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ESTUDOS DO GEMF

N.º 3

2008

**PUBLICAÇÃO CO-FINANCIADA PELA  
FUNDAÇÃO PARA A CIÊNCIA E TECNOLOGIA**

Impresso na Secção de Textos da FEUC  
COIMBRA 2008

# Exchange Rate and Interest Rate Volatility in a Target Zone: The Portuguese Case

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## Abstract

This work examines the participation of the Portuguese economy in the ERM of the EMS based on some of the main predictions of the target zone literature. The exchange rate distribution reveals that the majority of the observations lie close to the central parity, thus rejecting one of the key predictions of the Krugman (1991) model. Using a M-GARCH model however we confirm that there is a trade-off between exchange rate volatility and interest rates differential volatility. These results express the increased credibility of the Portuguese monetary policy, due mainly to the modernisation of the banking and financial system and to the progress made in terms of the disinflation process under an exchange rate target zone policy. In accordance to these results we can say that the participation of the Portuguese escudo in an exchange rate target zone was crucial to create the conditions of stability, credibility and confidence necessary for the adoption of a single currency.

**JEL Classification:** C32, C51, F31, F41, G15.

**Key Words:** Credibility, exchange rate stability, M-GARCH, ERM, EMS, volatility and target zones.

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<sup>1</sup> The authors thank Pedro Bação and Marta Simões for their helpful comments. The usual disclaimer applies.

## 1 – Introduction

The target zones are one of the exchange rates regimes that have been more often used throughout history, from the classical gold standard until the current exchange rate arrangement in the ERM II of the European Union. However, the traditional debate concerning the choice of appropriate exchange rate regime has neglected this fact, focusing its attention on the choice between fixed or flexible exchange rates<sup>2</sup>.

The functioning of the ERM of the EMS remains one of the best examples of a target zone regime. From March 13<sup>th</sup>, 1979 the majority of the currencies fluctuated within a band of  $\pm 2,25\%$  built around a central parity reference. The exchange rates could float more or less freely within an exchange rate band, committing the respective central banks to intervene whenever the target zone was threatened, which happened whenever the exchange rate reached one of the pre-established limits.

After some initial theoretical research on the functioning of exchange rate target zones, with major contributions from McKinnon (1982, 1984), Williamson (1985), Williamson and Miller (1987) and Dumas (1989), the literature on the subject has known a revival with the introduction by Krugman (1991) of the first model of a nominal exchange rate target zone in continuum time with rational expectations and flexible prices, using the structure of regulated Brownian motion<sup>3</sup>.

The basic target zone model has quite interesting implications for the behaviour of the exchange rate and the interest rates differential. The model predicts that the statistical distribution of the exchange rate must be U-shaped or bimodal, with a greater number of observations lying close to the edges of the band. Additionally, it predicts that the exchange rate is much less variable the closer it is to the edges of the band and that there is a negative relationship between the exchange rate and the interest rate differential. Therefore, we should find evidence of a trade-off between the volatility of the exchange rate and the volatility of the interest rates differential. These predictions can be tested against real world data in order to confirm the validity of the model and the credibility of the bands.

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<sup>2</sup> See Frankel (1999), Reinhart (2000), Fischer (2001), Calvo and Reinhart (2002), Bordo (2003), Reinhart and Rogoff (2004) and Levy-Yeyati and Sturzenegger (2005).

<sup>3</sup> Details of this literature can be found in Svensson (1992a), Magnier (1992), Bertola (1994), Garber and Svensson (1995), Pansard (1997) and Kempa and Nelles (1999). For a literature survey see the introduction in Krugman and Miller (1992).

However, although the former model leads to interesting predictions regarding exchange and interest rates differential dynamics these were rejected by empirical analyses of data. Examples can be found in Diebold and Nason (1990), Meese and Rose (1991), Flood, Rose and Mathieson (1991), Svensson (1991a, b), Frankel and Phillips (1992) and Lindberg and Soderlind (1994). These empirical results gave birth to the development of a set of critical extensions that include Svensson (1991c), Froot and Obstfeld (1991), Bertola and Caballero (1992) and Bertola and Svensson (1993), just to name a few.

This paper analyses the functioning of the Portuguese exchange rate target zone under the participation of the Portuguese escudo in the ERM of the EMS. Our main aim is to study the behaviour and volatility of exchange and interest rates based on the predictions of the first generation of target zones models. Our contribution to the literature stems from the fact that we are analysing a currency from the periphery of the system, the Portuguese escudo, while most previous work has focused on the Nordic countries and on fluctuation bands of the ERM of the EMS considered to be more stable and credible.

The paper is structured as follows. Section 2 examines the functioning of the Portuguese exchange rate target zone during the participation of the Portuguese escudo in the ERM of the EMS. Section 3 analyses the distribution and volatility of exchange and interest rates under the Portuguese exchange rate target zone. Section 4 explores the existence of a trade-off between exchange rate volatility and interest rates differential volatility under a M-GARCH model. Finally, Section 5 draws some conclusions.

## 2 – The Portuguese Exchange Rate Target Zone

On April 6 1992, the framework of the Portuguese monetary and foreign exchange policy changed when the Portuguese escudo joined the ERM of the EMS. This was made possible by the better convergence of the Portuguese inflation rate with the EU's average level and, in particular, with the values recorded by Germany. The central parity was fixed at 178,735 and 86,9393 escudos for the ECU and for the Deutschmark, respectively, and the Portuguese escudo was allowed to fluctuate within a band of  $\pm 6\%$ .

As there was a formal commitment to keep the Portuguese escudo within the band from this date, the credibility of the disinflation policy increased, facilitating the pursuit of the price stability goal. This foreign exchange policy course was maintained until the end of 1998, in spite of the disturbances that affected the EMS. Table 1 summarizes these events, allowing us to identify the main features of the Portuguese exchange rate target zone while the Deutschmark was the reference currency.

**Table 1: Bands for the Portuguese Target Zone (PTE/DM)**

Period / Date	Band	PTE/DM <sup>(a)</sup>		
		Lower Edge <sup>(b)</sup>	Central Parity	Upper Edge <sup>(b)</sup>
6 April 1992 <sup>(c)</sup>	$\pm 6\%$	81,9	86,9393	92,336
23 November 1992 <sup>(d)</sup>	$\pm 6\%$	87,108	92,488	98,232
13 May 1993 <sup>(e)</sup>	$\pm 6\%$	93,197	98,9177	105,042
2 August 1993 <sup>(f)</sup>	$\pm 15\%$	85,179	98,9177	114,811
6 March 1995 <sup>(g)</sup>	$\pm 15\%$	88,277	102,505	119,033

Source: Banco de Portugal.

Note: (a) Portuguese escudos necessary to buy one Deutschmark.

(b) The lower (upper) edge represents the maximum appreciation (depreciation) permitted to the Portuguese escudo against the Deutschmark.

(c) Membership of the Portuguese escudo of the ERM of the EMS with a bandwidth of  $\pm 6\%$ .

(d) Realignment in the EMS with a devaluation of 6% of the Spanish's peseta and the Portuguese escudo.

(e) Realignment in the EMS with a devaluation of 8% of the Spanish's peseta and 6,5% of the Portuguese escudo.

(f) Enlargement of the bands of the ERM to  $\pm 15\%$ , with the exception of the guilder/deutschmark exchange rate that maintained the  $\pm 2,25\%$  band.

(g) Realignment in the EMS with a devaluation of 7% of the Spanish's peseta and 3,5% of the Portuguese escudo.

In Figure 1 we depict the behaviour of the Portuguese escudo exchange rate against the Deutschmark and the evolution of the overnight interest rates differential between Portugal and Germany as part of the PTE/DM band<sup>4</sup>. Besides the target zone period, we simulated, from January 2 1987 to April 5 1992, an unofficial band of  $\pm 6\%$ , with an unofficial central parity (No\_C\_PTE\_DM) and unofficial intervention edges (No\_LI\_PTE\_DM\_6 and No\_LS\_PTE\_DM\_6) equal to that adopted on joining<sup>5</sup>.

<sup>4</sup> See Appendix I for a description of the data used.

<sup>5</sup> See Appendix II for a complete list of variables and their description.

**Figure 1: PTE/DM Exchange Rate and Overnight Interest Rate Differential**

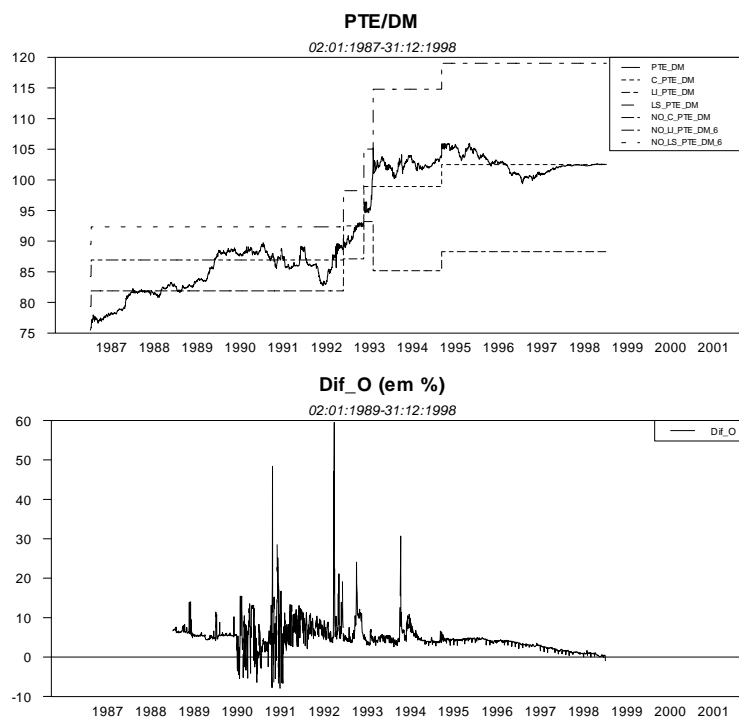


Figure 1 shows that the PTE/DM exchange rate had been relatively stable since the beginning of the 1990s. This was the result of the pegging of the Portuguese escudo to the Deutschmark, which allowed the Portuguese currency to benefit from the credibility, stability and discipline associated with the tacit acceptance of the anti-inflationary stance of the Bundesbank's monetary policy.

Concentrating on the target zone period, it is possible to confirm that after joining the ERM, the Portuguese escudo registered a significant nominal appreciation and an almost immediate decline to a value near the lower edge of its band. Furthermore, everything seems to indicate that the realignments were anticipated, given the high interest rates differential before the realignments. After the widening of the bands, the exchange rate again stabilises, but now within the implicit band of  $\pm 6\%$ <sup>6</sup>.

The effectiveness of the nominal stabilisation policy of the escudo allowed the Portuguese economy to substantially reduce inflation deviation against Germany. From 1992 onwards there was a gradual disinflation process in Portugal, expressed on a continuous decline in the inflation rate which coincided with the participation of the Portuguese escudo in the exchange rate target zone.

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<sup>6</sup> The use of interest rates with longer maturity times does not change these results. Similar conclusions were also obtained for the PTE/ECU exchange rate. Due to space limitations, we are only presenting the most important results. The other analyses are available from the corresponding author on request (email: portugal@fe.uc.pt).

Nevertheless, despite the fact that Portugal has made great strides in its European integration process, it should also be mentioned that disinflation brought about a drop in competitiveness due to the real appreciation of the escudo. This affected output growth and, consequently, employment, particularly in the sectors more open to international competition<sup>7</sup>. In comparison to other European countries, the costs of the disinflation process in Portugal seem relatively modest, at least at first<sup>8</sup>. However, the more aggressive effects of the exchange rate appreciation policy are felt in the long run, even if everything seems to indicate that in the short run the costs of the disinflation are relatively low. The findings of Rebelo and Végh (1995), European Commission (2004) and Abreu (2006) pointed in this direction. The main issue seems to lie in the fact that Portugal has joined the ERM of the EMS with a currency too appreciated.

The issues recently raised by the Bruegel policy brief seem to support these conclusions<sup>9</sup>. The first seven years of participation in the euro zone show that some countries, such as Ireland, have been successful, but others, such as Portugal, have faced some adjustment costs. In the case of Ireland, the appreciation of the real exchange rate was quickly adjusted by substantial improvements in terms of productivity and by upward movements in the value of tradable goods. In Portugal, however, the slow growth of productivity and the composition of exports, based on traditional sectors with low added-value, made the country more vulnerable to international competition from countries with low production costs, especially China and new European Union member states.

It was nevertheless possible to begin a cycle of exchange rate stability. Thus, improved competitiveness must be based on structural adjustments. Competitiveness requires productivity gains, which will depend to a great extent on the modernisation of the tradable goods sector and also to a depreciation of the real exchange rate and a tighter budgetary discipline, which may require an extended period of wage moderation. Careful monitoring of credit expansion is also essential to prevent an overshooting of domestic prices, especially because Portugal has to adjust to lower interest rates that it hasn't historically been accustomed to.

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<sup>7</sup> See Duarte (2001, 2002) and Macedo (2006).

<sup>8</sup> For suggestive evidence see Barbosa and Machado (1996).

<sup>9</sup> See Ahearne and Pisani-Ferry (2006).

### 3 – Distribution and Volatility under the Portuguese Exchange Rate Target Zone

According to the basic target zone model proposed by Krugman (1991), the behaviour of the exchange rate within the band depends on an aggregate fundamental and its expected rate of change, as can be described by the following equation:

$$s(t) = f(t) + \alpha E_t[ds(t)] / dt, \quad \forall t \text{ and } \alpha > 0, \quad (1)$$

where  $s(t)$  is the log of the nominal exchange rate at time  $t$ ,  $f(t)$  is the fundamental at time  $t$ ,  $\alpha$  is the absolute value of the semi-elasticity of the exchange rate with respect to its expected rate of change and  $E_t$  is the expectations operator conditional on the available information at time  $t$  according to the rational expectations hypothesis.

The fundamental is the sum of two components,

$$f(t) = m(t) + v(t), \quad (2)$$

the domestic money supply,  $m(t)$ , and a term representing a composite money demand shock, usually referred to in the literature on target zones as “velocity”,  $v(t)$ . The model assumes that “velocity” is an exogenous stochastic process, whereas the money supply is a stochastic process controlled by the monetary authorities. The question is then how the presence of a credible floating band may affect the behaviour of the exchange rate.

In the absence of any intervention, a situation common in a free floating regime, it is assumed that the money supply  $m(t)$  is kept constant. As a consequence, the fundamental is simply equal to “velocity”,  $f(t) = v(t)$ . It is thus assumed that “velocity” follow a Brownian motion with drift  $\mu$  and instantaneous standard deviation  $\sigma$ :

$$dv(t) = \mu dt + \sigma dz(t), \quad \mu \text{ and } \sigma \text{ positive parameters and } v(0) > 0, \quad (3)$$

where  $z(t)$  is a Wiener process with  $E_t[dz(t)] = 0$  and  $E_t[(dz(t))^2] = dt$ , that is,  $f(t)$  is the equivalent of a continuous random walk<sup>10</sup>.

This assumption implies that the exchange rate under a free floating regime is also a Brownian motion. Therefore, changes in the fundamental will translate into equal changes in the exchange rate,  $ds(t) = df(t)$ .

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<sup>10</sup> See Merton (1992), Campbell, Lo and Mackinlay (1997), Maddala and Kim (1999) and Demange and Rocher (2005).



In a target zone, it is assumed that the intervention rule is based on a specific floating band for the fundamental,  $f_L \leq f(t) \leq f^U$ , and that, if necessary, the fundamental will be regulated to remain within the band. This implies that the fundamental follows a regulated Brownian motion with constant drift and instantaneous standard deviation<sup>11</sup>:

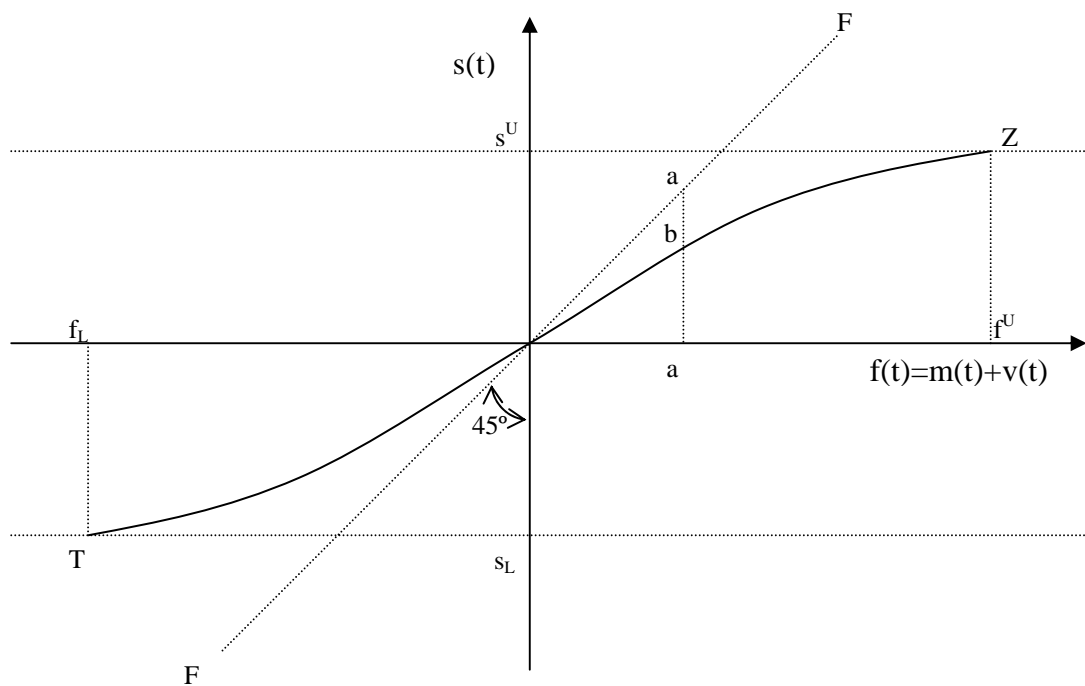
$$df(t) = \mu dt + \sigma dz(t) + dL(t) - dU(t), \quad (4)$$

where  $L(t)$  and  $U(t)$  are the lower and upper regulators, defined as continuous and increasing functions of  $t$ , so that  $dL(t)$  represents increases in the money supply, positive only if  $f(t)=f_L$  and  $dU(t)$  represents decreases in the money supply, positive only if  $f(t)=f^U$ . It is thus necessary to assume that the probability distribution of the interventions is determined by the current level of the fundamental,  $s(t) = s(f(t))$ , so that the exchange rate function in a target zone will be flat at the edges of the fundamental band and tangent to the edges of the exchange rate band:

$$s'(f_L) = s'(f^U) = 0. \quad (5)$$

Under these circumstances, the exchange rate function establishes a non-linear relationship between the exchange rate and its fundamental, as illustrated in Figure 2.

**Figure 2: Exchange Rate in a Perfectly Credible Target Zone**



<sup>11</sup> Harrison (1985) and Karatzas and Shreve (1997) provide a formal presentation of these processes.

The straight-line FF represents the equilibrium exchange rate in the free floating case. A shock in  $v(t)$  leads to a proportional change in  $f(t)$  and  $s(t)$ . According to equation (5), the exchange rate target zone function is tangent to the edges of its floating band, where  $s_L = s(f_L)$  and  $s^U = s(f^U)$ , represented by the curves TZ, non-linear, and S-shape, respectively.

The behaviour of the exchange rate in a target zone with perfect credibility leads to two main results. First, the slope of the curve TZ is always less than one. This feature is called “the honeymoon effect”, a reference by Krugman (1987: 19) to a “target zone honeymoon”. The exchange rate function thus appears less sensitive to changes in the fundamental than the corresponding free floating exchange rate. Moreover, the part of the adjustment supported by the exchange rate in a target zone is not constant, but decreases as the exchange rate moves away from the central parity. The “honeymoon effect” thus implies that a perfectly credible target zone is inherently stabilizing<sup>12</sup>.

Second, the curve TZ becomes flatter, reaching a zero slope at the edges of the band. At the edges of the target zone, the exchange rate function is tangential to the horizontal dashed lines that represent the edges of the exchange rate band. This result, represented by equation (5), is known as “smooth pasting” conditions, which correspond to the continuity conditions for the solution of the basic model. Given these conditions, the model predicts that the statistical distribution of the exchange rate must be U-shaped or bimodal.

We analysed the asymptotic distribution of the exchange rate within the band based on the work of Harrison (1985), Svensson (1991a) and Bertola and Caballero (1992). Since the exchange rate function,  $s(f)$ , is strictly increasing and invertible only on the interior of the band, the asymptotic density function of the exchange rate,  $\varphi^s(s)$ , is given by:

$$\varphi^s(s) = \frac{\varphi^f(f(s))}{|s'(f(s))|}, \quad (6)$$

for  $s_L < s < s^U$ , where  $f(s)$  denotes the inverse of  $s(f)$ . Since the fundamental is uniformly distributed, the exchange rate will change slowly near the edges of the band. The exchange rate will thus tend to fix itself in the region where it changes more slowly and  $\varphi^s(s)$  should present a peak near  $s_L$  and  $s^U$ .

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<sup>12</sup> Returning to Figure 2, if we consider that a positive random shock in  $v(t)$  increases the fundamental from the origin to point  $a$ , under a free floating regime the exchange rate increases by the same amount. However, in a target zone, agents recognize that there is a high probability of a future contraction in the money supply. Thus, agents expect the future appreciation of the exchange rate. This results in an equilibrium exchange rate that is less than  $a$ , at point  $b$ .

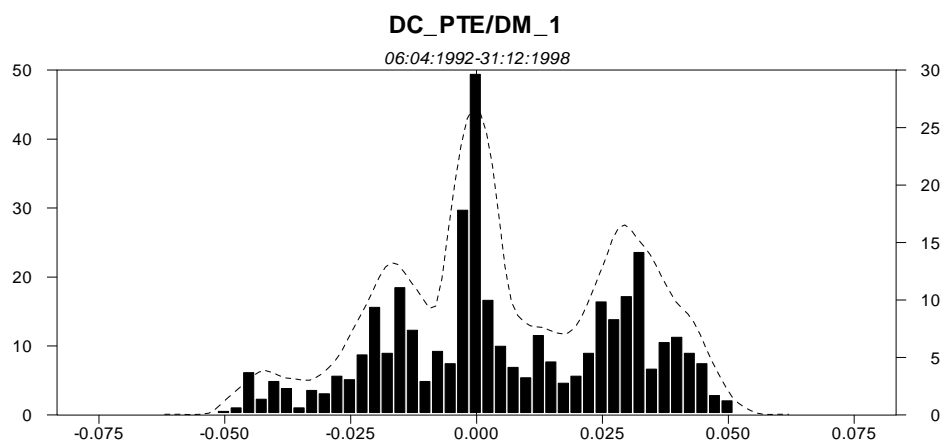
The model also implies that the exchange rate will be much less variable near the edges of the band. According to the model, the instantaneous variability of  $s(t)$  is directly proportional to the slope of the curve TZ:

$$V(t)[ds(t)] = [s'(f(t))\sigma]^2 dt, \quad (7)$$

where  $V(t)[ds(t)]$  is the conditional variance of the changes in the exchange rate. The variability of the exchange rate thus reaches a maximum at the centre of the exchange rate band and decreases as the exchange rate gets closer to the edges of the band.

Figure 3 shows the frequency distribution and the Kernel estimation of the PTE/DM exchange rate function for exchange rate regime 1 (Whole period in the ERM of the EMS<sup>13</sup>).

**Figure 3: Frequency Distribution and Kernel Estimation of the Probability Density Function of the PTE/DM Exchange Rate (Regime 1)**



We used the Epanechnikov function<sup>14</sup> for the analysis of the density distribution of the exchange rate. As we can see, most of the observations of the PTE/DM exchange rate often lie close to the central parity<sup>15</sup>. Despite the nominal exchange rate stabilization process, enabled by the participation of the Portuguese escudo in an exchange rate target zone regime, the U-shaped or bimodal density of the exchange rate is rejected by the statistical analysis of data<sup>16</sup>.

<sup>13</sup> See Appendix I for a description of the remaining periods used in the empirical analysis.

<sup>14</sup> RATS 6.2 uses the Normal distribution as Kernel, represented by the dotted line, while the histogram is represented by the vertical bars. See Pagan and Ullah (1999).

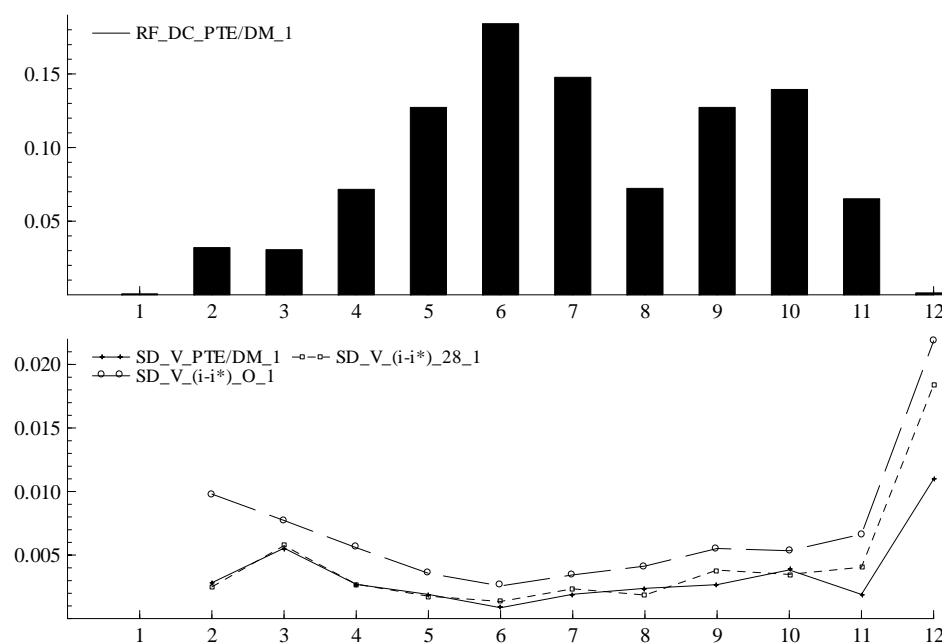
<sup>15</sup> The left axis concerns the histogram, as the right axis corresponds to the Kernel estimation.

<sup>16</sup> For the remaining exchange rate regimes, see Figure A.1 in Appendix IV.

We also evaluated the distribution of the exchange rate series in specific intervals of exchange variation of identical width. From this analysis, we proceeded to study the exchange rate and the interest rates volatility in each sub-interval used in the histograms. For this, we considered twelve sub-intervals in the  $\pm 6\%$  fluctuation band.

As can be seen from Figure 4 (top), most of the observations lie close to the central parity for the whole target zone period, thus rejecting once again the U-shaped or bimodal density of the exchange rate<sup>17</sup>.

**Figure 4: Exchange Rate and Interest Rate Distribution and Volatility (PTE/DM, Regime 1)**



The analysis of the histograms also allowed us to conclude that only in the period immediately after the Portuguese escudo joined the ERM (exchange rate regimes 2 and 8) were there a larger number of observations lying close to the limits of the band, although this is not very pronounced near the upper edge. The autonomy in monetary policy making as well as in exchange rate policies, possibly due to the maintenance of capital movement restrictions, explains the stability of the exchange rate near the edges of the band.

<sup>17</sup> At the bottom of Figure 4 we represent the exchange rate and interest rates differential volatility in each sub-interval considered in the histogram. We return to this subject later. For the remaining exchange rate regimes, see Figure A.2 in Appendix IV.

For the remaining exchange rate regimes, the U-shape in the distribution of the PTE/DM exchange rate is clearly rejected by the analysis of the histograms<sup>18</sup>. Table 2 summarizes the fundamental nature of these results.

**Table 2: Relative Frequency of PTE/DM Exchange Rate Observations in Twelve Sub-Intervals of the Band**

Regime	Lower Edge <sup>(a)</sup> (%)	Centre of the Band <sup>(b)</sup> (%)	Upper Edge <sup>(c)</sup> (%)	Distribution
1	13,50	53,17	33,33	∩
2	48,18	33,58	18,24	∪;
3	46,67	53,33	0	—
4	9,44	6,78	83,78	∪
5	6,42	77,74	15,84	∩
6	53,31	37,28	9,41	∪
7	4,58	57,03	38,39	∩
8	50,33	31,79	17,88	∪;
9	9,56	55,45	34,99	∩
10	49,61	48,31	2,08	—
11	0	94,71	5,29	∩

**Note 1:** (a) Sum of the relative frequencies of the sub-intervals 1 to 4 (%).

(b) Sum of the relative frequencies of the sub-intervals 5 to 8 (%).

(c) Sum of the relative frequencies of the sub-intervals 9 to 12 (%).

**Note 2:** ∩= bi-modal or U-shaped distribution (larger number of observations near the edges of the band); ∪= uni-modal or unshaped distribution (larger number of observations near the centre of the band); ∪= uni-modal distribution in the form of “U cut to the right” (larger number of observations near the lower edge of the band); ∩= uni-modal distribution in the form of “U cut to the left” (larger number of observations near the upper edge of the band); — = Undetermined distribution.

**Suggested reading:** In regime 1, 13,5% of the PTE/DM exchange rate observations are located near the lower edge of the band, 53,17% concentrated in the centre of the band and 33,33% located close to the upper edge of the band. Thus, the PTE/DM exchange rate presents a uni-modal or unshaped distribution, indicating a larger number of observations in the sub-intervals related to the centre of the band.

This lack of conformity with theoretical predictions, instead of indicating a lack of credibility of the bands, may be due to the existence of intra-marginal interventions, which were frequent during the period under analysis. Since the intra-marginal interventions limit the amount of time spent by the exchange rates near the edges of the band, their occurrence take the exchange rates close to the central parity, thus contributing decisively to the rejection of the first prediction of the model.

Table 3 presents the annual variation of the official foreign exchange reserves held by the Portuguese monetary authorities from 1990 to 1997. Its evolution allows the frequency of intra-marginal interventions to be evaluated and also helps to understand how the Portuguese authorities managed to stabilize the behaviour of the Portuguese escudo within the band, even during the periods of disturbance in the ERM.

<sup>18</sup> The results are not very different from those in Flood, Rose and Mathieson (1991), Bertola and Caballero (1992), Magnier (1992) and Lindberg and Soderlind (1994) for the case of the fluctuation bands of the countries of the centre of the EMS and for the Swedish unilateral target zone.

**Table 3: Annual Variation of the Official Foreign Exchange Reserves**

Year	Variation of Foreign Exchange Reserves (10 <sup>6</sup> PTE)		
	Foreign Currencies	Officials ECU	Total <sup>(a)</sup>
1990	412304	28350	440654 <sup>(b)</sup>
1991	809500	-4597	804903 <sup>(c)</sup>
1992	84218	-44350	39868
1993	-113106	89212	-23894
1994	-304108	-23914	-328022
1995	-72200	-53400	-125600
1996	79200	28800	108000
1997	332700	54900	387600
1992	-932	-528	-1460 <sup>(d)</sup>

Source: Adapted from the Reports of the Banco de Portugal.

Notes: (a) Positions at the end of period. Assets of the monetary authorities (Banco de Portugal and Tesouro), excluding gold and other assets.

(b) Variation evaluated initially in U.S. dollars. Subsequently it was used as conversion factor the PTE/USD exchange rates on December 29 1989 and December 31 1990.

(c) Variation evaluated initially in U.S. dollars. Subsequently it was used as conversion factor the PTE/USD exchange rate on December 31 1990.

(d) Variation evaluated in U.S. dollars.

As can be seen, during the periods of greater instability in the EMS, when the central parity of the Portuguese escudo was realigned, there was a fairly significant reduction in the foreign exchange reserves held by the Portuguese monetary authorities<sup>19</sup>. A few months after the beginning of the participation of the Portuguese escudo in the exchange rate mechanism, the Portuguese central bank began to lose quite substantial amounts of foreign exchange reserves. The realignment on November 23 1992 only temporarily relieved the pressure on the Portuguese currency, with the foreign exchange reserves again declining in March and April 1993. The realignment of the following month introduced some stability to the foreign exchange market. In an attempt to defend the original central parity with which the Portuguese escudo joined the exchange rate target zone of the EMS, and afterwards the parity adopted in November 1992, the Banco de Portugal lost in little more than six months around 30% of the foreign exchange reserves it held in late August 1992<sup>20</sup>.

In Table 4 the results of the foreign exchange intervention of the Banco de Portugal during those months are presented.

<sup>19</sup> In 1992 the total foreign exchange reserves, expressed in Portuguese escudos, increased by 39868 million escudos, but when evaluated in USD, they fell by 1460 million dollars. The variation in escudos can only be justified by the fact that, in terms of end of period positions there was a depreciation of the Portuguese currency, which increased from 134,184 escudos per dollar, to 146,758 escudos per dollar.

<sup>20</sup> See Loureiro (1998).

**Table 4: Monthly Change in the Foreign Exchange Reserves of the Banco de Portugal**

<b>Period / Date</b>	<b>Change in the Foreign Exchange Reserves (10<sup>6</sup> PTE)</b>
September 1992	-513393
October	-117789
November	-82416
December	127574
January 1993	124123
February	10399
March	-436538
April	-113102

Source: Adapted from Loureiro (1998).

**Note 1:** The evolution observed in the foreign exchange reserves reflects only the foreign currency reserves of the Banco de Portugal, and does not include gold or foreign exchange reserves held by the Treasury.

**Note 2:** Positive (negative) changes mean purchase (sale) of foreign currency by the Banco de Portugal.

**Note 3:** The changes in the foreign exchange reserves were evaluated initially in Deutschmarks. Subsequently, the PTE/DM monthly average exchange rate was used as conversion factor. It is assumed that the change in foreign exchange reserves results from the intervention in a single market, the reference market of the EMS, the Deutschmark market. This arises from the way in which the system operates, characterized by the fact that the Bundesbank is responsible for operating on the U.S. dollar foreign exchange market, while at the same time the other central banks have to operate through the ERM, to keep their currencies aligned with the Deutschmark.

As can be observed, in the periods preceding the realignments, the foreign exchange reserves suffered a marked fall in the attempt to defend the central parities. The foreign currency sales helped to cope with the speculative attacks on the Portuguese currency. We can also see that the foreign exchange reserves were restored in the periods immediately following the realignment. The change of central parity relieved the pressure on existing foreign exchange reserves, avoiding their total depletion. By using these two ways it was possible to keep the exchange rate in the target zone regime and, more importantly, close to the central parity. This analysis makes it is possible to explain the results lack of conformity with the predictions of the literature.

On the other hand, the fact that the Portuguese escudo floated within a wide band of  $\pm 6\%$  implied a lower probability that the edges of the target zone would be reached. If a narrow band of  $\pm 2,25\%$  had been adopted, the exchange rates would certainly have remained near the boundaries of the target zone more often.

However, the proximity of the exchange rates to the edges of the band should not be regarded by itself as a measure of lack of credibility, as it may simply indicate that the target zone is being tested by the agents operating in the market. It is also important to analyse the volatility of the exchange rate as it gets closer to the edges of the band. According to the literature, evidence of lower volatility near the edges of the band is an indicator of credibility. In most exchange rate regimes, the PTE/DM exchange rate volatility tends to increase as the exchange rate approaches the edges of

the band, particularly the upper edge, contrary to theoretical predictions<sup>21</sup>. However, this lack of conformity with the predictions of the basic model should not be interpreted as indicating the lack of credibility of the Portuguese escudo floating band. It is important to remember that the escudo very rarely approached the edges of the band, where the existence of less volatility in the exchange rate should be more obvious.

The exchange rate volatility analysis also confirms that the realignments are preceded by periods of above average volatility, largely as a result of speculative attacks and fear of a sudden depreciation in the currency value. The periods immediately after the realignments, however, are characterized by below-average exchange rate volatility, due to the fact that the weak competitive position of the currency has been restored<sup>22</sup>.

#### **4 – Trade-off between Exchange Rate Volatility and Interest Rates Differential Volatility under the Portuguese Exchange Rate Target Zone**

The basic model has also implications for the behaviour of the interest rates differential that emphasize the special features of the adjustment process in a target zone following a monetary shock. Svensson (1991c, 1992a, b) shows that in narrow target zones, with and without devaluation risk, the foreign exchange risk premium is likely to be very small. We thus assume that the foreign exchange risk premium is zero and that uncovered interest rate parity continually holds, that is:

$$i(t) - i^*(t) = E_t[ds(t)]/dt. \quad (8)$$

Letting  $\delta(t)$  denote the interest rates differential, we can combine (8) with equation (1) in order to represent the interest rates differential:

$$\delta(t) = \frac{s(t) - f(t)}{\alpha}. \quad (9)$$

In the case of a free floating regime it follows that the interest rates differential is constant and equal to the drift of the fundamental.

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<sup>21</sup> For a complementary analysis see Table A.1 in Appendix III.

<sup>22</sup> See Figure A.3 in Appendix IV.



Since under a target zone  $s'(f(t)) < 1$ , it follows that the interest rates differential will be decreasing in the fundamental,  $\delta'(f(t)) < 0$ . Furthermore, recalling that the exchange rate is an increasing function of the fundamental, the basic model implies a negative deterministic relationship between the exchange rate and the interest rates differential.

We can find here the main difference between a free floating regime and a target zone. In a free floating regime, the exchange rate is responsible for the whole adjustment process. In a target zone, the exchange rate and interest rates “share” that responsibility between them. The volatility spillover from the exchange rate to the interest rates can be analysed through the instantaneous variability of the interest rates differential. The variability of  $\delta(t)$  is computed using Ito’s lemma:

$$d\delta(t) = \frac{\delta(f(t))}{\alpha} dt + \delta'(f(t))\sigma dz(t), \quad (10)$$

where  $[\delta'(f(t))\sigma]^2 dt$  represents the conditional variance of the changes in the interest rates differential. It follows that the interest rates differential’s volatility is minimum at the centre of the band and increases near the edges of the band, replacing here the exchange rate as the main variable in the adjustment process<sup>23</sup>. There is thus a trade-off between the instantaneous variability of the exchange rate and the instantaneous variability of the interest rates differential<sup>24</sup>.

We examined the correlation between the estimated values of the conditional variances of the exchange rate and interest rates differentials under a M-GARCH (Multivariate Generalized-AutoRegressive Conditional Heteroscedasticity) model<sup>25</sup>, in a further attempt to validate the theoretical predictions.

The autoregressive conditional heteroscedasticity (ARCH) was proposed by Engle (1982) in order to explain the evolution of the residuals of financial time series models. A very general form of an ARCH model is given by:

$$y_t = x_t \beta + u_t \quad (11)$$

$$h_t = \text{var}(u_t) = \sigma^2(u_t), \quad (12)$$

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<sup>23</sup> Returning to Figure 4 (bottom), we observe that the interest rates differential volatility seems to behave more in accordance with the implications of the theory.

<sup>24</sup> See Svensson (1991a, 1994).

<sup>25</sup> See Hamilton (1994), Campbell, Lo and MacKinlay (1997), Johnston and DiNardo (1997) and Tsay (2002).

in which there is an ARCH (q) process if:

$$h_t = c_0 + a_1 u_{t-1}^2 + a_2 u_{t-2}^2 + \dots + a_q u_{t-q}^2, \quad (13)$$

where, by assumption, in the context of our analysis, the dependent variable is the daily depreciation (appreciation) rate of the Portuguese escudo against the Deutschmark.

Instead, Bollerslev (1986) proposed a GARCH (p, q) model where the variance term depends on the lagged residuals (squared), as well as on the lagged variances. This leads to a greater persistence of volatility but with a relatively smaller number of parameters. The GARCH (p, q) model for the variance is given by:

$$\begin{aligned} h_t &= c_0 + a_1 u_{t-1}^2 + a_2 u_{t-2}^2 + \dots + a_q u_{t-q}^2 + b_1 h_{t-1} + b_2 h_{t-2} + \dots + b_p h_{t-p} = \\ &= c_0 + \sum_{i=1}^q a_i u_{t-i}^2 + \sum_{j=1}^p b_j h_{t-j}. \end{aligned} \quad (14)$$

We used a two equations GARCH model (or multivariate GARCH), M-GARCH (p, q), with  $p=1, q=1$ :

$$Y_t = X_t \beta + \mu_t, \quad (15)$$

where  $Y_t$  is a vector with the exchange rate variation and the interest rates differential, and  $X_t$  a matrix with the deterministic variables. The exchange rate is always modelled with the constant. In the case of the interest rates differential, in addition to the constant, the model includes a trend and an auto-regressive value (the interest rates differential lagged one day)<sup>26</sup>.

In principle we have four variants of the M-GARCH (1, 1) model.

Variant 1 is the separate estimation of the variance for each of the variables in the model:

$$\mathbf{H}_{ij}(t) = c_{ij} + a_{ij} u_i(t-1) u_j(t-1) + b_{ij} \mathbf{H}_{ij}(t-1), \quad (16)$$

where  $\mathbf{H}_{ij}(t)$  represents the conditional matrix of the variances/covariances of the residuals.

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<sup>26</sup> See Engle, Lilien and Robins (1987) and Engle and Kroner (1993).

Variant 2 takes into account a more important dynamic between the variances. This model requires a positive semi-defined matrix<sup>27</sup>:

$$\mathbf{H}(t) = \mathbf{C}'\mathbf{C} + \mathbf{A}'\mathbf{u}(t-1)\mathbf{u}'(t-1)\mathbf{A} + \mathbf{B}'\mathbf{H}(t-1)\mathbf{B}. \quad (17)$$

Variant 3 is based on the assumption that the covariance between the conditional variances of the residuals is null, which implies that  $a_{ij}=0$  and  $b_{ij}=0$ , with  $i \neq j$ .<sup>28</sup>

Finally, the fourth variant of the M-GARCH (1, 1) model is based on the assumption of constant correlation between the conditional variances, which allows to overcome the over-parameterisation problem<sup>29</sup>.

In accordance to the purpose of our study, the option was naturally for the use of the first two variants of the M-GARCH (1, 1) model, since we want to find the relationship between the conditional variances.

Table 5 presents the results of the correlation analysis between the estimated values of the conditional variances of the PTE/DM exchange rate and of the overnight interest rate differential, according to variant 1, for the whole period<sup>30</sup>.

**Table 5: Correlation between CVr\_TxV\_PTE/DM and CVr\_(i-i\*)\_O  
(Variant 1; Whole Period)**

Variable	Coefficient	Standard Error	T statistic	Significance
1- Constant	1,9783e-06	1,1429e-05	0,17310	0,863
2- Constant	6,2772e-03	4,7366e-04	13,25257	0,000
3- Trend	-1,9301e-06	1,3781e-07	-14,00585	0,000
4- (i-i*)_O { 1 }	0,9567	4,7862e-03	199,88852	0,000
5- C (1, 1)	-5,7192e-11	0,0000	0,00000	0,000
6- C (2, 1)	-2,2643e-08	7,6961e-09	-2,94210	0,003
7- C (2, 2)	9,5160e-08	1,7838e-08	5,33458	0,000
8- A (1, 1)	0,0556	5,5260e-03	10,06433	0,000
9- A (2, 1)	9,2753e-03	0,0206	0,44953	0,653
10- A (2,2)	0,2894	0,0280	10,31747	0,000
11- B (1, 1)	0,9528	3,6375e-03	261,93571	0,000
12- B (2, 1)	-0,2363	0,5336	-0,44279	0,658
13- B (2, 2)	0,8041	0,0129	62,17371	0,000

Note: GARCH Model – BFGS Estimation; Observations used 2117; Convergence in 632 iterations; Final criterion was 0,0000005 < 0,0000100; Log Likelihood 19183,473.

<sup>27</sup> See Baba et al. (1990) and Engle and Kroner (1993).

<sup>28</sup> See Bollerslev et al. (1988).

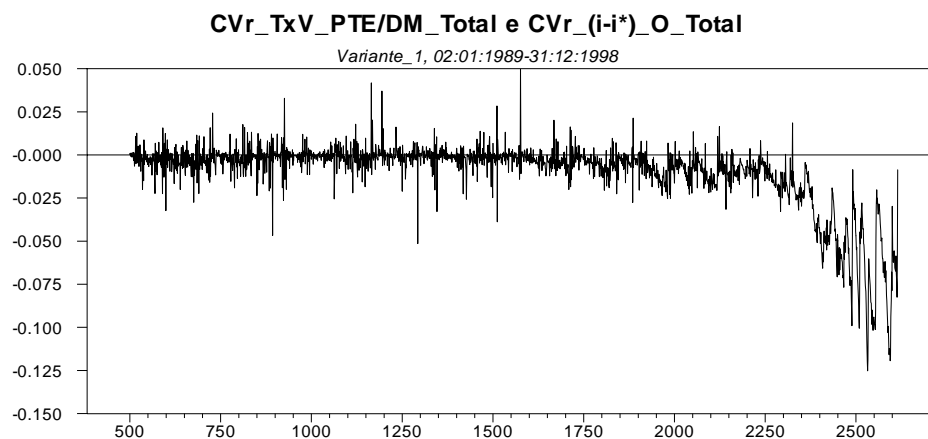
<sup>29</sup> See Bollerslev (1990).

<sup>30</sup> See Table A.2 in Appendix III for the interest rates with a maturity of 28 to 32 days.

The first constant relates to the PTE/DM exchange rate. The second constant and trend concern the overnight interest rate differential, followed by the values of the lagged coefficient of the interest rates differential. The constant in the variance equation is designated by *C*. The “ARCH” parameters (lagged squared residuals), in increasing lag order, are designated by *A*. The “GARCH” parameters (lagged variance), in increasing lag order, are designated by *B*.

The results of this analysis allow us to conclude that in at least one period there is a negative correlation between the estimated values of the conditional variances of the Portuguese escudo rate of change against the Deutschmark and the overnight interest rate differential. It is also worth mentioning that there is a trade-off between the PTE/DM exchange rate volatility and the overnight interest rate differential volatility. Figure 5 illustrates this.

**Figure 5: Correlation between the Conditional Variances of the Exchange Rate and Overnight Interest Rate Differential (Variant 1; Whole Period)**



The use of both variant 2 and the interest rate differential with a maturity of 28 to 32 days, led to similar results<sup>31</sup>. Possible explanations for this situation are the modernisation of the banking and financial system, and the progress made in terms of disinflation policy, which allowed the interest rate to serve as an alternative variable to the exchange rate in the adjustment process following a monetary shock, thereby facilitating the pursuit of the main objective of price stability. In this context, the participation of the Portuguese escudo in a target zone was crucial to create the conditions of stability, credibility, and confidence, necessary for the adoption of the single currency.

<sup>31</sup> See Table A.3 in Appendix III. The remaining results, and their graphical analysis, may be obtained from the corresponding author on request (e-mail: portugal@fe.uc.pt).

## 5 – Conclusion

In this study we have analysed the participation of the Portuguese escudo in the ERM of the EMS according to the literature on target zones. Although the results do not support the theoretical predictions, this does not mean that the participation in a target zone did not exercise a stabilizing effect on the exchange rate.

The analysis of the distribution of the exchange rate has confirmed that most of the observations tended to lie near the central parity, thus rejecting the U-shaped distribution implied by the theory. For most of the exchange rate regimes analysed, volatility tended to increase as the exchange rate approached the edges of the band, contrary to the predictions of the basic model. Interest rates differential volatility, on the other hand, seemed to behave in line with theoretical predictions.

The analysis of the correlation coefficients between the estimated values of the conditional variances of the exchange rate and the interest rates differential under an M-GARCH model allowed the identification of a negative correlation between the two variables. This result reveals the presence of a trade-off between the exchange rate volatility and the interest rates differential volatility. This is particularly interesting given the presence of a negative trend in the interest rate differential which, instead of representing inefficient actions in the foreign exchange market, reveals the high degree of macroeconomic stability achieved in the Portuguese economy. The downward path eventually reflects the increased credibility of the conduct of monetary policy, allowing the continued pursuit of exchange rate stability, in the context of the ultimate objective of price stability.

The integration process of the Portuguese economy should therefore be used as an example by other small open economies in the sense that they may benefit from participating in one of the dominant monetary areas, otherwise they will be more exposed to speculative attacks, especially in the case of real appreciation of their currencies. But from eight years of EMU, winner members have to conduct solid real convergence policies. Overappreciation currencies can be fatal for new members.

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## APPENDIX I – THE DATA

We used time series data with daily frequency in an attempt to cover the period from January 2, 1987 to December 31, 1998, which gives a total of 3130 potential observations. The observations corresponding to holidays and weekends were left out of the sample. In addition to the period when a target zone was officially functioning, between April 6 1992 and December 31 1998, we extended the analysis to a period in which Portugal adopted a crawling peg and a managed floating system, when the Portuguese escudo was pegged to the Deutschmark.

The exchange rate and interest rates data was taken from the Banco de Portugal (Long Series: Monetary and Financial Statistics of the Banco de Portugal) and the Bundesbank (Bundesbank Time Series Database). We used nominal exchange rates of the Portuguese escudo against the Deutschmark (PTE/DM). This exchange rate is computed by the Banco de Portugal as the average daily currency price. Interest rate data is available from January 2, 1989 and is measured as the average of the daily transactions held in the Money Market. Since we used daily data, we chose overnight interest rates and interest rates with a maturity of 28 to 32 days. Based on the examination of the evolution of the interest rates over time, we left out the outliers, defined as observations with values higher than 25% of the arithmetic average of the previous thirty observations relative to the observation under analysis. This methodology made the analysis of the volatility of the series feasible.

Unless otherwise stated, all the series have been transformed into natural logarithms. In the case of the interest rates, we used the natural logarithm of 1 plus the interest rate (%), divided by 100. In order to maximize the number of available observations, we were forced to extrapolate missing values whenever there were breaks in the series. The breaks occurred mainly in the Portuguese Money Market interest rates series with a maturity of 28 to 32 days. To compute the missing values, we used an extrapolation method based on an AR1 process with trend. The empirical analysis was applied to different sub-periods, also known as exchange rate regimes. We considered eleven exchange rate regimes:

Regime	Dates (Sub-periods)	Description	Potential Number of Observations
1	06:04:1992-31:12:1998	Whole Period in the ERM of the EMS	1759
2	06:04:1992-22:11:1992	Membership of the ERM - 1 <sup>st</sup> Realignment	165
3	23:11:1992-12:05:1993	1 <sup>st</sup> Realignment - 2 <sup>nd</sup> Realignment	123
4	13:05:1993-05:03:1995	2 <sup>nd</sup> Realignment - 3 <sup>rd</sup> Realignment	472
5	06:03:1995-31:12:1998	3 <sup>rd</sup> Realignment- EMU membership	999
6	06:04:1992-01:08:1993	Narrow band Period	345
7	02:08:1993-31:12:1998	Wide band Period	1414
8	06:04:1992-15:12:1992	Restrictions on Capital Mobility	182
9	16:12:1992-31:12:1998	Free Capital Mobility	1577
10	02:01:1987-30:09:1990	Portuguese Escudo Crawling Peg	976
10'	02:01:1989-30:09:1990	Portuguese Escudo Crawling Peg	455
11	01:10:1990-05:04:1992	Pegging of the PTE to the DM	395

**Note:** Exchange rate regime 10' presents a smaller number of observations since the interest rates database only contains 455 observations. When the analysis focused on the exchange rate we used the sample corresponding to exchange rate regime 10. When the analysis concerned both the exchange rate and the interest rates we used sample 10'.

The five observations immediately before and after the realignments and the date corresponding to the enlargement of the bands were excluded from the sample, in all the analyses. This was to avoid biases in the analysis. Most results were obtained using RATS 6.2, PcGive 10, and Jmulti 4.1<sup>32</sup>.

<sup>32</sup> See [www.estima.com](http://www.estima.com), for RATS 6.2, Hendry and Doornik (2001), for PcGive 10, and Lutkepohl and Kratzig (2004), for Jmulti 4.1 ([www.jmulti.de](http://www.jmulti.de)).

## Appendix II – Variables Used in the Empirical Analysis

PTE/DM = PTE\_DM: Nominal exchange rate of the Portuguese escudo against the Deutschmark

USD: U.S. Dollar

C\_PTE\_DM: Official central parity of the Portuguese escudo against the Deutschmark

LI\_PTE\_DM: Official lower edge for PTE/DM

LS\_PTE\_DM: Official upper edge for PTE/DM

No\_C\_PTE\_DM: Unofficial central parity of the Portuguese escudo against the Deutschmark

No\_LI\_PTE\_DM\_6: Unofficial lower edge for PTE/DM and an unofficial exchange rate band of  $\pm 6\%$

No\_LS\_PTE\_DM\_6: Unofficial upper edge for PTE/DM and an unofficial exchange rate band of  $\pm 6\%$

Dif\_O: Differential between the Portuguese overnight interest rate and the German overnight interest rate (%)

Dif\_28: Differential between the Portuguese interest rate with a maturity of 28 to 32 days and the German interest rate with a maturity of 28 to 32 days (%)

$(i-i^*)_O$ : Differential between the Portuguese overnight interest rate and the German overnight interest rate (log)

$(i-i^*)_{28}$ : Differential between the Portuguese interest rate with a maturity of 28 to 32 days and the German interest rate with a maturity of 28 to 32 days (log)

RF\_DC\_PTE/DM: Relative frequency of DC\_PTE/DM (%)

SD\_V\_PTE/DM: Standard deviation of the PTE/DM variation (log)

SD\_V\_ $(i-i^*)_O$ : Standard deviation of the variation of  $(i-i^*)_O$

SD\_V\_ $(i-i^*)_{28}$ : Standard deviation of the variation of  $(i-i^*)_{28}$

CVr\_TxV\_PTE/DM: Conditional variance of the rate of change of the Portuguese escudo against the Deutschmark

CVr\_ $(i-i^*)_O$ : Conditional variance of  $(i-i^*)_O$

CVr\_ $(i-i^*)_{28}$ : Conditional variance of  $(i-i^*)_{28}$

## Appendix III – Tables

**Table A.1: Exchange Rate and Interest Rate Volatility in Twelve Sub-Intervals of the Band (PTE/DM)**

Regime	Exchange Rate <sup>(a)</sup>				Interest Rate Differential Overnight <sup>(b)</sup>				Interest Rate Differential Maturity of 28 to 32 days <sup>(c)</sup>				Volatility		
	Minimum		Maximum		Minimum		Maximum		Minimum		Maximum		Exchange Rate  (a)	Interest Rate Overnight  (b)	Interest Rate 28 to 32 days (c)
	Standard Deviation (%)	Sub- Intervals	Standard Deviation (%)	Sub- Intervals	Standard Deviation (%)	Sub- Intervals	Standard Deviation (%)	Sub- Intervals	Standard Deviation (%)	Sub- Intervals	Standard Deviation (%)	Sub- Intervals			
1	0,08625	I <sub>6</sub>	1,09932	I <sub>12</sub>	0,25811	I <sub>6</sub>	2,18513	I <sub>12</sub>	0,13531	I <sub>6</sub>	1,83876	I <sub>12</sub>	∪	∪	∪
2	0,18888	I <sub>2</sub>	0,97383	I <sub>8</sub>	0,60932	I <sub>8</sub>	1,23089	I <sub>9</sub>	0,17470	I <sub>3</sub>	0,76075	I <sub>9</sub>	∩	∪	—
3	0,21328	I <sub>7</sub>	0,33621	I <sub>5</sub>	0,72791	I <sub>6</sub>	0,90201	I <sub>3</sub>	0,18404	I <sub>5</sub>	0,75829	I <sub>3</sub>	—	—	∪
4	0,19052	I <sub>11</sub>	1,09932	I <sub>12</sub>	0,18562	I <sub>2</sub>	2,18513	I <sub>12</sub>	0,16953	I <sub>5</sub>	1,83876	I <sub>12</sub>	—	∪	∪
5	0,04594	I <sub>6</sub>	0,19801	I <sub>10</sub>	0,12508	I <sub>5</sub>	0,55742	I <sub>10</sub>	0,08756	I <sub>6</sub>	0,31187	I <sub>10</sub>	∪	∪	∪
6	0,27716	I <sub>6</sub>	0,98555	I <sub>10</sub>	0,64246	I <sub>8</sub>	1,20590	I <sub>9</sub>	0,15438	I <sub>8</sub>	0,74500	I <sub>9</sub>	—	∪	—
7	0,04594	I <sub>6</sub>	0,26696	I <sub>10</sub>	0,12508	I <sub>5</sub>	0,66388	I <sub>11</sub>	0,08756	I <sub>6</sub>	0,40474	I <sub>11</sub>	∪	∪	∪
8	0,18888	I <sub>2</sub>	0,98555	I <sub>10</sub>	0,67213	I <sub>7</sub>	1,20590	I <sub>9</sub>	0,14730	I <sub>8</sub>	0,74500	I <sub>9</sub>	—	∪	—
9	0,08625	I <sub>6</sub>	1,09932	I <sub>12</sub>	0,18562	I <sub>2</sub>	2,18513	I <sub>12</sub>	0,13531	I <sub>6</sub>	1,83876	I <sub>12</sub>	∪	∪	∪
10	0,11178	I <sub>3</sub>	0,19476	I <sub>4</sub>	0,18979	I <sub>3</sub>	1,86544	I <sub>7</sub>	0,13282	I <sub>9</sub>	0,74216	I <sub>7</sub>	—	∩	∩
11	0,15781	I <sub>6</sub>	1,03457	I <sub>10</sub>	0,78696	I <sub>10</sub>	3,24793	I <sub>7</sub>	0,26865	I <sub>6</sub>	0,90948	I <sub>8</sub>	∪	∪	—

**Note 1:** (a) Standard deviation of the variations of the PTE/DM exchange rate in each sub-interval considered in the histogram.

(b) Standard deviation of the variations of the overnight interest rate differential in each sub-interval considered in the histogram.

(c) Standard deviation of the variations of the interest rate differential with a maturity of 28 to 32 days in each sub-interval considered in the histogram.

**Note 2:** I<sub>j</sub> with j= 1, 2, 3, ..., 11= Sub-intervals of the exchange rate band;

∪= Minimum volatility in the centre of the band (sub-intervals I<sub>5</sub>, I<sub>6</sub>, I<sub>7</sub>, I<sub>8</sub>) and increasing near the edges of the band (sub-intervals I<sub>1</sub>, I<sub>2</sub>, I<sub>3</sub>, I<sub>4</sub>, I<sub>9</sub>, I<sub>10</sub>, I<sub>11</sub>, I<sub>12</sub>);

∩= Maximum volatility in the centre of the band (sub-intervals I<sub>5</sub>, I<sub>6</sub>, I<sub>7</sub>, I<sub>8</sub>) and decreasing near the edges of the band (sub-intervals I<sub>1</sub>, I<sub>2</sub>, I<sub>3</sub>, I<sub>4</sub>, I<sub>9</sub>, I<sub>10</sub>, I<sub>11</sub>, I<sub>12</sub>);

∪= Increasing volatility near the lower edge of the band (sub-intervals I<sub>1</sub>, I<sub>2</sub>, I<sub>3</sub>, I<sub>4</sub>);

∩= Decreasing volatility near the lower edge of the band (sub-intervals I<sub>1</sub>, I<sub>2</sub>, I<sub>3</sub>, I<sub>4</sub>);

∪= Increasing volatility near the upper edge of the band (sub-intervals I<sub>9</sub>, I<sub>10</sub>, I<sub>11</sub>, I<sub>12</sub>);

∩= Decreasing volatility near the upper edge of the band (sub-intervals I<sub>9</sub>, I<sub>10</sub>, I<sub>11</sub>, I<sub>12</sub>);

— = Volatility with undefined behaviour.

**Suggested reading:** For instance, in regime 2 which covers the period from the date of joining the ERM and the first realignment of the Portuguese escudo against the Deutschmark, the exchange rate volatility is greatest in the centre of the band and decreases as the exchange rate gets closer to the edges of the band. The overnight interest rate differential volatility is smallest in the centre of the band and increasing as the exchange rate gets closer to the edges of the band, and there is therefore a trade-off between the two volatilities. The results relating to the volatility of the interest rate differential with a maturity of 28 to 32 days are not conclusive. However we can see that there is less volatility as the term structure of the interest rates increases.

**Table A.2: Correlation between CVr\_TxV\_PTE/DM and CVr\_(i-i\*)\_28  
(Variant 1; Whole Period)**

Variable	Coefficient	Standard Error	T statistic	Significance
1- Constant	2,0383e-06	1,1434e-05	0,17826	0,859
2- Constant	3,3537e-03	4,9228e-04	6,81266	0,000
3- Trend	-1,0155e-06	1,4691e-07	-6,91256	0,000
4- (i-i*)_28 {1}	0,9707	4,3473e-03	223,28392	0,000
5- C (1, 1)	-5,8879e-11	1,1600e-10	-0,50756	0,612
6- C (2, 1)	-4,7243e-08	2,7780e-08	-1,70059	0,089
7- C (2, 2)	3,8869e-08	9,8079e-09	3,96301	0,000
8- A (1, 1)	0,0554	4,0697e-04	136,15167	0,000
9- A (2, 1)	-2,1731e-03	1,2178e-03	-1,78441	0,074
10- A (2,2)	0,1518	0,0144	10,53108	0,000
11- B (1, 1)	0,9530	1,0848e-03	878,46365	0,000
12- B (2, 1)	-0,9873	8,4243e-04	-1172,00597	0,000
13- B (2, 2)	0,8768	8,8324e-03	99,26874	0,000

Note: All Observations  
GARCH Model – BFGS Estimation  
Convergence in 119 iterations. Final Criterion was 0,00000072 < 0,0000100  
Observations used 2117  
Log Likelihood 20279,110

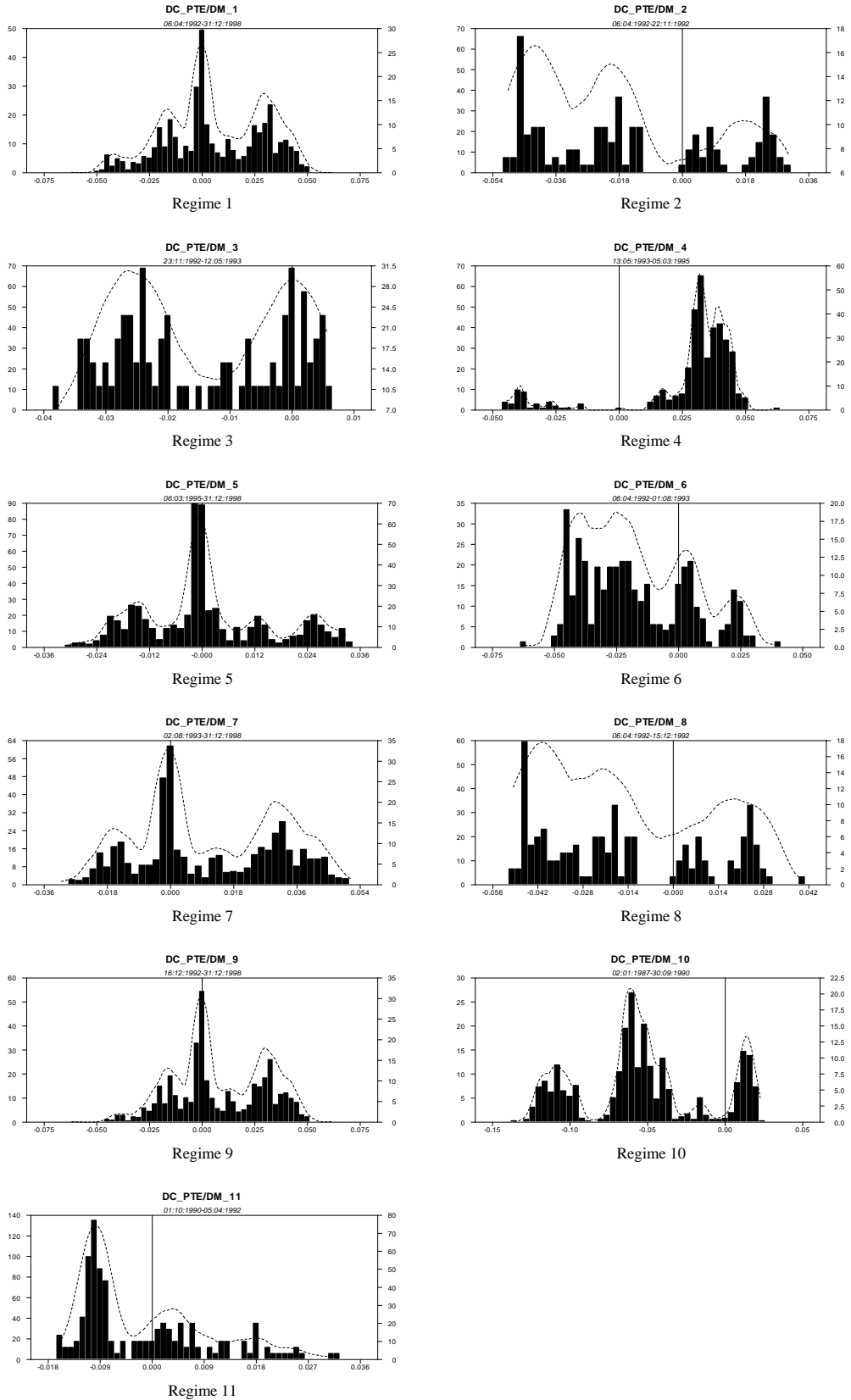
**Table A.3: Correlation between CVr\_TxV\_PTE/DM and CVr\_(i-i\*)\_O  
(Variant 2; Whole Period)**

Variable	Coefficient	Standard Error	T statistic	Significance
1- Constant	6,1536e-06	1,2324e-05	0,49932	0,618
2- Constant	5,4842e-03	4,8619e-04	11,28016	0,000
3- Trend	-1,6746e-06	1,4168e-07	-11,81932	0,000
4- (i-i*)_O {1}	0,9604	4,8173e-03	199,36618	0,000
5- C (1, 1)	9,7106e-06	4,8309e-06	2,01009	0,044
6- C (2, 1)	-2,5792e-04	3,5794e-05	-7,20576	0,000
7- C (2, 2)	6,7666e-09	1,2683e-04	5,33520e-05	0,999
8- A (1, 1)	-0,1972	0,0100	-19,68569	0,000
9- A (1, 2)	-0,2280	0,0344	-6,62200	0,000
10- A (2,1)	0,0135	3,1292e-03	4,31864	0,001
11- A (2, 2)	-0,5225	0,0262	-19,95680	0,000
12- B (1, 1)	0,9821	1,4145e-03	694,32568	0,000
13- B (1, 2)	-0,0319	5,7684e-03	-5,52804	0,000
14- B (2, 1)	4,4883e-03	8,3214e-04	5,39371	0,000
15- B (2, 2)	0,9026	6,7621e-03	133,47746	0,000

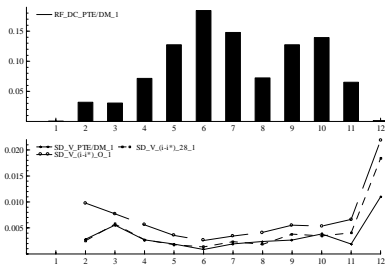
Note: M-GARCH Model, BEKK – BFGS Estimation; Observations used 2117; Convergence in 94 iterations; Final Criterion was 0,0000044 < 0,0000100; Log Likelihood 19141,904.

## Appendix IV – Figures

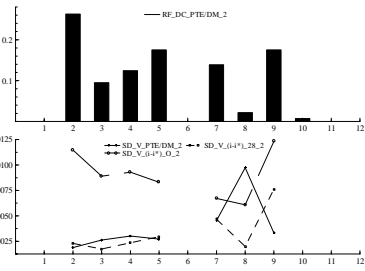
**Figure A.1: Frequency Distribution and Kernel Estimation of the Probability Density Function of the PTE/DM Exchange Rate (Regimes 1 to 11)**



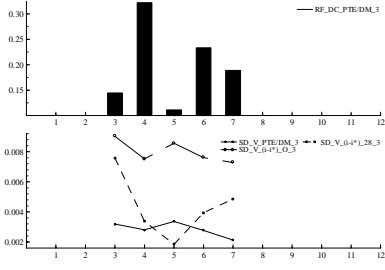
**Figure A.2: Exchange Rate and Interest Rate Distribution and Volatility (PTE/DM, Regimes 1 to 11)**



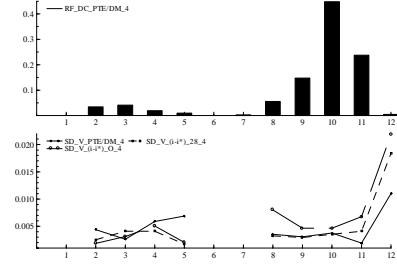
Regime 1



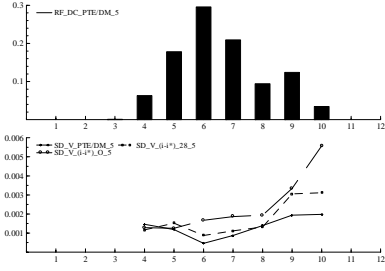
Regime 2



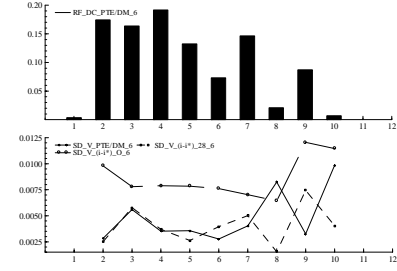
Regime 3



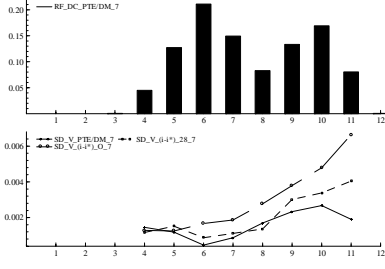
Regime 4



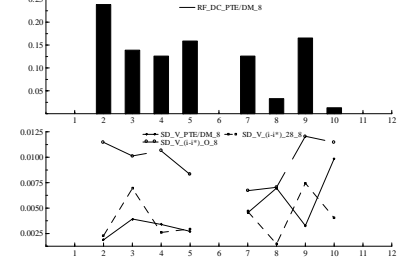
Regime 5



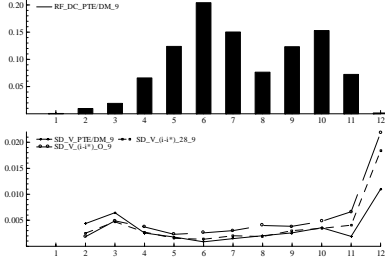
Regime 6



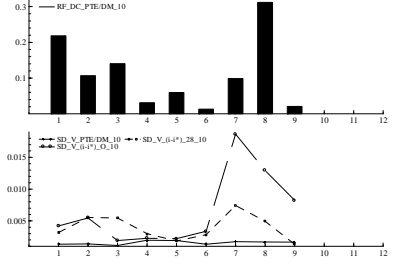
Regime 7



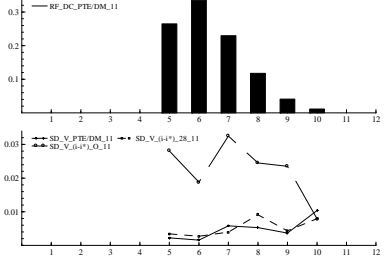
Regime 8



Regime 9

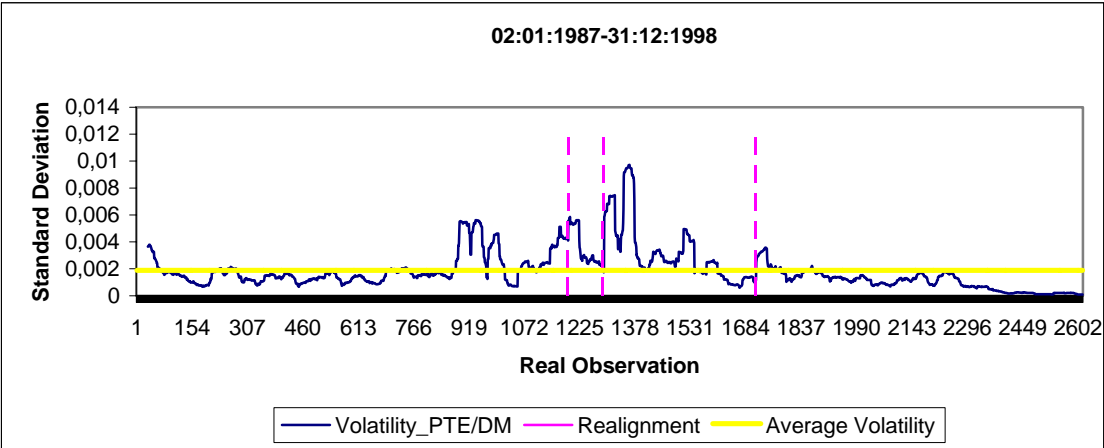


Regime 10



Regime 11

**Figure A.3: PTE/DM Exchange Rate Volatility**



**Note:** The volatility consists of the standard deviation of the variation of the PTE/DM exchange rate from the 30 most recent observations.

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