

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Why was the European Monetary System in 1992–93 swept by waves of disruptive speculative attacks? And what lessons emerge from that episode as regards the future of the European Monetary Union and subsequent crises?

A blend of theoretical and policy-oriented analysis, this book provides a comprehensive assessment of the causes and implications of the 1992–93 crisis of the exchange rate mechanism of the European Monetary System. Cogent factual presentation – including new details on the crisis – original theoretical analysis, and an interpretation rooted in the theory, make this treatment essential reading to understand the process toward economic and political integration in Europe and easing other financial crises.

The authors first sketch the history of monetary cooperation in Europe from Bretton Woods to Maastricht. A step-by-step account of the 1992–93 events follows, including a discussion of the extent to which financial markets anticipated the crisis. A survey of the recent literature on the subject introduces the authors' center-periphery model of currency crisis. The authors argue that the vulnerability of Europe to financial crisis was – and still is – the result of the lack of concern with the systemic dimensions of monetary policy-making (regarding both the international spillovers of domestic policies and the strategic interaction among monetary authorities). The methodology presented also sheds invaluable light on recent cases of crisis and contagion outside Europe, including East and Southeast Asia, Russia, and Brazil.

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the
1992–93 Exchange Rate Mechanism crisis

Willem H. Buiters, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the
1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Financial markets and European monetary cooperation

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Japan-U.S. Center Sanwa Monographs on International Financial Markets

Selection Committee:

Ryuzo Sato, *New York University* (Ex Officio Chairman and Editor)

Akiyoshi Horiuchi, *University of Tokyo*

Paul Krugman, *Massachusetts Institute of Technology*

Marti Subrahmanyam, *New York University*

James Tobin, *Yale University*

Richard Zeckhauser, *Harvard University*

The Sanwa Bank has established “The Sanwa Bank Research Endowment Fund on International Financial Markets” at The Center for Japan-U.S. Business and Economic Studies of The Stern School of Business, New York University to support research on international financial markets. One part of this endowment is used to offer an award for writing a monograph in this field. The Sanwa award is made annually on a competitive basis by the Selection Committee, and the winning published titles and proposals are listed below.

- 1992, Richard C. Marston, *University of Pennsylvania*: ***International Financial Integration: A Study of Interest Differentials Between the Major Industrial Countries*** (published 1995; ISBN 0 521 59937 7)
- 1993, Willem H. Buiter, *University of Cambridge*, Giancarlo Corsetti, *University of Rome*, and Paolo A. Pesenti, *Federal Reserve Bank of New York*: ***Financial Markets and European Monetary Cooperation: The Lessons of the 1992–93 Exchange Rate Mechanism Crisis*** (Published 1998; ISBN 0 521 49547 4)
- 1994, Lance E. Davis, *California Institute of Technology*, and the late Robert E. Gallman, *University of North Carolina, Chapel Hill*: ***Evolving Financial Markets and International Capital Flows: Britain, the Americas, and Australia, 1865–1914*** (ISBN 0 521 55352 0)
- 1995, Piet Sercu, *Catholic University of Leuven*, and Raman Uppal, *University of British Columbia*: ***Exchange Rate Volatility, Trade, and Capital Flows under Alternative Exchange Rate Regimes*** (published 2000; ISBN 0 521 56294 5)
- 1996, Robert P. Flood, *International Monetary Fund*, and Peter M. Garber, *Brown University*: ***Speculative Attacks on Fixed Exchange Rates***
- 1997, Maurice Obstfeld, *University of California, Berkeley*, and Alan M. Taylor, *University of California, Davis*: ***Global Capital Markets: Growth and Integration***
- 1998, Pravin Krishna, *Brown University*: ***Regional Trading Blocs and Preferential Trading Systems***
- 1999, Kose John, *New York University*: ***Corporate Governance and Agency Problems: Theory and Empirical Evidence***

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiters, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Financial markets and European monetary cooperation

The lessons of the 1992–93

Exchange Rate Mechanism crisis

WILLEM H. BUITER
University of Cambridge

GIANCARLO CORSETTI
University of Rome

PAOLO A. PESENTI
Federal Reserve Bank of New York



CAMBRIDGE
UNIVERSITY PRESS

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

XXXXXXXXXXXXXXXXXXXXXXXX

Cambridge, New York, Melbourne, Madrid, Cape Town,
Singapore, São Paulo, Delhi, Tokyo, Mexico City

Cambridge University Press
The Edinburgh Building, Cambridge CB2 2RU, UK

Published in the United States of America by
Cambridge University Press, New York

www.cambridge.org

Information on this title: www.cambridge.org/XXXXXXXXXXXXXXXX

© Willem H. Buiter, Giancarlo Corsetti, Paolo A. Pesenti XXXX

This publication is in copyright. Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of Cambridge University Press.

First published XXXX

First paperback edition XXXX

A catalogue record for this publication is available from the British Library

Library of Congress Cataloguing in Publication data

Buiter, Willem H., XXXX–

Financial markets and European monetary cooperation : the lessons of the XXXX–XX Exchange Rate Mechanism crisis /

Willem Hendrik Buiter, Giancarlo Corsetti, Paolo Arturo Pesenti.

p. cm. – (Japan-U.S. Center monographs on international financial markets)

⊠ European Monetary System (Organization) ⊠ Foreign exchange rates–

European Union countries. ⊠ International finance. ⊠ Monetary

policy–International cooperation. I. Corsetti, Giancarlo. II. Pesenti,

Paolo A. III. Title. IV. Series: Japan-U.S. Center Sanwa monographs

on international financial markets.

HGXXXXBXX XXXX

XXXXXXXXXXXX - dcXX

XX-XXXX

XXXX XXXX-XX-XXXX-XXXX-XX Hardback

XXXX XXXX-XX-XXXX-XXXX-XX Paperback

Cambridge University Press has no responsibility for the persistence or accuracy of URLs for external or third-party internet websites referred to in this publication, and does not guarantee that any content on such websites is, or will remain, accurate or appropriate. Information regarding prices, travel timetables, and other factual information given in this work is correct at the time of first printing but Cambridge University Press does not guarantee the accuracy of such information thereafter.

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Contents

<i>Forewords by Kenji Kawakatsu and Helmut Schlesinger</i>	vii
<i>Acknowledgments</i>	ix
1 Introduction	1
1.1 The roots of the European consensus on limiting exchange rate flexibility	3
1.2 The ERM and the logic of nominal anchors	5
1.3 Escape clauses and financial stability	7
1.4 The debate on the ERM crisis	9
1.5 Understanding the crisis: The missing elements	11
1.6 Lessons for the future	16
2 Exchange rate stability in Europe: A historical perspective	19
2.1 From Bretton Woods to the Treaty of Maastricht	19
2.2 The Treaty of Maastricht	31
3 The unfolding of the 1992–93 ERM crisis	38
3.1 Toward the crisis	38
3.2 A chronology of the ERM crack-up	54
4 Financial markets and ERM credibility	67
4.1 Capital market liberalization and “convergence plays”	67
4.2 Defining and measuring ERM credibility	70
4.3 Exchange rate expectations before the crisis	74
5 Modelling currency crises	83
5.1 Exchange rate crises and speculative attacks	83
5.2 Fundamental models of the ERM crisis	89
6 A Center–Periphery model	93
6.1 Introduction	93
6.2 The Center country	94
6.3 The Periphery countries	96
6.4 The objective function of the Center	97

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

vi	Contents	
	6.5 The objective function of the Periphery	99
	6.6 The semireduced form of the model	103
7	Unilateral pegs and escape clauses: The role of domestic credibility	108
	7.1 Exchange rate crises as equilibrium outcomes	108
	7.2 Imperfect commitment and expectations formation	112
	7.3 Multiple equilibria, self-fulfilling expectations, and the ERM crisis	118
	7.4 Open issues in the “self-fulfilling” vs. “fundamental” debate	122
	7.5 Revisiting theories based on domestic fundamentals	125
	7.6 A summary	132
8	Policy coordination and currency crises	134
	8.1 Introduction	134
	8.2 Noncooperative equilibrium	136
	8.3 Cooperation in the Periphery	149
	8.4 Does cooperation in the Periphery make a difference?	154
9	What caused the system to crumble?	163
	9.1 Building blocks of a systemic theory	163
	9.2 Lessons from the theory	165
	9.3 The interpretation of the 1992–93 ERM crisis in a Center–Periphery model	168
10	Rebuilding the system: What next?	176
	10.1 Introduction	176
	10.2 Microeconomic efficiency arguments for a common currency	177
	10.3 Seigniorage and exchange rates	180
	10.4 Nominal rigidities and the Keynesian arguments for an optimal currency area	185
	10.5 What makes up for loss of exchange rate flexibility?	191
	10.6 Capital mobility as an argument for a common currency	196
	10.7 Issues in the transition to EMU	198
	10.8 Reconstructing the monetary system in Europe through EMU	200
	Appendix	203
	<i>References</i>	205
	<i>Index</i>	215

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Foreword

The Sanwa Bank established the The Sanwa Research Endowment Found on International Financial Markets at The Center for Japan–U.S. Business and Economic Studies, Leonard N. Stern School of Business, New York University to provide continuing support for research on international economics and financial markets. One of the activities supported by the endowment is an annual financial award to write a monograph based on original research. The first monograph, “International Financial Integration: A study of interest differentials between the major industrial countries,” was written by Richard C. Marston, of the Wharton School of the University of Pennsylvania and published by Cambridge University Press in 1995.

The second award went to Professor Willem Buiter of the University of Cambridge, Giancarlo Corsetti of University of Rome III, and Paolo A. Pesenti of Princeton University. Each researcher gets two to three years to complete the monograph and three monographs are under preparation.

I am delighted that the second Monograph draws lessons that have much wider relevance than the 1992–93 crisis in European Rate Mechanism. The Bretton Wood System that established a period of considerable stability in exchange rates in the post-World War period ended with the Smithsonian Agreement of 1971. While the relatively higher rate of inflation in the United States made it impossible for many nations to pursue price stability and dollar parity at the same time, it was not clear that the fluctuations in exchange rate that followed were desirable. So Europe then moved to the Exchange Rate Mechanism with narrow bands for exchange rates.

The dollar–yen rate has fluctuated dramatically in the last twenty years, creating hardship for Japan’s exporters and accentuating political tensions between the two countries. This has prompted the suggestion that Japan should establish a Yen currency area with its neighbors. The monograph, by exploring the problems that arose within ERM, alerts us to difficulties in establishing such a currency area. The discussion of the need for policy coordination – not only between the center and the periphery economies but among the periphery countries themselves – should be carefully considered before any attempt is made elsewhere to replicate the European arrangement.

I would like to express my gratitude to the distinguished members of the Selection Committee of the Sanwa Monograph – Professors Ryuzo Sato of

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

viii **Foreword**

New York University (Chair), Akiyoshi Horiuchi of the University of Tokyo, Merton Miller of University of Chicago, James Tobin of Yale University, and Richard Zeckhauser of Harvard University – for their careful deliberation. I also thank Dean George Daly of the Stern School for his support to the program, and Professor Ryuzo Sato, C. V. Starr Professor of Economics and Director of the Center, Professor Rama Ramachandran, Associate Director of the Center, for making the monograph series such a success.

Kenji Kawakatsu
Senior Advisor, Sanwa Bank Limited

Financial Markets and European Monetary Cooperation examines the crisis of the exchange rate mechanism (ERM) of the European Monetary System (EMS), interpreting the 1992 and 1993 events through an analysis of the strengths and weaknesses of systems of fixed exchange rates. The authors describe and document thoroughly the historical antecedents and the actual events of the ERM crises on the basis of all available sources.

The book is focused on the crisis of the ERM within a narrow margin of fluctuations (1979–1993). Nonetheless, the analysis of the basic weaknesses that plague systems of fixed exchange rates sheds light on several other examples of such systems. The authors channel their commendable ambition towards the formulation of a “center-periphery model.” On the basis of the differentiation – which is helpful for analytical purposes – between the “center” and the “periphery” of fixed exchange rate systems, the authors emphasize that cohesion among the partner countries is indispensable. Therefore the willingness must exist to undergo realignments in due time, without waiting until adjustments are forced by the markets.

The history of the ERM shows that great dilemmas may occur between political objectives and market expectations. Such dilemmas tend to be more disruptive in a system with narrow margins of fluctuation than in the system with wide margins that has been adopted in Europe since mid-1993. The rather positive experience of the ongoing exchange rate arrangements can only be touched upon briefly in a book completed in 1996 on the 1992–1993 ERM crisis.

The reader will find the chapter on the planned European monetary union particularly useful. It discusses in a suitably detached manner the pros and cons of a union designed to last forever. It also clarifies the difference between monetary union and exchange rate system with fixed but adjustable parities. In particular, emphasis is placed on the requirement of jointly designed and stability-oriented monetary and fiscal policies that is an inherent characteristic of a monetary union.

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiters, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

ix

Because monetary union is not likely to include all member states of the European Union at its star and an exchange rate mechanism will have to be devised for the countries out of the EMU (a sort of ERM II), the core experience of the ERM I described in this book may prove to be especially useful. Thus, this book can contribute to reduce the discrepancy between the current barbed and often polemical political debate, on one hand, and the actual policy process determining the changeover from an EMS fraught with tensions to a clearly defined and stable monetary union on the other.

Helmut Schlesinger

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

Acknowledgments

In the aftermath of the 1992 speculative episodes in the European Monetary System, we planned a research project focusing on an assessment of the interpretations and “lessons” of these events, as a contribution to the ongoing debate on monetary unification and financial integration in Europe. In 1993, our proposal was chosen by the selection committee for the second edition of the Sanwa Foundation Monograph Award in International Finance. This monograph represents the end product of the research program outlined in that proposal. We gratefully acknowledge support and encouragement throughout this project from Mr. Kenji Kawakatsu, Chairman of Sanwa Bank Limited; Professor Ryuzo Sato, Director of the Center for Japan-U.S. Business and Economic Studies; and Professor Rama Ramachandran of New York University.

The list of persons to whom we owe an intellectual debt of gratitude is long indeed. We would particularly like to thank Dr. Helmut Schlesinger, former Chairman of the Deutsche Bundesbank and Visiting Professor at Princeton University in the fall of 1994. His thorough comments and remarks were crucial in shaping our reconstruction and interpretation of the 1992–93 events. Peter Kenen of Princeton University, Guido M. Rey of University of Rome III, and three anonymous reviewers offered countless helpful suggestions that improved both the substance and the presentation of the arguments in the monograph.

Among our colleagues and friends, special thanks for valuable comments go to Ben Bernanke, Michael Bordo, Jorge Braga de Macedo, Bill Brainard, Bill Branson, Alessandra Casella, Lilia Cavallari, Marcello De Cecco, Barry Eichengreen, Raquel Fernandez, Jeff Frankel, Jeff Frieden, Georg von Furstenberg, Peter Garber, Mike Gavin, Rex Ghosh, Vittorio Grilli, Koichi Hamada, Pierre-Yves Hénin, Yves Hervé, Karen Lewis, Richard Marston, Jacques Mélitz, Bill Nordhaus, Maury Obstfeld, Peter Orszag, Arvind Panagariya, Ken Rogoff, Nouriel Roubini, Chris Sims, Lars Svensson, Guido Tabellini, Aaron Tornell, Niels Thygesen, Jim Tobin, Bart Turtleboom, Andres Velasco, and Casper de Vries.

We thank seminar participants at the University of Amsterdam, Banca d'Italia, Bank of England, Berkeley, University of Bordeaux, Cambridge, Danmarks Nationalbank, European Monetary Institute, Harvard, Innocenzo Gasparini Institute for Economic Research, London School of Economics, University of Nantes, NBER Summer Institute, New York University, Princeton,

Cambridge University Press

978-0-521-79440-4 - Financial Markets and European Monetary Cooperation: The lessons of the 1992–93 Exchange Rate Mechanism crisis

Willem H. Buiter, Giancarlo Corsetti and Paolo A. Pesenti

Frontmatter

[More information](#)

xii **Acknowledgments**

University of Rome, Rutgers, Tinbergen Institute, World Bank, and Yale for helpful remarks and suggestions on early versions of Chapters 2, 3, 6–8, and 10.

We thank Mariagiovanna Baccara and Ning Zhang for excellent research assistance. While working on this book, Giancarlo Corsetti visited the Departments of Economics at Columbia University and Yale University, which offered him an extremely productive research environment. Paolo Pesenti thanks the IGIER in Milan, the Tinbergen Institute in Rotterdam, and the EPRU in Copenhagen for warm hospitality and intellectual encouragement.

Last but not least, we thank Jean, Trui, and Mette for their continuing support, as well as patience and tolerance, throughout the project. With affection and gratitude, this book is dedicated to them.