

The foreign-exchange costs of central bank intervention: evidence from Sweden[☆]

Boo Sjöö^{1,a}, Richard J. Sweeney^{b,*}

^a *School of Economics and Commercial Law, University of Gothenburg, P.O. Box 640, SE-405 30 Göteborg, Sweden*

^b *McDonough School of Business, Georgetown University, 37th and 'O' Sts., NW Washington, DC 20057, USA*

Abstract

This study presents evidence on risk-adjusted profits for the Swedish central bank. Estimated profits can be quite sensitive as to whether rates of return are risk-adjusted or not, and how the risk-adjustment is done. Various ways of adjusting for abnormal returns, and extracting buy–sell signals, are tried. Results, on daily data, support the view that Riksbank intervention did not make risk-adjusted losses over the period 1986–1990. The results might be challenged as arising from inappropriate risk adjustment. © 2001 Elsevier Science Ltd. All rights reserved.

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1. Introduction

It is a widespread opinion, especially among participants on foreign exchange markets, that central banks make losses on their foreign exchange interventions. From a theoretical view losses are not necessarily to be expected. Foreign-exchange speculators make buy–sell decisions based on expectations of coming market prices; successful speculation requires that the investor form better expectations than those

[☆] The Riksbank has classified some of the data series this paper uses.

^{*} Corresponding author. Tel.: +1-202-687-3742; fax +1-202-687-4031.

E-mail addresses: econsjoo@economics.gu.se (B. Sjöö), sweeneyr@msb.edu (R.J. Sweeney).

¹ Tel.: +46-31-773-1343; fax +46-31-773-1043.

contained in current market prices. Similarly, it can be argued that central banks are able to make profits on their interventions because they are better informed than speculators on coming government policies, for example, their own money-supply or interest-rate policies. Unlike speculators, central banks may consciously pursue policies that lead to losses. For example, a number of central banks describe their intervention policies as 'leaning against the wind'. Some observers argue that if intervention is used not to affect coming equilibrium rates but merely to reduce the speed at which the rate adjusts to equilibrium, the central bank may be expected to make losses on its intervention (Corrado and Taylor, 1986). These observations lead to the question whether central banks are able to break the strong-form market efficiency condition and make significant profits (or losses) when taking account of transaction costs and compensation for risk. Friedman (1953) argues that for central bank intervention to be stabilizing for the foreign-exchange market, intervention must make trading profits. Authors disagree over whether speculation is stabilizing and whether profits are useful in assessing a central bank's foreign-exchange market performance. If the central bank cannot affect the exchange rate, intervention may be profitable but not stabilizing (Dominguez and Frankel, 1993). Some authors provide theoretical examples of profitable but destabilizing intervention (Baumol, 1957; Kemp, 1963). Others point out that central banks have goals beyond exchange-market stabilization or profits (Bank of England, 1983), and that a bank may successfully pursue its goals even at the expense of intervention losses (Edison, 1993). Thus, in a broader context Friedman's conclusion, that stabilizing intervention yields profits, need not hold. Measuring intervention profits therefore becomes a question of quantifying the foreign-exchange costs of central bank intervention policy rather than assessing its stabilizing effects.

Evidence on intervention profitability is mixed (Sweeney, 1997 provides a review). Taylor (1982a,b) and Schwartz (1994) present evidence that central banks make substantial intervention losses. Argy (1982), Bank of England (1983) and Jacobsen (1983) present evidence of profits; Corrado and Taylor (1986) rebut this evidence. Jacobsen (1983) and Leahy (1989) argue that Taylor's profit measure is flawed: it is sensitive to interest rates earned on the central bank's domestic- and foreign-asset holdings, as are also the test-period's beginning and ending dates. Using versions of Taylor's measure modified to take account of interest rates, Leahy (1989, 1995) and Fase and Huijser (1989) present evidence that central bank intervention is profitable.

Sjöö and Sweeney (1996) argue that none of these studies appropriately accounts for the premium that a central bank earns from intervention as compensation for being exposed to foreign-exchange risk, though authors previously noted that risk premia may explain part of estimated profits (Leahy, 1989, 1995). They provide a method for finding risk-adjusted profits from central bank intervention. Using their measures, this paper estimates the risk-adjusted profits/losses of Riksbank intervention with daily data from 1986–1990.

The Swedish experience is of substantial interest. Sweden is a small, open, highly industrialized economy. Over the period studied, Sweden pegged to a basket of currencies, within a band, a popular strategy for exchange-rate management. This strat-

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