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The Lira: Back in the Zone

After more than four years, the Italian lira returned to the Exchange Rate Mechanism (ERM) of the European Union (EU) on November 25, 1996. A speculative attack had forced the withdrawal of the lira from the ERM on September 17, 1992. The ERM commits member countries to maintain their exchange rates within bilateral bands or target zones against all the other currencies. The lira is allowed to fluctuate within margins of 15 percent on both sides of the mid-point of the target zone, known as the central parity, which is 1.0101 DM per 1000 lire for the bilateral band with Germany. Although target zones are said to offer the advantages of more stable exchange rates and greater inflation credibility, the primary motivation of the Italian government for rejoining the ERM is the requirement that the lira remain within the target zone for at least two years before Italy can join the European Monetary Union (EMU). The EMU is scheduled to commence in January 1999 and will replace the currencies of its member states with a single European currency. Does the market believe the lira will be kept within the target zone?

The position of the forward exchange rate relative to the target zone at all horizons provides one simple indicator: If the forward rate is outside the target zone, market participants do not believe that the exchange rate band will be maintained. Thus, the band cannot be fully credible. To test this assertion, suppose that the forward rate at one year is less than the lower edge of the current target zone, 0.87719 DM per 1000 lire. If the target zone were completely credible, an investor could buy lire in the forward market and then sell them at the higher price in the future spot market, guaranteeing a profit. Such one-sided bets imply that the band is not fully credible.

The top panel shows the Italian experience during its previous period in the ERM. The lira's target zones were either 6 percent or 2.25 percent wide and

were frequently realigned. The forward rate in the top panel was frequently below the lower edge of the band. Thus, these narrow target zones were not seen as credible by the market. Since reentry, however, the forward rate, as shown in the lower panel, is well within the target zone, indicating that market participants expect the lira to remain within the target zones. Thus, the current wide bands appear to be more credible than the narrower bands of the earlier period.

— Christopher J. Neely

Target Zone, Spot and 1-year Forward Rate

