

Buchbesprechungen

Stephen D. Frowen and Dietmar Kath (eds.): *Monetary Policy and Financial Innovations in Five Industrial Countries. The UK, the USA, West Germany, France and Japan*, The Macmillan Press 1992, 171 pp.

In the mid-1970s, the central banks of most major industrial countries introduced quantitative targets for the development of monetary aggregates. The policy shift was motivated by the insight that in order to bring inflation rates down permanently central banks must reduce money supply growth rates. However, the relationship between nominal income and monetary aggregates has become unstable in several countries. Financial innovations are the major cause. These resulted from deregulation and internationalisation of financial markets and have reduced the predictability of money demand. The discussion of financial innovations has revealed conflicting views. Whereas bankers and firms' financial managers have found most of the innovations very useful, policymakers have viewed them rather sceptically. In particular, they have been concerned with their implications for the conduct of monetary policy and for the stability of the financial system.

The present book looks at the experience and the problems of monetary policy in five major countries. It contains nine papers, six of which were written by present or former members of central banks and seven were presented at the conference on 'Financial Innovations, Deregulation and the Control of Monetary Aggregates' in Guildford, England (unfortunately, the date of the conference is not mentioned).

Claus Köhler ('National Monetary Policy in an Open World Economy') considers the large exchange rate changes which occurred during the 1980s as a consequence of the increased liberalisation of international capital movements. In his view those fluctuations have a negative impact on economic development. Therefore he recommends central bankers to intervene in a coordinated manner in the foreign exchange markets and to cooperate in their interest rate policies. However, it is somewhat surprising that the author has no doubt about the success probability of international policy coordination.

Thomas Mayer ('Federal Reserve Policy since October 1979: A Justified Response to Financial Innovations?') addresses the issue of whether the strong increase in financial innovations in the United States caused the Fed to deviate from controlling the money supply. From October 1979 to August 1982 the Fed's policy was more or less in line with monetarism, since it did not try to stabilize interest rates, whereas in former periods the Fed's priority was to restrain the fluctuations of the funds rate to a narrow range. Nevertheless the Fed failed to control the growth rate of its monetary target M1. In Mayer's view this failure does not justify giving up monetary targeting and shifting to an interest rate or a

GNP target. He emphasizes that the great advantage of announcing targets for monetary aggregates is the independence from political pressure which it gives to central bankers. With respect to the appropriate choice of monetary aggregates he argues that financial innovations have caused the interest elasticity of money demand to decline which implies that in order to control M1 one has to accept larger interest rate fluctuations.

Norbert Kloten ('The Control of Monetary Aggregates in the Federal Republic of Germany under Changing Conditions') mainly reviews monetary policy between 1975 and 1986, where the Bundesbank pursued a quantitative target for the growth of the so-called 'central bank money stock'. Only in 1978 and in 1986 did monetary policy clearly fail to meet its target. In both years the US-\$ was very weak which made the Bundesbank's restrictive monetary policy more difficult. Financial innovations, however, did not hinder the Bundesbank's policy performance. In Kloten's view the wave of financial innovations did not reach Germany because of a flexible universal banking system and relatively stable interest rates. However, the overall assessment of German monetary policy may be less positive if one considers the more recent experience which, unfortunately, is only described in the appendix of Kloten's article.

Stephen F. Frowen and *Heinrich Schlomann* ('Financial Innovations and the Stability of the Demand for Money in Germany since 1974') provide estimates of the money demand function with respect to M1, M2 and M3 for the period from 1974 to 1987 and several subperiods. They obtain the 'best' regression results for the money stock M1. Moreover, they find that the evolution of the demand for money has become less predictable since the beginning of the 1980s because the influence of interest rates and exchange rates on money demand has become rather unstable. After 1987 money demand was even more difficult to predict as foreign residents (especially in Eastern Europe) increased their holdings of DM cash.

Robert Raymond ('The Effects of Financial Innovation and Deregulation on French Monetary Policy') describes the decline in financial intermediation by banks and the increase in the importance of financial markets for the collection and investment of funds. The French government played an active role in introducing new financing instruments. It promoted firms' access to capital markets and stimulated the demand for equities by introducing tax incentives. The bond market has absorbed an increasing share of private savings as short-term mutual funds and short-term open-ended unit trusts were introduced in 1982. The substitution of bank deposits and bank loans through marketable securities caused the authorities to use market operations instead of credit ceilings as an instrument of monetary policy.

Tatsuya Tamura ('Monetary Control in Japan') first argues that the main reasons for the introduction of money stock targets in 1975 were double digit inflation rates and increasing difficulty in interpreting interest rate movements. He then describes the various measures which led to a deregulation of interest rates and to the use of new financing and investment instruments at the end of the seventies and the beginning of the eighties. He suggests that these developments caused bank lending to become less affected by monetary policy.

John S. Flemming ('Financial Innovation: A View from the Bank of England') discusses the effects of abolishing major differences in the regulation of banks and building societies in the U.K. Since the beginning of the 1980s banks have entered the mortgage market, and building societies have offered various forms of deposits to the public and have been allowed to use the money market as a source of funds. These measures made borrowing more flexible and the housing market less sensitive to interest rate changes.

Gordon T. Pepper ('Capital Flows and Exchange Rates: Some Implications') explains why capital flows have increased strongly during the 1980s and why this resulted in increased exchange rate volatility. The current account has ceased to be the crucial determinant of exchange rate movements. Capital flows have been fostered by strong advances in information and communications technology, the creation of new financing instruments and the abolition of controls in most major economies. Pepper emphasizes that the strong increase in international capital flows has made domestic monetary control more difficult and has increased the interdependence of national business cycles.

C. A. E. Goodhart ('British Monetary Policy: October 1990') discusses several alternatives to a discretionary monetary policy. Although the narrow money stock M0 has been the official monetary target in the U.K. since 1985, British monetary authorities did not try to control it strictly. This experience and the problems of controlling monetary aggregates in other countries suggest that implementing some form of monetary targeting would not be a credible strategy. In Goodhart's view the only convincing strategy for the U.K. would be to establish an independent central bank.

In sum, the book demonstrates that the institutional environment in which monetary policy has to operate diverges considerably across major countries. The observed differences in the forms and the extent of financial innovations as well as in the conduct and in the performance of monetary policy can only be understood by considering the heterogeneity of the institutional framework. If one has to mention one weakness of the book then it would be that the discussion of the adverse effects of flexible exchange rates is at most only indirectly related to the topic. Nevertheless the volume is a valuable source for those interested in the practical problems of monetary policy during the last two decades.

Hildegard Breig, Freiburg