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Correction 1

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Subject: **Transparency in Central Bank Operations in the Foreign Exchange Market**

CORRIGENDUM

Page 10, footnote 16: Deleted

Page 15, footnote 24, lines 3 and 4: for "standards of disclosure. See Valencia (1997)...bank operations."
read "standards of disclosure."

Page 18, lines 9 and 10: for "notably South Africa and Thailand"
read "notably Australia, South Africa, and Thailand"

Page 23, References, "Kovanen, Arto, 1996,...Operational Paper": Deleted

Page 24, References, "Valencia, Anna-Maria, 1997,...Operational Paper": Deleted

Corrected pages are attached.

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At a simple level, such covert intervention may be regarded as desirable when the authorities do not wish to give a signal of their involvement. This would occur, for instance, when the authorities are comfortable with their overall policy stance, and feel that they are facing a temporary shortfall or glut in demand for currency and are seeking to avoid this temporary shortage or glut getting built into expectations and thus having a longer-lasting impact on the market. A second reason would be where the central bank is not sure of its own commitment or ability to defend a particular rate, and therefore does not wish to jeopardize its credibility by being seen to support a rate which is subsequently not held. This may well be the case in the event of central bank intervention to "lean against the wind" and safeguard orderly market conditions rather than to protect the level of the exchange rate per se. A third reason, in some ways the converse of the second, may be where the central bank has limited credibility (or limited reserves) and where it is concerned that its appearance in the markets may in fact prompt increased market pressures against it.[14] A fourth possibility is that in cases where a country is operating within a foreign exchange rate band regime (such as the exchange rate mechanism (ERM) of the European Monetary System), there may be advantages in covert intramarginal intervention to avoid the speculative pressures that might emerge if the rate were permitted to move to the edge of the band.[15] Finally, and more prosaically, there may

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[14]Cukierman and Meltzer (1986) demonstrate, in the context of ambiguity in the operation of monetary policy, that a central bank is likely to seek more ambiguous control procedures the more uncertain its objectives and the higher its rate of time preference.

[15]Experience from the ERM indicated that, in cases of moderate divergences from the central rate, there was mean reversion in expectations; in cases where there was substantial divergence from the central rate, on the other hand, markets tended to expect the divergence to increase further. Studies of this experience led to the so-called Basle-Nybörg Agreement

(continued...)

well be sound operational reasons for keeping intervention covert. On some occasions, a central bank may, like a typical market participant, wish to get the "best rate" (i.e., the lowest spread around the central rate) it can for any deal; it does not wish to risk that it is perceived as "distress buying," since—even if there is full credibility that its intervention will be sufficient to achieve the desired effect on the exchange rate—this might well encourage market counterparties to offer it worse terms. In this sense, the central bank would aim to disguise its intentions exactly as would any other sizeable player in the foreign exchange market.

On other occasions, the central bank will wish to make its intervention overt where it wishes to give the market the signal that it has a policy preference as to where the rate will be, and it has sufficient credibility that this signal will encourage expectations that this rate will be achieved and will thus move expectations toward that rate. For instance, in cases where there is a large discrete trade, overt smoothing operations may help avoid overreaction to market fluctuations. An additional reason for making intervention overt is where the central bank feels that it will anyway be unable to conceal the intervention and thus considers that giving the market accurate information on intervention will be preferable to the market generating

[15](...continued)
(see, for instance, Ungerer (1997), pp. 179-80)—under which it was agreed that the authorities should act to prevent exchange rates from reaching their bands, including through intramarginal intervention.

In order to prevent such restrictions becoming impossibly onerous and isolating the central bank too severely from the markets in which it is operating, the effects of such restrictions might be mitigated, for instance, by clarifying to the greatest extent possible ex ante the basis on which the central bank will be operating (so that the value of any proprietary information is limited), minimizing the time during which information is proprietary, and minimizing the number of central bankers who have access to it.

IV. Transparency Through Disclosure

Beyond the restrictions discussed above to prevent non-transparencies in central bank foreign exchange market activity, the most effective form of ensuring transparency is likely to be through the reporting of a central bank's activities in the foreign exchange market. Reporting can be of the flows or of the stocks of its foreign exchange involvement; the first typically comprises figures of central bank intervention, while the latter conventionally comprises figures for the country's foreign exchange reserve position.[23]

[22](...continued)
appropriate response to concern over revealing inside information might be that central bankers should maximize their exposure to the public media, and maybe the rating agencies, so that information would be quickly disseminated to the public as a whole.

[23]A further important source of transparency is through disclosure requirements through the accounts of the central bank. In the area of central bank accounting there has been a widespread trend toward higher standards of disclosure.

Both these forms of disclosure have been practiced for many years, and it is perhaps surprising that concerns about the drawbacks of the conventional presentations have emerged so recently. The first problem with intervention figures is that typically they have related only to intervention in the spot foreign exchange market by the central bank. As noted above, these figures may therefore exclude forward market intervention, or intervention by other state organs, including state-owned commercial banks.

Foreign reserves figures may be even more problematic.[24] They relate to the gross stock of foreign exchange assets (however defined) at a particular point in time. There is thus immediately a question as to what assets are included, and how they are valued—this is most pronounced in the case of holdings of gold. Probably even more seriously, they ignore foreign exchange obligations. Thus reserves can be inflated through forward transactions, in which the obligation to repay occurs after the measurement date, or simply through borrowings. Also, reserves may not be freely useable; some countries have placed some of their foreign reserves with the commercial banks, making their availability in part dependent on the soundness and the liquidity positions of those banks.

Recognition of these factors is not new. There appear to have been situations where a central bank has reportedly undertaken transactions in the forward market so that the reserves figures would give a truer picture of the extent of discretionary market intervention over a period

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[24]Issues concerning the statistical presentation of foreign reserves data are covered in IMF (1993) and IMF (1995).

when the actual figures had been significantly affected by the central bank's agency business for government, or by swings in other identifiable erratic items.[25] Also, the size of borrowings in foreign exchange reserves has frequently not been concealed. IMF drawings, and borrowings in the markets, are totally public. The United Kingdom, for instance, explicitly said that its ECU borrowings in the 1980s were intended to augment its reserves. Indeed, high gross reserves partially matched by borrowings may be seen as a sign of strength, showing—in the case of market borrowing—that the country has recourse to the markets, or—in the case of Fund drawings—that it is, or has been, operating in accordance with a Fund-supported program. The emphasis placed both in the major industrial countries, and more recently among the South East Asian countries, on having sizeable standing facilities available—which generally have to be repaid fairly quickly, and are entirely at the risk of the borrower—indicates that even borrowed reserves are considered useful.

Nevertheless, the continued focus on gross reserves, and the way in which these figures can be manipulated, may serve to detract from markets' proper understanding of the underlying economic condition of a country. The ability of the authorities to switch their assets between those that appear on balance sheet and those that are off balance sheet means also that reported rates of change of the assets have limited meaning. Without properly presented

[25]For instance, if there have been net purchases of say US$100 million in the foreign exchange market, but the central bank has spent US$200 million for delivery of an aircraft, it might not wish to give the wrong signal to the markets by reporting simply a US$100 million loss in reserves. Some of the spent dollars might therefore be temporarily reconstituted through a forward transaction.

figures on the external balance sheet of a central bank,[26] there may be a failure to detect emerging economic problems, and the opportunity to take remedial measures on a timely basis may be lost. Reviews of the economic crisis in Mexico in 1994 highlight the degree to which Mexican figures were non-transparent in the period before the crisis, and led to policy recommendations for greater transparency in data, including data on foreign exchange reserves. More recently, an important element in the Fund-supported program for Thailand has been the increase in transparency in the country's foreign exchange reserves. Thus in August 1997 the authorities for the first time published data on their forward positions as well as their spot positions. Such publication is still unusual. Only a few countries, most notably Australia, South Africa, and Thailand, publish such data on a timely and regular basis. The United Kingdom has announced[27] that it too will now publish its forward book.[28]

V. Further Issues in Disclosure of Foreign Exchange Activities

The issue arises to what extent the adoption of higher standards of disclosure among a few countries will prompt similar higher standards of disclosure among other countries. On the one hand, data on gross reserves have always been held in some importance, and their value

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[26] As well as of MoF and other government accounts in cases where they are not in the central bank.

[27] Speech by the Chancellor of the Exchequer at the Annual IMF/World Bank Meetings in Hong Kong, September 20, 1997.

[28] Further information can be obtained from the IMF Dissemination Standard Bulletin Board (http://dsbb@imf.org

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