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ScienceDirect
Research in Economics 62 (2008) 45–54
RESEARCH IN ECONOMICS
www.elsevier.com/locate/rie

Transparency and central bank losses in developing countries

Osama D. Sweidan[a,*], Benjamin Widner[b,1]

[a] Department of Economics, P.O. Box 27272, University of Sharjah, Sharjah, United Arab Emirates
[b] Department of Economics and International Business, New Mexico State University, P.O. Box 30001/MSC3CQ, Las Cruces, NM 88003-8001, United States

Received 2 April 2007; accepted 6 December 2007

Abstract

Recent evidence shows central banks suffering from losses in some developing countries. This is a surprise to economists and policymakers. At the same time, these banks are asked to conduct monetary policy within a more transparent framework. Therefore, this paper seeks to answer the following question: Would more transparency in developing countries suffering from central bank losses be beneficial?

This paper shows that the cost constraints of conducting monetary policy, central bank losses, in both transparency and opacity alike is significant and affects positively the error of the private sector in expected inflation rate and the output gap. In a country suffering from central bank losses, the expected benefits of transparency and the existence of cost constraint move in two opposite directions. As a result, it is unwise for developing countries suffering from central bank losses to focus on transparency. Priority should be given to fixing monetary policy and to developing financial markets.

Keywords: Transparency; Central bank losses; Monetary policy

1. Introduction

Central banking has experienced considerable change during the last decade. The recent paradigm in monetary policy is to have independent and transparent central banks. The argument among economists about transparency is a continuation to the debate that tries to answer the following question: Should monetary policy be made by rule or discretion? This dispute is related more to the institutional characteristics of the central banks and their effect on the monetary policy performance. Recent studies in this area have attempted to focus more on the optimal degree of transparency. The proponents of transparency agree that it is a self-evident necessity in order to attain sound monetary policy. As well, it affords better control of the public's expectations by the central bank. Besides, it helps the actions adopted by the central banks to be more accountable. The technical effect of transparency to achieve price stability at lowest cost comes from the following process: the central bank should preannounce a low inflation target and commit to achieving it. In addition, the central bank should make the target reasonable for the public to let the announcement influence their expectations.

* Corresponding author. Tel.: +971 6 5053572; fax: +971 6 5585050.
E-mail addresses: osweidan@sharjah.ac.ae (O.D. Sweidan), bwidner@nmsu.edu (B. Widner).
[1] Tel.: +1 505 646 5989; fax: +1 505 646 1915.

1090-9443/$ - see front matter
doi:10.1016/j.rie.2007.12.002

Some economists went further to describe transparency as a part of democratic society. They assure that transparency should be a feature of the economy to guarantee successful economic policy. Stiglitz (1998) describes transparency as a central aspect of the democratic process, and a necessary condition for democratic governance to survive. Furthermore, he believes that the existence of transparency and democratic society reduces the concentration of power in the hands of single individuals, and is able to control human fallibility. Likewise, Mishkin (1999) demonstrates that transparency not only increases the ability of the central banks to conduct an effective monetary policy, but also helps to align central banks with democratic principles. Moreover, it promotes public support for the goals of monetary policy and reduces political pressures on the central banks.

On the other hand, in a vital work Cukierman (2005) does not agree with full transparency in all cases. He assures that full transparency is not necessarily an optimal solution. Consequently, he distinguishes between areas in which high transparency is desired and areas in which an intermediate level of transparency is desired. He corroborates that it is highly risky and counterproductive to publish signals about severe problems in the financial system. This behaviour might lead to an unanticipated reaction from the public.

Within the context of this debate, the central banks of developing countries are asked to present increased transparency. However, most of the theoretical analysis of transparency never pays no attention to the features of developing counties. Recent observations from developing countries submitted by economists such as Dalton and Dziobek (2005), Chandavarkar (1996) and Leone (1993) show that many central banks are suffering losses. It reads like a novel having losses in the income statement of a central bank.

Thus, the current paper tries to address a specific question which is: would more transparency in developing countries be beneficial within this restriction? To answer this question, we use a known model from monetary economics. This model is used by Tarkka and Mayes (1999), and we upgrade part of it to shed light on the uniqueness of developing countries. Our results show that the cost constraints of conducting monetary policy, the central bank's losses, in both transparency and opacity alike are significant and affect positively the error of the private sector's expected inflation rate, and the output gap. In a country suffering from central bank losses, the benefits of transparency and the effect of cost constraint move in opposite directions. As a result, it is unwise for developing countries suffering from central bank losses to focus on transparency. Priority should be given to fixing monetary policy and to developing financial markets. The result of the current study raises an important implication and even a solution to why developing countries do not switch to using required reserve ratio as a monetary tool to guarantee a minimum cost of short-run operations of monetary policy. Despite the fact that this tool has criticisms[2] it is still a good choice to help monetary authorities in these developing countries to catch a balance in their income statements.

The rest of the paper is organized as follows: Section 2 presents the literature review about both transparency of monetary policy and central bank losses. Also, it describes the problem facing developing countries and its effect on conducting monetary policy. Section 3 introduces the model of the paper. Sections 4–6 bring in the calculations of both inflation error and output gap under transparency and opacity. Conclusions are drawn in the last section.

2. Literature review

2.1. Transparent monetary policy

Let us confirm that we are talking about two important issues; transparency is a vital and necessary process which we try to apply, and central bank losses which is a matter of fact in some developing countries. Hence, the goal of the paper is to connect them by understanding the effect of the former on the economy within the existence of the latter. Also, we would like to confirm, based on our knowledge, that there are no previous studies making this connection. Therefore, we utilize a model used by other economists to study transparency. Transparency can be defined as the existence of symmetrical information between the central bank and the economic agents.[3] Some economists consider that adopting a framework of inflation targeting and publication of inflation forecasts is an example of transparent monetary policy. This means that transparency reduces uncertainty. For the purpose of this study, we define transparency as an easy flow of information concerning economic variables and expectations between the central

[2] For more details about required reserve ratio see Mishkin (2004).

[3] For more details see Enoch (1998), Jensen (2000), Faust and Svensson (2001) and Gerrats (2002).