The Quest for Nominal Stability: A Vignette from 1993

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Inflation targeting first emerged more than three decades ago against a background of uncertainty over the institutional arrangements that might best consolidate the progress industrial economies had made since the early and mid-1980s in reducing inflation. Within Europe, inflation targeting reflected the shadow of currency crisis. Prior to 1992-93, the Exchange Rate Mechanism of the European Monetary System had played a key role in orienting monetary policies. In effect, member states prone to inflation hoped to import the credibility of Germany's Bundesbank by establishing hard pegs to the deutschemark. But confidence in exchange-rate based approaches had been shattered by the ERM crisis that erupted in the second half of 1992.

The underlying macroeconomic tension causing the ERM crisis stemmed from the high German interest rates accompanying German reunification. The immediate spark for the crisis, however, was the bumpy ratification process for the 1992 Maastricht Treaty, which had set out a detailed road map for EU monetary unification under a European Central Bank dedicated above all to price stability. For its architects, the single currency would solve the problem of finitely credible ERM pegs (and German monetary dominance) by abolishing national currencies. But the ERM crisis raised questions about the realism of the Treaty's goal that persisted even after ratification.

This crisis and others help to explain how inflation targeting, initiated by New Zealand in 1990, followed by Canada in 1991, caught on more widely. The early 1990s were a transitional time in "the quest for nominal stability." For me, an experience I shared in 1993 with Lars Svensson (as well as with Mervyn King, who is also attending this conference), underlines why so many countries, developed and emerging alike, have ultimately found inflation targeting coupled with exchange rate flexibility to be a feasible and successful policy regime.

In May 1993, I was privileged to be a visitor at the Institute for International Economic Studies here in Stockholm. I already knew Lars well, not only from the usual rounds of NBER conferences but also from Lars's yearlong visit to NYU in the mid-1980s when I was on the faculty at Columbia.

One day during my stay at the Institute, I received an invitation from the Banque de France to write a paper for a research conference the following autumn. The paper was to be published in the BdF house journal, the *Cahiers Économiques et Monétaires*. In the easy collegial environment of the Institute, with open doors and regular afternoon tea, it didn't take long to discover that Lars, too, had been invited to prepare a paper for the conference. We coordinated our responses. If we both accepted, the conference experience would be more fun, and our work might have more impact despite appearing in the BdF house journal (where most papers were in French). I returned to Berkeley, and we set to work on our contributions.

Lars's paper was entitled "Monetary Policy with Flexible Exchange Rates and Forward Interest Rates as Indicators" (Svensson 1994a).[1] The topic is close to Silvana Tenreyro's for this conference. I want to quote at length from Lars's introduction, which took off from his Marshall Lecture in Helsinki in 1993 (Svensson 1994b), because it brilliantly describes the state of play at the time in Europe's monetary-policy evolution:

P*revious monetary policy with fixed exchange rates in Europe the last few years can be described, with some simplification, as Germany's pursuing an independent monetary policy directed at domestic price stability, and the rest of the countries' pegging their exchange rate to the German mark, the European anchor currency. This was the case for the countries within the ERM as well as the countries outside the ERM that unilaterally pegged their exchange rate to the mark, as Austria, or the ecu, as Finland, Norway and Sweden. Monetary policy outside* G*ermany was then in principle very simple, it consisted solely in defending a fixed exchange rate towards the mark or the ecu....*

The last year's turmoil in Europe has dramatically changed this. The Finnish markka, the Italian lira and the British pound were forced to float in September 1992. In November the same year the Swedish krona was floated, in December the Norwegian krone. In August 1993 the exchange rate bands for the currencies that remained in the ERM were increased to ± 15 percent, with the exception of the German mark and the Dutch guilder which remained in the narrow band.

The loss of the fixed exchange rates means the loss of the nominal anchor for the countries that used to peg their exchange rates to the mark or the ecu. Except for Austria and the Netherlands, fixed exchange rates do not now seem a realistic alternative for the European countries in the short or medium term. Even if fixed exchange rates towards a stable currency were feasible, if the ultimate target for monetary policy is price stability, one can seriously doubt the efficiency of fixed exchange rates as an intermediate target to achieve price stability.... Hence, for several reasons there is a need to discuss how monetary policy should he designed in the new situation with flexible exchange rates in Europe.

Here was the fundamental problem to be solved: if an exchange-rate based approach to price stability was unworkable, what mode of nominal anchoring should replace it? Lars's paper proposed a framework for an autonomous national monetary policy based on floating exchange rates and aimed at internal, not external, price stability. This, in essence, was the approach of inflation targeting. Inflation targeting does not eliminate macro spillovers between countries or even the possible benefits of internationally coordinated policies, but it assures primacy for national monetary objectives legitimized by domestic political processes.

[1] Available at URL: https://gallica.bnf.fr/ark:/12148/bpt6k64967087/f307.item

My paper, entitled "The Logic of Currency Crises," was an investigation of *why* mechanisms based on fixed exchange rates were likely doomed to failure. The paper drew inspiration from the European crises of the previous year and set out "second-generation" models of currency crises in which a government's decision to abandon a currency peg was endogenous to market conditions and political objectives. In that setting, currency pegs like those in the ERM could become fragile and subject to self-fulfilling speculative attacks if economic conditions deteriorated (like higher German interest rates) or political calculus shifted (like a lower probability that the Maastricht Treaty would be ratified).

Europe had tried to make the ERM parities more credible through enhanced cooperative arrangements between member governments. It had not been enough. The approach of the Treaty was in some sense the polar opposite of autonomous inflation targeting. If one cannot make currency pegs credible, then eliminate exchange rates altogether and endow a common central bank with monetary powers. In principle, this mechanism might assure internal price stability for the monetary union as a whole, but at the possible expense of price stability within each national component. A paper by Niels Thygesen at the BdF conference explored the prospect of a single currency (Thygesen 1994).

I remember very little of how conference participants received the papers. Much of the conference discussion was in French, and Mervyn, who had become the Bank of England's chief economist in 1991, impressed by addressing the room in excellent French. Sadly, I have been unable to find a record of his remarks.

What sticks most in my mind, though, is the lunch. The French quail hunting season had just started and *caille* was the main course. Lars, Mervyn, and I were to be seated at the head table with the recently-appointed governor of the French central bank. Mervyn and I arrived to the table first, whereupon Mervyn ruefully remarked that our host had been instrumental in undermining sterling during the recent ERM crisis. This led the United Kingdom famously to leave the ERM under intense market pressure on Black Wednesday, September 16, 1992. Some observers see a link between those events and the much later Brexit.[2]

The facts of the episode were already widely known, having been reported in detail earlier in the *Financial Times.* They reflected a breakdown of European monetary cooperation, apparently driven by national political imperatives of the type my conference paper suggested are all-important in determining the stability of fixed exchange rate systems.

At the height of the crisis in September 1992, Germany discreetly floated a proposal to lower its interest rate in return for a general realignment of ERM exchange rates. Action on the German proposal required formal consideration by the full European Monetary Committee, which oversaw the ERM, but the committee chair, at the time the director of the French *Trésor*, did not convene the needed meeting. He may have feared that the French franc might be included

[2] See, for example, Helmut Schlesinger's interpretation (Schlesinger 2017).

in a system-wide realignment. In any case, the British were not made aware of the German proposal, the crisis was not defused, and sterling crashed out of the ERM.

In his account of these events, Barry Eichengreen eloquently summarizes the implications for nominal anchors based on fixed currency arrangements between sovereign nations, even in the presence of cooperative institutional structures (Eichengreen 2003):

That Europe, where monetary cooperation was more highly developed than anywhere else in the world, was unable to respond to this crisis cooperatively is revealing of the obstacles to the collective management of exchange rates under even the most favorable circumstances.

The chair of the European Monetary Committee in 1992, who became the governor of the Banque de France in 1993, was Jean-Claude Trichet. He now joined us at the lunch table. Lars was seated to Jean-Claude's left, leaving me, with my poor French, in the diplomatically sensitive seat to his right between him from Mervyn.

As I poked at the diminutive birds on my plate, I could not know what lay in the future for my lunch companions.

The Bank of England had taken the first steps toward inflation targeting soon after Black Wednesday. Mervyn went on to develop the Bank's operational structure for inflation targeting, seeing his efforts rewarded when the Blair government gave the Bank instrument independence in May 1997. The Bank lost its prudential role at the same time, however, an error that was reversed after the Global Financial Crisis. Mervyn would later lead the Bank of England for a decade comprising that crisis and the euro crisis that grew out of it.

Jean-Claude became the second president of the European Central bank in 2004, steering the euro area's monetary policy through the Global Financial Crisis and the initial stages of the euro crisis. Although the single currency project was meant to eliminate exchange rate instability and foster price stability over a large unified market, the euro crisis showed that in the absence of an underlying political union, national political considerations could still drive self-fulfilling financial speculation, if not in foreign exchange markets, then in interbank lending markets and markets for sovereign debt. At the extreme, fears that member states might exit the euro (as Britain eventually exited the EU) could emerge and be intensely destabilizing, actually forcing the imposition of capital controls within Europe to maintain some of the "irrevocably fixed" exchange rates.

Lars became an influential advocate for inflation targeting in Sweden. He pioneered the analytical foundations for understanding and applying it, intellectual advances that have helped turn numerous countries into inflation targeters with more flexible exchange rate regimes. The decline in inflation around the world since the 1990s is truly remarkable. Later, as deputy governor of the Sveriges Riksbank, Lars battled for his monetary-policy views in his inimitably persistent way. He later developed those views analytically, including in important work at the IMF, work that I was proud to authorize for release as director of the IMF Research Department

(Svensson 2016).[3] It is for these achievements (and many more) that we have honored Lars at this conference.

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[3] This paper appeared in the *Journal of Monetary Economics* in 2017.