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# The advantages of introducing an exchange rate target within the statutes of the European Central Bank

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**Abstract**

With the help of a Keynesian dynamic macro-economic model in an open economy, this paper studies the possible consequences of introducing an exchange rate target within the statutes of the European Central Bank. It appears that such a target would have only slight implications for the mitigation of demand or external supply shocks. In the case of internal negative supply shocks, this scheme could limit the conflict of goals between the monetary and budgetary authorities and reduce the slowdown in economic activity. Nevertheless, the fact that the central bank tends to limit the fluctuations in its interest rates already has the same implications. On the contrary, in the case of positive shocks on interest rates in the rest of the world, an exchange rate target could have its own advantages. Such a scheme could limit the budgetary deficits and the variations in economic activity triggered by foreign shocks.
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## 1. Introduction

Many economic studies have tried to estimate the consequences of the creation of a monetary union on the international volatility of exchange rates, and to compare the potential volatility of the exchange rate of a unique currency with the volatility of ancient national currencies after a monetary unification (e.g. Bartolini and Bodnar, 1996; Benassy et al., 1997; Benassy and Pisani-

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Ferry, 1998; Creel and Sterdyniak, 1998; Fitoussi, 1999; Van Oorschot et al., 2000). But the results of these studies are generally divided, as many phenomenons act in opposite directions regarding the volatility of a common currency like the euro, for example. Indeed, Martin (1997) estimates that in the context of the Economic and Monetary Union (EMU), the big countries are less incited to use the exchange rate in a strategic way in order to stabilize the real economy, thus limiting the volatility of the euro. Indeed, the monetary policy of the European Central Bank (ECB) now reacts to an average of the conjuncture conditions of the European countries: its utilization is then more limited than if the monetary policies were differentiated. Nevertheless, a little country must be worried about stabilizing its exchange rate, in order to avoid large inflationary or commercial shocks. But this is not the case of the European monetary zone, whose degree of openness is only slightly above 10% of GDP (Artus, 1997; Cohen, 1997; Benassy et al., 1997). Afterwards, in case of a conflict of goals between the monetary and budgetary authorities for the stabilization of the negative supply shocks, a bad management of the European "policy-mix" could imply an overly restrictive monetary policy and excessive increases in interest rates, that could also increase the instability of the euro. Moreover, Creel and Sterdyniak (1998) mention that the paralysis of the budgetary policies in Europe due to the stability and growth pact could also increase the monetary activism and the volatility of the euro. Finally, whereas the mistaken variations in the dollar in relation to the European currencies could be at the origin of tensions in the EMS framework, this is no longer the case in the EMU. The ECB could then be tempted to neglect the fluctuations in the euros's exchange rate.

Article 109 of the Maastricht Treaty implies a certain institutional haze on the respective responsibilities of the ECB and of the governments of the member states of the EMU for the determination of the European exchange rate policy. But what could be the consequences if the ECB fully neglects fluctuations in the value of the common currency? Institutionally, the main objective of the ECB is to preserve the price stability; the hypothesis that it could target the exchange rate has been studied however rejected by the European Monetary Institute in 1997. Nevertheless, an important depreciation in the European currency, like in 1999 and 2000, increases the risks of an imported inflation and also discourages the capital investment in Europe. However, after March 2002, the euro has greatly appreciated, which is on the contrary harmful to the European exports. Despite these risks traditionally mentioned, the ECB seemed to neglect any exchange rate target at the beginning of its existence. Indeed, the non-sterilized interventions on the exchange markets in order to stabilize the euro directly put into question and are in competition with its internal main objective of price stability. Nevertheless, the ECB knows that the euro's exchange rate influences the inflationary anticipations (through its impact on the import prices), and that the value of the euro determines the price competitiveness and the growth perspectives of the whole Euro-zone. It also influences the credibility, the efficiency and the stability of the European financial system.[1]

Beyond these traditional arguments, the second section presents a dynamic Keynesian macroeconomic model able to make clear the risks associated with a negligence of the exchange rate by the ECB that are less often underlined, related to the inefficiency in a non-coordinated formation of the European policy-mix. Afterwards, the third section studies the consequences of an absence of exchange rate target for the global economic policies led by the authorities with more precision. The fourth section then analyzes the implications of these policies on the well-being of the economic agents. Finally, the fifth section concludes.

[1] See e.g. Buti and Sapir (1998), p. 75and Van Oorschot et al. (2000), p. 221.

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