

Abstract

This dissertation studies in an historical perspective the factors behind the use of exchange rate target zones. The participation of the Portuguese Escudo in the exchange rate mechanism (ERM) of the European Monetary System (EMS) is analyzed in detail, with the aim of comparing its functioning with the main results and predictions produced by the literature on this topic.

The research presented here innovates by bringing together an historical-economic perspective and an applied-theoretical perspective, which are used to analyze a small open economy with little weight in the EMS. The results obtained are both positive and normative, and are based on bilateral and multilateral analyses of the ERM.

The empirical distribution of the Escudo's exchange rate shows that most observations lie near the central parity, which contradicts a main prediction derived from Krugman's (1991) model. Another empirical fact is that volatility increased as the exchange rate moved nearer the edge of floatation bands. On the other hand, the volatility of interest rate differentials was lower near the center of the band, and higher near the edge. The existence of a trade-off between exchange rate volatility and the volatility of interest rate differentials was confirmed by means of an M-GARCH model.

Our econometric analysis did not find evidence of a deterministic negative relation between interest rate differentials and exchange rate deviations from central parity. We also did not find evidence of a non-linear, S-shaped, relation between the exchange rate and its fundamental determinants. The presence of a negative trend in the interest rate differential explains these results. However, the observed trajectory reflects the increased credibility of Portuguese monetary policy. Exchange rate stability, framed within the main goal of price stability, was therefore feasible, en route to joining the Euro area.

The application of variance ratio stationarity tests provided confirmation of the efficiency of foreign exchange markets, despite absence of mean reversion within the band. This contributed decisively to exchange rate stabilization. Portugal's European integration process must therefore be used as an example for other small open economies, which have an interest in joining one of the dominant monetary areas.