



EMERGING MARKET PERSPECTIVES

The Case for Intervention

Under the right conditions, foreign exchange intervention can reduce unwarranted currency volatility

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When central banks in the world's large economies slashed interest rates after 2008, smaller emerging market economies, especially in Asia, faced a flood of capital that caused their currencies to appreciate and interest rates to fall. Now that major central banks are rapidly tightening policy, financial flows have reversed: emerging market currencies are depreciating, inflation is increasing, and central banks are under pressure to raise interest rates even as growth stalls.

Global economic and financial integration has weakened the national transmission of monetary policy and made international factors a stronger driver of domestic prices and economic conditions. Free-floating currencies are ideal for most emerging market economies, but external developments can soon throw exchange rates out of kilter with economic fundamentals. Policy autonomy is guaranteed only if economies are strong enough to withstand volatile exchange rates and significant misalignment.

Intervention in the foreign exchange market allows policymakers to moderate the pace and

extent of currency appreciation or depreciation. It can also counter pressure on the exchange rate by reducing one-sided expectations about the currency's future value. A deeper financial system helps with intermediation but can be a double-edged sword: increased availability of financial instruments and greater liquidity may attract more capital inflows. Open emerging market economies with large globally integrated financial systems must hold more foreign exchange reserves and intervene more aggressively to avoid excessive volatility. Successful intervention is not guaranteed, however.

Successful intervention

Several factors make intervention more likely to work. For brevity, I will focus here on those that determine success when defending a depreciating currency.

- **Level of foreign exchange reserves:** Foreign reserves are not costless, but they are invaluable when the exchange rate comes under unwarranted depreciation pressure. They are even more important for countries with linked exchange rates (such as Hong Kong Special Administrative Region) or exchange-rate-based monetary frameworks (Singapore).
- **Strength of domestic economy and financial system:** The strength of these fundamentals provides the central bank with greater flexibility in terms of how much to intervene and let the exchange rate move. It allows more effective intervention because the central bank does not have to engage actively in liquidity operations that undermine its foreign exchange interventions (see the fourth bullet).
- **Intended exchange rate that is “defensible”** in that it reflects economic fundamentals: Pressure on the currency due to sustained outflows on the trade and current accounts of the balance of payments often reflects a failure to create a diversified, competitive, and globally integrated economy. Intervention will not help. If weak domestic fundamentals such as a large fiscal deficit, excessive monetary growth, or high inflation are affecting the exchange rate, then intervention would also be futile. Unless there is a determined effort to deal with these weaknesses, they will continue to exert a negative influence on the currency.
- **Actions by central banks to manage the liquidity consequences of intervention:** When the central bank intervenes to defend the exchange rate, it decreases the supply of the local currency

and increases the supply of foreign currencies. If other factors remain the same, this should support the local currency's exchange rate. The decrease in local currency liquidity pushes up domestic interest rates, which provides additional support to the exchange rate. However, the central bank often wants to protect the domestic economy from higher interest rates. The government is also likely to be unhappy with the higher cost of financing public debt. So the central bank usually injects liquidity back into the banking system, keeping local interest rates relatively stable but undermining its efforts to support the currency. If a weaker currency is causing higher domestic inflation, these liquidity operations weaken not only the exchange rate but domestic price stability as well. This makes monetary policy and the intervention operations less effective.

- **Openness of the capital account:** Open emerging market economies vary in their degree of openness, particularly when it comes to the capital account. An open capital account can facilitate two-way flows under normal circumstances, but large one-way flows during times of instability can overwhelm the central bank's ability to stabilize the currency. Yet it is crucial to avoid large swings in the exchange rate because of the ease with which short-term financial flows by residents and nonresidents can occur in response to exchange rate expectations.
- **Private sector foreign currency exposure and how much it is hedged:** In emerging market economies, the central bank must track this exposure carefully and even regulate it to ensure that it poses no risk to national economic and financial stability. Without these precautions, pressure on the exchange rate from panicked buying of foreign exchange can negate interventions to support the currency.

Adequacy of reserves

The level of reserves is important not only for intervention but also for instilling confidence in a country's ability to pay its way in the world. Maintaining a sufficiently large stock of reserves is an important policy consideration.

One way to reduce demand on the central bank's reserves is to **develop the local foreign currency market**, providing more opportunity for private intermediation of foreign exchange flows and for new hedging instruments. This should reduce the

frequency of central bank intervention. A common problem in times of uncertainty is that foreign currency dries up due to excess demand or hoarding. Ultimately, the central bank's reserves must again provide the safety mechanism for the market.

The sustainability of reserves also **depends on the sources** from which they are built. Reserves built from current account surpluses and flows of foreign direct investment are generally more reliable than reserves from short-term portfolio flows. Reserves should be built during good times. Central banks in emerging market economies are often vulnerable to political pressure that diverts existing reserves to other purposes. This leaves countries vulnerable and limits central banks' capacity to intervene when they need to.

There are **emergency sources of reserves**. Funding from the IMF is an option, but it is an option of last resort for many countries, especially in Asia. Countries also have bilateral swap arrangements to provide emergency liquidity in dollars or local currencies. Among the ASEAN+3 economies, a \$240 billion resource-pooling arrangement known as the Chiang Mai Initiative Multilateralisation Agreement provides liquidity support to regional economies in times of external stress. However, it has not diminished member economies' desire to build their own reserves for various reasons, including policy independence.

When reserves are running low, or capital flows are so large that intervention is unlikely to succeed, more direct intervention is needed to restore stability. Policymakers can rightfully consider **measures to restrict financial flows**. Many factors that make for successful intervention will also come into play in determining the success of capital controls. Policymakers who impose capital controls must also be cautious in timing their removal—doing so prematurely can be as risky as keeping them in place too long.

Done right, capital controls can act as a circuit breaker to preserve foreign reserves and provide policymakers with temporary breathing room for reforms to reduce vulnerabilities and support the economy, without the worry of external instability. Confidence in the local economy is a key fundamental that must be restored through credible policies, after which the controls can be gradually relaxed and removed. **FD**

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