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Book Reviews

Limiting Exchange Rate Flexibility: The European Monetary System. By F. GIAVAZZI and A. GIOVANNINI. MIT Press, Cambridge, Mass., and London. 1989. xi+230 pp. £25.00.

This is an excellent book by two of the leading academic contributors to the analysis of the European Monetary System (EMS), integrating and extending their pioneering research published in a number of journals and conference volumes in the second part of the 1980s. It is written in a relatively non-technical manner, which makes the results accessible to a wider audience than the original research papers.

The first two chapters are introductory. Chapter 1 discusses the reasons behind 'The Quest for Exchange Rate Stability in Europe'. The authors suggest the openness of European economies, the legacy of the interwar experience, the close integration following the Treaty of Rome and the Common Agricultural Policy of the EC as the main reasons behind the drive for stable nominal exchange rates. They also discuss the European experience during Bretton Woods, and EC exchange rate initiatives following its collapse. The scene is set for introducing the EMS.

The nature of the EMS is discussed in Chapter 2, which deals with topics such as intervention rules (including the divergence indicator), the very short-term financing facility, provisions for changing central parities and the role of the ECU in the exchange rate mechanism. In this last section the authors clearly demonstrate that pegging the exchange rate to a weighted average of currencies in a system cannot provide a nominal anchor. Either there must be a cooperative arrangement to peg the weighted average to some external nominal target, or one of the members must adopt such an external target. They suggest that the Bundesbank's reluctance to accept divergences from the ECU as the mechanism that would trigger intervention, and its insistence on a bilateral parity grid, is exactly the element that made the EMS an asymmetric system like Bretton Woods, rather than a symmetric one. This insistence was out of concern that in an ECU-based system upward divergence of the Deutschmark (DM) would put pressure on Germany to relax its monetary policy. The result of the adoption of the bilateral parity grid is that the ECU is 'devoid of any meaningful role in the exchange rate mechanism' (p. 4).

Chapter 3 considers the impact of the EMS on exchange rates. Given that the EMS involves both relatively wide fluctuation bands and realignments, the authors first discuss the legitimate question of whether the system is a genuine regime that 'limits exchange rate flexibility', or just 'a veil over a system of de facto floating exchange rates' (p. 43). They conclude that the system has reduced the volatility of bilateral nominal and real exchange rates, but that the volatility of real effective exchange rates has increased in all countries apart from Germany. This they attribute to the different effects of dollar disturbances before and after the EMS. While in the 1970s the significant appreciation of the DM against the dollar was accompanied by appreciation against the other European currencies as well, in the 1980s European currencies have on average stayed closer to the DM in the light of the rise and fall of the US dollar. Thus, the effective DM rate has been stabilized relative to the 1970s, while the effective rate of other currencies was not, as they fluctuated more against the dollar. It is in this chapter that the authors first allude to the main benefit of the EMS for Germany, namely the limitation of the detrimental effects of dollar disturbances.

Chapters 4, 5 and 6 contain the main contributions of the authors to the analysis of the EMS. The material has been published before (in *Economic Policy*, *Economica*, *European Economic Review* and various CEPR conference volumes, among others), but the integration that is achieved in the book puts the contributions in perspective and makes the results more accessible.

Chapter 4 considers what is possibly the central message of the book, namely that the EMS is a 'Greater DM area'. The authors demonstrate that the burden of EMS-related intervention was shared very unevenly. Most of the intra-marginal intervention was carried out by countries other than Germany, while Germany intervened only when bilateral fluctuation margins were reached. They then go on to suggest that, in the presence of sterilization, intervention rules are not useful in determining whether or not an exchange rate union is symmetric. By using a rudimentary monetary model of intervention and sterilization, they demonstrate that in an asymmetric system the centre country sterilizes foreign disturbances in an attempt to control its money supply. The 'satellites' avoid sterilization in an attempt to control their foreign exchange reserves. This yields the strong prediction that the centre country's interest rates are affected only by domestic money market conditions, and all international portfolio shocks are reflected entirely in the interest rates of other countries. The data presented seem to support the hypothesis that only Germany sets monetary policy independently in the EMS. For example, German interest rates are hardly affected in the weeks preceding EMS realignments. Some evidence from estimated reaction functions for monetary aggregates that is also presented is less supportive of this hypothesis, but policy reaction functions are dismissed as not very reliable econometric equations.

Chapter 5 discusses the role of the anti-inflationary reputation of the Bundesbank for the European disinflation of the 1980s. Using models of policy games between monetary authorities and their private sectors, and between monetary authorities in different countries, the authors examine the thesis that the main advantage for EMS countries other than Germany in going for fixed exchange rates was that they borrowed the anti-inflationary credibility of the Bundesbank *vis-à-vis* their private sectors and thus ended up with lower inflation (or less costly disinflation). In their examination of alternative exchange rate regimes (fixed, flexible, managed and models with periodic realignments), the authors conclude that the argument that exchange rate pegging is a superior strategy for fighting inflation is theoretically weak, as it relies on the assumption that exchange rate targets are more 'visible' or credible than other nominal targets, and as it cannot explain the motivation of the centre country to participate in such an arrangement. However, they do not totally dismiss it for the case of the EMS, mainly in view of the stabilization of Germany's real effective exchange rate that the EMS implied. They suggest that the question is ultimately empirical, and present some evidence on wage-price dynamics, based on reduced forms (vector autoregressions). Their results suggest possible shifts in wage-price dynamics that could be attributed to shifts in expectations. However, given the nature of the tests, the evidence cannot be conclusive. One of the highest priorities of research on the EMS still remains the testing of this central hypothesis by means of structural models of the inflationary process.

Chapter 6 delves deeper into one other asymmetry in the operation of the EMS, namely the US dollar-DM polarization. It is motivated by the observation that when the dollar is strong in foreign exchange markets the DM tends to be weak *vis-à-vis* other European currencies, and vice versa. The authors document this fact, and discuss its significance for EMS realignments. They find that all realignments, which incidentally resulted in appreciations of the DM, have been preceded by a large fall in the effective dollar index, and have been followed by a recovery of the dollar. However, market rates in the EMS are not strongly affected by changes in central parities. To a large extent, EMS realignments seem to accommodate existing trends in market rates. The authors heuristically examine potential explanations for this polarization in terms of dynamic portfolio models, exchange controls and transaction costs. They argue that a transaction-costs model that generates endogenous market 'thinness' can explain the stylized facts.

This issue is taken up further in Chapter 7, which considers various aspects of capital controls. After a thorough examination of the relation between offshore and onshore interest rates around realignments, the authors present an interesting, although stylized, general equilibrium model, which highlights the determinants of the effectiveness of capital controls. For example, they show that controls on transactions by households are complementary to controls on firms' transactions and isolate the incentives of firms to use trade credits for international diversification purposes, and the significance of adjustment costs in trade and production for the effectiveness of controls.

Conclusions are given in Chapter 8. This chapter also briefly touches aspects of the EMS that are not discussed in the main body of the book, such as public finance (seigniorage) arguments for a two-tier EMS, and whether the EMS is exportable. The discussion of these two issues is brief and somewhat cursory, and the tentative conclusions must be taken with more than the usual pinch of salt.

For example, although in southern European countries seigniorage revenue has been a more important source of government revenue than in northern Europe, this does not necessarily imply that the southern countries should not form an exchange rate union with those in the North. The differences in seigniorage revenue are only of the order of 2-3 per cent of GDP, and a large part of this discrepancy is going to disappear anyway if financial deregulation makes the use of currency and reserve requirements of commercial banks more uniform across the EC. Also, it should not be forgotten that during the Bretton Woods system these countries were in effective exchange rate union with the North. It would be very difficult to argue that it was their requirement for higher seigniorage revenues that destabilized Bretton Woods.

On the suitability of the EMS as a blueprint for international monetary reform, the authors are rather negative, pointing out that policy coordination is higher in Europe than in the Europe-United States-Japan axis, that exchange rate targets at a global level will lack the credibility offered by EC institutions, and that the United States and Japan do not have capital controls. These points are fine, but the fact that the EMS has been characterized by some special features that are unlikely to be replicable at a global level does not necessarily mean that a global experiment with fixed exchange rates will not replicate the success of the EMS.

Overall, I found this book an extremely useful piece of scholarship. It blends theory and facts in a masterly fashion and is very well written. It is bound to be the most influential monograph on the EMS for years to come, and should grace the shelf of every serious student of exchange rate regimes and European affairs. I recommend it without reservations.

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The Insider-Outsider Theory of Employment and Unemployment. By ASSAR LINDBECK and DENNIS SNOWER. MIT Press, Cambridge, Mass. 1988. London. 1989. x+285 pp. £24.75.

This book has a rare quality. Its authors are not only distinguished in the field but can fairly be said to be *the* pioneers in the field. For obvious reasons this raises readers' expectations, but there are also some potential drawbacks. Authors with less command of the material might try a bit harder on the exposition and have a greater sense of detachment.

The book consists basically of nine previously published articles which form Chapters 2-10 together with an introductory chapter and a concluding chapter. Each of Chapters 2-10 has a short introduction written specially for the book. These introductions are an attempt to stitch together the diverse strands running through the chapters and relate them to the underlying theme. In a sense, the value of the book lies in the two new chapters and the introductions to the previously published papers. The introductory chapter has a useful overview of what insider-outsider theory is about and, perhaps even more importantly, what it is *not* about. The concluding chapter deals with policy issues although, rather disappointingly, it does not attempt to spell out a research programme for the future.

Insider-outsider theory rests fundamentally on asymmetries which are intrinsic to the labour market. Incumbent workers (insiders) in a firm have an advantage over potential entrants (outsiders) which can be exploited to drive up the insider wage. This advantage springs essentially from three possible sources: (1) training and hiring costs, which drive a wedge between the wages at which it is profitable to hire insiders and outsiders; (2) cooperation activities, by which insiders support each other, and harassment activities directed at outsiders, both of which tend to deter firms from hiring equally productive outsiders; and (3) the possibility (and credible threat) of insiders cooperating in strikes, which deters the firm from hiring outsiders. These themes are addressed in Chapters 2-8. In each case the methodology is to show how rent-seeking activities by insiders can lead to involuntary unemployment of outsiders. Chapters 9