

Central bank secrecy in the foreign exchange market

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Abstract

This paper argues that with sticky goods prices and a forward-looking exchange rate, the central bank will only want a partial dissemination of its information about shocks to the economy. It is shown that, in such a model, the central bank may prefer to intervene secretly in the foreign exchange markets when responding in anticipation of future shocks, but openly when reacting to current shocks. The model thus provides a rationale for secrecy in central bank foreign exchange operations. The model also elucidates the relationship between the signaling and portfolio balance channels of sterilized intervention. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

At a time when central banks are being urged to be more open and transparent in their operations, it is worth pausing to ask whether central bankers' traditional penchant for secrecy has any economic rationale, or whether it is merely part of the mystique of central banking.¹ A series of papers has tried to

¹ This penchant for secrecy has long been criticized. In the United States, for instance, there are periodic congressional attempts at reform of the Federal Reserve (see, e.g. HR-2735, the Federal Reserve Reform Act of 1989) and the Federal Reserve was even the subject of a lengthy lawsuit, which the Fed eventually won; see Goodfriend (1986) and Mayer (1987). More recently, the IMF's Special Data Dissemination Standard requires subscribing countries to disseminate information on central bank reserve assets on at least a monthly basis (with a lag of no more than one week).

explain why the central bank may find it desirable to remain secretive in setting its monetary policy.² The literature to date, however, has not examined the secrecy shrouding interventions in the foreign exchange market. This omission is surprising since exchange market interventions are often amongst the most secretive operations undertaken by central banks.³

The operating procedures of central banks are generally designed to prevent market participants from discovering the magnitude, and often the direction, of official intervention. Thus, typically the central bank will use several brokers in order to prevent the market from deducing the total size of the intervention.⁴ Of course, some information leaks out through the very process of influencing the exchange rate. Correlating daily intervention data with newspaper accounts, Domiguez (1989) found that market participants were at times able to infer that the central bank was intervening, but they seldom knew the magnitude of the intervention. This reticence of the central bank to announce its interventions is particularly puzzling in light of econometric evidence that the most important effects of intervention operate through signaling channels. Presumably, therefore, the central bank could achieve its maximum impact by intervening in as conspicuous a manner as possible. The purpose of this paper is to provide an explanation for secrecy in intervention operations.

To explain central bank secrecy only three assumptions are required. First, we assume that the central bank has superior information to that available to the private sector (otherwise the private sector could always infer the central bank's intervention anyway). Second, we assume that, *ceteris paribus*, the central bank prefers to undertake as little intervention as possible. Third, in line with most open-economy macroeconomic models, we assume that the goods market clears more slowly than asset markets (Dornbusch, 1976). In essence, the slow adjustment of the goods market means that the central bank prefers a partial dissemination of its private information to either complete revelation, or perfect secrecy. Secret intervention allows the central bank to achieve the objecting of only partially disseminating its information with the minimum amount of intervention.

² See Cukierman and Meltzer (1986), Rudin (1988), Lewis (1990) and Oh and Garfinkel (1990).

³ So much so, that central banks are often reluctant to release high frequency historical data even for research purposes. Funabashi (1988) reports that the intervention strategy adopted at the Plaza Agreement had to be spelled-out in a 'non-paper' – so dubbed because the meetings' participants has to return their copies of the paper at the end of the meeting. Indeed, 'the Plaza participants confirmed that they must not reveal any indication of the amounts or other details to the media, and they need adopt a consistent approach to answering questions concerning intervention strategy'.

⁴ Brokers quote a price and then must supply the currency – regardless of the amount – to the central bank at the quoted rate. Since the broker will generally have to buy that currency from others, he has little incentive to reveal that the central bank is participating in the market for fear of driving up the price at which he must buy.

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