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III Capital Flows, Sterilization, Monetary Policy, and Exchange Intervention

The central issue in understanding the international transmission of inflation is whether or not national borders make a real difference: Is the world economy an aggregate of individually perfectly open economies, or is it an aggregate of linked, but partially independent economies?

Channels of transmission among countries were examined within the context of the Mark III International Transmission Model in part II. There the channels were found to be surprisingly weak, but, as with any large-scale model, these results might be an artifact of some unknown peculiarity in the model's specification. So the research on the openness question reported in chapters 10 through 13 is either relatively model free or at least based on alternative, smaller-scale models. Thus the reader can assess these results without substantial investment in evaluating the model.

Darby and Laskar in chapters 10 and 11, respectively, test for perfect openness by examining its implication that nonreserve central banks under pegged exchange rates have no control over their individual domestic money supplies. They argue that previous analysts, with a few notable exceptions, have not adequately dealt with the sterilization activities of the nonreserve central banks and, as a result, have performed tests which have little power to distinguish an alternative hypothesis of monetary control from a

null hypothesis of no control. New tests are presented which confirm the exercise of monetary control by nonreserve central banks during the Bretton-Woods era.

Nonreserve monetary control under pegged exchange rates implies that a pure foreign exchange operation can influence the country's floating exchange rate. Dan Lee develops a dynamic portfolio-balance model in chapter 12 and uses it to contrast the effects of a central-bank exchange of domestic bonds for foreign bonds with those of an exchange for domestic money.

Many economists—including perhaps most persuasively William Branson—have used a portfolio-balance approach to argue that international assets are not perfect substitutes. Since perfect substitutability of assets is the most popular assumption leading to perfect openness, the issue is an important one. In chapter 13, Michael Melvin advances the portfolio-balance approach by introducing with some success the exchange-rate risk covariance measures implied by the international-asset-pricing model into the capital flows equation. This analysis provides an alternative to the capital-flows specification presented in chapter 5 and used in the Mark III International Transmission Model.

Thus part III supplements the results of part II by first presenting alternative and more formal tests of monetary control under pegged exchange rates. The implications under floating exchange rates of the lack of perfect openness are then examined. Finally, an empirical advance is made in the implementation of the portfolio-balance approach—the underlying theoretical explanation for the observed imperfect substitutability of international assets.