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INTERNATIONAL FINANCE DISCUSSION PAPERS

# BOOK REVIEW

The Responsiveness of Demand Policies to Balance of Payments: Postwar Patterns. By Michael Michaely. New York and London:* National Bureau of Economic Research, 1971. Pp. X, 299. $10.00.

by

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The Responsiveness of Demand Policies to Balance of Payments: Postwar Patterns. By Michael Michaely. New York and London:* National Bureau of Economic Research, 1971. Pp. X, 299. $10.00.

The problems of the postwar international monetary system have been separated in the literature into liquidity problems, confidence problems, and adjustment problems. The main emphasis has been on theoretical analysis of these problems with much less attention devoted to empirical work. The problems and implications of different international adjustment processes in particular have been dealt with extensively from a theoretical viewpoint; but very little empirical work has been done on how countries have, in fact, responded to external imbalances.

Professor Michaely in this volume--No. 5 in the NBER series of Studies in International Economic Relations -- analyzes how aggregate demand policies responded to external imbalances during the period 1951 to 1966 under the adjustable peg exchange rate system. He examines nine developed countries (the countries making up the "Group of Ten" excluding Canada) to see if patterns can be detected in how countries individually and as a group adjusted their monetary and fiscal policies in response to external problems.

Several different instruments of monetary and fiscal policy are examined. Michaely chooses policy instruments that are general in

*/ Forthcoming in the Journal of Economic Literature.

their effects on aggregate demand and common to most of the countries studied. For measures of monetary policy he uses: the discount rate, reserve ratio requirements, central-bank lending to the commercial banks, central-bank lending to the government, commercial-bank lending to the public, central-bank total domestic claims, and the money supply. For measures of fiscal policy he uses current government expenditures, current government revenues, and the balance.

The first three chapters of the book explain the purposes of the study, describe the methodology used, and contain a summary of the conclusions of the individual country studies. The last nine chapters contain the individual country studies. Individual countries are studied using a common method to facilitate comparisons across countries of how adjustment policies are handled.

For each country the quarterly time series used to measure external imbalance is divided into periods of surplus, deficit, and stability (near zero balance). Each policy instrument is then examined to see if it is consistently contractionary when the balance of payments is in deficit, and expansionary when the balance of payments is in surplus. Those policy instruments that do display this kind of behavior are labeled as policy instruments that, at least during the period of study, aided balance of payments adjustment.

Michaely goes somewhat beyond this to interpret the relationships between targets and policy instruments. He interprets the relationships as causal: targets are the cause and changes in policy instruments are the result. Furthermore, Michaely assumes policy makers do have some discretion in how they react, or do not react, to balance of payments problems. He assumes the units in which time is measured -- a cycle phase in the balance of payments lasting from two quarters to several years -- are long enough so policy instruments respond to concurrent targets and not lagged target values. He then treats the observed relationships between concurrent targets and policies as indicating how policy makers responded to external imbalance.

Each policy instrument is also checked against alternative possible targets: measures of price changes, the unemployment rate, and the rate of change in the industrial production index. He does this for policy instruments that moved to adjust the balance of payments in order to insure the relationship was not merely a reflection to a close association between the balance of payments and another target that the instrument was genuinely directed at. Instruments that do not tend to move in a manner consistent with the needs of external balance are checked against alternative targets to see if it can be determined why and under what circumstances they were not used for balance of payments adjustment.

From the individual country studies Michaely concludes that policy makers in several of the countries examined use monetary policy -- measured by rates of change in the money supply or the discount rate -- for balance of payments adjustment. In almost all countries studied though, some monetary sterilization took place via the central-banks altering their holdings of domestic assets in a non-adjusting direction. In none of the countries studied does fiscal policy consistently move in what Michaely considers to be an adjusting direction.[1/] Only in Sweden and the United States was he able to relate fiscal policy to alternative target variables.

It is unsettling that the analysis used indicates, in the majority of the countries studied, that fiscal policy is made in an apparent vacuum. This is especially surprising since a constant employment measure of fiscal policy was not used.

The behavior of fiscal policy variables suggests Michaely's analytical method may be too confining. Policy makers behavioral functions may be stable; but in the real world, policy instruments may not be assigned to only one target. The positions of several targets may interact in determining the policies undertaken. This suggests multiple regression techniques may be useful in correctly identifying relationships between targets and policies. Michaely rejects formal regression analysis for several reasons; the primary one seemingly being that the formal regressions he ran (reported in the appendix) did not work very well.

A rather severe limitation of this application of the standard National Bureau business cycle approach is that the conclusions are qualitative rather than quantitative. For each policy instrument Michaely can at best only report the sign of the relationship but

1/ If capital is highly mobile, a contractionary fiscal policy may worsen rather than improve a balance of payments deficit. This possibility is not considered by Michaely.

not its magnitude. It is very difficult than to sum over the different policies and get any idea whether a country was moving in an adjusting or non-adjusting manner, much less the order of magnitude of the adjustment.

There are a couple of minor annoying features of the book. Michaely does not set out the balance sheet relationships that relate the different monetary aggregates used as policy instruments. The absence of explicit consideration of these balance sheet relationships leads to some foncusion. One of the indicated purposes of the book is to stimulate further research by others. However, the raw data Michaely uses are not presented in the study except for some bits and pieces. A data appendix would have been a valuable addition. Also, it is never made clear exactly when seasonally adjusted data are being used. Michaely only has a comment to the effect that seasonally adjusted data are used when necessary.

This book can be read with benefit by anyone interested in the international adjustment mechanism. The book is clearly written and the analysis is provocative.

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