Reserves management and foreign exchange intervention

People's Bank of China

Abstract

In recent years, emerging market economies (EMEs) have built up their foreign reserves. On one hand, this has been driven by accommodative monetary policies of advanced economies. On the other hand, EMEs have accumulated reserves to cope with potential financial market shocks and to strengthen domestic market resilience. This note suggests that the monetary policy impact of central banks' FX spot market interventions depends on whether they can be fully sterilised. We also touch on the practices of the People's Bank of China in diversifying its FX reserves and outline various ways in which the effectiveness of its reserves management will be further improved.

Keywords: foreign reserve, FX interventions, emerging market economies and China.

JEL classification: E58, F31.

Foreign reserves in EMEs are on the rise

Accommodative monetary policies of advanced economies have driven the growth of foreign reserves in emerging market economies (EMEs). In recent years, especially after the 2007–09 Great Financial Crisis, the advanced economies adopted ultra-easy monetary policies to boost liquidity, which caused a surge in international capital flows. With the uneven recovery in the advanced economies, international capital poured into EMEs for speculative reasons, driving up their foreign exchange reserves.

China's FX reserves are not immune from the significant impact of international capital flows. From the early 2000s to 2014, large international capital inflows quickly pushed up China's foreign reserves. These increased from USD 154.7 billion in 2000 to a peak of USD 3.99 trillion in June 2014, representing an average annual growth rate of more than 26%. Since 2015, China's reserves have been falling owing to stronger dollar and capital outflows, stabilising at around USD 3 trillion. In October 2018, China's foreign reserves amounted to USD 3.05 trillion, remaining the largest in the world.

EMEs accumulate reserves to protect themselves from financial market shocks and to strengthen the resilience of their domestic markets. In recent years, growing cross-border capital flows have confronted EMEs with increasing exchange rate risks. As a result, many EME monetary authorities have chosen to maintain large FX reserves to fulfil their international payment obligations and mitigate financial risks.

Generally speaking, the level of FX reserves in EMEs is determined by factors such as their economic size, current account status and external debt. Against the backdrop of increasingly intertwined financial markets worldwide, countries are highly exposed to risks arising from exchange rate fluctuations and capital flows regardless of their economic scale, current account status and external debt levels. Therefore, it is important for EMEs to maintain reserves that are sufficient to safeguard themselves against such risks.

FX interventions in EMEs

EME central banks conduct FX interventions mainly in the spot market, but the use of derivatives is becoming increasingly common. By using reserves to intervene in the spot market, central banks can counter a sharp depreciation or overshooting of their currencies. However, this will also reduce the liquidity in local currencies and incur sterilisation costs. By comparison, the use of FX derivatives has the advantage of not affecting the money supply. It can also buy time for economic restructuring. Moreover, once the economic fundamentals recover and depreciation pressures are gone, central banks can close their position by executing a reversing transaction in order to slow the appreciation of their currencies. It has become common in Brazil and many other EMEs to use currency swaps and other FX derivatives to intervene in the market in the past few years.

FX interventions might reduce FX volatility, but they are difficult to sustain at a given level in the longer run. In the short term, central banks can use their reserves to intervene in the market and prevent excessive trading of their currencies,

which can lower the probability of abnormal short-term exchange rate fluctuations. But as exchange rates in the long run are determined by international capital flows, interest rate policies and other factors, it is difficult to keep the rate stable only through FX interventions. Further, EMEs find it difficult to keep exchange rates stable while maintaining an independent monetary policy and free capital flows, as schematised in the "impossible trinity" concept.

The impact of an FX intervention on monetary policy depends on whether central banks can fully sterilise it. If full sterilisation can be achieved, an intervention's impact on policy implementation is limited, although it can still increase capital flows and therefore reduce the policy effectiveness. But if full sterilisation cannot be achieved, an intervention may increase or reduce liquidity in the market, thus hindering the implementation of interest rate policies and reducing the effectiveness of monetary policy. Moreover, during financial crises, the effect of FX intervention on liquidity is often inconsistent with the aim of monetary policy, so that the latter's effectiveness is reduced.

China's practices in reserves management and FX intervention

The objective of China's reserves management is to ensure safety and liquidity, after which a certain level of return is also sought. In recent years, China's reserves investment has been constantly improving in terms of size, currency structure and diversification.

The PBC continues to explore ways to use its reserves in a diversified manner. In recent years, new channels for investing reserves such as entrusted loans and equity investment were explored. In the process, foreign exchange was placed with financial institutions such as commercial banks and policy banks, as well as with the real sector. With these, a new mechanism for the use of reserves has gradually been developed, with a clear mandate, clear objectives and multiple layers. Meanwhile, the PBC actively provides funding resources to international organisations and cooperates with several bilateral/multilateral funds and multilateral financial institutions. China's reserves investment now covers a range of products including bonds, equities, funds and multilateral co-funding arrangements.

The PBC is also committed to building a comprehensive risk management system and an internal governance framework in line with its expanded reserves management activities. Safeguarding market security and providing liquidity when necessary are the priorities of reserve management. China has attached great importance to protecting its reserves from potential risks and to enhancing the capabilities of its reserves manager in managing risks and maintaining internal controls, so as to better respond to developments in the international financial markets. Over the past few years, the transparency of China's reserves has been steadily increased. In July 2015, China adopted the IMF's Special Data Dissemination Standards. The IMF then began to publish information about central banks' holdings of renminbi. This has further enhanced the transparency of China's reserves management.

The PBC also seeks to enhance its credibility in improving the effectiveness of its reserves management. Any reserves management activities can exert a

profound influence on the decisions of market participants. As the manager of China’s reserves, the PBC closely monitors developments in the global financial regulatory environment, constantly strengthening its internal controls and prudential management, with a view to strengthening its credibility in the FX market and enhancing its reserves management capabilities.