

The Riksbank's interventions in the foreign exchange market – preparations, decision-making and communication

1 Introduction

In connection with the entry into force of the new Sveriges Riksbank Act in 1999, the Executive Board of the Riksbank decided to publish a document clarifying the procedures and implementation of monetary policy strategy. This largely covered issues related to the inflation target and to how decisions on the repo rate could be taken within the new organisation. The concentration of the clarification document was logical given that the repo rate has been the most important instrument in achieving the objective set by the government, of maintaining price stability under a floating exchange rate regime, and given that the new legislation involved new forms for making decisions on the repo rate.

In 2001 the Riksbank intervened in the foreign exchange market for the first time since the new legislation came into force. In the light of the experiences gained then, it is deemed appropriate to publish a document also clarifying the procedures and framework regarding interventions.

Section 2 discusses how interventions affect the exchange rate and section 3 concerns the motives behind interventions in the foreign exchange market. Section 4 contains a survey of the arguments in favour of transparency with regard to the preparations and decision-making in this field. In section 5 comes a report on the rules of procedure when preparing, deciding and implementing interventions in the foreign exchange market and how minutes of meetings in connection with interventions will be formulated and published in future. Section 6 proposes that the Executive Board shall agree to adopt the system described.

The Riksbank's most important tasks are to maintain price stability and to promote a safe and efficient payment system.¹ At present, the Riksbank governs the devel-

¹ Pursuant to Chapter 1, § 2 of the Sveriges Riksbank Act, the Riksbank has the task of maintaining price stability. The Riksbank shall also promote a safe and efficient payment system. According to the preliminary work (Government Bill 1997/98:40) for the Sveriges Riksbank Act, the Riksbank

opment of price stability mainly by determining the repo rate. Theoretically, it would be possible to use other means of steering, such as operations directly in the bond market or by setting a cash requirement for the banks, but the Riksbank's and other central banks' experiences are that the repo rate as a steering interest rate is the most effective method of implementing monetary policy.

The Riksbank can thus take many different measures, including sterilised interventions in the foreign exchange market. However, interventions are used with restraint. The Riksbank's actions are now normally guided by an assessment of inflationary trends over the coming years. Short-term exchange rate fluctuations are of little significance in this context.

The system for interventions described here is designed for a regime with a floating exchange rate and inflation targeting. If this regime should change, there would be reason to reconsider the system for interventions in the foreign exchange market.

2 Effects of interventions

The term intervention means that the Riksbank buys or sells quantities of Swedish krona in the foreign exchange market with the aim of affecting the development of the exchange rate.² The effect of the intervention on domestic liquidity is neutralised via the bank's normal market operations. Sterilised interventions do not have a direct effect on the economic conditions governing pricing of the exchange rate in the medium term, such as interest rates, inflation expectations or economic growth.

Influence via signalling

The most important reason for interventions in the foreign exchange market having a more permanent effect on the exchange rate is that they give a signal regarding future monetary policy. Communication in connection with the interventions and through the interventions enables the Riksbank to show what its intentions are with regard to monetary policy, e.g. if a change in policy is necessary. The influence on the exchange rate then comes through a change in the market's pricing of the future interest rate policy.

The change in the assessment of future monetary policy achieved in this way could normally also be achieved through other methods, such as statements by prominent representatives of the Riksbank. However, interventions can be considered a particularly effective form of communication, as the Riksbank takes a certain risk when making an intervention.

Influence when the foreign exchange market does not function efficiently and certain other mechanisms

may additionally, without prejudice to the price stability target, support objectives for general economic policy with the aim of attaining a sustainable level of growth and high employment. Pursuant to Chapter 7, § 3 of the Sveriges Riksbank Act, the Riksbank may buy, sell and mediate foreign currency, etc. for foreign exchange policy purposes.

² The Riksbank has also implemented foreign currency exchanges against Swedish krona in certain other contexts. Such exchanges are made, for instance, on behalf of the Swedish National Debt Office.

Interventions can also have effects on the exchange rate when the market is not functioning efficiently. The exchange rate can deviate during longer or shorter periods from the level that is motivated by economic fundamentals. This can be the case even when the assessment of what is fundamentally motivated is shared by certain operators in the foreign exchange market. The cause could be the market's method of functioning, for instance, elements of herd behaviour. In this type of situation, it is conceivable that the Riksbank might want to provide some support to the market operators who act on the basis of a more fundamental assessment of the exchange rate. Interventions can be considered to contribute to a correction of the pricing. It is also conceivable that a particular order may have a more lasting effect on the pricing, particularly in situations where liquidity in the foreign exchange market is low (known as thin trading).

It is also conceivable that the Riksbank can affect the relative supply of domestic and foreign assets, what is normally termed the portfolio-balance channel. If investors want to avoid risk, which is a common assumption, they will wish to distribute their assets among different currencies. Domestic and foreign assets are therefore not completely interchangeable (imperfect substitutes). This in turn means, for instance, that an increased supply of domestic assets requires a corresponding increase in demand to avoid a change in the price. This increase in demand can be achieved by adapting the exchange rate.

Conclusion

One reason why interventions can affect developments in the exchange rate is that they can signal a change in the future direction of monetary policy. Interventions can also affect the exchange rate more directly if the foreign exchange market, for various reasons, is not efficient. The conditions for this type of influence are probably better in situations with a liquidity shortage. Experiences gained by the Riksbank and other central banks indicate, as does the research in this field, that it is very difficult to assess the effects of interventions in the foreign exchange market.

3 Motives for interventions

It is the Riksbank's task to maintain price stability and to promote a safe and efficient payment system. According to the preparatory work for the Sveriges Riksbank Act, the Riksbank shall also support objectives for general economic policy if this can be done without prejudice to the price stability target.

The inflation target as a motive

Monetary policy is aimed at achieving the inflation target. The Riksbank's main instrument for influencing inflation is the repo rate. This is normally adjusted so that the assessment of inflation for the coming years lies in line with the Riksbank's target. In addition to adjusting the interest rate, the Riksbank can resort to interventions in the foreign exchange market and a number of other measures for the purpose of maintaining price stability. A possible situation that could motivate interventions is if the inflation target was threatened in the relative time perspective and a weak or strong krona was deemed important in this context.

It is theoretically conceivable to try to stabilise inflation in the short term by affecting the exchange rate and import prices. Changes in the exchange rate can, if they are perceived as permanent, have a direct and relatively rapid effect on the prices of at least some imported consumer goods. Effects could also come at a longer time lag through resource utilisation, for instance in that demand for Swedish export products is affected. In practice, all central banks with an inflation targeting policy have made the assessment that monetary policy should not rely on such mechanisms. This is connected with the fact that it is difficult in practice to have a permanent effect on the exchange rate.

The direct effects of monetary policy on the exchange rate are not unequivocal. The exchange rate is a relative price between two countries' currencies and expectations of the future exchange rate and future monetary policy in both countries have an effect on the rate now. The supply and demand for currencies are also affected by a large number of other factors, including commodity prices, portfolio flows and expected productivity, which can be assumed to lie outside of the Riksbank's immediate control.

As a result of these circumstances, and because the target for monetary policy is to stabilise inflation in a medium-term perspective, there is normally no motivation to intervene in the foreign exchange market to counteract short-term fluctuations in the exchange rate. However, the issue is complicated by the fact that substantial deviations from the expected exchange rate path on which monetary policy is based can increase uncertainty as to whether the monetary policy target will be achieved. Interventions in the foreign exchange market could from this point of view be regarded as a means of contributing to a future development of the exchange rate that aided the inflation rate to develop in line with the Riksbank's target in the relevant time perspective. The motive for interventions in this type of context could be that they are estimated to contribute to attaining the inflation target with less negative real economy side-effects than other alternative measures.

The exchange rate as a motive

As long as monetary policy is conducted with a floating exchange rate, the Riksbank has no target for the exchange rate. If the inflation rate is in line with the target and there is confidence that the situation will remain this way, there is no reason to try to steer the exchange rate to a particular level by means of currency interventions. Nor is there usually any reason to intervene to stabilise exchange rate fluctuations.

An exchange rate that is substantially out of line with that perceived as the equilibrium rate could affect resource allocation in the economy or economic growth in an undesirable way, as could rapid changes in exchange rates that are not motivated by real economy fundamental factors. In these situations, there may be a motivation for interventions, if it is considered possible to affect the foreign exchange market in the desired direction. Interventions would then contribute in the long run to supporting the objectives of the general economic policy.

However, interventions in this type of context are connected with considerable problems. It is difficult to determine what is an equilibrium rate. Additionally, an ambition to maintain a particular exchange rate or to stabilise the development of the exchange rate could come into conflict with the inflation target or create greater uncertainty regarding monetary policy.

The method of functioning of the foreign exchange market as a motive

The Riksbank may also, in certain situations, wish to act to promote a satisfactory method of functioning in the foreign exchange market. However, it is not evident that the foreign exchange market functions less efficiently than other markets, e.g. the stock market or bond market. The methods and measures normally used to influence the method of functioning of financial markets, such as oversight, supervision and regulation, are therefore usually to be preferred when it comes to the foreign exchange market too, rather than direct intervention.

Conclusion

Under the current regime the Riksbank does not have any target for the exchange rate in terms of targeting a particular exchange rate level or having an ambition to stabilise exchange rate fluctuations. Interventions in the foreign exchange market are primarily a means of signalling and emphasising changes in monetary policy that are used to maintain price stability. Without prejudice to the inflation target, and in exceptional cases, the Riksbank can, if it considers it to be possible and appropriate, act in the foreign exchange market to influence exchange rate developments, with the aim of supporting the general objectives of economic policy. The Riksbank can also, in exceptional cases, resort to interventions to promote market functionality.

4 Some bases for a system regarding interventions

The system for preparing and making a decision on intervention should, like all of the Riksbank's work, be characterised by a high degree of transparency and clarity. At the same time, it should of course be possible to take any measures rapidly and efficiently.

Arguments in favour of openness and clarity

The essential motives for transparency and clarity in monetary policy also apply to currency interventions. The Riksdag (Swedish parliament) has delegated decision-making on monetary policy to the Riksbank. This also applies to currency interventions. When decision-making in important issues has been delegated to an independent authority, it is desirable that the grounds on which the decision is made are reported in an open and clear manner. This makes it easier for the Riksdag to assess the work of the Executive Board, for instance. Openness also makes it easier for external analysts to assess the quality of the information on which the decision is based. Normally, the policy pursued will also be more effective if it is communicated in an open and clear manner.

The fact that intervention decisions in Sweden, unlike in many other countries, are made by the central bank without consultation with the government, contributes to

making the policy clear; there can be no uncertainty with regard to the central bank's operational control over monetary policy.

A clear system for preparation and decision-making regarding interventions could help increase confidence in both the underlying assessment made and the decision taken. Moreover, there may be a particular value in ensuring that the preparation and decisions regarding interventions are handled in a way as similar as possible to that for monetary policy decisions. This could provide stability in the internal processes and reduce the risks of mistakes in internal management and external communication. Openness and clarity could thus support the interventions' function as instrument for signalling.

Balance between transparency and efficiency

In addition to transparency and clarity, efficiency is also an important basis when designing a system for interventions in the foreign exchange market. In those cases where transparency and clarity increase efficiency, there is no problem. However, situations could arise where this is not the case, and a balance has to be found between efficiency and openness.

The difficulties in implementing interventions in an efficient way are basically connected to the fact that the Riksbank's direct influence on the foreign exchange market via interventions is limited. Interventions are more complicated to implement with the intended effects than are repo rate decisions, as the Riksbank can normally determine the short market rate through its position on the daily lending market, while in currency interventions the bank is merely one operator among many in the market. Interventions can thereby have a greater effect if the Riksbank does not show complete openness with regard to its readiness to intervene, the length of its operations, the time the decision was made, and the scope, currencies or counterparties involved in the intervention.

It is possible, for instance, that knowledge of the Executive Board's considerations and decisions could have a detrimental effect on the outcome of the measures taken. There is also a possibility that information regarding the scope of the interventions could contribute to action by market operators that limited the effect of the interventions. If the Riksbank provides more information on its actions than the other operators in the foreign exchange market, these may gain an information advantage that can be utilised in a way that counteracts the desired effect.

There is no self-evident balance between transparency and clarity on the one side and efficiency on the other side. Taking into account that the motive for openness is primarily to enable an assessment of the Executive Board's activities, it appears natural that openness should be greatest with regard to the fundamental discussion of motive, etc. The risks involved in publishing information that shows the decision-making situation within the Executive Board will also decline over time.

The Riksbank has chosen to also show great openness in its operations. In its contacts with counterparties the Riksbank has stated that the price query is for the purpose of making an intervention. When questioned by the general public, the Riksbank has immediately communicated whether currency interventions are implemented. The interventions have also been made with a large number of counterparties on each occasion. However, there may be motivation for exceptions from

this method of working, which is one reason why operational considerations are handled in a different system from the considerations regarding the motives for the interventions in the rules of procedure described here.

5 System for preparing, deciding and communicating interventions

Routines for decisions on interventions

Decisions on interventions in the foreign exchange market are normally taken by the Executive Board. However, pursuant to § 4 of the Riksbank's Instructions, the Governor of the Riksbank can decide on measures motivated by foreign exchange policy, if the Governor assesses the situation to be so urgent that it cannot wait for a decision by the entire Board. In this type of situation, the decision should be reported to the Executive Board. The report should be minuted in accordance with the system described. If necessary, the Executive Board can also delegate the decision-making right for individual matters.

A situation that could be so urgent that it motivated interventions being made without waiting for a decision by the Executive Board is if the Riksbank received an enquiry from a private or public counterparty interested in exchanging large amounts of currency or Swedish krona directly with the Riksbank.

This type of transaction should not normally be made with private operators. Transactions with public counterparties should also be made with great restraint.

Interventions should normally be prepared like other monetary policy decisions. This secures a clear connection to other monetary policy work within the Riksbank at the same time as the risk of mistakes in external communications declines. Before interventions are taken up on the Executive Board's agenda, they should normally have been prepared by the drafting committee for monetary and foreign exchange policy.

On the matter of currency interventions, the Executive Board should make two separate decisions:

- a nominal intervention mandate and
- a motivation text for the interventions.

The same division can be followed in the minutes of the meeting (see next section).

The Executive Board should take a position on the motives for the interventions and make a decision on a motivation text. The main elements in this should normally be published in the form of a press release. A public motivation contributes to a thorough preparation work, where possible motives are examined against the Riksbank's objectives. Clear and jointly-decided motives also facilitate communication with the surrounding world in connection with interventions.

The mandate should normally state the time period for implementing the intervention and give a framework for the scope of the interventions. This can be more or less detailed, depending on the circumstances. The mandate should normally apply

no longer than until the next monetary policy meeting of the Executive Board (naturally, a shorter delegation period is also possible). The responsibility for implementing and communicating the interventions would normally be delegated to the Governor of the Riksbank in consultation with one or more of the members of the Executive Board.

Minutes of meetings when making decisions on interventions

Deliberations with regard to the *motives for the interventions* should be reported in the minutes of the meetings published some time after the mandate has run out. This enables the desired transparency and clarity to be achieved. The minutes of the meeting can have the same form as with other monetary policy decisions with regard to the discussion of the factors affecting the decision. The minutes are normally published with a time lag of a minimum of one month and a maximum of one year after the intervention mandate has expired. An assessment can be made from case to case as to whether information in the minutes can be assumed to counteract the purpose of the decided or anticipated measures and when the confidentiality can be lifted (see Chapter 3, § 1 of the Secrecy Act).

Decisions on a mandate for the interventions are normally entered into separate minutes for the meeting. Publishing these minutes can be assumed to counteract the purpose of the decided or anticipated measures. The provisions in Chapter 3 § 1 of the Secrecy Act are therefore applicable to these minutes and confidentiality cannot normally be lifted until a later date.

Co-ordinated interventions

It is possible that interventions may be implemented at the initiative of other central banks. In such cases there may be reason to deviate from parts of the system proposed here.

6 Proposal for a decision

It is proposed that the Executive Board adopt the system for preparing, deciding and minuting decisions on interventions in the foreign exchange market as described in section 5.