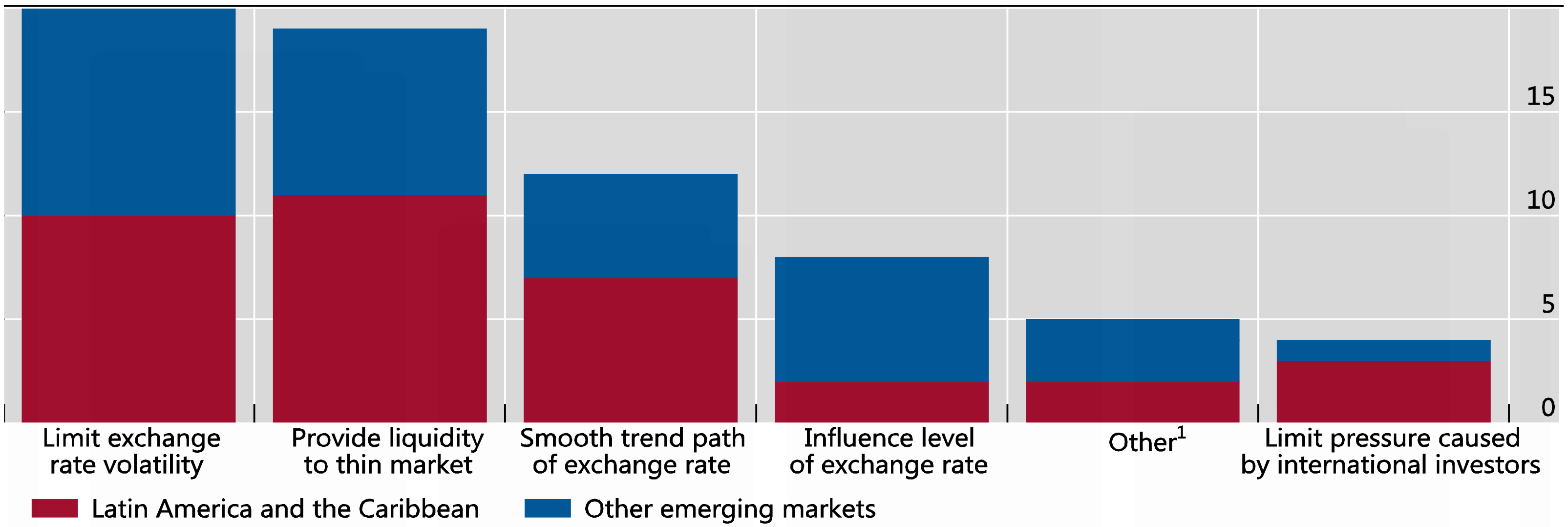
Goals and intermediate objectives

- **Intermediate objectives-** set to operalise goals.
  - Limiting exchange rate volatility strongly linked to most intervention goals.

Limiting exchange rate volatility and providing liquidity are the primary objectives

Number of countries

Graph 2



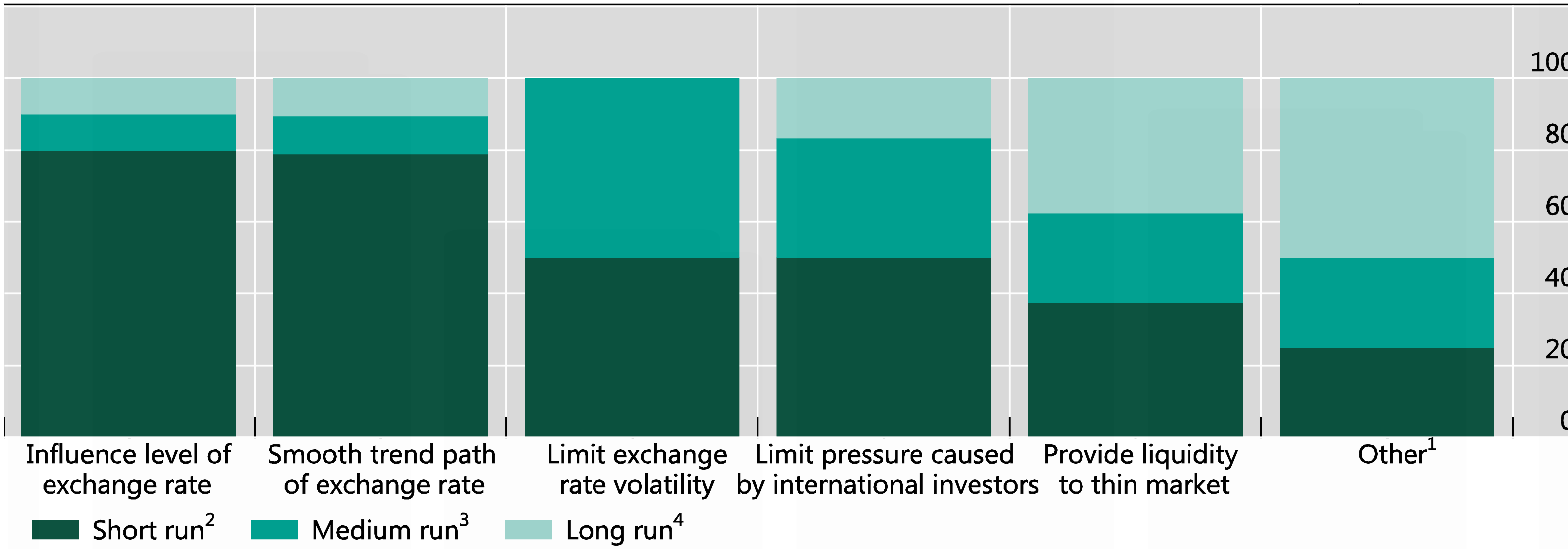
[1] Mostly non-floating exchange rate arrangements.

Transmission channels and effectiveness

- **Effectiveness** can be judged only against goals and objectives.
  - Empirical cross-country studies find that FX interventions have a strong impact on the level and volatility of the exchange rate.

FX interventions are mostly effective in the short to medium run, but not beyond

As a percentage of respondents who pursue the respective objective — Graph 3



[1] Based on the responses of four instead of five central banks, as one central bank did not make an assessment. [2] Up to one month.
[3] One to six months. [4] More than six months.

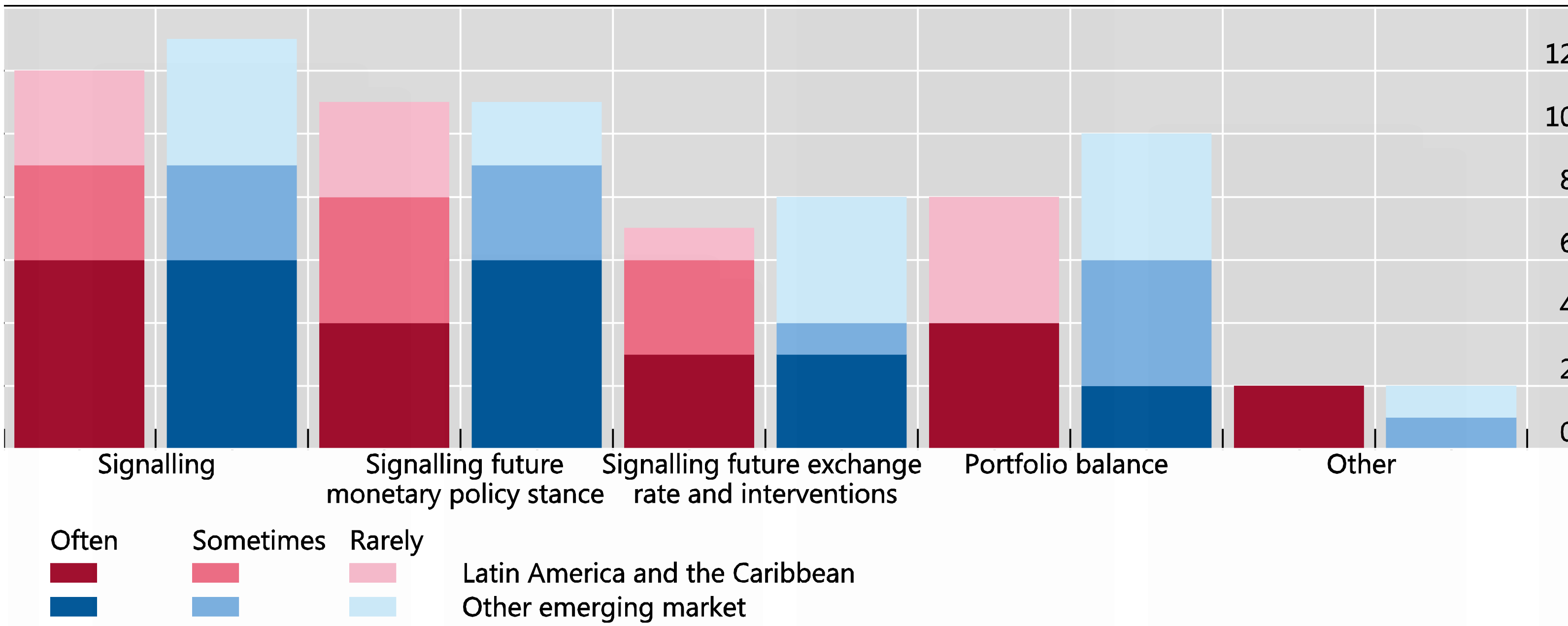
Transmission channels and effectiveness

- **Portfolio balance**- agents regard assets dominated in different currencies as imperfect substitutes.
- **Signaling**- shifts market participants expectations about macroeconomic fundamentals or future policy

Signalling is considered the most important channel of FX intervention

Number of countries

Graph 4



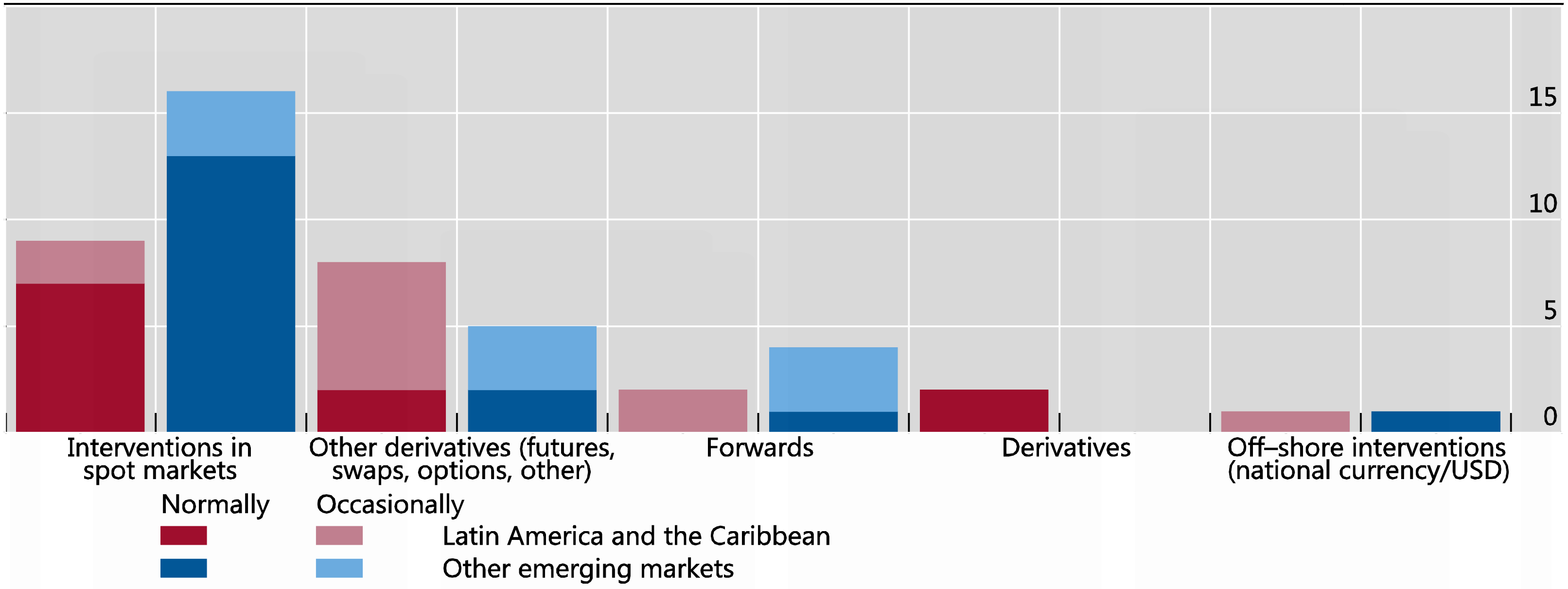
Methods and techniques: instruments

- The use of derivatives has continued to expand (eg. FX swaps):
  - Increasing importance of financial stability considerations.
  - Bigger role of non-bank financial intermediaries.

Toolkit has continued to expand, but spot market interventions most common

Number of countries

Graph 5

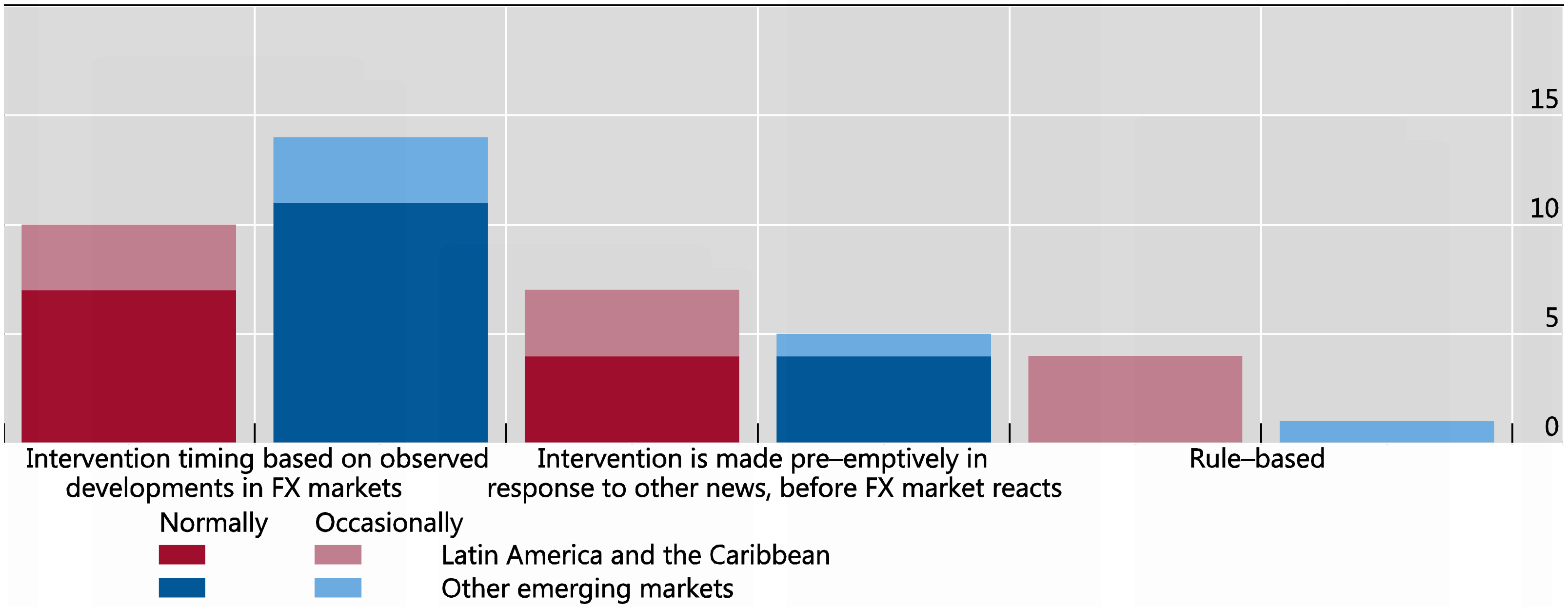


Methods and techniques: rules vs discretionary

- Predominant use of **discretion** may be the result of:
  - CB aim to prevent detection
  - Maximise market impact
  - Rules may be difficult to formulate based on real-time information.

Intervention mostly discretionary and in response to market developments

As a percentage of respondents — Graph 6



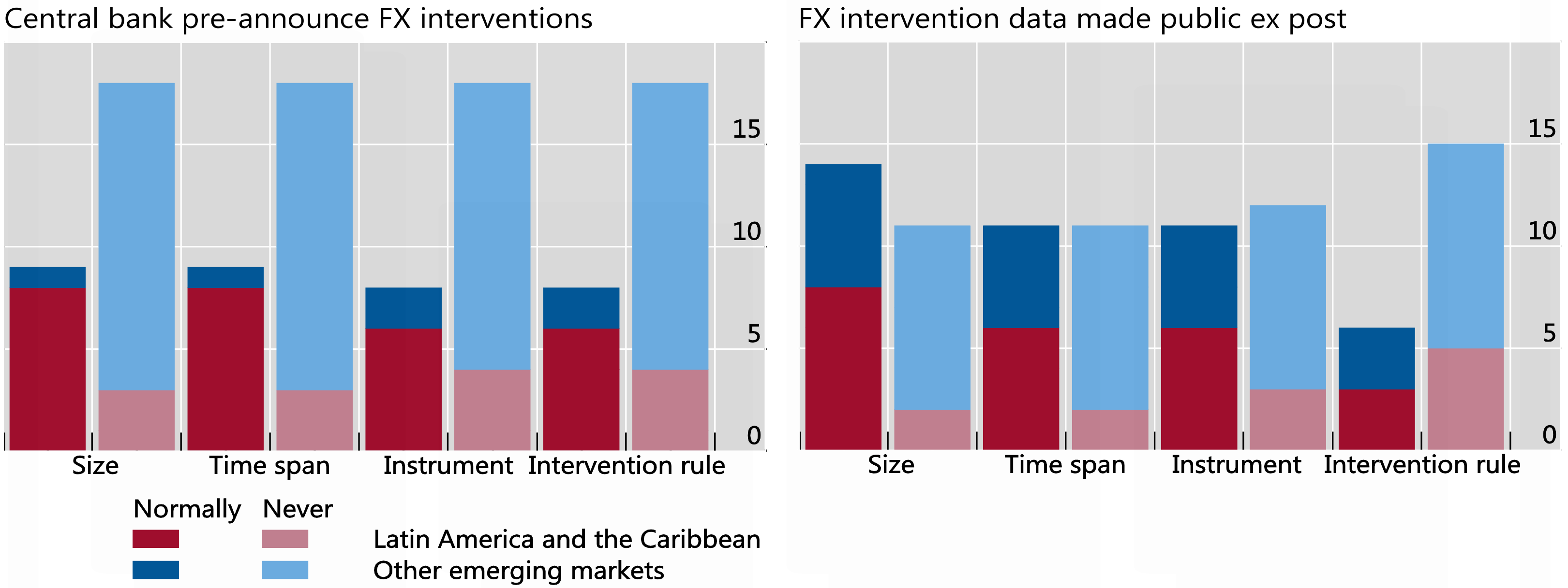
Strategies and tactics: disclosure of information

- Advantages of **transparency:**
  - Indispensable if the CB intends to provide a signal.
  - Strengthens portfolio balance channel.
  - Prevails when CB rely on rules and wish to anchor expectations.

Transparency is still a key issue

Number of countries

Graph 7



Strategies and tactics: sterilisation

- Interventions are always sterilised in Latam
- Trade-offs of **sterilisation** instruments
  - Non-market-based instruments are less costly but may hinder smooth market function.
  - Market based instruments may help the development of deep and liquid domestic bond markets.

Central bank securities are the most used instrument for sterlisation

Number of countries

Graph 8