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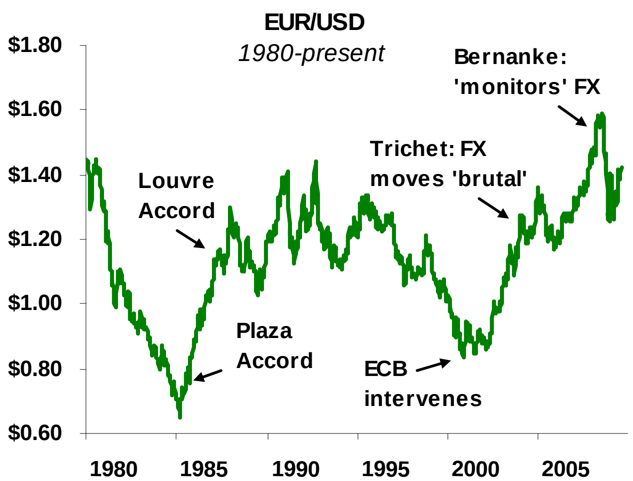
Who's Afraid of FX Intervention?

Joint G7 action: A Thing Of The Past?

As the global economy starts to emerge from recession, policymakers around the world have displayed some sensitivity to exchange rate movements. For example, the Swiss National Bank intervened this year to counter the deflationary impact of the Swiss franc's appreciation, while central banks in Canada and New Zealand have expressed concern that a stronger currency may hinder economic recovery. At the same time, the bias for a weaker currency inevitably raises concerns that some countries may be tempted to pursue 'beggar-thy-neighbor' devaluation policies in order to help generate economic growth. It is thus telling that in their most recent statement leaders of the G8 nations vowed to "refrain from competitive devaluations of currencies".



Over the past decade, coordinated global FX interventions have become less frequent. This has not always been the case - the Plaza and the Louvre accords of the 1980s played a major role in the weakening and the subsequent strengthening of the US dollar. The last major coordinated FX intervention dates back to September of 2000 when the central banks in the US, Eurozone, Japan, UK and Canada intervened to support the euro. Since then, G7 intervention or a 'grand accord' has become more challenging, giving way to occasional verbal interventions, with varying degrees of success. For example, the Dubai G7 statement in September of 2003 was seen as a 'green light' to dollar weakness, prompting a further decline in the greenback. In contrast, an apparent attempt to stem the dollar's decline in 2008 had a limited impact on the markets.

Thus, currency matters remain, to quote the ECB president Trichet, "a very touchy issue". Traditionally, authorities in the major economies have tended to intervene when currencies were judged to have moved out of line with fundamentals or when currency trading became particularly volatile and threatening to economic stability.

Recently, a consensus over the 'appropriate' exchange rate levels has become increasingly hard at the G7 level. For example, in 2008, there was some agreement that the dollar was broadly too weak, but less agreement by how much or against which currencies. In practice, intervention remains very much a country-specific choice, with notable differences across the G7, while attitudes towards FX intervention have also shifted over time in some countries. Below, we provide a brief overview of policymakers' stance on intervention among eight major economies.

The 'Free Floaters'

The countries characterized by a relatively 'hands-off' approach to currency intervention over the past decade are the US, UK and Canada. In the US, the Treasury (nominally) maintains a 'strong dollar' policy. Although the term was coined under Secretary Rubin in the mid-1990s when the dollar was indeed on the ascendance, its relevance and impact on the currency market has eroded significantly over the subsequent prolonged period of US dollar weakness.

While currency matters continue to primarily remain the domain of the Treasury, Chairman Bernanke and the Fed have on occasion spoken on the dollar. For example in June of 2008 (at the time the dollar was close to its multi-year lows) Mr. Bernanke said the Fed "continues to carefully monitor developments in the FX markets" and is "attentive to the implications of changes in the value of the dollar for inflation". However, the dollar's eventual recovery had more to do with the onset of the financial crisis than Bernanke's comments. In our view, the Fed will likely steer away from currency intervention for the foreseeable future.

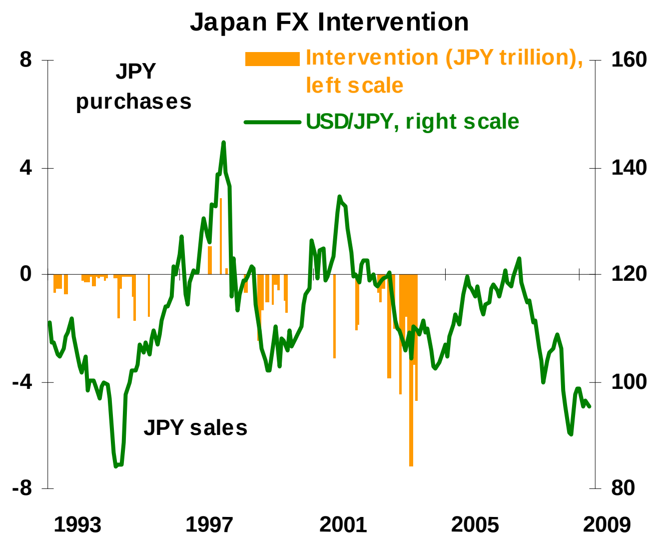
FX intervention by the Bank of England is reserved to occasions when it is necessary to obtain the monetary policy objective. In practice, the Bank has refrained from intervention in the foreign exchange markets since gaining independence in 1997. During a notable period of large and rapid depreciation of the pound in early 2009, UK policymakers expressed little concern, probably due to the fact that they were easing monetary policy aggressively and were focused on deflation risks. The latest rally in the pound has triggered some relatively mild comments from one policymaker who said he "did not want to see a strong recovery in the sterling from current levels". That said, in our view the UK authorities are among the least likely to engage in FX intervention in the future.

Although we have placed the Bank of Canada in the 'non-interventionist' camp, this has not always been the case. Prior to September 1998, the Bank of Canada intervened systematically in the foreign exchange market. According to the Bank of Canada, the policy was changed due to the "ineffectiveness to resist movements to the exchange rates caused by changes in fundamental factors". Currently, intervention is reserved for either periods of "market breakdown" or whenever currency movements threaten the long-term growth in the Canadian economy. To that effect, the Bank of Canada typically distinguishes between FX moves that are driven by fundamentals and 'other' factors. In practice the Bank of Canada has not intervened since 1998, even when the Canadian dollar was particularly strong back in the second half of 2007. The Bank does however frequently indicate whether it sees currency moves as being in line with fundamentals. Recent strength in the Canadian dollar has also prompted only mild remarks from the central bank, and we believe that the probability of intervention is low.

The 'Activists'

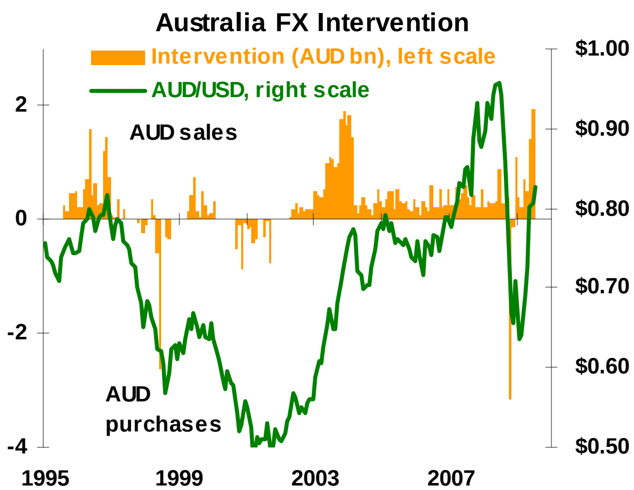
Over the years, Japan's Ministry of Finance and the Bank of Japan have earned a reputation for being particularly sensitive to currency movements, even though the last episode of FX intervention dates back to 2004. The Japanese authorities continue to intervene verbally into the currency markets and although the exact impact is often difficult to measure, the BoJ's past history of actual intervention gives its verbal warnings a certain weight.

Examining the monthly data on FX intervention by the Bank of Japan over the last 15 years we notice a clear asymmetry in the intervention policies. The authorities overwhelmingly tended to intervene to weaken the currency rather than to strengthen it (44 months vs. 3 months).



Furthermore, applying a statistical probabilistic model we find that the probability of Bank of Japan intervention rises when the trade-weighted real exchange rate deviates from its 15-year average. For example when the yen is 25% above its average level, the chance of FX intervention rises to about 80% according to our model. The yen is currently some 6% below its average inflation adjusted trade weighted index but it is some 13% above its nominal index. We would thus perceive the current odds for an intervention as relatively low, although they would increase should the yen strengthen beyond JPY90 per dollar.

The Reserve Bank of Australia remains one of the central banks most actively involved in the foreign exchange markets although its activities have gone through some changes over the recent years. Generally, the approach has moved from relatively small interventions with frequent changes in direction to less frequent but larger scale interventions when the Australian dollar 'overshoots' around the cyclical lows and highs. Since 1995, the RBA was a net seller of Australian dollars for 118 months and a net buyer for only 20 months, suggesting a bias towards intervening when the Australian dollar is "too strong". We also find statistical relationship between the size of RBA intervention and the degree of deviation of the currency from its trade-weighted exchange rate. The RBA stepped up sharply Australian dollar purchases at the height of the global financial crisis in October of 2008, while most recently the bank has been selling increasing amounts of the Australian currency. Admittedly the RBA's presence and impact on the markets remains relatively muted compared to the central banks in Asia that 'actively manage' their currencies, and the RBA's interventions do not typically cause large one-off moves in the exchange rate.



The 'Ad-Hoc Interventionists'

In the relatively short history of the euro there has been one major instance of FX intervention, related to countering euro weakness in 2000. The European Central Bank intervened first as part of a coordinated move with four other major central banks and subsequently unilaterally. Since then, the central bank has not intervened physically into the market although the ECB President Trichet used 'verbal' intervention in 2004 when he sought to stem the euro's rise by describing recent currency moves as 'brutal'. In recent years comments from the ECB have tended to refer more to the speed rather than the direction of currency movements. It may take a move in EUR/USD some way above $1.50 to solicit more attention and stronger comments from the ECB at the current economic juncture.

The Swiss National Bank surprised the markets in March 2009 by announcing and carrying out an intervention to weaken the franc. Of course, given the fact that Switzerland is a small and very open economy, foreign exchange fluctuations matter for inflation and monetary policy, and the central bank's primary motivation for intervention was to counter the deflationary impact of the franc's appreciation. Although historically the central bank closely follows and often comments on the EUR/CHF exchange rate, this year's actions mark the SNB's first solo foray into the foreign exchange markets since 1992. It does appear that further intervention by the Swiss authorities remains a constant threat, with EUR/CHF at CHF1.50 remaining somewhat of a 'line in the sand' for the central bank.

In 2004 the Reserve Bank of New Zealand clarified its FX intervention policies to include instances when the "exchange rate has reached levels that are inconsistent with economic fundamentals" or to "avoid dysfunction in the foreign exchange market". However, the only episode of actual FX intervention dates to June of 2007, when the central bank was selling New Zealand dollars in the FX market to weaken the currency. Given that the move came against the direction of interest rate policy, the market impact of the intervention was limited and the currency continued to rally. Most recently, the central bank has been intervening 'verbally' into the market. For example, after its decision to leave rates unchanged in July the central bank said that stronger currency could hurt economic recovery. Actual intervention by RBNZ in our view still remains some way off.

Conclusions:

This analysis suggests several takeaways for market participants trying to interpret and anticipate possible central bank intervention in foreign exchange markets:

- FX interventions have become less frequent, especially coordinated interventions at the G7 level as countries have found little agreement on the 'appropriate' levels of exchange rates. Individual country approaches vary a great deal. For example, the US and UK authorities have historically had a 'hands-off' attitude their currencies, whereas central bank FX market activity is more common in Japan and Australia.
- We find a bias to intervene to weaken rather than strengthen the domestic currency across in recent years. This is not surprising since sales of domestic currency are not constrained by the size of FX reserves. For those currencies where sufficient data is available we also find a statistical link between the decision to intervene and the degree of the deviation of the real exchange rate from its long-term average.
- Although only the Swiss National Bank and the Reserve Bank of Australia have been active in FX markets most recently, others have engaged in 'verbal' intervention. We believe that in addition the Bank of Japan is more likely than others to step into the market in the foreseeable future. At the same time we do not see a round of "competitive devaluations" and neither do we see significant prospects for a 'grand accord' on currencies at upcoming G7 central bankers/finance ministers' meetings.