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Should central bankers talk to the foreign exchange markets?

Michel Beine[a,b,c,*], Gust Janssen[d], Christelle Lecourt[e]

[a] University of Luxembourg, Luxembourg
[b] University of Brussels, 162A avenue de la Faiencerie, L-1511, Luxembourg
[c] Ces Ifo, 162A, avenue de la Faiencerie, L-1511, Luxembourg
[d] University of Leuven, Naamsestraat 69, B-3000 Leuven, Belgium
[e] Louvain School of Management and University of Namur, FUNDP, B-5000 Namur, Belgium

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A B S T R A C T

In this paper we study the role of official statements and speeches given by central bank authorities in charge of foreign exchange policy. We investigate the impact of statements that comment on and confirm such interventions on the day of the intervention on the two major foreign exchange markets over an extended period (1989–2003). We also study the impact in terms of policy effectiveness of central bank communication before the actual operations. Our results suggest that appropriate speeches clarifying the current intervention policy can have marginally virtuous effects, both in terms of exchange rate level and exchange rate volatility. This leads us to conclude that, in general, actual interventions on the market should still be employed, provided that official statements are used to clarify the nature and purpose of these interventions.

1. Introduction

The exchange rate policies conducted by major countries have changed radically since the mid-1990s. Most central banks, such as the Fed and the ECB, have become increasingly reluctant to rely on actual interventions and have shifted towards the use of communication policy to influence exchange

* Corresponding author. University of Brussels and Ces Ifo, 162A avenue de la Faiencerie, L-1511, Luxembourg.
E-mail address: michel.beine@uni.lu (M. Beine).

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rates. In recent years, only Japan has continued to intervene actively and unilaterally, both by buying currencies and by using words. As a matter of fact, the way central banks communicate with the market has also changed radically. Before, central banks had a tendency to favour secrecy by not clarifying their objectives. Along with a trend towards greater independence, and under pressure from governments, there has been a significant move towards more communication and transparency in both monetary and exchange rate policy.

One underlying factor behind this trend is undoubtedly the link between communication and policy effectiveness. But through what channels does communication influence exchange rates? The signalling channel remains one of the most important theories of how the market is influenced: actual interventions, in the form of purchases and sales of currencies in FX markets, may have an impact on exchange rates by conveying a signal about the fundamentals or future monetary and exchange rate policies (Mussa, 1981; Kaminsky and Lewis, 1996; Vitale, 2003). In the same way, communication may influence exchange rates by signalling future monetary policies or interventions. A recent alternative suggestion, related to the emerging literature on microstructure exchange rate models, is the co-ordination channel (Sarno and Taylor, 2001; Taylor, 2004). According to this new theory, official statements may be considered as a co-ordination tool allowing market participants to align their views on a new equilibrium.

While a growing literature has been devoted to the issue of the effectiveness of communication and transparency in monetary policy (see, *inter alia*, Geraats, 2002; Ehrmann and Fratzscher, 2007; Sager and Taylor, 2004), a few papers have also investigated the desirability of transparency for exchange rates (e.g. Bhattacharya and Weller, 1997; Enoch, 1997; Vitale, 1999; Popper and Montgomery, 2001). Some recent papers (Fratzscher, 2004, 2006, in press; Jansen and de Haan, 2005, 2007) have dealt with this issue from an empirical perspective.

In this paper, we present an empirical assessment of the economic desirability of communication in foreign exchange central bank interventions (CBIs). Specifically, we investigate the role of central bank communication as a complementary instrument to actual interventions. To this end, we focus on a key element of communication: statements by monetary authorities made after (but on the same day as) central bank interventions, which are aimed at either confirming the intervention, providing additional comments, or just declining to comment on the operation.

Our work is related to other empirical studies (Fatum and Hutchison, 2002; Fratzscher, 2004, 2006, 2008; Jansen and de Haan, 2005, 2007) that focus on the effect of official statements on exchange rates.[1] However, it differs in several respects from this emerging literature. The most significant original contribution of this paper is its investigation of central bank statements as tools that complement, rather than replace, actual interventions on the foreign exchange market. While Fratzscher (2004), for instance, concludes in favour of a good communication policy as a substitute for actual interventions, we find that communication can also be beneficial once the intervention has been carried out. Our approach implies that we consider one particular type of communication, namely *ex post* communication, as representative of all the official statements perceived by market participants that are issued after direct interventions. We also investigate the impact of *ex ante* communication, i.e. statements made in the context of G7 meetings or threats of future intervention issued directly by the central banks. The nature and type of official statements studied in this paper are thus different from those analysed elsewhere.

We ask the following question: to what extent do official statements make the impact of direct central bank interventions (CBIs) more effective? In other words, we examine whether an official statement made after a FX intervention is an effective policy tool, one that has the intended impact on the exchange rate. To this end, we used a new data set, based on newswire service releases, to collect and classify the daily statements made by officials of the Bundesbank (after 1999, the European Central Bank (ECB)), the Federal Reserve (Fed), and the Bank of Japan (BoJ) over the period 1989–2003 for the EUR/USD and 1991–2003 for the YEN/USD exchange rates.[2] Using a standard event-studies regression approach (Dominguez, 1998), we test whether the impact of reported central bank interventions that are followed by a statement differs from the impact of those with no subsequent statement. We test the

[1] These studies are reviewed in Section 2.1.
[2] The euro is used in stead of the Deutsche mark throughout this paper.