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Are International Financial Crises a Barbarous Relic?

Inflation Targeting as a Monetary Vaccine

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Escaping the swamp: fixed exchange rates and financial crises

The 1990s were plagued by international financial crises. Countries rich and poor, large and small, saw their currency attacked by speculators and witnessed their fixed exchange rate policies fall into the dust-bin of history. The UK in 1992, Mexico in 1994, Thailand in 1997, Russia in 1998, Brazil in 1999,... the list is long. Yet since the collapse of Argentina in 2001, the international financial system has been an oasis of stability. Some believe this is merely good luck, and that the bad old days will return. They are wrong.

Most all the international financial crises of the previous millennium had a common element: a monetary policy geared towards a fixed exchange rate. For central bankers steeped in monetary history, that made sense; there was essentially no alternative. There were only a couple of plausible monetary strategies, and a fixed exchange rate was the time-tested option. During the 'Bretton Woods' regime after World War II, countries fixed their exchange rates to the US, and through it to gold. A fixed exchange rate is a well-defined monetary policy. It subordinates monetary policy to the objective of exchange rate stability. Since this subordination came at the expense of domestic interests, most fixed exchange rates did not stayed fixed for long.

What is to be done after floating? The limited number of monetary regimes

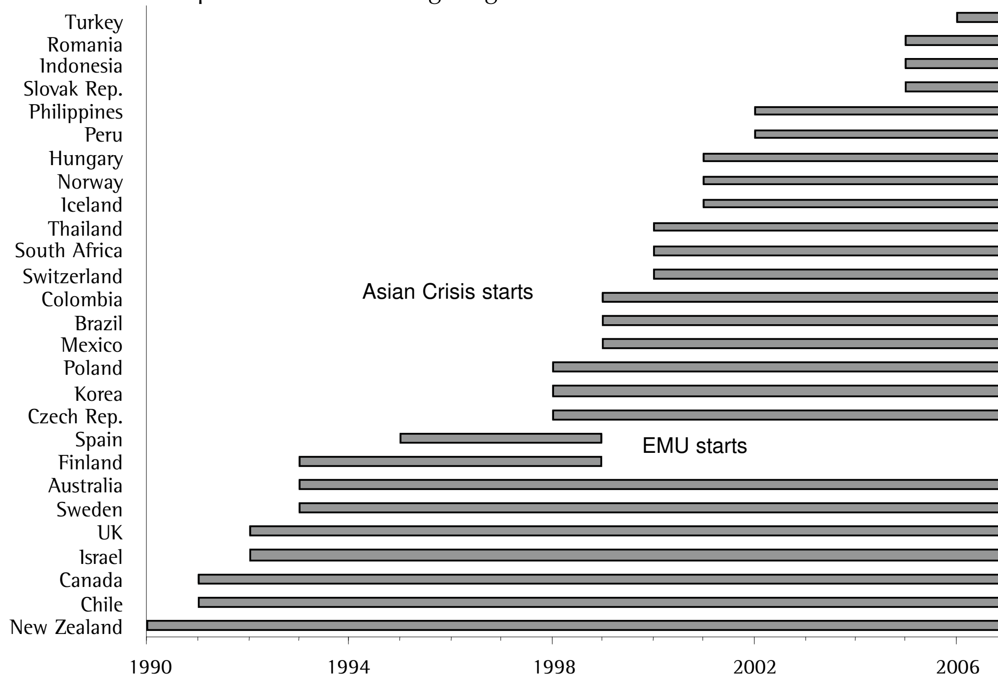
When a country loses its fight with the speculators and floats its exchange rate, it has to choose another monetary regime; floating is not a monetary policy. But until recently there was essentially no alternative to fixed rates. Two decades of unsuccessful experimentation followed the collapse of Bretton Woods in the early 1970s. Some countries tried, in vain, to pursue money growth targets. Others adopted hybrid strategies involving multiple or moving targets; still others adopted currency boards or monetary unions; some countries operated without clearly defined monetary policies.

That was then. In 1990 a new monetary strategy emerged from the Antipodes: inflation targeting. Inflation targeting requires that the central bank has a numerical inflation target to hit in the medium run in a transparent and accountable fashion, and this should be the most important objective of monetary policy. Inflation targeting has met with unprecedented popularity in the stodgy world of central banking; fourteen of the thirty OECD countries have already adopted the strategy! But even this understates its importance. Twelve OECD countries are in EMU, which is almost a formal inflation targeter and may become one soon; more are waiting in the wings to join EMU. The United States has also been an implicit inflation-targeting country for years, and may become an explicit one soon. There is much speculation that Japan may adopt inflation targeting when its deflationary days are definitively over. So the entire OECD may soon be using the same monetary strategy. And inflation targeting is not simply a policy of rich countries. Ten developing countries with 750 million people have also adopted inflation targeting – often after losing the fight to maintain a fixed exchange rate. In all, inflation targeting is the formal basis of monetary policy for well over a billion people in countries that constitute over a quarter of the global economy, and the informal framework accounts for much more (see the timeline in Figure 1). Where New Zealand leads, the world follows.

Hello inflation targeting, goodbye monetary instability

Inflation targeting is a durable monetary strategy. Indeed, it is perhaps the only durable monetary strategy. To date, twenty-seven countries have adopted inflation targets. Only two of those – Finland and Spain – have abandoned inflation targeting. Both left to join EMU in 1999, neither under economic duress (and the ECB maintains an inflation target as part of their monetary strategy). This stands in stark contrast to alternative monetary regimes experienced since World War II,

Figure 1 Timeline for adoption of inflation targeting



which have been plagued by crisis and failure, and have been accordingly transient. Fixed exchange rate regimes do not stay fixed forever! And durability is important; it is the best single indicator of success. Poor policies tend to be changed while things that ain't broke aren't fixed. Countries are switching to inflation targeting because it seems to deliver the goods: financial stability.

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The durability of inflation-targeting regimes is the most striking contrast with previous international monetary systems such as the Bretton Woods system, often considered to be the 'good old days.' But there are many other differences. In fact, there are so many points of comparison between the features of the Bretton Woods system and the behaviour of the inflation targeters that I have collected them together in Table 1.

Inflation targeting, the opposite of Bretton Woods

Most of the differences between regimes are straightforward. Mundell's celebrated 'Incompatible Trinity' states that fixed exchange rates, free capital flows and a domestic focus for monetary policy are desirable goals that are mutually exclusive. So inflation targeters tend to let their exchange rates float reasonably freely. Most inflation-targeting countries have liberalised capital markets and relinquished control over their exchange rates – the exact reverse of the Bretton Woods system. Indeed the emerging 'system', or non-system to be more precise, could be accurately labelled as Bretton-Woods-reversed, or BWR for short. Since the inflation-targeting countries float, there is typically no important role for public capital flows; speculative activity on the foreign exchange markets no longer revolves around speculators trying to attack a country's fixed rate. And the increased volume of private capital flows has allowed the system to handle large sustained current account imbalances, which are proportionately larger now than during the Bretton Woods regime.

Much about the new system's attractiveness can be seen by tracing out the history of its emergence. The Bretton Woods regime was deliberately planned, the outcome of a long series of wartime negotiations among eminent economists representing the interests of critical countries, especially the UK and the US. This is in stark contrast with the evolutionary development of the BWR system. Countries that adopt inflation targeting do not agree to join an internationally recognised monetary system and do not accept 'rules of the game', either implicitly or explicitly. Rather, the system has grown in a more Darwinian style, simply because of its manifest success. Also, international cooperation is not a key part of the emerging international monetary system. This is another difference with the Bretton Woods system, which required massive international cooperation to function (as do many modern attempts to reshape the international financial architecture). Accordingly, some of the key institutions of the Bretton Woods system are now essentially irrelevant. The International Monetary Fund has evolved into a crisis-manager for developing countries (often those suffering speculative attacks on their fixed exchange rate regimes) and plays no real role in the new system. There is no special role for a centre or anchor country (the United States during Bretton Woods; Germany for the European Monetary System), so there is no hegemonic title to fight over. Gold is irrelevant. It may be for these reasons that developing countries are participating more quickly and fully in the system than they did under Bretton Woods. The key players are each nation's central bank, with these now more independent, accountable and transparent than they were under Bretton

Table 1 Features of International Monetary Systems

	Bretton Woods 1959-1971	Inflation Targeting 1990-Present
Regime durability	Low	High
Exchange rate regime	Fixed	Floating
Focus of monetary policy	International	Domestic
Intermediate target	Exchange Rate	None/inflation forecast
Capital mobility	Controlled	Relatively unrestricted
Capacity for current account imbalances	Limited	High
System design	Planned	Unplanned
International cooperation	Necessary	Not required
Role of IMF	Key in principle	Small
Role of gold	Key in principle	Negligible
Role of US as centere country	Key in practice	Small
Key members	Essentially large and northern	OECD/LDCs, often small
Central banks	Dependent, unaccountable	Independent, accountable
Transparency	Low	High
Alignment with academics	Low	High

Woods. All of this is in contrast not only to Bretton Woods, but also to the many complicated plans currently being proposed to tie monetary policies more tightly together in Asia, Africa, and the Gulf.

...The system of domestically-oriented monetary policy with floating exchange rates and capital mobility was not formally planned. It does not have a central role for the United States, gold, or the International Monetary Fund. In short, it is the diametric opposite of the postwar system...

One final point is of interest. Serious objections had been made to the Bretton Woods system by well-known economists long before its demise. Robert Triffin observed as early as 1947 that the system had a tendency to meet the demand for reserves through the growth of foreign dollar balances, making it dynamically unstable. Milton Friedman famously made the case for floating exchange rates in 1950, a case emphatically echoed by Harry Johnson in 1969. By way of contrast, there is a much greater alignment of inflation targeting with academic thought. Indeed, much of the case for inflation targeting was made by distinguished academics including Ben Bernanke, Rick Mishkin and Lars Svensson.

The domestic focus on inflation does not result in international tradeoffs

Inflation targeting requires relegating the exchange rate to second-place (at best) as a target for monetary policy. But do countries with inflation targeting experience systematically higher exchange rate volatility in practice? No. My recent CEPR Discussion Paper No.5854 presents formal statistical evidence which shows that the presence of a durable monetary framework eliminates policy shocks that cause exchange rate volatility. It turns out that the observed exchange rate volatility is, if anything, lower for inflation-targeting countries than it is for countries pursuing other strategies. This means that the domestic focus of inflation targeting does not seem to come at the expense of higher exchange rate volatility. Further, countries that switch to inflation targeting also experience a drop in the frequency of 'sudden stops' of capital inflows.

Concluding remarks

Countries have few choices for their monetary strategy. Historically a large number of countries chose to hitch their monetary policy to a fixed exchange rate – a choice that frequently produced exchange rate crises. In reaction, the past decades have seen many nations experimenting with other strategies – money growth targets, monetary unions and boards, ill-defined or hybrid strategies. Since 1990, however, a new trend has emerged. An increasing number of countries have granted their central banks the independence to pursue a domestic inflation target.

Inflation targeters let their exchange rates float, usually without controls on capital flows and often without intervention. Because the goal of monetary policy is aligned with national interests, inflation targeting seems remarkably durable, especially by way of contrast with the alternatives. No country has ever been forced to abandon an inflation-targeting regime. But the domestic focus of inflation targeting does not seem to have observable international costs. Countries that target inflation experience lower exchange rate volatility and fewer 'sudden stops' of capital flows than their counterparts.

As a result of its manifest success, inflation targeting has continued to spread; it now includes a number of developing countries as well as a large chunk of the OECD. The system of domestically-oriented monetary policy with floating exchange rates and capital mobility was not formally planned. It does not have a central role for the United States, gold, or the International Monetary Fund. In short, it is the diametric opposite of the postwar system: Bretton Woods, reversed.

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