The Political Economy of the Costs of Foreign Exchange Intervention

Central Banks around the world increasingly intervene in the foreign exchange market for a variety of reasons, such as maintaining exchange rate stability and maintaining a buffer against the impact of capital flight. In fact, research shows that central banks can lean against the macroeconomic policy trilemma through maintaining reserves and intervening in the foreign exchange market, and thereby secure policy space. However, securing this policy space can come at substantial cost. This dissertation explores the political economy of these costs of foreign exchange intervention. Paper I discusses the concept of the direct cost of intervention, calculates these costs for several countries over the period 1990–2015, and shows the trends in this cost across countries and over time. This essay shows that foreign exchange intervention and the cost associated with it has increased substantially since the 1990s. Moreover, this cost is higher for developing and emerging economies, countries with more open capital accounts, and countries with less access to a de facto international lender of last resort.

Paper II shifts focus to the indirect costs of foreign exchange intervention. Accumulation of foreign exchange reserves by central banks has meant that they have some capacity to act as a lender of last resort, even when emergency liquidity required is not denominated in their own currency, thereby reducing the probability of default by borrowers in their country in the event of a financial crises. This paper examines whether the accumulation of reserves due to foreign exchange intervention can be counterproductive by encouraging the inflow of volatile capital flows that are linked to the occurrence of financial crises. Using panel data regression analysis, this paper finds that episodes of high reserve accumulation are likely to be followed by surges in inflows of capital within one year and five years, and a heightened probability of the occurrence of a currency crisis within five years. However, a higher level of foreign exchange reserve accumulation is associated with a lower probability of systemic banking crises.

Finally, Paper III revisits the importance of institutions that form the global financial safety net in mitigating the costs of foreign exchange intervention. Paper I and II highlight the importance of access to the global financial safety net, particularly the role played by central bank swap lines with the Federal Reserve in mitigating the costs of foreign exchange intervention. Therefore this paper explores the factors that explain the differential access of countries to the global financial safety net, specifically to provision of emergency liquidity by the US Federal Reserve and the Exchange Stabilization Fund of the U.S. Treasury. Specifically, it examines the relative importance of economic and political factors in determining which countries secure access to these de facto lender of last resort operations. This paper finds that in addition to economic factors like US bank exposure and trade links, political factors like capital account openness, US unemployment rate, defense cooperation agreements, and the party composition of the US government plays an important role in determining access to these International Lender of Last Resort institutions.