

Lehment, Harmen; de Grauwe, Paul

Book Review — Digitized Version

[Book Review of] Grauwe, Paul de: Monetary interdependence and international monetary reform. A European case study. Westmead/Farnborough, Lexington/Mass. 1976

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Grauwe, Paul de, Monetary Interdependence and International Monetary Reform. A European Case Study. (Saxon House Studies.) Westmead, Farnborough 1976. Saxon-House D.C., Heath Ltd. Lexington Books. Lexington, Mass. VIII, 118 pp.

The study contains an analysis of the national and the international effects of monetary policies under a regime of fixed exchange rates. The book is divided into four parts. In the first part a model describing the international links in the monetary base of different countries is derived and estimated for seven European countries. The main characteristic of the fixed exchange-rate model is that it allows not only for monetary independence of the international reserve center (the United States) but also for some independence of the European central banks.

While the author points out that monetary control may depend on a country's size, he does not make it sufficiently clear in the first chapter which factors exactly determine the degree of national monetary independence. The answer to this question can be inferred from de Grauwe's discussion of the technical limits to the use of sterilisation policies in the second part of the book (pp. 29sq.), although it is not explicitly stated there: *monetary independence under a fixed exchange-rate system is a function of the ability to change the net supply of the reserve currency (dollars)*. If the exchange rate is to remain constant, a European central bank can only increase the supply of its currency when it, at the same time, raises the net supply of dollars proportionately (by selling part of its reserves including borrowed reserves). If the net supply of dollars cannot be altered simultaneously, the European currency comes under pressure which requires a reversal of the European monetary expansion in order to maintain the exchange rate against the dollar. Likewise, a contractive monetary policy requires a proportionate reduction in the net supply of dollars. In the first case, monetary control depends on the available amount of foreign reserves — in this respect Switzerland may possess a higher degree of monetary independence than Italy which is larger but has less reserves. In the second case, monetary control depends on the amount of the central bank's assets other than reserve currency, i.e., the equivalent of the domestic component of the monetary base, or on the possibility to lower the monetary base multiplier through changes in reserve requirements. It may be interesting to note that by raising the amount of its international liquid reserves at the expense of its holdings of domestic securities, a central bank gains resources to pursue an expansionary monetary policy, but reduces its own ability to pursue a contractive monetary policy.

The model used by de Grauwe implies that a monetary expansion (contraction) in a European country will have an expansionary (contractive) effect on the monetary base in all the other countries of the system; for an expansionary domestic monetary policy goes along with an increase in the net supply of dollars, which again causes a monetary expansion in the other European countries to defend their dollar exchange rates. It should be

stressed that the independence of European monetary policies depends crucially on the reaction of the U.S. central bank. When the Federal Reserve immediately neutralises the change in the net supply of dollars caused by a sale or purchase of reserves by European central banks, European countries have no control over their money supplies even in the short-run.

In the second part of the book the effects of sterilisation policies are quantified by simulations of the model. The results obtained indicate that U.S. monetary policies are the predominant variable for the growth of the European monetary base under the Bretton Woods system while the influence of individual European monetary authorities is relatively small even when sterilisation policies are used. The author also shows that sterilisation policies can lead to policy conflicts between different countries. To illustrate this point assume that Germany wishes to prevent a revaluation of its currency by purchasing dollars against domestic securities (a sterilised inflow of reserves). The reduction in the net supply of dollars tends to cause a devaluation of the other European countries which sell dollar reserves and raise the domestic component of their money supplies to defend the exchange rate. The sale of dollars will, then, put the German mark under pressure to revalue so that the German central bank purchases even more dollars, and so on.

De Grauwe mentions the possibility that the system may explode, but it seems more probable that the reserve flows will come to an end when the technical limits to sterilisation policies are reached, e.g., when a country runs out of international liquid reserves.

In the third part central bank interventions in the Eurodollar market and their effects on the European monetary system are analysed. The author concludes that a sale of liquid dollar reserves against interest-bearing Euro-dollar assets will have inflationary effects and diminish the scope for independent monetary policies by European central banks. Moreover, he finds sterilisation policies preferable to swap transactions as a means of attaining a limited degree of monetary independence.

In the fourth part de Grauwe modifies the assumptions of the model by introducing a float of the dollar vis-à-vis the European currencies, which maintain fixed rates among themselves. In this context he introduces a new international reserve asset, the *Europe*, which has a close resemblance to Special Drawing Rights. The fact that the author stresses the necessity for central banks to hold international reserves under a fixed exchange-rate system is somewhat surprising in the light of the results of the previous parts: international liquid reserves are only necessary if a country wants to pursue a sterilisation policy when its currency tends to depreciate; for with liquid reserves it can prevent a fall of its exchange rate by selling foreign currency, i.e., inflation abroad, instead of reducing the domestic money supply, i.e., deflation at home. But in the other parts of the book de Grauwe clearly expresses his reservations against sterilisation policies, especially as these will only work as long as the foreign countries tolerate the increase in the net supply of their currencies.

The most interesting result of the joint float system is that a U.S. monetary expansion may disturb the equilibrium between the European currencies. The author argues, that — other things equal — European countries with a high degree of openness against the United States tend to revalue against the other European countries so that the maintainance of fixed rates requires a flow of reserves to, and a stronger monetary expansion in, the countries which are more open. The author does not, however, make it sufficiently clear, whether he regards these results as valid only in the short-run or also in the long-run. With an initial situation of full employment, monetary theory, including the recent monetary approach to the balance of payments, suggests that in the long-run a monetary expansion will have no effect on relative prices, including the exchange rates between other countries. In this case there will be no net reserve flows between European countries.

In his final conclusion de Grauwe emphasises the necessity of rules relating to the general conduct of national monetary authorities in a fixed exchange-rate system. The author suggests that these rules should include a restriction of sterilisation policies and a prohibition of swap transactions, as these are a source of instability and as their effectiveness tends to be small, when they are used by more than one country.

One may even go a step further and argue for a complete ban of sterilisation policies. For sterilisation policies are nothing but an attempt to defend the exchange rate by altering the supply of foreign instead of domestic currency, or by "making a foreign instead of a domestic monetary policy." Thus a prohibition of sterilisation policies (which may be extended to all exchange-market interventions, sterilised or unsterilised) means that a country is not allowed to interfere with foreign monetary policy.

On the whole the study by de Grauwe is a valuable documentation of the ineffectiveness of attempts by monetary authorities to prevent the automatic adjustment process of the Bretton Woods system from operating. The book is well written and the fact that the author summarises the main results of the preceding simulations at the end of each chapter in a non-technical form will be appreciated especially by readers who like to skip over the mathematical and statistical details of the analysis.

Harmen Lehment

Herring, Richard J., and Richard G. Marston, *National Monetary Policies and International Financial Markets*. (Contributions to Economic Analysis, 104.) Amsterdam, New York, Oxford 1977. North-Holland Publishing Company. XV, 302 S.

Die Auffassung, internationale Kapitalbewegungen würden in einem System weltweit fixierter Wechselkurse eine auf binnenwirtschaftliche Stabilität ausgerichtete Geldpolitik empfindlich behindern, wenn nicht sogar unmöglich machen, wird heute kaum noch bestritten. Herring und Marston