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Summary of
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"Testing the Credibility of Belgium's Exchange Rate Policy" by Ioannis Halikias

The Belgian franc has been a member of the exchange rate mechanism of the European Monetary System since its inception in 1979. Following frequent downward realignments of the currency during the first half of the 1980s, Belgium pursued a progressively tighter exchange rate policy, and in May 1990 the monetary authorities announced their objective to tightly peg the Belgian franc to the strongest currency within the system.

This paper seeks to determine if long-run exchange rate credibility for the Belgian franc over the period 1982-92 has been attained. The starting point of the analysis is the interest rate corridor methodology introduced by Svensson (1990). This approach assumes that uncovered interest rate parity holds, and it takes explicit account of the currency's position within its fluctuation band in testing for exchange rate credibility. Tests along the lines of the interest rate corridor method suggest that despite substantial progress, long-run exchange rate credibility for the Belgian franc can be rejected throughout the period under discussion.

The remainder of the paper explores the sensitivity of this result to the strong assumption of interest rate parity. In addressing this issue, the determinants of the Belgian-German long-term interest rate differential are examined in detail. This differential turns out to be significantly affected by relative inflation (or relative competitiveness) and by fiscal variables (both the relative debt-to-GDP ratio and primary deficit-to-GDP ratio) in the usual ways. In addition, devaluations of the Belgian franc vis-à-vis the deutsche mark appear to have resulted in a significant widening of the differential over the short term, while the announcement of the hard currency policy appears to have led to a narrowing of the differential. Variables such as the unemployment rate and the external balance do not appear to significantly affect the differential, suggesting that the monetary authorities are perceived to attach a relatively low weight to these objectives.

The paper then breaks down the impact of the fiscal variables into an exchange rate risk and a sovereign credit risk component, by explicitly modeling inflationary expectations. The resulting adjustment in the interest rate corridors reveals that long-run exchange rate credibility cannot be rejected from mid-1990 onward.

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