

Monetary Policy in an Integrated World Economy: Symposium 1995.; The Macroeconomics of International Currencies: Theory, Policy and Evidence.



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the system and the Fund's operations so as to ensure their continued prosperity. A high degree of international cooperation, especially on technical matters, was seen in the reform attempts in the early 1970s but the later 1970s brought the oil price shocks and the debt crisis of the 1980s, ushering in a new phase and type of cooperation quite different from that envisaged by the economists and officials at Bretton Woods. In a world of high capital mobility and floating exchange rates for the major countries, the old rules of Bretton Woods were no longer relevant but the habits of consultation, technical collaboration, and exchange of information fostered by the IMF and other less universal international institutions definitely were and still are.

All these complicated developments are skilfully and authoritatively recorded using the archives of the IMF to which the author had full access for this study and other archives such as those of the Bank of England and the Bundesbank. The result is very readable and indeed enjoyable to read. Fundamental economic and political issues are always very clearly stated and kept on display. On occasion, however, the clarity and fluency of the prose verges on glibness. In the chapters (3 and 4) on the 1940s, James tends to skate over the complexities, whereas later chapters on the reform attempts are full of details of personalities, conversations and memoranda. As a result the volume is, it has to be admitted, too long, at times repetitive. Inevitably in a work of this length there are also some mistakes – to take a couple of early ones, the suggestion that the United Kingdom legally abandoned the gold standard in the First World War (page 17) and the identification of Stafford Cripps as the UK Chancellor of the Exchequer in 1945 (page 68). Nonetheless, James has undoubtedly produced a valuable contribution to the literature on the world economy since the Second World War, one which will be of great use to students as well as to many other readers.

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Monetary Policy in an Integrated World Economy: Symposium 1995. Edited by SIEBERT (HORST). (Kiel: J.C.B. Mohr (Paul Siebeck) Tübingen, 1996. Pp. viii+280. ISBN 3 16 146657 8.)

The Macroeconomics of International Currencies: Theory, Policy and Evidence. Edited by MIZEN (PAUL) and PENTECOST (ERIC J.). (Aldershot and Lyme, NH: Edward Elgar, 1996. Pp. xii+259 £55.00 hardback. ISBN 1 85898 077 1).

Monetary economics, be it national or international, is all about substitution and arbitrage. Arbitrage between good states and bad states of the economy is the motive for monetary policy but also drives private sector speculative and hedging behaviour. A-temporal mispricing is quickly eliminated by private sector arbitrage. Capital market liberalisation and massive substitution between different domestic and international assets has necessitated a reorientation of

our views on monetary policy. The second collection of essays under review is primarily focused on currency substitution and its ramifications for monetary policy interdependencies. The first collection of essays, from a symposium at the Kiel Institute, is wider in scope and deals with a number of different arbitrage issues in the domain of monetary economics.

The Kiel book starts with a nice review essay by Benjamin Friedman on monetary policy. It discusses the by now familiar but daunting problems of identification and causality in a world where both private agents and policy makers are forward looking. The other review essay in the book is by Charles Goodhart. It provides an eloquently written account of the effects of and issues pertaining to financial innovations and the enlarged scope for asset substitution.

The book contains a number of pieces with novel work. The essay by Manfred Neumann and Katrin Wesche puts forward the interesting hypothesis that a negative trend in velocity can be explained by changes in the wealth distribution. Changes in the distribution of wealth are an indirect source for asset substitution, because different wealth levels induce different asset preferences if agents are risk averse. It would be of interest to pursue this matter further in a general equilibrium setting with multiple assets. Barry Eichengreen and Jürgen von Hagen argue in their chapter that because countries which will participate in the European Monetary Union retain the jurisdiction over the tax base and fiscal policy, there is no need for the fiscal restrictions as written into the treaty of Maastricht. This claim is supported by a cross country study of borrowing restrictions on sub-central governments.

The book also contains a number of thorough comments. Clemens Kool, for example, takes issue with Otmar Issing's defence of monetary targeting. Kool first argues that past Bundesbank behaviour can as well be interpreted as inflation targeting, and argues furthermore that European monetary integration may warrant attention to a broader palette of monetary indicators. Monetary targeting may be especially difficult at the start of the union, due to the fact that there are no observations on the (backward looking) target variable before the start of the union. In contrast the forward looking variables like the exchange rate and interest rate can be immediately observed, and one or the other can be targeted.

There is widespread belief that by granting a central bank independence, society solves the inflation bias which stems from the inability of monetary authorities to commit themselves to refraining from output stimulation. But, as Susanne Lohman nicely argues, this presupposes that the policy makers can commit themselves to the institutional arrangement. And she asks, if they can, why can they not directly commit to the noninflationary policy? This Russian doll of indirect mechanisms needs an ending. Prudent monetary policy making can be sustained, so argues Lohman, if there is an outside principal, i.e., the public, who is able to punish the agent for misconduct. To this end policy decisions must be made visible so that public monitoring is feasible. Hence, visibility and accountability instead of secrecy and discretion are the best guarantees for monetary stability in a democracy where independence is a

contradiction in terms. Nevertheless, delegation of monetary policy to an agent with clear responsibilities at arm's length from the government is conducive to the monitoring capabilities by the public and parliament, because this separates and thereby distinguishes one public task from the other. But, as the present essay argues forcefully, this is something quite different from independence. It is for the future to model this desirable feature of overt monetary policy making more explicitly. Another direction for future research is to try to do away with the infinite horizon trigger strategies, and to focus on finitely repeated games with multiple Pareto ranked equilibria. The Pareto dominated outcomes can often be used as disciplining threat devices in finitely repeated games. This allows one to study e.g. the effect of a limited political horizon.

A direct link between the two books is the article by Timothy Lane in the Kiel volume and the article by Michael Artis in the book on currency substitution. Both articles focus on the money demand function in Europe after monetary unification. This hypothetical construct is obtained from a weighted average of current European money demand functions. Invariably in this literature the authors conclude that aggregate European money demand is more stable than money demand in the individual countries, and hence that unification will overcome the instabilities that are caused by currency substitution at the national level. As pointed out by Ivo Arnold in the *Weltwirtschaftliches Archiv*, 1996, the literature in concluding for stability simply overlooks the fact that the variance of an equally weighted average of n different i.i.d. components decreases by the square root of n . The proclaimed stability of the aggregate is more apparent than real. Moreover, as unification will put all monetary noses into the same direction, such aggregation illusion will no longer be present once the Euro has arrived. Money demand of the union will rather be very similar to the behaviour of current money demand in any of the individual countries. Unfortunately, the argument is widely abused by the Brussels bureaucracy pretending not to know anything about the Lucas-critique.

The currency substitution book starts off with a welcome survey of what we mean by currency substitution and how we measure it. Currency substitution can be classified according to whether it is direct substitution between currencies or indirect via other assets, and as to whether it is measured at the margin or in volumes. The book contains examples of all four possible combinations. Theoretical models of currency substitution are either directly specified at the macro level, or are micro based. The former type builds on the monetary model or uses an expanded version of the portfolio balance model. The macro based models use the cash-in-advance constraint, the overlapping generations vehicle, or posit a transactions time saving technology to model the role of money. Substitution between currencies is determined by the opportunity costs of holding domestic and foreign currency, i.e. the domestic rate of interest and the foreign rate of interest cum the expected rate of depreciation. While this measure of substitution is clearly explained in the review chapter, not all of the studies in the book, like the chapter by John

Rogers on Mexico and Canada, use this concept. For this reason some of the substitution elasticities are only seemingly contradictory to other reported results.

McKinnon in his chapter explains once again the mechanism behind indirect currency substitution via changes in the demand for internationally traded assets other than money. Apart from indirect currency substitution, asset substitution or portfolio shifts between M1, M2, M3, etc. are at least equally important factors behind the perceived instability of money demand. Unfortunately, as of today little is known about the relative importance of all three substitution channels. In principle, a data set like the one which is used by Gianne Boere and Guiseppe Tullio in their study on currency substitution in German demand for M1 and M3 could be used for this purpose.

To conclude, domestic and international demand for money is all about arbitrage opportunities and substitution possibilities. Both volumes provide a lively account of these processes.

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A Monetary History of Italy. By FRATIANNI (MICHELE) and SPINELLI (FRANCO). (Cambridge and New York: Cambridge University Press, 1997. Pp. xvii+305. £40.00 hardback. ISBN 0 521 44315 6.)

Fратиanni and Spinelli's book, a revised version of their 1991 volume (which was published in Italian), surveys the monetary history of Italy from 1861 to September 1992. It is a 'monetary history' in the sense in which Friedman and Schwartz implicitly defined the term by their *Monetary History of the United States*. That is to say, it contains data, economic analysis, statistical analysis, and political and banking (and even a trace of social) history. It is therefore an ambitious book – ambitious in both what it seeks to cover and in the comparison with the Friedman and Schwartz classic that it inevitably invites.

There are ten chapters. The first summarises the structure and main points of the book, and the second examines the determinants of money growth in Italy from 1861 to 1991. That second chapter has an appendix of Italian monetary data. (More are available on request from the authors.) The final chapter sets out what the authors see as the six main themes of their work. The intervening chapters divide the period chronologically; this is done not by equal numbers of years, but rather by the nature of the period – gold standard, or war and its aftermath, for example.

Of such an enterprise the first question to ask is, how well are the data constructed and handled? The answer in this case is, with scrupulous care.

The authors are aware of the importance of changing monetary regimes. They note the important distinction between form and substance '... witness times (such as in the early part of the twentieth century) when the regime was one of inconvertible paper money de jure but gold standard de facto.' They