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Thoughts following G7 intervention

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If reduced liquidity in FX markets was responsible for the surge in the yen that triggered the G7's intervention, currency authorities and central banks seeking to prevent a recurrence should (1) expand the knowledge of pricing systems for supplying liquidity and (2) flexibly administer central bank swaps and complementary lending facilities to facilitate yen funding. They should also consider revamping the disclosure rules for FX margin trades. Inasmuch as FX intervention by developed nations is intended to quell concerns that "excess volatility" will destabilize global financial markets, discussion and decision-making by G7 member nations, which have deep vested interests, will remain an effective tool.

Introduction

On 18 March we saw the first concerted FX intervention in a decade. Market participants and commentators have already offered a variety of observations and opinions regarding the action and its impact on other markets, including comparisons with past cases. I would like to take a longer-term perspective in discussing market developments and possible responses.

The issue of market liquidity

The steep decline in USD/JPY began when it was trading around 79.80, before 5pm on 16 March in New York. Within 30 minutes the yen had surged to 76.32. A similar movement occurred when the financial crisis erupted in August 2007, but at that time numerous trades were being made. This time, dollar bids by market makers reportedly dried up temporarily. In that sense the recent event resembles the June 1998 plunge in USD/JPY, when the dollar fell by 10 yen in two days.

Although global FX markets are open 24 hours a day, the period between 5pm in New York, when the US market is effectively closing for the day, and 8am in Sydney, when trading begins to pick up in Australia—is still characterized by low liquidity. When Japan engaged in massive intervention in 2003–04, many trades were executed at this time to maximize their impact on the market. And as an article in the electronic edition of the WSJ noted on 18 March, the fact that the trading programs of financial institutions supplying liquidity become less functional for a short period after the US market "closed" may have contributed to the sharp fluctuations .

That said, such conditions were not unique to the day on which USD/JPY plunged, so we need to look elsewhere for a trigger. Many have already pointed to changes in the yen money market. Exhibit 1 provides a timeline of rates based on European time (GMT). Readers should note the dollar premium in currency forwards (S/N) for several days starting on 15 March. Not only did effective yen funding rates rise sharply relative to dollar rates, but short-term yen Libor also rose. Reasons cited include (1) a scaling back of short-yen positions by foreign investors who found themselves over-hedged on FX market following the plunge in Japanese equities and (2) cutbacks in yen-based investments by Japanese financial institutions, which had adopted a more conservative approach to funding. But there is little objective evidence in favor of either hypothesis. Nor is it entirely clear why foreign banks did not (could not) borrow yen funds in BOJ operations even though the Bank began supplying massive amounts of funds to the market on 14 March, causing current account balances to climb to ¥27trn on 16 March. Regardless of the reason, it can be assumed that an increase in short-term yen interest rates would automatically prompt yen

Exhibit 1. Yen funding rates

	11 Mar	14 Mar	15 Mar	16 Mar	17 Mar	18 Mar	21 Mar	22 Mar
USD / JPY S / N max (¥)	-0.04	0.04	0.83	0.27	0.10	-0.01	-0.04	-0.04
Annualized (%)	-0.17	0.17	3.67	1.22	0.45	-0.04	-0.17	-0.17
Yen Libor S / N (%)	0.107	0.111	0.491	0.181	0.174	0.144	0.134	0.123

Source: Thomson Reuters

buying—including by program traders.

In the first half of the week starting on 14 March (Japan time), the drop in Japanese stocks accelerated and the situation at the nuclear plants continued to deteriorate, adding to yen-buying sentiment as investors shunned risk. Many also cite the concentrated closing of FX margin positions. Long-USD positions on the Tokyo Financial Exchange climbed to ¥243.6bn on 16 March (Japan time) as the yen moved steadily higher. The sharp rise in the yen early on the morning of 17 March (Japan time) automatically triggered stop-loss orders on many positions as unrealized losses exceeded a specified percentage of margin, prompting substantial yen buying. Confirmation is offered by the sharp drop in long-USD positions to ¥152.8bn on 17 March.

Exhibit 2. Net short-yen positions on TFE (¥100mn)

	11 Mar	14 Mar	15 Mar	16 Mar	17 Mar	18 Mar	21 Mar	22 Mar
USD / JPY	2394	2131	2279	2436	1528	1470	1424	1486
Others	3803	3367	3947	4100	2958	2562	2121	2018
Total	6197	5498	6226	6536	4487	4033	3545	3504

Source: Tokyo Financial Exchange

Response (1): FX spot market

If the kinds of mechanisms noted above did play a role and currency authorities and central banks seek to prevent a recurrence, they will need to identify the factors leading to the large drop in market liquidity in USD/JPY spot transactions, typically characterized by high liquidity. At the very least, they need to understand the operation and stress characteristics of trading programs used for supporting market liquidity. This knowledge is important, since FX markets are increasingly controlled by a few large players, with a relatively small number of them providing liquidity in USD/JPY spot transactions. At the same time, an understanding of market fluctuations requires a framework enabling the timely sharing of information between currency authorities and central banks and key players when liquidity dries up, as it did recently.

Response (2): FX swap market

During the financial crisis the market for FX swaps became dysfunctional for many currency pairs, including USD/JPY. This led to the appearance of rates that were not consistent with short-term interest rate differentials and hindered term lending. While counterparty risk does not appear to have been an issue this time, the appearance of similar phenomena would imply that FX swap market has some fragility with a tendency to stop functioning during times of stress.

There should be no quantitative problems in obtaining yen funds even with a dysfunctional market for FX swaps, because the BOJ has provided ample funds through its operations,both during the financial crisis and in the wake of the recent earthquake. But these operations are not fully substitutable for FX swaps when we take into account eligible collateral, the time of day when the operations are conducted, and the settlement date for FX swaps. As such, the central bank may need to address the issue of FX swaps in addition to providing an ample flow of funds via its operations.

The simplest method in that case would be for the central bank to participate in FX swap market. At present, however, it may not have the ability to do so. If foreign banks are having difficulty obtaining yen funds in FX swap market, central banks could conduct FX swaps among themselves and have the central bank in the distressed bank's home country provide the yen funding. This would simply be a yen version of the dollar funding arrangements seen during the financial crisis, when dollar swaps were combined with dollar funding operations. Major central banks could implement this without difficulty, and it would have the added advantage of enabling foreign banks to obtain yen funding against the security of home-currency assets.

FX swaps between central banks may be an effective method for addressing dysfunction in FX swap market over specific periods of time, such as during the financial crisis. However, they may be less useful when stresses emerge suddenly. In such cases it may be more appropriate to promote the use of a complementary lending facility. A flexible review of the current framework is probably called for if financial institutions find it difficult to use.

Response (3): FX margin trades

If the intensive unwinding of large positions exacerbated market fluctuations, adjusting the margin requirements for FX margin trades may be one way to curb the accumulation of such positions. This approach is often used by financial exchanges everywhere, and is in fact used with FX margin trades on the TFE. From a practical perspective, however, it can be difficult to maintain harmony with trades between margin dealers conducted off the exchanges.

Another point concerns the disclosure of positions. Exchanges need to provide prompt and appropriate disclosure to enable investors to make rational investment decisions. But the markets as a whole are characterized by an asymmetry in which transparent disclosure exists only for FX margin trades conducted via exchanges. This could encourage speculative trades by other players. Consequently, we should consider reducing the frequency of disclosure to once a week or establishing a time lag while maintaining consistency with the CFTC's COT data and taking into account trades going through dealers.

Currency intervention validity and framework in developed nations

Speculation about the repatriation of capital by Japanese investors in the wake of the earthquake fueled expectations of FX intervention. But I did not expect a concerted intervention. I suspect that the interests of the West coincided with those of Japan in wanting to prevent falling Japanese share prices and a rising yen in the week starting March 14 from triggering a downward spiral in US and European markets, where the situation in the Middle East and fiscal problems in Europe had already left investors increasingly risk-averse. The concerted intervention was probably an attempt to arrest this vicious cycle early on.

As noted in the official statement from the 18 March meeting of G7 finance ministers and central bankers, the intervention was carried out in response to "excess volatility and disorderly movements in exchange rates." Such actions are considered justified under additions made to Article IV of the IMF Articles of Agreement (Part II, 14.B and 14.C) as long as "the interests of other members" are taken into account. At the October 2008 G7 meeting as well, the deepening financial crisis threatened to spark a vicious spiral of yen appreciation (in a flight-to-quality trade) and share price declines. Western nations did pledge to keep yen appreciation in check, working from a similar perspective as at the recent meeting.

There is one other valid reason for FX intervention under the IMF Articles: a significant divergence from a currency's "fundamental equilibrium level." Among the developed nations, at least, this justification appears to be losing its validity given the difficulty of consistently determining the fundamental equilibrium. Even when measures such as relative purchasing power parity are used, the equilibrium value can differ significantly depending on the price index used.

It is interesting that this aspect of FX intervention by the developed nations implies an extension of the G7's lifetime. An agreement by the developed nations to engage in intervention is a sign that their currencies are exhibiting "excess volatility and disorderly movements in exchange rates" and that there are concerns about instability in the global financial system. To the extent that it is the developed nations, with their globally interconnected financial markets, that have the greatest to lose from such conditions, it makes sense for them to continue to discuss and decide such issues at meetings of the G7. To be sure, the emerging economies also have prominent financial institutions and exchanges. At least for now, however, they have yet to become globally interconnected, in part because of continued regulation of the financial sector and FX and capital transactions or a dearth of institutions engaged in cross-border transactions. While it is true that it would be more appropriate for the G20 to address the misalignment of emerging economy exchange rates, it is still premature—from a practical if not a political standpoint—to shift all discussion of global financial problems to the G20.

Conclusion

In the markets, some appear to feel that a gradually rising yen amid persistent global risk aversion would place the Japanese authorities in a difficult position inasmuch as it would remove the reason for concerted intervention. While this risk cannot be dismissed, it is also important to recall a key condition for market support of interventions; they must be consistent with the direction of monetary policy. The central banks of the West are expected to gradually normalize monetary policy, and it is difficult to expect Japan to take the lead. In that sense, the recent concerted intervention might have a larger-than-expected impact in the longer term perspectives.

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