



# Central bank authorities' beliefs about foreign exchange intervention

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## Abstract

This paper presents the results of a survey of monetary authorities with respect to foreign exchange intervention. The survey offers evidence on new issues that would otherwise be difficult to investigate, such as response times, non-foreign exchange factors in intervention and profitability. The survey also reveals new evidence on previously studied issues, such as channels of effectiveness. Respondents disagreed with predominant views on intervention and volatility and common arguments against intervention. Exchange rate regimes explain central bank beliefs about important aspects of intervention, including factors that lead to detection of secret interventions and the potential profitability of intervention.

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## 1. Introduction

The frequency of foreign exchange intervention among developed nations has waned in the last 10 years. The Japanese authorities, for example, have not intervened since March 2004. Even as the frequency of developed country intervention has declined, intervention sizes have increased and intervention remains a policy tool for both developed and developing countries.

The study of the causes and effects of intervention remains pertinent, therefore, both for its own sake and as a way to shed light on microstructure issues such as the role of information

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transmission. The paucity of accurately timed intraday data on intervention and the simultaneity of intervention and exchange rate returns complicate the econometric study of intervention, however (Neely, 2005a,b; Fischer, 2006).

The views of individuals familiar with the practice of intervention provide a natural complement to econometric inference or event studies. Central bankers who conduct intervention have collectively witnessed thousands of natural intervention experiments and presumably have important insights into its workings. This observation has motivated at least three surveys of central bankers on the subject of intervention: Neely (2000), Mihaljek (2004) and Lecourt and Raymond (2006).

These three surveys differed in their coverage and emphasis. Neely (2000) surveys the foreign exchange desk/reserve management departments of 22 central banks, asking about the mechanics of intervention. Most responding authorities conduct intervention in spot markets, with domestic commercial banks, during domestic business hours. Misalignments and volatility motivate interventions, while desire for market impact produces mixed effects on secrecy. Interestingly, Neely (2000) finds that central banks unanimously support the idea that intervention is effective in changing exchange rates. Lecourt and Raymond (2006) follow up by surveying only central banks of industrialized countries, exploring beliefs about the effectiveness of intervention through various channels. After emphasizing the importance of expectations and credibility to the effectiveness of intervention, the authors go on to describe the quantity and frequency of G3 intervention from publicly released data. Mihaljek (2004) exclusively focuses on authorities of developing countries, finding that interventions are small relative to market size and that most authorities view intervention as effective in calming disorderly markets. Mihaljek (2004) finds that respondents consider intervention to work through expectations of both future monetary policy and intervention. The study concludes that intervention's effectiveness depends on the consistency of macro/monetary fundamentals with intervention. Finally, a substantial part of the work deals with the beneficial effects of reserve accumulation on sovereign credit ratings and vulnerabilities to external shocks.

Instead of focusing on intervention mechanics, the present survey asks market participants about their beliefs about the motivations for, effects of, and arguments against intervention. Neither does survey participation require recent intervention, the cover letter specifically asked authorities to refer to past experiences if they have conducted little or no recent intervention. Several authorities declined to answer the survey, however, citing a lack of recent intervention experience and/or institutional memory.

In addition to studying authorities' beliefs on a wide variety of intervention topics, the present survey considers whether a country's exchange rate regime and per capita output explain the responses. As discussed earlier, the exchange rate regime can obviously influence the motivations for and outcome of intervention. Per capita output serves as a rough proxy for the sophistication of financial markets. Central banks that face deep and sophisticated financial markets might well have different views on the reasons for and efficacy of intervention than those facing developing markets. To presage the results, central bankers' experiences with exchange rate regimes and — to a much lesser extent — the level of development of their financial markets are often correlated in sensible ways with their beliefs about intervention.

A number of papers have surveyed foreign exchange traders, including at least three that touch on beliefs about intervention. Cheung and Wong (2000), Cheung and Chinn (2001), and Cheung et al. (2004) survey traders in Asia, the United States, and the United Kingdom, respectively. None of these surveys encounter more than modest support for intervention among traders. Most traders believe that intervention raises volatility and are split about whether

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