International Journal of Engineering, Management and Humanities (IJEMH)
Volume 2, Issue 2, pp: 195-197 www.ijemh.com

An Analysis on the Desirability of Currency Intervention

Serene Liza Thomas
Assistant Professor at St. Thomas College, Thrissur

Date of Submission: 01-05-2021 Date of Acceptance: 15-05-2021

ABSTRACT: In the aftermath of the global financial crisis and the Euro Crisis, the principle of currency intervention has been considerably in the limelight. It entails the purchase or the sale of foreign currency by the fiscal authority or the monetary authority of a country usually against its own, on the exchange market to influence the value of the domestic currency; its critics are numerous and often question the efficiency of such a manoeuvre. The reasons behind such a move are numerous but motivations behind it include central bank authorities aiming to calm excessively volatile markets and pre-empting destabilizing speculation to stabilizing the spot rate around a prescribed target level and transmitting information about future monetary policy. This paper delves with the desirability of currency speculation and the consequences of the same.

KEYWORDS: Currency intervention, volatile, destabilizing, fiscal authority, monetary authority

I. INTRODUCTION

The mechanism acting behind the official intervention involves monetary authorities purchasing or selling of foreign assets in the two following ways; firstly, it is said to be sterilized when the authorities simultaneously or within a very short time lag take steps to counter or "sterilize" the effects of a change in official foreign asset holdings on the domestic monetary base. Secondly, the occurrence of “non sterilized” intervention occurs when the authorities buy or sell foreign exchange, normally against their own currency without as such counteracting actions. In the latter case, it has the same impact on monetary liabilities as an open market operation would have with the only difference being that it would alter the monetary base through a change in foreign asset holdings instead of a change in domestic asset holdings. In the case of the first type of intervention, it would be neutralized by the sale or purchase of domestic-currency bills or bonds by the monetary authorities so that the effects on the monetary base of changes in the holdings of net foreign assets are in fact countered one-for-one by the effects of alterations in net domestic asset holdings

Objectives

1) To trace out the path of some historic currency interventions
2) To analyse the effects of currency intervention.

Timeline of central bank intervention

The first instance of currency intervention took place even before globalisation of currency in early 1920’s when federal reserve started buying gold and selling US dollars. Later on, during 1978-79 when dollar came under severe pressure due to high oil prices, inflation and deteriorating balance of payments a new dollar support program was introduced. Another historic movement was the Plaza accord of 1985 where U.S, Germany, Japan, Britain, France (G5) met at Plaza hotel in New York to discuss about the measures of bringing down the dollar value in order to maintain competitiveness. The US decided to sell the dollar for other G5 currencies. In February 1987 Louvre Accord was formed to uplift the weakening dollar and to counter the rising trade deficit. The G5 along with Italy met at Louvre in Paris to stabilise the exchange rates around current level. During the gulf war of 1992 the dollar got weakened and the US had to spend more that 2.5 billion dollars in buying currencies. The dollar dropped down to record lowest against German mark in 1995. The US had to intervene in the market to prop up US currency. The Bank of Japan disbursed USD 833 million to support the weakening Yen against USD in 1998. Similar incident happened in 2000 where Japan had to sell yen due to too much strengthening of the currency. Japan sought the help of Federal bank and European Central Bank to recover from the crisis. In 2000 the European Central Bank intervened for first time since its establishment when the euro hits all time low. In September 2001, after the attack on US cities, BOJ intervenes to sell yen for dollars. Again, in June 2002, BOJ sold yen in Tokyo trading lifting the dollar value. Moreover, throughout the 2003 Japan had intervened in the market many a times to stabilise the value of Yen. In June 2007 New Zealand had intervened in the market as their currency drove to a 22-year high. In April 2010 the Swiss National Bank interfered in the foreign exchange market to weaken franc against euro. In August 2015 the People's Bank of China devalues Chinese Yuan over 3% of its value against US dollar. Most of these interventions were conducted to stabilise the excessive appreciation or depreciation of the currency which could harm the export- import balance. The central bank sells their own currency if they want to decrease the value and vice versa.

Effects of Currency Intervention

Currency intervention in simple terms is the buying or selling of currency by the government or corresponding agencies to maintain the desirable exchange rate. It is believed by many that this practice possesses a number of benefits which explains its wide use by central banks. Kathryn M.E. Dominguez in her paper on "The Market Microstructure of Central Bank Intervention", illustrates that The Federal Reserve's (America's Central Bank) interventions in the market of the order of about a billion-dollar intervention would lead to a 29 basis point maximal price impact. Furthermore, real life applications and evidence of this claim can be found by the following instances: the Plaza Accord of 1985 to push down the dollar, the Louvre Accord of 1987 to contain the dollar's slide, the joint intervention by Japan and America to stop the dollar's free-fall against the yen in 1995; and then to support the yen in 1998; and the G7 manoeuvre to support the euro in 2000. China, through its interference on the foreign exchange has been able to turn it to its advantage by printing new currency to buy U.S. dollars and U.S. government debt, and then it floods the market with Chinese currency and increasing demand for American dollars. Subsequently, it can dictate the currency level of the US dollar through a method known as "pegging." Despite reports that has stopped such a practice, estimates reveal that it keeps the Yuan about 20 percent below its free market value against the dollar.

The spot exchange rates are determined in the general equilibrium of world markets for goods and a dramatic change in the foreign exchange rate implies that a country shall lose its competitive advantage or edge in international trade. Notwithstanding, history shows that a rise or fall in the exchange rate by itself frequently has not had a direct nor lasting impact on many countries' international competitiveness, this begs the question on efficiency of currency intervention. Many academicians remain sceptical on its ability to influence exchange rates. After all, it is merely a "tear drop" in the ocean compared with the trillions of currencies daily traded on the markets. A plethora of interventions have failed; one landmark example would be in 1992, when the United Kingdom tried to shadow the German Deutschmark and stay in the Exchange Rate Mechanism. In a single day, the former spent billions of pounds in attempting to upkeep its currency value; however, markets knew it was in vain and kept selling. The United Kingdom's manoeuvre backfired, and a little-known currency trader called George Soros rose to prominence. In his analysis of currency intervention, Mark Taylor (2004) underscored that while it is designed to 'fine-tune' the level of the real exchange rate, it may turn out to be counter-productive for both policymakers as well as market participants will find it hard to agree precisely on the appropriate level of the exchange rate.

Back in 1997, whenever the rupee was under pressure and during times of crises, the Reserve Bank of India's main policy was direct intervention on the foreign exchange market thus, it sold dollars in the spot and forward markets, to the tune of USD 1.5 billion, and USD 730 million respectively. Using a modified Keynes-Mundell-Fleming (KMF), Bhaumik and Mukhopadhyay (2000) used data from that very period and demonstrated that, owing to the presence of the intricate causal links within the macro-economy, the nature of the impact of the central bank's intervention was unclear even when the action in the foreign exchange market was supported by full sterilisation. This reinforces the fact that the yields of currency intervention remain ambiguous and equivocal. The essence of the foreign exchange rate lies in the fact that it involves two currencies, thus the intervention policy of one country will influence monetary and credit conditions in other countries. Consequently, in order to have the intended effect, intervention must be carried out with explicit account being taken of foreign policy responses through international coordination.

II. CONCLUSION

In the words of legendary economist Nouriel Roubini ", History shows that coordinated actions by central banks works better that unilateral action. We are in a world where everyone wants a weak currency." Currency intervention remains an important feature of the conduct of economic policy in the present system of widespread floating. Central banks continue to interfere for a variety of reasons ranging from to "lean against the wind" of short-run fluctuations in exchange rates in order to promote "orderly market conditions," or to lean against the wind of longer-term movements in attempts to influence trend like appreciations or depreciations. While this modus operandi has some advantages, it has proved in a number of cases to be ineffective; a better alternative would be coordinated actions by central banks of various countries with the same objective in mind.

REFERENCES

[1]. Bhaumik, S.K. & Mukhopadhyay. H. (2004, Jan-Feb). RBI's Intervention in Foreign Exchange Market: An Econometric Analysis. Economic and Political Weekly

[2]. Brandner, P. & Grech, H. (2005). Why Did Central Banks Intervene in ERM I? The Post-1993 Experience. IMF Staff Papers

[3]. Cornell, B. & Reinganum, M.C. (1981, Dec). Forward and Futures Prices: Evidence from the Foreign Exchange Markets. The Journal of Finance, 36

[4]. Dominguez, K.M.E. (2003). The Market Microstructure of Central Bank Intervention. Journal of International Economics, 59

[5]. Eckwert, B. & Broll, U. (1998, Dec). International Trade and the Risk Premium in the Currency Forward Market. Journal of Economic Integration, 13

[6]. Fieleke, N.S. (1975, Sep). Exchange-Rate Flexibility and the Efficiency of the Foreign-Exchange Markets. The Journal of Financial and Quantitative Analysis, 10

[7]. Frankel, J.F. & Froot, K.A. (1990, May). Chartists, Fundamentalists, and Trading in the Foreign Exchange Market. The American Economic Review, 80

[8]. Genberg, H. (1981, Sep). Effects of Central Bank Intervention in the Foreign Exchange Market. Staff Papers - International Monetary Fund, 28

[9]. Ghosh, S.K. (2002, Jun). RBI Intervention in the Forex Market: Results from a Tobit and Logit Model Using Daily Data. Economic and Political Weekly, 37

[10]. Henning, R. C. (1995, Oct). Divine Intervention? Governmental Efforts to Moderate Exchange Rate Fluctuations Currencies and Politics in the United States, Germany, and Japan. Mershon International Studies Review

[11]. Jones, M. (1984, May). Optimal Foreign Exchange Market Intervention: Evidence from the Bretton Woods Era. The Review of Economics and Statistics, 66

[12]. Liew, L.H. & Wu, H.X. (2002, Jun). Not All Currency Traders Believe in Unfettered Free Markets: Currency Speculation and Market Intervention in Hong Kong. The China Quarterly, 170,

[13]. Macdonald, R. & Torrance, T.S. (1990, July). Expectations Formation and Risk in Four Foreign Exchange Markets. Oxford Economic Papers, 42,

[14]. McKinnon, R.I. (1993, Mar). The Rules of the Game: International Money in Historical Perspective. Journal of Economic Literature, 31