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Book Review — Digitized Version

[Book Review of] Capital controls, exchange rates, and monetary policy in the world economy, Sebastian Edwards (ed.): Cambridge: Cambridge Univ. Press, 1995

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– in contrast to the 1940s and 1950s – in the inner core of the profession. But, and this is an even more important message of most parts of the book, endogenous growth theory with its rich microeconomic structure (including the ability to deal with increasing returns to scale and imperfect competition) provides a very promising source to tackle many of the most pressing issues in development theory. The final message is that in many areas this task still waits to be undertaken.

Therefore, for all readers interested in the field, the book presents a wide range of very interesting contributions which shed important light on the link between (new) growth theory and development economics.

Uwe Walz

Edwards, Sebastian (ed.), *Capital Controls, Exchange Rates, and Monetary Policy in the World Economy*. Cambridge 1995. Cambridge University Press. VIII, 436 pp.

The title as well as the contents of this book seem to announce a highly timely publication. After a series of exchange rate crises in the 1990s which started with the EMS crisis in 1992/93, proceeded with the tequila crisis in Mexico and its fallout in Latin America in 1994/95, and ended for the present in the Asian crisis in 1997/98 and the Russian crisis in 1998, exchange rate regimes and capital flows are hotly debated in political and academic circles. Moreover, the structure of the book seems to offer a summary and a discussion of all these events given by outspoken experts in the field.

The book starts by three articles on general issues written by *Robert Mundell* (Stabilization and Liberalization in Semi-Open Economies), *Jeffrey A. Frankel* (Monetary Regime Choice for a Semi-Open Country), and *Manuel Guitián* (Capital Account Liberalization: Bringing Policy in Line with Reality). This introduction is followed by three parts with a regional focus on

- **Europe** with contributions from *Patrick Minford* (The Lessons of European Monetary and Exchange Rate Experience), *Jeffrey R. Shafer* (Experience with Controls on International Capital Movements in OECD Countries: Solution or Problem for Monetary Policy?), *Alberto Giovannini* (Real Exchange Rates and Capital Flows: EMS Experiences), and *Wilhelm Nölling* (Monetary Policy after German Unification);
- **the Asia-Pacific region** with papers by *Yung Chul Park and Won-Am Park* (Capital Movements, Real Asset Speculation, and Macroeconomic Adjustment in Korea), *Shin-ichi Fukuda* (The Determinants of Capital Controls and Their Effects on Trade Balance During the Period of Capital Market Liberalization in Japan), *Michael Doolley* (Capital Mobility and Economic Policy), and *Victor Argy* (Monetary and Exchange Rate Policies 1973–1991: the Australian and New Zealand Experience); and
- **Latin America** with articles from *Sebastian Edwards* (Exchange Rates, Inflation, and Disinflation: Latin American Experiences), *Guillermo A. Calvo*, *Leonardo Leiderman*, and *Carmen M. Reinhart* (Capital Inflows to Latin America with Reference to the Asian Experience), and *James A. Hanson* (Opening the Capital Account: Costs, Benefits, and Sequencing).

However, the book cannot live up to what the contents promises because the time schedule of its publication was just one step behind the developments in international capital markets. The papers on which the essays are based were originally presented at a conference on Monetary Policy in Semi-Open Economies, held at the Korean Institute of Economic Research in November 1992 when the EMS crisis had just started. As a consequence, this crisis is only mentioned in a postscriptum by *Manuel Guitián* and in the introduction by *Patrick Minford*. The book was then published in 1995 shortly after the Mexican tequila crisis and reprinted in 1997 when the Asian currency crisis

was just about to develop. Therefore, the book is not a timely publication because no work has been done to include these important events in the analysis.

The book is nevertheless of some interest because one may check what economists have thought in 1992 when only the EMS crisis was known of. Did they mention the policy mistakes and exogenous events which have been blamed to have caused the Latin American and Asian crises in more recent publications? The answer to this question is not a clear-cut one. The arguments put forward in the essays contain the basic message about macroeconomic disequilibrium, real exchange rate overvaluation, and the chances and risks related to capital inflows. However, with the benefit of hindsight the emphasis of the argumentation would be different. Two examples may illustrate this point.

With capital just starting to pour into emerging markets, *Manuel Guitián*, *Jeffrey A. Shafer*, and *James A. Hanson* stress rather the benefits of foreign capital financing domestic development rather than the risks related to the instability of such capital flows. Manuel Guitián even goes so far to argue that "... (n)either should the opening of the capital account wait until all desirable conditions are in place, because such a point in time is unlikely to be reached..." (p. 85). Moreover, the possibility of controlling capital flows is rated rather low while in the meantime the Chilean example demonstrates that at least the structure of capital inflows could be influenced by a consistent policy package which includes regulations for short-term capital. To be fair, there are two statements which sound as being written in 1998. On p. 30 *Robert Mundell* remarks that "... (i)t may be better for Korea to rely less on capital imports even if it would mean reducing the share of investment in GDP to 35 percent..." and *Yung Chul Park and Won-Am Park* claim that "... one cannot be overcautious about the opening of capital account, especially when the Korean domestic economic conditions are not stable, characterized, for example, by real asset speculation and a massive deficit in the current account..." (p. 225).

In the same vein, the role of financial intermediation in determining the extent of a currency crisis is hardly discussed in the book. It is only discussed by *Guillermo A. Calvo*, *Leonardo Leiderman*, and *Carmen M. Reinhart* who write that "... attempting to insulate the banking system from short-term capital flows is an attractive goal in cases where most of the inflows take the form of increased short-term bank deposits..." and "... marginal reserve requirements could be sharply raised such that they become higher as the maturity of deposits shortens..." (p. 379). Also, *James A. Hanson* concludes on the basis of the experiences of Southern Cone Countries in the early 1980s that countries are likely to end up nationalizing private external debt if "... a large percentage of the debts that were assumed reflected external liabilities... of financial intermediaries that were intermediated domestically..." and that "... there appear to be a number of policies within the financial sector to limit the intermediation of foreign funds, if the political will exists to limit the boom..." (p. 417). Obviously, the lessons necessary to avoid exchange rate cum financial crises of the Asian type have already been learnt the hard way by Latin American countries already in the 1980s but were judged to be of less importance for other than Latin American countries at the beginning of the 1990s.

Taking the shortcomings into consideration which result from the timing of the publication, the structuring of the conference proceedings according to the region with which the papers deal in the first place does not make much sense. Fortunately, the editor of the book offers a helping hand. In his excellent introduction *Sebastian Edwards* give an outline of the issues at hand by summarizing his own thoughts and including individual papers in his discussion. He names the following four topics to which he relates the contributions to the book (by author):

- **Capital account liberalization** (*Jeffrey Shafer* and *Manuel Guitián*)
- **Measuring the degree of capital mobility** (*Michael Dooley* and *Shin-ichi Fukuda*)

- **Nominal exchange rate regimes, monetary policy, and capital controls** (*Patrick Minford, Jeffrey A. Frenkel, Victor Argy, Wilhelm Nölling, and Sebastian Edwards*)
- **Real exchange rates and capital flows: the sequencing issue** (*Yung Chul Park and Won-Am Park, Guillermo A. Calvo et al., James A. Hanson, and Alberto Giovannini*).

Whether or not the introduction increases the incentives to read the book is an open question. More reasonably, it promotes the idea to read about all relevant issues in the editor's own publications. This seems to be a reasonable strategy for those who want to be introduced to the topic of exchange rate policy in emerging market economies. They may refer to the book as an additional source for alternative opinions and for some empirical exercises. Apart from that, the book is a historical document which summarizes the state of the art at the beginning of the 1990s, i.e., before the major currency crises of this decade demonstrated the risks related to capital flowing in from globalizing capital markets.

Rainer Schweickert

Giersch, Herbert (ed.) for the Egon-Sohmen-Foundation, Reforming the Welfare State. Berlin, Heidelberg, New York 1997. Springer-Verlag. X, 331 pp.

This book comes timely although the conference, in which the papers have been given, took place already in the summer of 1995. It is not too difficult to be timely in this field as the issue of how to reform our welfare states is a difficult, controversial and thus slowly moving process.

The book features an interesting cast of characters: economists, historians, political scientists and a philosopher. This gives the book breadth and adds to the international perspective represented by authors from both sides of the Atlantic. As always in social policy issues, Asia is suspiciously absent. Is there a lesson to be learnt?

The book, and by implication, the conference, has a clear-cut agenda. It is set out in Herbert Giersch's brief preface as a set of (almost rhetorical) questions: Does the welfare state have harmful side effects (in essence, moral hazard effects), and have these negative incentive effects evolved over time such that only after two or three decades of generous social policy we are feeling their impact. These questions are almost rhetorical as the book leaves no doubt that the answers are affirmative. This is not particularly unexpected as it concerns the first question. An important insight that is underappreciated is the second point: it takes society a while to learn how the welfare state works, and only over time will the negative incentive effects bear out their full force. This historical path dependency is important because it refutes the empirical line of reasoning that under the same policy the same behavior has to follow; more importantly, one cannot conclude that a certain policy cannot be the cause of observed negative incentive effects now which were not observable in the past.

The book is, a little arbitrarily, divided in five parts. The first two parts are more philosophical and discuss history, fundamental mechanisms and future scope of the welfare state. The third part provides three case studies: Sweden, Germany, and the United Kingdom representing extreme points in the wide specter of how welfare states evolved over time. The fourth part investigates in greater depth specific branches of the welfare state: old-age pensions, health care and unemployment insurance. Somewhat awkwardly, the fifth part contains a single paper that would have nicely fit into the first part as it describes a fundamental mechanism: the "self-serving altruism" which might explain the growth of the welfare state.

The historian *Peter Baldwin* sets the stage with juxtaposing the Beveridgian social citizenship philosophy with the Bismarckian social insurance philosophy of setting up