CENTRO DE ESTUDIOS MONETARIOS LATINOAMERICANOS

XII BIS – CEMLA Roundtable, this time on: Reserve Management and FX Intervention

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Cartagena de Indias, Colombia

June 17 and 18, 2019

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

FX Interventions. Overview

1. **Foreign exchange interventions** are a part of a set of economic policies. Their use should consider such policies jointly.
2. The **decision to intervene** can be based on several types of economic events (shocks). Having a correct diagnostic is crucial for their effectiveness. Transitory vs permanent? Fundamental vs liquidity?
3. For instance, intervening in response to a **permanent** macroeconomic **shock** is generally unwarranted. In contrast, intervening in response to a **temporal** shock is, in general, desirable.
4. Under **microstructure** issues, intervening for **liquidity provision** is in general suitable.
5. **While tempting for policy makers, FX interventions cannot be a substitute for needed macroeconomic adjustment.**
6. In terms of their **assessment**, we have that there is not that much concern for levels, the focus generally being on other aspects such as FX volatility and, at times, on other statistical moments (Ramos-Francia et al. 2014).

FX Interventions. Issues

1. FX interventions have been used in several EMEs with satisfactory results (e.g., Chamon et al., 2019).
2. Objectives
   - General or ultimate objectives.
     - ✓ *Price stability*
     - ✓ *Circumvent FX speculation*
     - ✓ *Accumulate reserves*
   - Operational or intermediate objectives.
     - ✓ *Limit FX volatility*
     - ✓ *Provide liquidity*

FX Interventions

❸ Transmission Channels

- Portfolio Channel (Hurnpage, 1986)
  - ✓ *Sterilized vis-à-vis unsterilized.*
  - ✓ *Feasibility. Size of market.*
- Signaling Channel (Mussa, 1981)
  - ✓ *Historically more relevant.*
  - ✓ *Importance of credibility. Borrowing to defend?*
  - ✓ *Effectiveness and Informational advantage?*
  - ✓ *Signaling over future intervention policy.*
  - ✓ *Signaling over future monetary policy.*

FX Interventions

④ Tactics

- Rules vis-à-vis discretion. Objective dependent. Conditions dependent?
- Timing.
  - ✓ *Preemptive interventions.*
- Markets and participants.
- Transparency
  - ✓ *Ex-ante / ex-post.*
  - ✓ *Can enhance credibility.*
  - ✓ *Stealth to minimize market impact.*

FX Interventions

5 Instruments

- Most commonly in the spot market.
  - ✓ *Size of EMEs' FX spot markets.*
- Derivatives have been used more recently.
  - ✓ *The use of derivative markets has increased.*
  - ✓ *Can be better suited to hedge risks.*
  - ✓ *Derivative markets have grown in EMEs.*
  - ✓ *Advantages over direct use of reserves.*
- Equivalency?
  - ✓ *Market segmentation*

FX Interventions

6 Assessment in real time

- Interventions are assessed in real time; in particular, discrete ones, as authorities might decide to modify them.
- Market intelligence has been key to understanding the implications and effectiveness of FX market interventions in real time.
- Expertise from policy makers is crucial; particular so, as interventions are typically implemented as significant macroeconomic events are unfolding.
- In this case, one typically focuses on intermediate goals.

FX Interventions

7 *Ex post* assessment

- A more academic flavor to it.
- Expected vis-à-vis surprise. (Rules-based vis-à-vis Discretionary)
- Key challenge: build a judicious counterfactual.
- Also, derivative implicit distribution (risk-neutral distribution) (Ramos-Francia et al. 2014).
- Data frequency. Persistent effects?
- Endogeneity is challenging (Blanchard and Adler, 2015).
- Can focus on either goals, intermediate or final.

Liquidity Risks

1. Strong increase in the demand for high risk assets (long-term bonds, corporate bonds, and EMEs assets).
2. New regulation, such as greater capital requirements and operation restrictions, have reduced the capacity of market makers.
3. Elevated concentration of players and investments(GAMs). ETFs, as well as specialized investors such as HFTs, dominate investments.
4. Herd behavior.
5. Investment vehicles (funds) offer more liquidity than their investments allow for. Can lead to considerable liquidity risk. (BIS, 2011; IOSCO, 2018; and, Stein, 2013)
6. A growing operation in anonymous electronic platforms, dominated by automatic trading. These are important liquidity demanders, rather than providers.
7. Liquidity (not) provided by algorithms during stress periods ("kill switches").

FX Interventions: Final Remarks

FX interventions have been used as an important policy tool in EMEs (e.g., see Chamon et al. 2019).

- Important to distinguish between operative/intermediate and general/ultimate objectives.
- Their assessment is challenging for a plethora of reasons, as discussed.
- The general perception is that they have been useful; for instance, to accumulate reserves, mitigate volatility, and avoid harmful non-fundamental equilibriums.
- New approaches have proven to be effective and less costly in terms of the direct use of reserves. They might need to be tested in periods under significant financial stress.

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