

Technical Analysis, Central Bank Interventions and Exchange Rate Regimes

by

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Abstract

This investigation studies the usefulness of technical trading rules on foreign exchange markets and the way it depends on central bank interventions and exchange rate regimes. The first objective is to carry out a systematic analysis of the statistical and the economic significance of returns from following technical trading rules for flexible exchange rates. We find strong evidence for technical trading rule profitability and show that for several ways of adjusting trading rule returns for risk, technical trading rules tend to be less, rather than more risky than buying and holding currencies or stock market indices. The second objective of this investigation is to clarify the relationship between technical trading rule profitability and central bank interventions. Using daily data on foreign exchange interventions of both the Bundesbank and the Fed we provide further evidence that central banks earn profits with interventions and that technical trading rules are abnormally profitable on days on which interventions take place. We find that this seeming contradiction is due to the fact that whilst in the short run exchange rates move in a direction contrary to the central banks' intentions, in the long run this effect reverses. Moreover, we argue that the reason why technical trading rules are so profitable on days when central banks intervene is that since interventions are aimed at turning technically motivated trends (or, more metaphorically, are aimed at pricking speculative bubbles) they are a more reliable signal of the existence of a trend than a technical trading rule by itself. The third and final objective is to examine the influence of the participation in a fixed exchange rate regime on the usefulness of technical trading rules. We find that technical trading rules are unprofitable for exchange rates belonging to the European Monetary System (EMS) and that this was the case even during the early 1980s, when the fixed exchange rate parities in the EMS were non-credible and subject to frequent realignments. Moreover, examining the cases of the Italian lira and the British pound reveals that leaving/joining the EMS had a significant effect on the profitability of technical trading rules.