What Prompts the Central Bank of Taiwan to Intervene in the Foreign Exchange Market?

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Abstract

The secret nature of Taiwanese foreign exchange intervention (FXI) has posed difficulties for unveiling the true exchange rate policy taken by the Central Bank of Taiwan. In order to get a clear grasp of the Taiwanese exchange rate policy even in lack of officially disclosed FXI records, firstly, this study goes through a rigorous process of searching for the most plausible proxy of the Taiwanese FXI in the existing literature, with considering the distinctive characteristics of the central bank's intervention behavior. Secondly, I estimate the central bank's FXI policy reaction function to uncover the Taiwanese exchange rate policy, using the most plausible proxy. Due to data availability, the sample period is set from January 2001 to December 2020. The endogeneity problem that possibly stems from the structural relationships (reverse causation) between interventions and exchange rate movements is avoided by using the Ito and Yabu (2007) dynamic regression model specification. In this specification, whether the orthogonality conditions are satisfied is further checked to avoid endogeneity. Moreover, since the regression residuals likely fail to be independent in time series regressions, the autocorrelation structure within the residuals is also specified to help to generate credible estimation results.

It turns out that there exists a structural change within the Central Bank of Taiwan's FXI behavior around December 2011. Before December 2011, the Central Bank of Taiwan basically followed the following rules to intervene in the foreign exchange market: adopting lean-against-the-wind intervention in the short run, enhancing the New Taiwan Dollar's value in the long run, asymmetrically conducting the interventions, and the intervention itself was positively autocorrelated. In contrast, for the period after December 2011, the central bank became less engaged in the outright purchasing/selling operations in the foreign exchange spot market, and no longer followed the intervention rule that it had been used to follow in the previous decade. This may suggest that the Central Bank of Taiwan indeed relaxed its controls on the value of the New Taiwan Dollar, or turned to adopt other measures to affect the exchange rates more often than directly purchasing/selling foreign exchanges in the spot market since 2012.

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