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Foreign Exchange Intervention in Times of Financial Stress: Empirical Evidence from India

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Abstract: This paper aims to investigate whether the exchange rate response to the Reserve Bank of India's purchase/sale of foreign currency is conditional upon the level of financial stress that prevails in the market. In this regard, a threshold vector autoregression (TVAR) model is estimated using monthly time series data for the sample period from January 2000 to December 2021. The impulse response for one and two standard deviation shocks indicates that the response of the exchange rate depends on the magnitude of the intervention. Further, the evidence shows that the success of official intervention that aims at moderating exchange rate fluctuations depends upon the level of financial market stress. To be specific, the authority seems to have succeeded in preventing the rupee fall (rise) through the official sale (purchase) of foreign exchange only when the financial market stress is below a certain threshold level.

Keywords: Foreign Exchange Intervention, Exchange Rate, Financial Stress, Threshold VAR Model

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