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THE CONSOLIDATION OF THE ANGLO-SAXON/ EUROPEAN CONSENSUS ON PRICE STABILITY

From International Coordination to a Rule-Based
Monetary Regime

Arie Krampf

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THE CONSOLIDATION OF THE ANGLO-SAXON/EUROPEAN CONSENSUS ON PRICE STABILITY

FROM INTERNATIONAL COORDINATION TO A RULE-BASED MONETARY REGIME

Arie Krampf

Abstract

During the 1990s, a consensus consolidated among policy makers and economists worldwide regarding the desirability of very low inflation targeting. So far, this process has been explained on the basis of a domestic-functional thesis, according to which commitment to very low inflation provides local economic gains with no costs. In this paper, I present an alternative explanation, according to which the global norm of very low inflation targeting was consolidated as a political solution to the problem of exchange rate misalignment and volatility. I argue that policy makers in Germany and the US believed that convergence of monetary policies and inflation rates, in addition to liberalization of financial markets, will stabilize exchange rates without the need for direct coordination. The paper employs the theory of liberal intergovernmentalism as a benchmark to explain the choice of the European and the G-5/7 countries to establish a low-inflation rule-based international monetary regime. The paper concludes that the regime of very low inflation targeting was consolidated as a politically viable solution to a political problem rather than as an economic best practice. Furthermore, it concludes that the norm of very low inflation targeting was a “corer solution” that neglected the problem of exchange rate stability.

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1. Introduction¹

Following the recent Euro crisis, the German insistence on policy rules of austerity became an issue of contention which attracted fierce criticism from neighboring European countries as well as from the United States (US) and the International Monetary Fund (IMF). The emergence of the debate regarding the rationale of commitment to monetary policy rules marks a milestone in the history of the international monetary system: The consensus on very low inflation targeting that characterized the international policy discourse from the 1990s onwards, has been severely cracked and the debate whether commitment to very low inflation is desirable in any circumstance was reopened.

Recently, senior economists at the IMF called for questioning the norm of very low inflation targeting arguing that hitherto

“[s]table and low inflation was presented as the primary, if not exclusive, mandate of central banks. This was the result of a coincidence between the reputational need of central bankers to focus on inflation rather than [economic] activity (...) and the intellectual support for inflation targeting provided by the New Keynesian model.” (Blanchard et al. 2010: 3)

The dissolution of the worldwide consensus on price stability provides a good opportunity to trace the origin of this consensus and the politico-economic conditions that facilitated it.

During the 1990s, a consensus consolidated among policy makers and economists worldwide regarding the desirability of very low inflation targeting. In the early 1990s, IMF economists declared that “[i]t is now widely recognized that the primary objective of central banks is—or should be—the maintenance of price stability” (Chadha et al. 1991: 1; see also IMF 2000). Inflation, it was argued, distorts “prices, erodes savings, discourage investment, stimulates capital flights, inhibits growth, makes economic planning a nightmare, and, in its extreme forms, evokes social and political unrest” (Masson et al. 1989).

The consensus was coupled by a global wave of central bank reforms that increased the legal independence of central banks to pursue the objective of price stability and by a growing number of countries that adopted inflation targeting as their declared policy objective (Truman 2003; IMF 2006). While New Zealand adopted inflation targeting and independent central banking in 1988 (Thiessen 2000), most other countries adopted the new norm during the 1990s (Polillo/Guillén 2005; Marcussen 2005). The Maastricht Treaty was a catalyst for adopting these practices within the European Community (EC). Following the disintegration of the Communist Bloc, European and international financial organizations used both “soft” and “hard” measures to diffuse price stability-seeking independent central banks to East Europe (Broome 2010; Bléjer et al. 2000). The financial crises in Latin America and South-East Asia were an opportunity for

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the IMF to press for adoption of these practices in the developing countries (Batini/Laxton 2006). By the end of the 1990s, a firm consensus consolidated regarding the role of central banks. As the President of the New York Federal Reserve Bank put it, “[c]entral bankers in all countries share a number of concerns. Perhaps the most important of these is the desire for price stability” (McDonough 1997: 1).

There was nothing special in the mere fact that economists and policy makers acknowledged the risks of inflation and its devastating economic and social costs. However, there were four features that characterized the 1990s consensus which, taken together, make it a unique phenomenon in historical perspective. First, the consensus advocated the targeting of very low inflation, usually below 2 or around 2 percent. Such a level of inflation was defined as “price stability”. Second, it advocated very low inflation as the *sole* policy objective of monetary policy, even at the expense of other desirable policy objective such as growth, exchange rate stability or balanced current account. Third, it promoted *commitment* to very low inflation irrespective of changing economic conditions. And fourth, it advocated very low inflation in *all countries* irrespective of domestic structures.

What makes this phenomenon even more puzzling is the fact that *in practice* most central banks did not actually follow the norm. In fact, as Stanley Fischer argues, the practice of central banks did not change significantly in the 1990s and most of them continued to take into account other objectives than price stability and had changing inflation targets² (see also Cagliarini et al. 2000; Fischer 2010). Moreover, recently and following the financial crisis, the General Manager of the IMF called for increasing the inflation targets (Blanchard et al. 2010). How then can the emergence of this consensus be explained?

The common argument held by economists is that commitment to very low inflation is simply a rational thing to do from a domestic perspective. It has economic benefits and no costs. Therefore, rational and responsible governments are likely to make such a commitment. This argument, however, suffers from several weaknesses which I discuss below. In this paper, I present an alternative explanation, which emphasizes the spillover effects of monetary policy on exchange rate volatility and misalignment. The aim of the paper, therefore, is to explain how the effects of monetary policy on exchange rates led to the consolidation of the norm of inflation targeting among the European countries and the G-5/7. In this paper I make three key arguments. First, I argue that the norm of very low inflation targeting was not adopted in order to solve the domestic problem of inflation, but rather in order to solve the international problem of exchange rate instability and misalignment. Second, I argue that commitment to very low inflation suited the preferences of the dominant countries, that is, Germany and the US. Finally, I argue that the European integration process provided a focal point of coordination and, therefore, the European norm of very low inflation targeting was uploaded to the international level and was institutionalized as an international norm.

The paper proceeds as follows. The second section presents the functional-domestic explanation for the adoption of the norm of price stability as well as its weaknesses. The third section presents the economic and politico-economic foundation of the alternative explanation. In this section, I present the theory of liberal intergovernmentalism, which will be used as a theoretical benchmark for the analysis. The theoretical discussion outlines the causal links between domestic and international monetary considerations. The

² Personal Interview with Stanley Fischer, Tel Aviv, July 2011.

next two sections present the historical evidence. Section four discusses the international negotiations (or the lack of them) among the G-5/7 regarding exchange rate coordination from the early 1980s and until the Plaza and Louvre Accords. The fifth section traces the Europeanization of the German practice of price stability through the Delors Committee and the therein prevailing German superior negotiation power. The sixth section presents the views of the professional actors—the Director of the Bank of International Settlements (BIS) and the Director of the IMF Research Department—regarding coordination of exchange rates. It demonstrates the fact that professional economists were critical of the rule-based institutional design of the European Monetary Union (EMU), as recommended by the Delors Report. The seventh section traces the internationalization of the European norm of price stability through the IMF executive organs and the Research Department.

2. Domestic Stability or International Coordination

So far, economists have explained the consensus on price stability on the basis of a domestic-functional explanation (Eijffinger/de Haan 1996; Alesina/Summers 1993; Cukierman 1992). According to this explanation, inflation has only long-term economic costs. While Keynesian economists assume that in certain conditions inflation has short-term gain, monetarist economists argue that the short-term economic gains in terms of growth and employment are illusory and temporal and that they are neutralized in the medium- and long-term and even cause long-term damage. The domestic-functional thesis further assumes that politicians have structural incentives to inflate the economy in order to achieve short-term political objectives (at the expense of the future). Therefore, a rational and responsible monetary arrangement would be based on a credible commitment to low inflation accomplished by delegating the monetary powers of the government to an independent central bank (Cukierman 1992; Alesina/Summers 1993). Economists often referred to the US experience with anti-inflationary policies during Paul Volcker's post at the Federal Reserve as a demonstration of the domestic-functional thesis (Thornton 2010).

While the domestic-functional thesis captures some essential elements in the political economy of inflation, especially in countries such the US and the United Kingdom (UK), it cannot explain the consolidation of the norm of very low inflation targeting in the 1990s as a *global norm* for several reasons.

First, in the second half of the 1980s, the perceived risk of inflation was low. During this period, inflation levels among the G-5 countries fell below 5 percent. The G-7 declared in 1988 that “[i]n the 1980s inflation has been brought under control, laying the basis for sustained strong growth and improved productivity” (Toronto Summit 1988). This view was shared by the World Economic Outlook of the IMF (WEO 1987: 5). Why, then, were drastic anti-inflationary measures institutionalized globally in a period in which inflation was not a pressing problem?

Second, the experience of the anti-inflationary policies in the 1970s and early 1980s demonstrates that governments were able to fight inflation without making legal changes in the statutes of central banks, that is, without making credible commitments. In fact, the support of the government, the ministry of finance and the public opinion in anti-inflationary policies proved to be just as important as the legal autonomy of

the central bank in industrial countries.³

Third, the assumption that the *only* incentive of policy makers to increase inflation levels is political survival is questionable, to say the least. The view that money is completely neutral has never been consensual among economists. While in all cases low inflation is preferred over high inflation, achieving very low inflation has incurred costs for other desired policy objectives.⁴ Hence, the question why policy makers would be willing to give up their discretion regarding monetary policy persists. What were the advantages of a strategy that justified the associated costs?

Finally, in the second half of the 1980s the G-5/7 countries were concerned by the problem of exchange rate volatility and misalignment much more than by the problem of inflation. They all referred to the current account imbalances, uncertainty of exchange rate behavior and persistent protectionist pressures as key problems (Tokyo Declaration 1986; Louvre Accord 1987; see also Boughton 2001: 247). The prioritization of the problem of current account imbalances over the problem of inflation was also acknowledged by the IMF (Boughton 2001: 250). Why then, in a period in which policy makers were concerned with external stability, did they adopt an instrument allegedly designed to achieve domestic price stability? The functional-domestic thesis does not provide an answer to this question.

The theory of liberal intergovernmentalism enables us to address these questions. Liberal intergovernmentalism (Moravcsik 1998; Moravcsik/Schimmelfennig 2003) rests on two fundamental assumptions: The first is that governments are key actors in shaping transnational institutional designs and the second is that governments behave rationally to promote national preferences. National preferences are determined on the basis of domestic factors and actors. Once preferences are set on the domestic level, policy makers promote the national preferences on the international level based on their relative bargaining power. The second is that international institutions are the manifestation of pooling and delegating sovereignty (Moravcsik 1998). Pooling and delegating sovereignty serve two purposes. First, they institutionalize bargaining outcomes. Second, commitment to policy rules on the international level increases the capacity of policy makers to confront pressure groups and veto players on the domestic level (“cut slack”) by “shifting the blame” to international institutions (Risse-Kappen 1995: 285; Moravcsik 1998: 256, 268; see also Putnam 1988).

In this paper, I adopt the liberal intergovernmental framework, with two qualifications. First, liberal theories assume that rule-based regimes are politically neutral in the sense that they only institutionalize negotiation outcomes and that the choice of adopting rule-based regimes is a necessary stage in international relations. As Moravcsik and Schimmelfennig argue, states establish rules in order to distribute gains according to “the pre-existing bargain and reduce the costs of coordinating their activities, monitoring the behavior of others, and mutually sanctioning non-compliance” (Moravcsik/Schimmelfennig 2003: 72). This approach does not account for the fact that establishing rules in itself has distributing effects.

³ This view is based on the experience of the industrial countries. In developing countries legal independence is likely to be a more important anti-inflationary factor.

⁴ Dornbusch and Fischer argued in a paper from 1991 that in countries of “moderate inflation” (10-15 percent), seigniorage was the least significant factor in explaining persistent inflation and that it was impossible to reduce inflation further without substantial costs in terms of growth (Dornbusch/Fischer 1991).

The limitation of this view is that it does not account for the fact that a rule-based regime is not the only way to institutionalize international relations. Tanja Börzel distinguishes between two types of transnational institutions. The first type is “intergovernmental institutions” designed to “solve collective action problems” through negotiation. The other consists of supranational institutions that “make collectively binding decisions” (Börzel 2011: 10). The choice of pooling and delegating sovereignty corresponds to the latter type. There is also a third alternative, which is the choice not to coordinate. The question is, then, why in certain cases flexible arrangements of intergovernmental negotiation are preferred while in other cases binding arrangements are preferred, and in still other cases countries chose not to coordinate? Therefore, in this paper I assume that there are three types of managing international economic issues: non-coordination, direct negotiation and rule-based regimes. The answer to this question will explain the choice between the three types. Second, for Moravcsik, state preferences are determined by domestic business groups and the state trade interests. In the policy area of domestic and external monetary stability preferences are determined, to a large extent, by the political elite and experts, rather than by the balance of power between domestic actors. Moreover, I assume that state preferences are affected by the structure of the domestic banking system: Market-based systems prefer rules while credit-based, state-led systems prefer exchange rate coordination.

Moravcsik’s intergovernmental analysis conflicts with other accounts, which highlight the role of ideas and ideational entrepreneurs (Dyson 1994; McNamara 1998; Dyson/Featherstone 1999; Verdun 1999). Dyson argues that “[t]he victory of sound money ideas was closely linked to the privileged position of the central banks in the EMS [European Monetary System] and EMU policy process” (Dyson 1994: 257). Verdun’s argument is more cautious. She states that central bankers as an epistemic community did not stand “above” geopolitical politics, but that the experts were asked for advice “precisely because national decision makers needed extended legitimacy and knowledge about how to take the next step in international co-operation” (Verdun 1999: 323). The idea-based explanation would serve as a third alternative explanation.

3. State Preferences and Institution Design

The aim of the paper is to explain the consolidation of the low-inflation rule-based regime, that is, the choice of a rule-based regime as well as the content of the rules on the basis of national preferences. In the following sections, I present the factors that shape the national preferences of the dominant countries regarding this issue. I will focus on the monetary national aspects rather than on the trade interests of groups within each country.

3.1 *Domestic Factors*

What are the domestic factors that determine the states' preference for rules in general and to commitment to very low inflation in particular? In this paper, I assume that there is a trade-off between domestic and external stability, that each country had a different preference regarding domestic and external stability and that the level of convergence determines the extent to which the two objectives contradict.

From a purely economic perspective, rational policy makers are likely to pursue both domestic stability (low inflation) and external stability (low volatility of exchange rates and balanced current account). However, economic theories tell us that domestic and external stability are not always compatible, and that in most cases there is a trade-off between them (Bearce 2008). Different countries have different preferences regarding the preferred position along the trade-off curve between domestic and external stability. Therefore, they have different preferences regarding the concessions they are ready to make in order to coordinate exchange rates.

In the period from 1980 to 1995, three strategies that were adopted by different countries can be identified. First, the Anglo-Saxon "traditional" approach prioritized domestic stability, with the assumption that rational and efficient global financial markets would take care of exchange rate stability and alignment (cell II table 1). The preference of the US and the UK towards this strategy could be explained by their market-oriented financial structures (Zysman 1984) and the fact that it suited Reagan's supply-side reforms and Thatcher's monetarist reforms (Hall 1986). Therefore, they both preferred "sound money" policies and the approach of "putting your own house in order". Moreover, the US is a large "closed" economy that was not expected to benefit significantly from international coordination. Finally, policy makers in a country characterized by a decentralized political structure are likely to prefer rule-based regime, in order to lock in domestic veto players. In such cases "state representatives act independently from their national governments, built coalitions with like-minded officials from other countries, and then use these alliances to strengthen their own bargaining power at home" (Risse-Kappen 1995: 285). This may explain why the US and the UK preferred rule-based regimes on the international level.

The diametrically opposed strategy was that of France. France sought to maintain domestic autonomy macroeconomic discretion. At the same time, however, stability was also a desirable policy goal. The regime of pegged but adjustable exchange rates reflected this preference, as it enabled the country to maintain a space of discretion as well as the ability to import stability by pegging exchange rates (cell III). The

pegged-adjustable regime required coordination and discretion on the international level to determine the exchange rates that reflect “economic fundamentals”. During the European Monetary System (EMS), the European regime was quite close to this strategy. In the period from 1985 to 1988, a similar strategy was adopted by the G-5-7.

The preference of France for this option could be explained by its domestic credit-based, state-led financial structure and its capacity to control and channel resources administratively (Zysman 1984). Moreover, France’s preference towards this approach should be understood in relation to the alternative: complete liberalization. The EMS was framed in the French policy discourse as a *shield against global pressures*, rather than as a *part of globalization*. Last but not least, weak-currency countries were likely to prefer discretionary regimes because such regimes distributed the burden of adjustment more symmetrically than rule-based regimes. Although theoretically, rule-based regimes could be designed to have a symmetrical distribution of the burden of adjustment, historically, most if not all, rule-based regimes were shaped by the strong-currency countries which favored surplus countries. The exception is of course the US, which was a deficit country but no weak-currency country.

Finally, the third strategy consisted of both domestic rules of “sound money”, as well as international coordination of exchange rates. This strategy was held traditionally by Germany (Cell I).⁵ The German preference for “sound money” has been discussed extensively in the literature and it was traced to its ordoliberal ideology, its “culture of stability” and the position of the Bundesbank (Neumann 1998; Ptak 2009). It is less clear, however, why Germany accepted intervention in exchange rates.

To explain this German preference for coordination of exchange rates, it is necessary to account for geopolitical factors. While Germany had superior economic negotiation power within Europe, the relative advantage of France lay in its capacity to link geopolitical and economic issues. Until the Delors Report Germany was willing to accept a more discretionary European monetary arrangement (pegged but adjustable exchange rates) in order to keep the European project on track. This strategy, however, conflicted with the Anglo-Saxon preferences. After the Delors Report, amid globalization pressures on Europe and liberalization of capital control within Europe, the European strategy shifted in favor of the German economic preferences, a transition that paved the way to a German and US consensus.

⁵ This is shown clearly by the Annual Report of the BIS which states that the “German and, especially, the Japanese monetary authorities have over the last five years or so often opted for co-ordination” (BIS 1990: 231).

*Table 1: Rules vs. Discretion; Coordinated vs. Floating Exchange Rates:
National Preferences Regarding Domestic and International Monetary Regimes*

		External Policies (Exchange Rates)	
		Fixed or Coordinated Exchange Rates	International Laissez-Faire
Domestic Policies	Domestic Rules	I Germany Maastricht Treaty	II UK (Thatcher Monetarism); US (Reagan Supply-side reforms)
	Domestic Discretion (Demand-Side Economics; Keynsianism)	III France EMS (Baker and Lawson: 1985-1988)	

Source: Author's Illustration

3.2 International Factors

While each country determines its own preferences regarding domestic and external stability on the basis of domestic factors, state preferences are also determined collectively by international factors. There are two international factors that will be considered. First, in an interdependent world with floating exchange rates and no capital control—as were the conditions during the 1980s—the capacity to maintain both domestic and external stability was dependent upon the extent to which different economies converged in terms of policies and structures. In a fully converged region with perfect and rational financial markets, the region could be envisaged as one economic unit and, therefore, domestic and external stabilities are fully correlated. In such a perfect world, pursuing price stability in each country independently would secure exchange rate stability. In the real world, in which economies are not fully converged, a conflict is likely to arise between domestic and external stability. When the divergences and disparities among economies give rise to as severe perceived problems, there is a growing incentive for countries to take collective actions to address these problems by either coordinating macroeconomic policies or by enforcing homogenous structural reforms.

The second international factor that affects the willingness of governments to coordinate is what I call a *shared sense of crisis*. A shared sense of crisis arises when the key actors in the international system believe that a collective crisis is very likely to occur unless collective actions would prevent it. A shared sense of crisis reduces the relative weight of the distributional effects of coordination and regime building and increases the relative weight of the collective gains. Therefore, the existence of a shared sense of crisis increases the willingness of governments to accept international arrangements that do not fully reflect their

relative bargaining power. These two international factors are important in order to explain the shift from the strategy of no cooperation in the early 1980s to the strategy of direct negotiation in the mid-1980s. In this case, both the US and Germany deviated from their traditional set of preferences.

To what extent can this constellation of domestic and international factors explain the shift from non-coordination to direct negotiation and the subsequent consolidation of the inflation targeting rule-based regime? The question will be discussed below.

3.3 *Method*

The dependent variable in this study is the international regime in the policy area of exchange rate coordination during the 1980s and early 1990s. This variable can have three distinct values: non-coordination, direct negotiation with country specific recommendations and a rule-based regime. My aim is to explain the consolidation of each regime, with a specific focus on the consolidation of the rule based regime in the late 1980s and early 1990s.

The independent variables are domestic, economic and geopolitical factors such trade position, the financial structure (market- or credit-based), structure of the political system (centralized or de-centralized), and international economic conditions (“a sense of crisis”). The analysis focuses on four key industrial countries: Germany, France, the UK and the US. The paper traces how national preferences in the monetary policy area were translated into bargaining positions and tactics and into institutional outcomes.

The primary material on which the study is based includes Communiqués of summits of the G-5 to G8, Proceedings of the IMF Board of Governors and the Interim Committee, Annual Reports of the Bank of International Settlements, IMF staff papers, World Economic Outlook reports and Annual Reports of the IMF. In addition, I draw on the analysis of newspaper publications and secondary literature. Specifically, the canonical works of Moravcsik (Moravcsik 1991; Moravcsik 1998) and Dyson and Dyson and Featherstone (Dyson 1994; Dyson/Featherstone 1999) should be pointed out as secondary resources, which the research draws upon.

4. From Non-Coordination to Direct Negotiation

In order to analyze the different strategies by which the G-5/7 and the European countries addressed the problem of international coordination of exchange rates, it is convenient to divide the period between 1980 and the 1990s into four sub-periods. First, the *period of non-coordination* (1980-1984): In the first half of the 1980s, the US prioritized the domestic problem of inflation with no regard to the international implication of high interest rates. Europe followed the French approach manifested in the EMS. The conflict between the US and France prevented international coordination. Second, the *period of direct negotiation* (1985-1988): Following James Baker's nomination to the Treasury in 1985, the US accepted the rationale of inter-governmental coordination of exchange rates and the road was paved to the Plaza and Louvre Accords. Third, the *period of rule-based regime building* (1989-1991): Following the Delors Report, German reunification and the disintegration of the Communist Bloc, Europe abandoned the strategy of direct negotiation in favor of the prioritization of rule-based regime building. The new European strategy paved the way for an Anglo-Saxon/European consensus regarding rule-based regime building. And finally, the *period of consolidation of the regime* (1992 to late 1990s): The global norm of inflation targeting was institutionalized and legitimized as best practice from a *domestic* perspective. In the following sections, I seek to explain the transitions from each period to the following one.

4.1 Non-Coordination Period

Until 1985, the G-5 governments did not reach a common understanding regarding the favorable coordination strategy of exchange rates. The obstacle was the disagreement between the US and France concerning the causes of the problem and the right way to solve it. The US policy makers during the Reagan Presidency—Donald Regan, the treasury secretary, Beryl Sprinkler, from the Council of Economic Advisors, and Paul Volcker from the Federal Reserve Bank—opposed any kind of intervention in the exchange rate markets. They adhered to the view that in order to stabilize the exchange rate markets, it was necessary that each government would “put its house in order”, a phrase that according to the Anglo-Saxon jargon meant the implementation of supply-side or monetarist reforms. Once domestic policies were “in order”, it was assumed, international financial markets—which were expected to behave rationally and prioritized mid-term over short-term profits—would bring exchange rates to reflect economic fundamentals (Eichengreen 1996: 140, 147).⁶ Exchange rates coordination was interpreted as state intervention and, therefore, according to most American policy makers and economists, was ineffective and even harmful (Boughton 2001: 190).

On the French side, Mitterrand, Delors, and La Genière had a different view. Despite internal debates within the French administration,⁷ at the international level France advocated the view that exchange rate

⁶ Volcker's policy prioritized domestic price stability to the extent that he ignored the implication of his aggressive anti-inflationary policy on the “over-shooting” of exchange rate (Eichengreen 1996: 146).

⁷ Mitterrand wished to implement expansionist demand-side policies to inflate France out of the European slowdown. Such policy, however, risked other French interests of staying within the EMS and maintaining a reasonable level of foreign exchange reserves. While Mitterrand pushed for expansion, Delors, Camdessus and La Genière

movements were the key threat to growth and economic stability and, therefore, exchange rates should be managed through coordinated government intervention (Boughton 2001: 190). In other words, the French preference was to promote an international regime that was similar to the European Monetary System. The EMS provided France with a combination of protection from international speculative capital flows and a leeway in domestic policies.

The US and French divide had its foundation both in ideas and interests. Ideationally, policy makers in the two countries differed in the trust they conferred on international financial markets. While the US paradigm assumed that financial markets promoted stability and that they brought exchange rates to reflect economic fundamentals, the French paradigm considered global financial markets a destabilizing factor.⁸ However, the intellectual division also had a material foundation that rested on the differing financial structures that characterized each of the countries. The US financial sector was characterized by a market-based structure while the French financial sector was characterized by a credit-based, state-led structure (Zysman 1984). Therefore, intervention in exchange rates was expected to suit the French interest more than that of the US. Moreover, New York, like London, was an international financial center and, therefore, the US opposed any policy, which might lead to restriction on transnational capital flows. Finally, the US economy was a large and closed economy that was not as affected by external instability as the small European countries and, therefore, their relative gain from coordination was likely to be relatively lower (Frenkel et al. 1989a: 199).

4.2 *Direct Negotiation and Country-Specific Recommendation*

In the period from 1983 to 1987, the current account imbalances between the US on the one hand and Japan and Germany on the other surged together with the volatility of exchange rates (Chart 1, Appendix). This period was also characterized by increasing liberalization and a surge in intra-European and transatlantic trade.⁹ Hence, the perceived risk of international imbalances increased. The growing surpluses and deficits of current accounts within the G-5 increased the incentive of policy makers to find a solution to the problem of international coordination. This “sense of crisis” may explain why governments with strong negotiation power were willing to abandon their traditional preference that were determined by domestic factors and accepted international arrangements that were favorable to the weaker countries. Particularly the US abandoned its isolationist traditional approach and Germany was willing to adopt more expansionary policies in order to reduce international imbalances.

The trigger that had tipped the balance in favor of coordination was probably the nomination of James

emphasised the risks of leaving the EMS (Eichengreen 1996: 166; Helleiner 1996: 142).

8 Rudiger Dornbusch was the first to present a model that explained why financial markets are likely to destabilize exchange rates (Dornbusch 1976). The basic logic of the model is that an interaction “of sluggishly adjusting goods markets and hyperactive asset markets” leads to overshooting of exchange rates (Rogoff 2002).

9 Moravcsik explains the convergence on interests among the European countries on the basis of growing trade liberalization as part of the Single European Act (Moravcsik 1998: 317). In this paper, the issue of international monetary instability is emphasized.

Baker as Secretary of the Treasury in February 1985 at the beginning of Reagan's second term. Baker was a firm advocate of international coordination. It has been suggested that Baker saw international coordination as an instrument to confront domestic pressure groups that promoted protectionist policies and resisted international coordination (Baker 2006: 32; The Financial Times London 1986). In his advocacy, Baker went so far as to compare the inter-governmental negotiations in the mid-1980s to the origin of US federalism. Just like the representatives of the American states in Philadelphia, he said in the IMF Annual Meeting, "we, as representatives of the global community, share similar needs and responsibilities that transcend our particular borders and require a strengthened framework for cooperation for the good of us all" (IMF 1987: 106).

The US preferences as shaped by Baker reduced the gap between the US and the French approaches. Reagan and Mitterrand even considered re-establishing a fixed exchange rate regime similar to that of the Bretton Woods system (Boughton 2001: 203). This plan was abandoned but Baker still believed that international collective action was needed to "facilitate exchange rate adjustments to reflect more fully underlying economic fundamentals" (IMF 1987: 106). The British Finance Minister Nigel Lawson also shared this view arguing that "[w]ith hindsight, some of the arguments for free floating seem much less compelling". Moreover, "the belief that markets would provide a stabilizing influence, through the operations of medium-term speculation, has not been borne out" (IMF 1987: 89).

The new spirit of coordination led to the Plaza and the Louvre Accords in 1985 and 1987, respectively. The two Accords consisted of country-specific recommendations which distinguished between policies in surplus and deficit countries. From a French perspective, the form of the Accords (country-specific recommendations) reflected its success to upload the European coordination strategy to the international level. "The strategy of cooperation", declared Balladur, the French Governor at the IMF, "instituted by the Louvre agreement represents a genuine success and, in my opinion, gives encouragement to those who, like myself, believe in the need to restore a more stable international monetary system" (IMF 1987: 34). The German central banker, Karl Otto Pöhl, praised the strategy of direct negotiation with country-specific recommendations, arguing that the recent strategy pursued by the major industrial countries "rightly emphasizes the need for effective policies designed to ensure that domestic demand expands more rapidly than domestic output in major surplus countries and less rapidly in deficit countries" (IMF 1987: 81). The convergence between Anglo-Saxon countries and the French-led European approach was a milestone that facilitated three years of exchange rate coordination.

The consolidation of the direct negotiation strategy could best be explained by two factors. First, the strategy of direct coordination at the international level was very similar to the EMS at the European level. While the EMS officially consisted of pegged rates, in effect, European countries with weak currencies often adjusted their exchange rates with the D-Mark, and, therefore, the arrangements provided flexibility, discretion and a more symmetrical distribution of the burden of adjustment. Second, due to the growing sense of crisis on the international level, the US abandoned its traditional reluctance to coordinate exchange rates.

4.3 *Coordination and Surveillance*

The spirit of international coordination of exchange rates was manifested also in the publication of the *World Economic Outlook* (WEO), which became a significant transnational actor in the 1980s. The Plaza and Louvre Accords were based on direct negotiations between the heads of states, finance ministers and central banks' governors. They took into account a relatively large number of economic indicators—specifically both domestic and external indicators—and provided country-specific recommendations (Vines 2004). As the Directors of the IMF Research Department described it, the Accords provided “country-specific policy commitments” on the basis of “concerted official views on the pattern of exchange rates” (Frenkel et al. 1989b: 187). The country-specific approach enabled the ministers and governors to make a distinction between policy recommendation to “surplus countries” and “deficit countries”, thereby distributing the burden of adjustment more symmetrically (Dyson 1994: 160).

The G-5/7 countries acknowledged that coordination required the support of a transnational actor to facilitate trust. This strategy was institutionalized by the *World Economic Outlook* (WEO). The WEO was a publication prepared by the IMF and its official purpose was the “surveillance” of economic policies and macroeconomic indicators of the member countries by collecting and distribution information. The first WEO report was published in 1980 and the project was coordinated by the Research Department with the participation of other departments of the IMF (WEO 1986, v, 20). The formal role of the IMF as a surveillance actor was re-affirmed in the Versailles Summit in 1982. The G-7 declared that they were “ready to strengthen our cooperation with the IMF in its work of surveillance” (Group of 7 1982). This was done on the basis of section IV of the IMF Articles of Agreement according to which the “Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations.” The role of surveillance became more essential after 1985 when the G-5 started to coordinate. James Baker was an active player behind this initiative (Baker 1986). In 1986, the WEO was instructed directly by the Interim Committee of the IMF to “improve the scope for discussing on external imbalances, exchange rate developments and policy interactions among members” (WEO 1986: 20). In its capacity as a surveillance actor, the WEO put emphasis on the issue of exchange rates. The G-7 specifically instructed the WEO to focus on economic indicators that affected exchange rates (Group of 7 1987). James Baker made a point saying that surveillance should provide information regarding a relatively large number of economic indicators including commodity price, growth, external imbalances and exchange rates (IMF 1987: 108). It was also the French view that emphasis should be given to exchange rates within the economic indicators traced by the WEO (Boughton 2001: 205).

The modest function of the IMF as a surveillance actor until 1988 is contrasted, as I show below, to its role in the rule-based regime from 1989, when it became a powerful transnational actor that legitimized rules, monitored compliance at the international level and exercised discretion.

4.4 *Obstacle of Coordination*

Despite the relative success of the strategy of direct coordination, its key weakness was the lack of commitment mechanisms. The experience of the Louvre and Plaza Accords shows that it was easier for the G-5/7 policy makers—central banks and finance ministers—to reach an agreement than to implement it in their home countries. This problem was particularly severe in the case of the US where the decentralized political system enabled veto players and societal groups to bloc policies which the administration was committed to at the international level (Brawley 2005: 374) and in the case France, which was characterized by strong labor unions.

The incapacity of the US government to implement locally the policies it was committed to internationally was used by opponents to coordination in the US domestic discourse as a reason why the US should not take part in international coordination. Martin Feldstein, previously Chairman of the Council of Economic Advisers and Chief Economic Advisor to President Ronald Reagan, argued that the US “is constitutionally incapable of participating in such a negotiation” (Feldstein 1988: 10). Stanley Fischer, at the time at the Massachusetts Institute for Technology (MIT) School of Management, prior to his post as Vice President and Chief Economist at the World Bank, was quite skeptic about coordination of exchange rates, and he argued that the gains from cooperation “will rarely be significant” and in many cases “coordination worsens rather than improves economic performance” (Fischer 1987: 49). The skepticism regarding the US incapacity to commit was also raised by European economists who argued that “[t]he problem is that US policy is dictated primarily by domestic considerations” and therefore “[a] change in circumstances could easily prompt a US retreat into isolationism”, a senior European monetary official commented (The Financial Times 1986).

However, for the supporters of international coordination, the incapacity of the US to implement its international commitments was exactly the reason why they believed the US should engage in the international coordination: International agreements would enable policy makers to overcome domestic veto players and to implement the “right” policies (Baker 2006: 32; Webb 1995: 226; Henning/Destler 1988). This argument is in line with the theory of two-level games, according to which policy makers may make international commitments in order to lock in domestic policies that they wish to pursue irrespective of the international commitments.

The problem, therefore, of the strategy of direct negotiation with country specific recommendations was that it did not provide a mechanism that helped policy makers to mobilize support at the local level. Contrariwise, a rule-based regime that enforced similar policy rules on all countries was easier to justify, legitimize and monitor on the domestic level.

5. The EU: From the EMS to the EMU

The shift from direct negotiation to a rule-based regime took place almost simultaneously on the European and the international levels. The timing suggests that the two processes were causally linked.

5.1 *The Delors Report: Framing the Problem*

In the years following the Plaza Accord, France was optimistic regarding its prospect to promote an EMU based on intergovernmental coordination, country-specific policies and symmetric distribution of the burden of adjustment. During 1987, this strategy was manifested in the Basle-Nyborg agreement and the Franco-German summit at Karlsruhe. In 1987, Chirac's government initiated an attempt to institutionalized direct coordination with Germany by establishing the Economic Council of Finance Ministers and Central Bank Governors. According to the French proposal, the Council would enable both countries to "coordinate" and "harmonize" policies (Dyson 1994: 124). The French proposal shared similarities with the G-5/7 strategy of coordination: direct coordination of fiscal and monetary policies without pre-given rules. The French government, therefore, had expectations that the Delors Committee would provide a template for an European monetary union based on this approach.

At the German domestic front, in 1987, there were strong incentives to keep France inside the EMS and to progress with the project of a European Monetary Union. The German Foreign Minister Hans-Dietrich Genscher was among the key promoters of this approach. In 1988, Genscher prepared a "Memorandum on the Creation of a Monetary Union and a European Central Bank", in an attempt to bridge between the ordoliberal view of the Bundesbank and those who promoted European unification due to geopolitical and ideological reasons. Genscher's innovation was the proposition of the establishment of a European central bank—as the French government wanted—but unlike the French model of a central bank, Genscher's idea was to emulate the German model of a central bank and endow it with the mandate to pursue price stability even at the expense of other desirable objectives (Dyson 1994: 331; Verdun 1999). Genscher's memorandum could be conceived as a milestone in the evolution of the European integration because it translated the German traditional preferences in a new way, thereby opening the way for progress.

The Delors Committee was established in order to accelerate the European integration as well as to address specific weaknesses of the EMS. The Committee, set up by the European Council, was mandated to examine steps leading to the EMU. It was composed of the governors of the national central banks of the EC members as well as the General Manager of the Bank of International Settlements, Alexandre Lamfalussy, and Jacques Delors, the President of the European Commission and the former French Finance Minister. The Committee's report adopted Genscher's idea of a German-style European central bank.

For our purpose, the justification of the institutional design is just as important as the design itself. According to the Committee's Report, the key problem of the EMS was insufficient "convergence of fiscal policies" (Delors 1989: 8; see also Eichengreen 1996: 163; Giavazzi/Giovannini 1990). As explained above

in section 3.1, the lack of convergence destabilizes an economic zone because it creates a conflict between domestic and external monetary stability. The decision-making authorities within the EC countries, it was argued, were “subject to many pressures and institutional constraints” that were the result of the strategy of “voluntary cooperation”. To face the problem, the Committee recommended creating “more binding procedures” (Delors 1989: 11). The Report put forward instruments to increase convergence and to minimize “regional disparities”. The instruments were, on the one hand, financial support to weak economies and, on the other hand, enforcement of stricter policy rules. The system of European central banks was designed to play a key role in the process.

“The Governors [of the central banks] would [...] manage the proposed system for [European] Community exchange rate relations, which would progressively lead to a narrowing of the fluctuation bands. Progress in the convergence of economic and monetary policies should be such in the course of the second stage [of the EMU] that Member States no longer have to resort on an autonomous basis to the instrument of parity adjustment.” (Delors 1989: 559)

Hence, the Delors report framed the problem of lack of convergence among EU member countries as crucial to the stability of the European economic system. Therefore, the Europeanization of the German model of central banking and the construction of the system of independent central banks were justified not as a solution to the problem of inflation per se but as a means to homogenize monetary policies.

5.2 The EU and Inflation Targeting

All historical accounts agree that the Delors Committee was dominated by the views of Karl Otto Pöhl, the president of the Bundesbank (Dyson/Featherstone 1999; Moravcsik 1998).¹⁰ Pöhl’s dominant position in the Committee was based on Germany’s negotiation power. Despite the fact that the Delors Committee was chaired by Delors, France was in a weak position in the Committee. Its weakness in the Committee was already predetermined by the decision to appoint a committee of experts rather than a mix of politicians and experts. This decision weakened the negotiation power of France because it differentiated between economic and geopolitical issues, and prevented the country to demand economic concessions.

France’s negotiation power rested on a linkage between geopolitical and economic issues: As a weak-currency country it sought economic concession in exchange for staying within the EU, which was considered a German interest. Germany, for the same reason, benefitted from de-linking between economic and geopolitical issues. Therefore, the insistence of Kohl on an expert rather than a mixed committee was already a German success in terms of agenda setting: Economic and political considerations were differentiated and France lost its capacity to link economic and geopolitical issues (Dyson/Featherstone 1999: 124).

The UK did not have any significant influence on the Delors Committee. Thatcher sent the Governor of the

¹⁰ Alex Cukierman confirmed that the idea of a stability-seeking independent central bank was based on the German model (Personal Interview with Alex Cukierman, 18 January 2011; see also Goodfriend 2007).

Bank of England to the Committee only because it did not want to stay behind. The governor did not have any concrete proposal or demands. Nevertheless, the emphasis that the Delors Report put on the objective of price stability created favorable conditions for assuaging the British skepticism and suspicious position towards the European project. Thatcher, the most ardent Euroskeptic on the British side, had admired the Bundesbank for its anti-inflationary record and she believed that the UK had much more in common with Germany than with France concerning this matter (Dyson/Featherstone 1999: 606, 678). As Moravcsik put it, the new European approach was “an extension of her [Britain’s] domestic regulatory reform” (Moravcsik 1998: 324).

5.3 *The EU as the a Promoter of Central Bank Independence*

For the purpose of this paper, the key importance of the Delors committee is the way it framed the key European problem and the solution it proposed. The key problem was not inflation per se but a lack of convergence; the solution was the establishment of a network of independent central banks. The Report stated that the weakness of the EMS stemmed from “the lack of sufficient convergence of fiscal policies as reflected in large and persistent budget deficits in certain countries has remained a source of tensions and has put a disproportionate burden on monetary policy” (Delors 1989: 8). Therefore,

“[i]n these circumstances the effectiveness of national monetary policies will become increasingly dependent on cooperation among central banks. Indeed, the growing coordination of monetary policies will make a positive contribution to financial market integration and will help central banks gain the experience that would be necessary to move to a single monetary policy.” (Delors 1989: 16)

The Delors Committee recommended the establishment of national autonomous central banks in the first stage of the road to a currency union and an independent European System of Central Banks Council (ESCB) in the second stage (Delors 1989: 22). The central banks, individually and as a network of central banks, were to be “committed to the objective of price stability” (Delors 1989: 21). In later years, the establishment of an independent central bank was set as a precondition for joining the EMU (Eijffinger/de Haan 1996).

Hence, according to the Delors Report, Europe could achieve convergence by establishment of national independent central banks with the sole objective of price stability. This institutional arrangement—in addition to other types of measures—would create stronger pressures on governments to converge fiscal policies. If successful, this strategy would stabilize exchange rates within Europe and would enable a smooth transition to an EMU.

6. The BIS and the IMF Research Department

It might be argued that the analysis presented so far does not contradict the domestic-functional thesis. The fact that inflation rules were adopted to solve intra-European coordination problems does not rule out the fact that commitment to very low inflation is also beneficial from a domestic perspective. However, during the period when the low-inflation regime was consolidated, economists from international organizations – the BIS and the IMF – warned policy makers that such a regime runs the risk of losing the capacity to maintain exchange rate stability. This fact supports the argument that the regime was a political solution to a political problem rather than an economic “best practice”.

6.1 The BIS

The BIS was established in the late 1920s to handle the reparation from Germany in an “apolitical” manner. In practice it turned into a “club” of European central bankers (Simmons 1993; Toniolo 2005; Marcussen 2008). Following the Second World War, its clout diminished but it continued to play a role on the European level. The EC central bankers convened monthly at the BIS and the Managing Director of the BIS, Alexandre Lamfalussy, took part in the Delors Committee. Therefore, prior to the establishment the European Central Bank, the BIS was the key organization for the coordination of monetary policies within Europe.

Lamfalussy, who in principle embraced the Delors Report, was concerned by the assumption of the Report that convergence could be actually achieved. Given his belief that convergences would not be accomplished despite conditionality pressure, he argued that exchange rates would have to be managed and that fiscal policies would have to be coordinated.

In the paper he submitted to the Committee, he expressed his reservations regarding “the adequacy of sanctions imposed by the market mechanisms”. He argued that experiences in other federal states show that “fiscal convergence [...] is probably the result of tradition and history, factors which in Europe appear to favour divergence” (Lamfalussy 1989, 93, 96). Since it would be impossible to enforce convergence, Lamfalussy argued, macroeconomic coordination would be necessary. In fact, Lamfalussy warned that without fiscal coordination the strategy of a rule-based regime would be destabilizing:

“The combination of a small Community budget with large, independently determined national budgets leads to the conclusion that, in the absence of fiscal coordination, the global fiscal policy of the EMU would be the accidental outcome of decisions taken by Member States [...]. As a result, the only global macroeconomic tool available within the EMU would be the common monetary policy implemented by the European central banking system [...]. But such a situation would appear even less tolerable once the EMU was regarded as part and parcel of the world economy, with a clear obligation to cooperate with the United States and Japan in an attempt to preserve (or restore) an acceptable pattern of external balances and to achieve exchange rate stabilization. To have even the smallest chance of reaching these objectives, all cooperating partners will need flexibility in their policy mixes.” (Lamfalussy 1989: 101)

Lamfalussy emphasized the economic risks associated with the rule-based monetary regime proposed by the Delors Report. Monetary policy instruments, he argued, are “the most flexible and probably the most powerful policy instrument at the authorities’ disposal for fighting inflation and controlling exchange rate developments” (BIS 1990: 236, 179). A policy of inflation targeting rules restricted the flexibility of monetary authority to maneuver between the two policy-objectives. Lamfalussy rejected the view common among the Anglo-Saxon economists and policy makers, according to which foreign exchange markets stabilize exchange rates (BIS 1990: 211). Rather, he was quite adamant in claiming that “[f]loating exchange rates [...] require a certain degree of international policy co-ordination if exchange rate relationships are not to become grossly distorted” (BIS 1990: 231).

6.2 IMF Research Department

A similar line of argument was promoted by the Research Department of the IMF at the international level. Jacob Frenkel, the director of the Research Department (1987-1991), was very active in promoting international coordination of exchange rates. Until he left the IMF in 1991, he continued to promote the view that exchange rates should not be left to the market forces. Frenkel and his deputy, Morris Goldstein, framed the international problem of exchange rates instability in very much the same way as the BIS framed the European problem: It was a problem of maneuvering between two desirable economic objectives: domestic stability and external stability. Due to the fact that they do not coincide, monetary policy should pursue a certain combination of the two objectives.

For Frenkel, both domestic and external stability were *international collective goods* that required inter-governmental collective action to secure their supply. “We see the responsibility for price stability as a collective one of the largest industrial countries, rather than as the responsibility of any one country alone (Frenkel et al. 1989b: 209). In the same way, external stability was understood as a “public good that can be under-supplied if some large suppliers act in a decentralized way” (Frenkel et al. 1989b: 196).

Frenkel and Goldstein did not share the view—which became commonplace in the 1990s—regarding the risk of even mild levels of inflation. They referred to the “widely regarded view” that price stability should be the principal priority for monetary policy as “warranted”, but they rejected the “false corner solution” in which the prioritization of domestic price stability led to the a “benign neglect of the international repercussions of national policy decisions” (Frenkel et al. 1989b: 189, 195). Moreover, they believed that policies should be country-specific and that “[e]xchange rate commitments should be tailored to the characteristics and circumstances of individual economies” (Frenkel et al. 1989b: 210).¹¹

The WEO during Frenkel’s term at the Research Department reflected his views. The report stated that governments had to maintain a “reasonable price stability” (WEO 1987: 17) in addition to watching for

¹¹ Frenkel and Goldstein published extensively about the significance of coordination during the second half of the 1980s, they organized conferences and edited books (see for example Branson et al. 1990; Frenkel 1983; Frenkel et al. 1989b, 1990, 1991; Masson et al. 1989; Goldstein 1995).

other economic indicators including the current account balance, the level of private saving and domestic investment (WEO 1987: 17). The WEO described inflation levels of around 3.5 percent as “favorable inflation performance” (WEO 1987: 5).

The report also approved of the fact that monetary authorities in industrial countries broaden “the focus of concern to include also growth and exchange rates” (WEO 1987: 6). Following the Louvre Accord, there was acknowledgment that “[m]onetary policy is also being actively used as an instrument of policy coordination” (WEO 1988: 4-5).

The gap between the Delors Report and the views of the BIS and the Research Department of the IMF supports the assumption that the EMU was the product of state interests rather than of economic ideas. Moreover, it supports the claim made in this paper that prior to 1991 there was no consensus among economists regarding the economic benefit of very low levels of inflation.

7. The Internationalization of the Norm of Price Stability Targeting

During the 1980s, the role of the IMF in the international monetary system changed. This change was described by Camdessus, the Director of the Fund, as a “silent revolution”, a phrase that became the title of a book about the same process (Boughton 2001). During the process, the IMF became a key transnational player that promoted the so called neoliberal regime.

Until 1989, the IMF fulfilled the role of an observer. As a surveillance actor it was expected to collect and distribute information in order to facilitate a more efficient coordination. When the strategy of direct negotiation shifted to a rule-based regime, the IMF’s role was changed significantly and it began to play a key role in the legitimization of the new regime in the international context, monitoring compliance and exerting conditionality

The shift in the IMF’s role started in the executive organs. Michel Camdessus, the Managing Director, opened his address in the Forty Fourth Annual Meeting in September 1989, six months after the publication of the Delors Report, by announcing that industrial countries “must bring inflation down further” (IMF 1989: 11). Rather than “coordination” the new strategy was “peers pressure on all participants so that they give proper weight to the international repercussions of their domestic policies” (IMF 1989: 13). As an IMF staff paper explained, the strategy of direct negotiation “has not promoted discipline and coordination in the conduct of macroeconomic policy”. And this fact was “probably the single most damaging charge because short-term volatility and longer-term misalignments are both widely regarded as manifestation of this failure to get underlying monetary and fiscal policies ‘right’” (Crockett/Goldstein 1987).

The representatives of the Anglo-Saxon countries hailed the new strategy but unlike Camdessus they did not make any reference to the issue of external stability. Nicholas Brady, the American Secretary of Treasury who replaced Baker, proclaimed that “our future success remains noninflationary economic growth” (IMF 1989: 39). Lawson, the British Minister, went so far as to compare the emerging regime with the gold

standard to demonstrate why the international community did not have to worry about external imbalances. Both in the gold standard period and in the present, he argued, capital flows freely across borders and in such conditions “large current surpluses and deficits are not unusual” because financial markets “carry[ing] out their fundamental roles—allocating excess private sector savings to the countries with investment opportunities that exceed their domestic savings” (IMF 1989: 90). A year later, the UK joined the European Monetary Mechanism (ERM) after more than 10 years of reluctance. While previously the British reluctance to join was justified by Thatcher’s fear that the ERM would restrict national autonomy and would import inflation (Walters 1986; Dyson/Featherstone 1999: 548), in 1990, John Major justified the UK joining the ERM as an anti-inflationary instrument (The Financial Times 1990).

Despite differences, the German Minister of Finance, Theodor Waigel, supported the new approach warmly. He referred to the “economic realities” and the acknowledgment that “without credible economic reforms, outside help will not fall on fertile ground” (IMF 1989: 78). He pointed out that “we must back up a tight monetary policy with appropriate fiscal policies” and that “there must be no relaxing the effort to reduce excessive budget deficit” (IMF 1990: 85). Even the French Minister, Pierre Bérégovoy, supported the new approach: “[E]ach country must play by the rules” and “no effort should be spared in securing compliance with them” (IMF 1990: 39).

7.1 *World Economic Outlook: Institutionalization of the Norm of Inflation Targeting*

Once the consensus consolidated within the executive organs of the IMF, the change was institutionalized in the Research Department. In 1991, the economist Michael Mussa replaced Frenkel as the director of the Research Department. Mussa was previously a member of the US Council of Economic Advisers under the Reagan administration (1986-1988). He spent most of his early career at the Chicago Business School, which is known for its pro-free market monetarist tradition. Mussa described himself as “wobbly monetarist”. According to the Washington Post, Mussa “was at the heart of IMF decision making as the institution responded, often in controversial ways, to economic tumult on nearly every continent” (Bernstein 2012). Mussa was always a firm believer in the rationality of global financial markets (Mussa 1993) and he adhered to the view that coordination of exchange rates is futile and that exchange rate stability depends on the “degree of convergence in the economic performance and domestic policy needs” (Mussa 1993: 36). As the director of the Research Department, Mussa was also the general director of the WEO.

Mussa was also “particularly critical of IMF surveillance of exchange rates” (Larsen 2012). Therefore, in his term the notion of “surveillance” was redefined. Rather than providing and distributing economic information in order to promote direct negotiation among governments, the new role of surveillance was to monitor the adherence of the specific countries to the standardized policy rules and, if necessary, to inflict soft or hard pressure to insure compliance. As Camdessus put it, “[w]hat is needed is to form, and then expand, a ‘low inflation club’, and to ensure that a convergence occurs, by high-inflation countries adjusting their performance toward that of low-inflation countries” (IMF 1989: 13).

The 1992 Report of the WEO referred to the

“consensus reached among the industrial countries at the beginning of the 1980s that medium-term objectives were best served by adhering to anti-inflationary monetary policies, by reducing fiscal deficits (preferably by restrictions on government spending rather than tax increase), and by eliminating structural rigidities” (WEO 1992: 16). It was stated that “the reduction of inflation to only 2.5 percent [...] in the industrial countries as a whole stands out as a major achievement.” (WEO 1995: 2)

Inflation was framed as the most urgent domestic policy problem. The WEO stated that there is “an asymmetric relationship between inflation and economic activity whereby excess demand has much stronger effect in raising inflation than excess supply has in reducing inflation” (WEO 1995: 20). It was only in the 1990s—not in the late 1980s—that the experience of the 1970s was presented as a period that taught the “key policy lesson” regarding the importance of price stability.

The discourse of the WEO effaced any reference to the view that very low inflation targeting was adopted in order to achieve convergence and to facilitate international coordination. The WEO report of 1995 stated that “[i]t is always difficult to explain with any degree of precision the movement in exchange rates, or other financial variables for that matter” (WEO 1995: 18). This view was a reflection of the Anglo-Saxon view that financial markets cannot be governed. Moreover, the WEO promoted a more standardized conception of policy making. While in previous years it included sections on “policy issues in individual countries” (WEO 1989; WEO 1990), the new directors employed a standardized approach claiming that “[a]lthough the relative emphasis differs across countries, the principal goals of monetary policy are to achieve and maintain a high degree of price stability” (WEO 1993: 48).

8. Analysis and Conclusion

This paper sought to explain the emergence of the consensus on very low inflation targeting during the 1980s and the 1990s. The key argument of the paper is that the global norm of very low inflation targeting was consolidated on the basis of state preferences regarding exchange rate stability and coordination. I argued that the issue of negative implications of inflation on growth did not play a significant role in shaping the national preferences regarding the commitment to very low inflation.

In a wider historical context, the norm of very low inflation targeting provided a new international monetary standard following the dissolution of the Bretton Woods agreements in the early 1970s and the entry of the international system into a period of “no-system”. In the 1970s and 1980s, exchange rates were floated, financial markets were liberalized and the lack of a common standard led to growing imbalances and instability. The norm was part of a new international regime that emerged in the 1990s. While the norm of very low inflation targeting provided a domestic monetary anchor, I argued, its institutionalization as an international norm was based on the need for an intergovernmental coordination mechanism. This mechanism reflected the consensus that emerged between the two strongest economies in the Western industrialized world, the US and Germany.

Using the benchmark of liberal intergovernmentalism, the analysis identified three consecutive strategies of exchange coordination: the lack of coordination in the early 1980s, direct negotiation in the mid-1980s and a rule-based regime in the late-1980s and the 1990s. The most important factor that explains the transition from non-coordination to direct negotiation was a common international “sense of crisis” that increased the incentive of governments to coordinate macroeconomic policies, at the cost of abandoning their traditional set of preferences. The most important factors that explain the transition from direct negotiation to rule-based regime were the state preferences and their relative negotiation power.

The paper makes several contributions. First, the paper contributes to the debates regarding the economic usefulness of very low inflation targeting. It demonstrates that the norm of very low inflation targeting was not consolidated on the basis of an *economic rationale* but on the basis of a *political rationale*. That is, commitment to very low inflation was not conceived as a “best practice” from a purely economic perspective, but rather as a political arrangement that was politically viable in a concrete time and place. It was a “corner solution” for the problem of exchange rate coordination that was institutionalized because it suited the preferences of the countries with the superior bargaining power and because it provided a better solution to the issue of compliance, monitoring and commitment.

The claim that the norm of very low inflation targeting was a political solution does not imply that it was a wrong solution. I am not putting forward a normative argument. Policy making is taking place in the “real” world and, therefore, policy solutions should be both economically effective and politically viable. However, if my analysis is valid, than it undermines the common belief in the 1990s that very low inflation targeting was a “best practice” from an economic and domestic perspective anytime and anywhere.

Second, the paper contributes to the debate regarding the respective role of interests and ideas in shaping the institutional design of the EMU (Verdun 2010). The key question in this debate was whether the consolidation of the EMU could be explained on the basis of state interests alone as Moravcsik argued (1998), or whether ideational entrepreneurs—the community of central bankers—played an irreducible role in shaping institutional outcome as Dyson and Featherstone (1999) argued. Verdun presented a more cautious argument according to which policy makers applied for experts for advice (Verdun 1999).

The analysis presented in this paper shows that there was no agreement among experts and central bankers regarding the desirability of a rule-based regime in general and very low inflation targeting in particular. The theories about epistemic communities and their relative power to shape institutions rests on the assumption that epistemic communities can provide certainty through the distribution of common causal beliefs and norms (Haas 1992). In the case of the EMU, there was no consensus within the community of central bankers regarding the desirability of rules. Economists from international organizations—the BIS and the IMF—criticized the institutional design of the EMU and the rule-based international monetary regime for not being flexible enough. The lack of consensus among economists and central bankers prior to the consolidation of the EMU weakens the argument that ideational entrepreneurs played an important role in shaping the EMU. This conclusion does not imply that they did not play a central role in legitimizing

and stabilizing it once it was consolidated.¹²

Third, the paper contributes to a better understanding of the linkage between the European integration on the one hand and international coordination on the other. Moravcsik's analysis makes reference to the influence of "globalization" process—liberalization of capital flows—on the incentives of European countries to hasten the integration process (Moravcsik 1998: 410). However, the question regarding the extent to which the European integration affected the international monetary regime in the 1990s has been less discussed.¹³ The evidence presented in this paper suggests that the international monetary regime that was consolidated in the 1990s, that is, the neoliberal regime, was the outcome of convergence of interests between the US, Germany and what later became the EMU.

12 This conclusion is dependent on the way we define ideational entrepreneurs. It might be argued that any actor is an ideational entrepreneur because it uses ideas to promote its interests. However, such a wide definition empties the concept from any meaningful sense. In this paper I assume that ideational entrepreneurs are actors whose legitimacy is based on their reputation as apolitical professional actors.

13 For discussion of the linkage between the European integration and the emergence of the neoliberal regime see Nousios et al. 2012.

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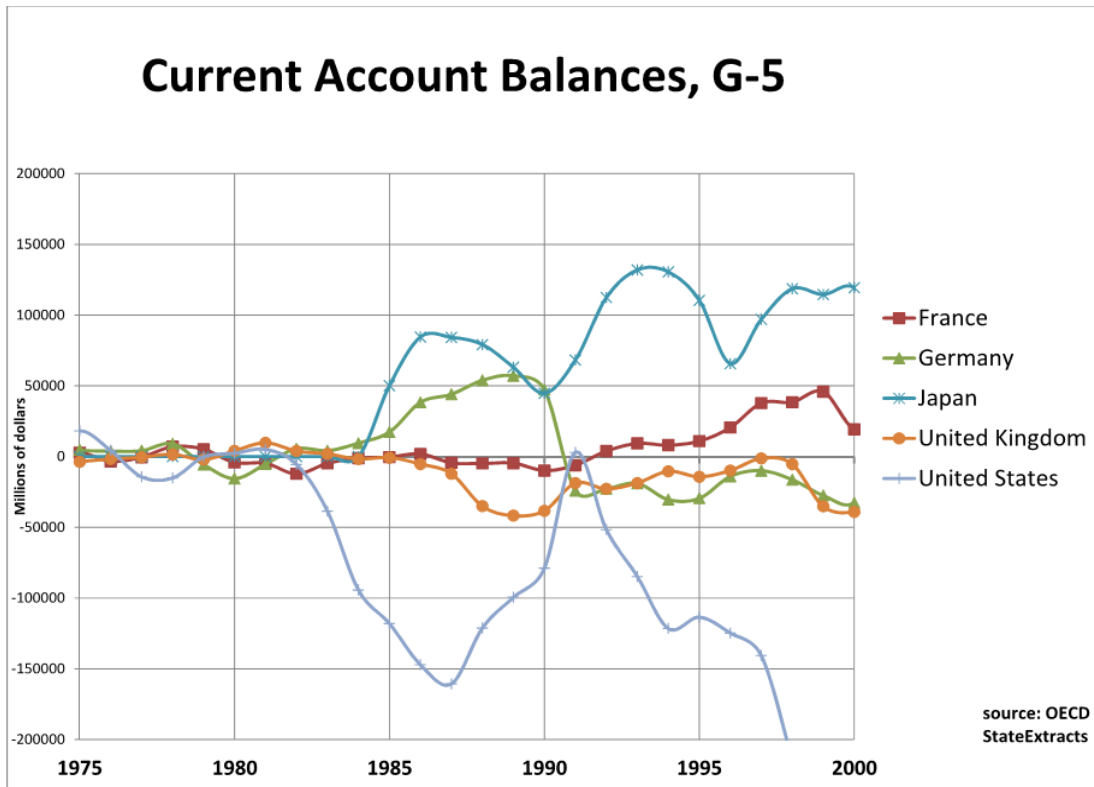
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Appendix



The Kolleg-Forschergruppe - Encouraging Academic Exchange and Intensive Research

The Kolleg-Forschergruppe (KFG) is a new funding programme launched by the German Research Foundation in 2008. It is a centrepiece of the KFG to provide a scientifically stimulating environment in which innovative research topics can be dealt with by discourse and debate within a small group of senior and junior researchers.

The Kolleg-Forschergruppe „The Transformative Power of Europe“ brings together research on European affairs in the Berlin-Brandenburg region and institutionalizes the cooperation with other universities and research institutions. It examines the role of the EU as promoter and recipient of ideas, analyzing the mechanisms and effects of internal and external diffusion processes in three research areas:

- Identity and the Public Sphere
- Compliance, Conditionality and Beyond
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