Why Was the Plaza Accord Unique?

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Plaza Accord Sept 22, 1985 was unique

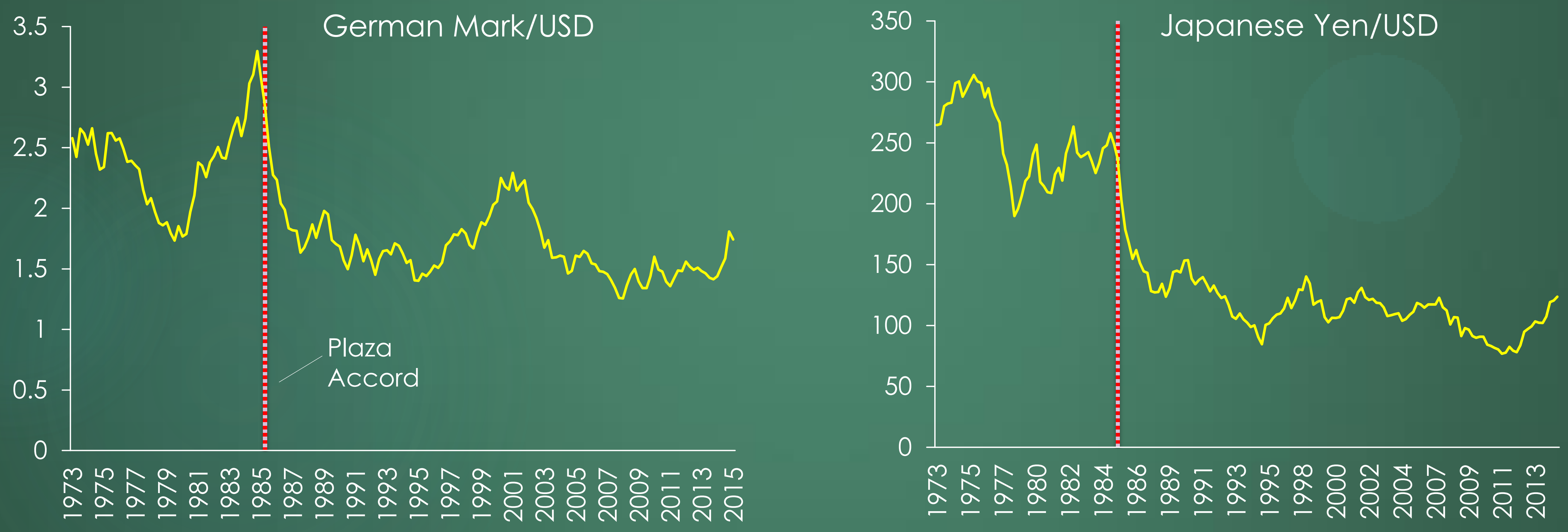
- It lasted
  - Dollar stayed low, continuing to decline for 2 years
  - Most agreements fall apart after months
- It worked
  - Achieved targeted 10-12% depreciation of dollar on time
  - Allowed US trade balance to adjust
  - Many other coordinated interventions have little impact
- It inspired
  - Spawned 2-4 year period of intense international coordination
  - Similar sustained interest in coordination not really seen elsewhere

Why Was the Plaza Accord Unique?

- Many Theories
  - Big surprise US policy shift to active dollar management
  - Uniquely strong protectionist sentiment
- Our hypotheses
  - Dollar misalignment in 1985 was greater than any time since 1973
  - Domestic monetary policy backed up the intervention for all three currencies
    - Dollar, yen, mark

Mark and Yen against the Dollar

Nominal Exchange Rates, 1973-2015



Real exchange rates adjusted for interest differentials

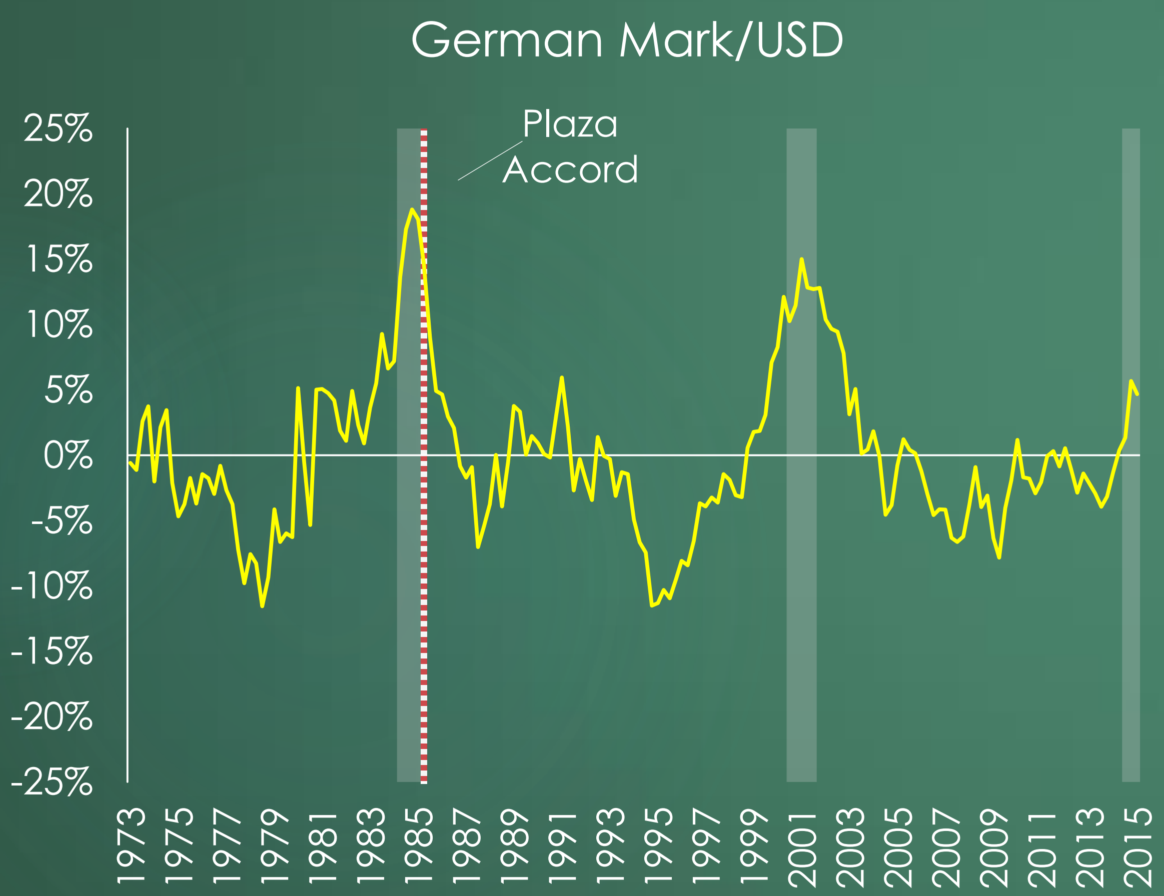
- Start with real interest parity
  - $E_t \Delta q_{t+1} = r_t - r_t^*$
  - q = real exchange rate, r = real interest rate
  - Need an assumption about future q

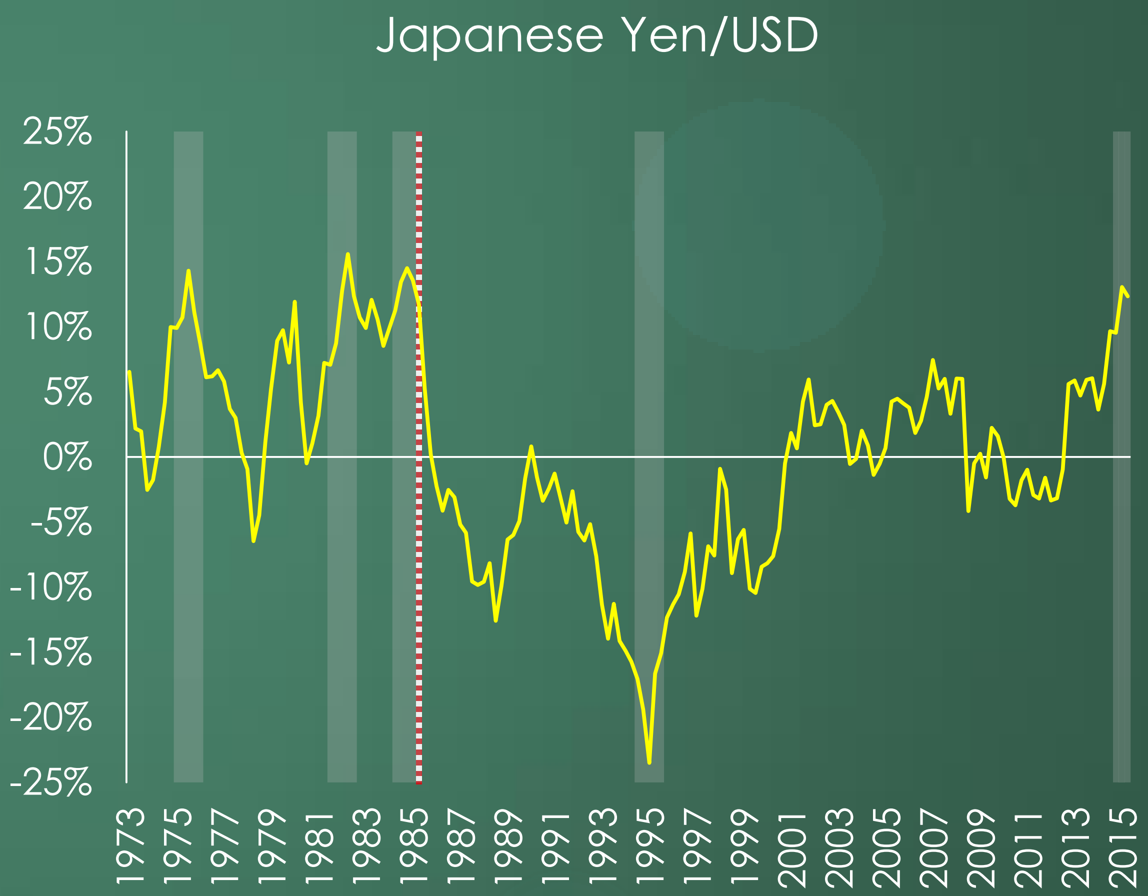
- Assume relative PPP, so real exchange rates are constant in long-run
  - "standard assumption", e.g. Edison and Melick (1999)

- Estimate $q_t = a + \beta r_t - r_t^*$ with OLS
  - Residuals are estimates of real exchange rate misalignment

Mark and Yen against the Dollar

Log Real Exchange Rates Adjusted for Real Interest Differentials, 1973-2015





Was Intervention Consistent with Monetary Policy?

- Evidence that FX intervention works is weak
  - One factor that helps is consistency with monetary policy
  - So tightening monetary policy is consistent with FX intervention to strengthen the currency

- How do we know which way monetary policy is headed at the time of FX intervention?

Taylor Rules Approximate Monetary Policy

- Taylor rule: widely used to evaluate monetary policy

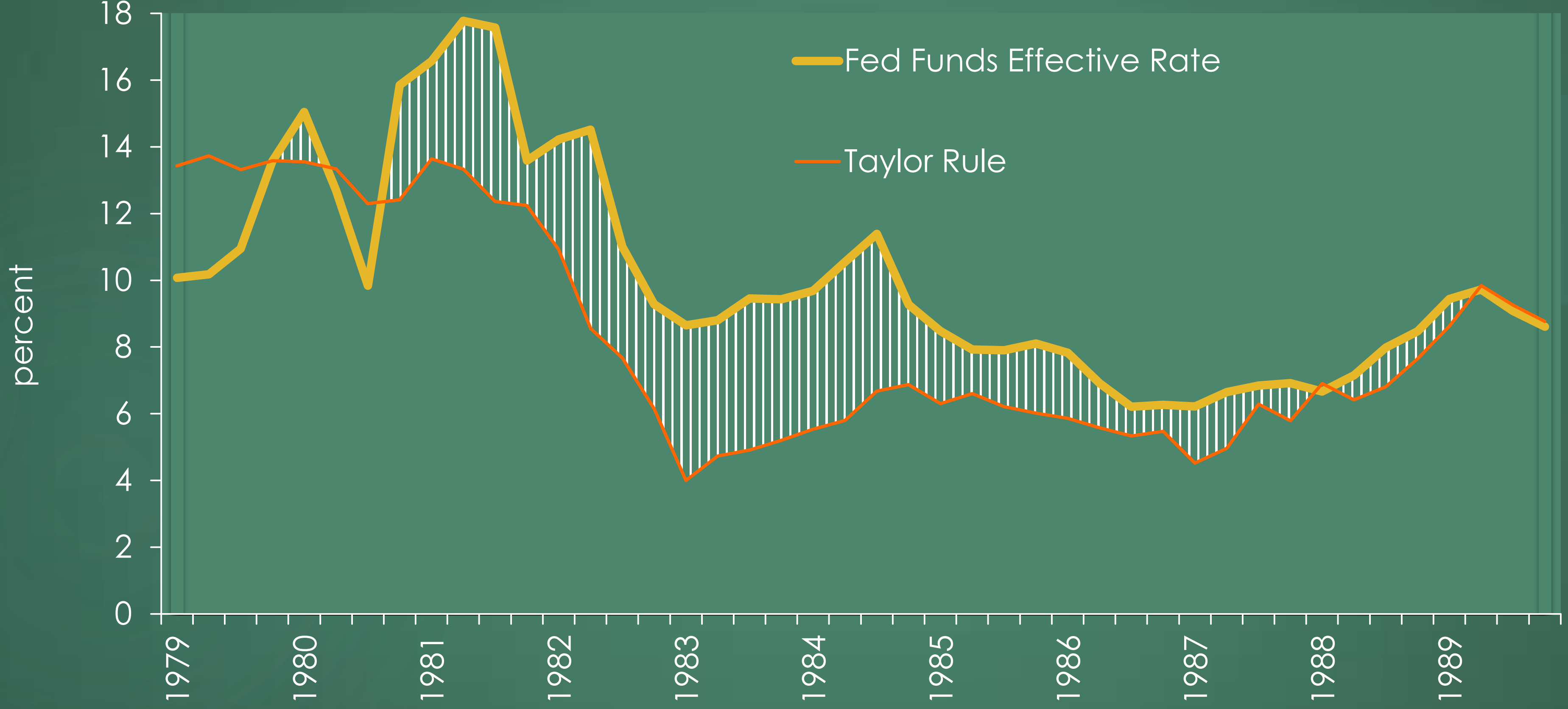
  $$i = 1 + 1.5 \times \pi + 0.5 \times \textit{output gap}$$

  - i = nominal interest rate, π= inflation rate

- Construct Taylor rules for US, Japan, Germany using real-time data

- We say a gap between the actual interest rate and the Taylor Rule rate indicates "policy space" to move towards the Taylor Rule

Interest Rates above Taylor Rule = Policy Space to Loosen



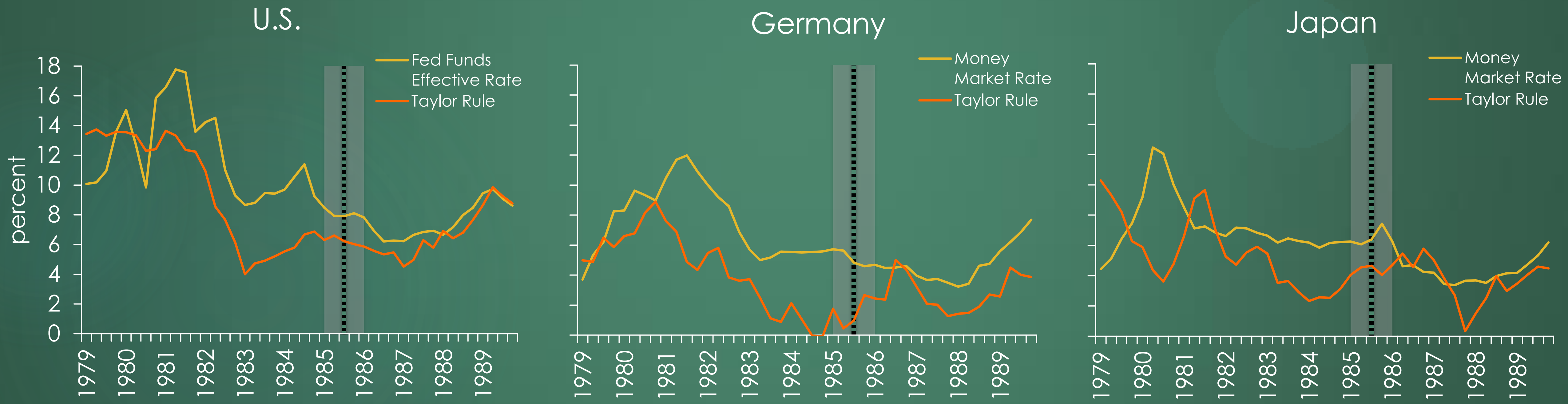
Was Intervention Consistent with Monetary Policy?

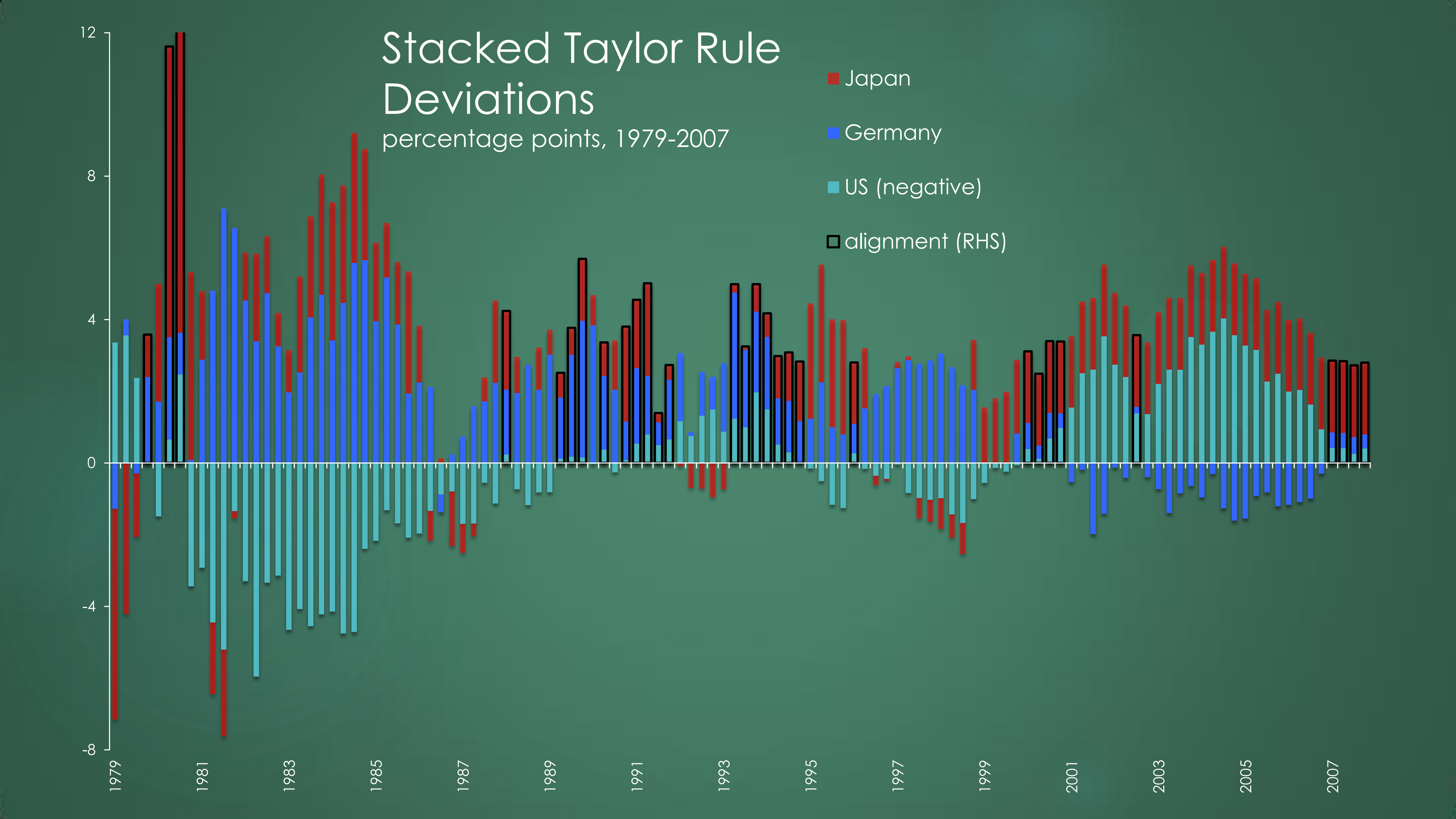
- For the Plaza Accord to have been consistent with monetary policy, we would need to see:

1. Does the U.S. have policy space to loosen?
   - Consistent with FX intervention to weaken the dollar

2. Do Germany and Japan have policy space to tighten?
   - Consistent with FX intervention to strengthen the mark and yen

Consistent?


U.S.
Germany
Japan
Fed Funds Effective Rate
Taylor Rule
Money Market Rate
Taylor Rule
Money Market Rate
Taylor Rule
percent
18
16
14
12
10
8
6
4
2
0
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989



Stacked Taylor Rule Deviations
percentage points, 1979-2007
Japan
Germany
US (negative)
alignment (RHS)
12
8
4
0
-4
-8
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007

The U.S. Was the Main Story at the Plaza Hotel

- We interpret the evidence that the Plaza effectiveness was driven by the U.S. story
  - Along with monetary policy consistency, there was the big switch in FX policy
- Maybe markets believed that Japan and Germany consider exchange rate factors in their monetary policy
  - Taylor rule may need an exchange rate term
- Maybe the Plaza intervention had no effect
  - Monetary policy consistency was irrelevant

Today

- Similarities
  - Dollar is strong
    - Not quite as strong
  - ECB and Japan should not want to tighten
- Differences
  - US is not going to loosen
  - Protectionist momentum is much lower

- Little chance of another Plaza soon