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The Louvre Accord and central bank intervention: was there a target zone?

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Abstract

This paper presents an empirical analysis of central bank intervention during the 10-month period following the Louvre Accord. We first examine whether the Bank of Japan and the Federal Reserve adopted a target zone in order to stabilize the yen–dollar exchange rate, by using daily foreign exchange intervention data. We then estimate the expected future exchange rate and the expected rate of devaluation in order to verify if there was a credible target zone. On the basis of these two tests, we conclude that the central banks did adopt a target zone during the period following the Louvre Accord, but that the target zone for the yen–dollar exchange rate was not credible. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

Over the past decade, a considerable number of theoretical studies have analyzed the exchange rate target zone (e.g. Krugman, 1991; Bertola and Caballero, 1992; Bertola and Svensson, 1993). However, comparatively little attention has so far been paid to the target zone which is believed by some to have been adopted following the Louvre Accord.[1] Accordingly, this paper will present an empirical analysis of central bank intervention following the Louvre Accord of February 1987 in order to determine whether or not a target

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[1] As notable empirical studies, Flood et al. (1991) and Lindberg and Söderlind (1994) have examined the post-Louvre (as well as pre-Louvre) target zone in the context of the Exchange Rate Mechanism of the European Monetary System.

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zone was indeed adopted and, if so, to characterize the nature of that target zone. In particular, this paper will examine whether the Bank of Japan and the US Federal Reserve adopted a target zone in order to stabilize the yen–dollar exchange rate during the 10-month period following the Louvre Accord. If such a target zone is found to have existed, moreover, the paper will further analyze how credible the zone might have been by estimating the expected future exchange rate and the expected rate of devaluation.

On 22 February 1987, major industrial countries agreed that they would coordinate macroeconomic policies to stabilize exchange rates at 'around current levels' in what became known as the Louvre Accord. Although the details of the agreement were not made public, it is suggested in the popular literature that the countries adopted target zones as a way of maintaining exchange rate stability (Funabashi, 1989). Because they announced neither the central rates nor the bands for the exchange rate, it may be said that these were unofficial target zones, if the target zone arrangement was adopted at all.

According to Funabashi (1989), the central rates following the Louvre Accord were supposedly 153.50 yen and 1.825 marks per dollar with a band of ± 5 percent. In the case of the yen–dollar rate, it is also said that, on 7 April, the central rate was rebased to 146 yen per dollar in order to reflect the new market conditions. It should be noted, however, that no official statement ever confirmed the adoption of a target zone. The first of our tasks in this paper is thus to follow Lewis (1990) and to verify whether or not the central banks indeed adopted the target zone arrangement.

According to Bertola and Caballero (1992), Bertola and Svensson (1993) and others, the exchange rate would not be stable in a target zone, unless the zone were credible. The issue of target zone credibility in the context of the Exchange Rate Mechanism (ERM) of European Monetary System (EMS) and the Sweden krona has been analyzed by Bertola and Svensson (1993), Lindberg et al. (1993) and Svensson (1993), by estimating the expected rate of devaluation. Thus, our second task is to follow their methodology to examine how credible the target zone was during the period immediately following the Louvre Accord, by assuming that a target zone was indeed put in place.

The paper is organized as follows. Section 2 will present an overview of the Louvre Accord and post-Louvre intervention. Section 3 will ascertain whether or not the Bank of Japan and the US Federal Reserve adopted a target zone, by using a multinomial logit model. Section 4 will examine the credibility of the presumed target zone by estimating the expected future exchange rate and the expected rate of devaluation. Section 5 will present a summary and concluding remarks. Finally, Appendix A will outline the sources of data.

2. The Louvre Accord and central bank intervention: an overview

2.1. The Louvre Accord

Let us begin by presenting an overview of the Louvre Accord. The dollar had depreciated substantially against the other major currencies during the period following the Plaza Agreement of September 1985. In particular, the yen had appreciated from 240 to 155 yen to the dollar. The authorities of most major countries recognized that a further substantial shift in the value of their currencies could damage the prospect for economic

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