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The impact of central bank intervention on exchange-rate forecast heterogeneity

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Beine, Michel, Bénassy-Quéré, Agnès, and MacDonald, Ronald—The impact of central bank intervention on exchange-rate forecast heterogeneity

We investigate the impact of official foreign exchange intervention on forecast heterogeneity, on the basis of a sample of forecasts made by a large number of commercial banks over two distinct periods, for the DEM (or EUR) and the JPY against the USD. We show that heterogeneity increases as a result of foreign exchange intervention. In the case of the DEM–EUR/USD market this increase is due to unexpected intervention, while for the JPY/USD it is due to expected intervention. Our results also emphasise the role of rumours, especially for the JPY/USD. In sum, official interventions are shown to move market opinions, albeit differently across the two markets. *J. Japanese Int. Economies* **21** (1) (2007) 38–63. University of Lille 2 (Cadre), France; Dulbea, University of Brussels, campus du Solbosch, avenue Franklin Roosevelt 50, B-1050 Brussels, Belgium; CEPII, 9 rue Georges Pitard, 75015 Paris, France; University of Glasgow, Department of Economics, Adam Smith Building, Glasgow G12 8RT, Scotland, UK.

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1. Introduction

Since the publication of the Jurgensen report (1983), suggesting that official foreign exchange market intervention had little impact on exchange rates, the effectiveness of such interventions has been controversial. In trying to gauge the effectiveness of intervention more recent research has sought to disentangle the portfolio channel from the signalling channel.¹ For example, using survey data on exchange-rate expectations, Dominguez and Frankel (1993) demonstrated that official interventions do have an impact both on the risk premium (portfolio channel) and on exchange-rate expectations (signalling channel). They also highlighted the importance of using interventions that are publicly advertised, as opposed to “secret” interventions, i.e., interventions not reported in the press or by wire services. Finally, Dominguez and Frankel showed that concerted interventions by several central banks were more likely to be successful. Using different empirical techniques, and sometimes a looser definition of successful intervention, Humpage (1999), Ramaswami and Samei (2000) or Fatum (2002) also found official interventions to be successful, especially when co-ordinated. However other authors have found little empirical evidence of official interventions moving the exchange rate in the desired direction: when significant, interventions were often found to push the exchange rate in the “wrong” directions; that is, a dollar purchase leads to a depreciation of the dollar (Edison, 1993; Baillie and Osterberg, 1997b; Beine et al., 2002).

The recent release of official data concerning Japanese interventions has moved the consensus back towards some effectiveness of interventions (Ito, 2002; Dominguez, 2003; Fatum and Hutchinson, 2003; Chaboud and Humpage, 2003; Castrén, 2004; Morel and Teiletche, 2004). This result, however, remains fragile since it is mainly based on a particular episode (Japanese large interventions under Mr. Sakakibara directorship of the International Finance Bureau of the Ministry of Finance) and/or on a specific empirical technique (the event study methodology), and Galati and Melick (2002) and Galati et al. (2004) do not provide support for such effectiveness using standard time series techniques.

The empirical literature has also devoted much attention to the impact of official interventions on exchange-rate volatility. This literature generally concludes that interventions tend to raise exchange-rate volatility, be this volatility measured as the realized variance (Beine et al., 2004), by conditional volatility (Baillie and Osterberg, 1997a, 1997b; Dominguez, 1998; Beine et al., 2002; Beine, 2004) or by implied expected volatility as recovered from option prices (Bonser-Neal and Tanner, 1996; Galati and Melick, 1999;

¹ The monetary channel is generally excluded since interventions by central banks have been routinely sterilized in industrialized countries. The portfolio channel covers the direct impact of official sales or purchases on market equilibrium. This channel is active to the extent that assets in different currencies are not perfect substitutes. The signalling channel works through official interventions containing some information about future monetary policy (Mussa, 1981).

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