tion on the use of monetary policy for strictly domestic purposes" (italics mine). Nothing that Scott and Schmidt say requires this conclusion to be altered.

PETER M. OPPENHEIMER

Oxford

Imported Inflation and Monetary Policy: A Reply

We are pleased that Mr. Oppenheimer concedes us victory over a straw man. But we believe we are dealing with central bankers' tissue.

While he thinks our discussion of the external constraints is an "obvious weak spot", we hold that he admits our argument precisely at this point. He writes that "The country's external debt will then have to reach very high levels indeed before the increasing-risk principle comes into play. Hence the supply of capital *will* be perfectly elastic over a considerable range, and it will take time — months, a year, perhaps several years — to work this off". It would appear from this statement that Mr. Oppenheimer sees an end to the perfectly elastic range. Hence, the monetary authorities should, in the face of a threat of imported inflation, rapidly accelerate the application of measures for monetary restraint until the less-than-perfectly-elastic region is reached and monetary policy, therefore, becomes effective. Apart from the negligible administrative resources employed, there is no cost in increasing monetary restraint which is ineffective because it attracts foreign funds; so there is no reason why the monetary authorities cannot *quickly* reach the point where their policy becomes effective (1). If restraint will "bite"

(1) It is, to say the least, interesting to observe that in the United Kingdom offsetting action occurs automatically through the operations of the Exchange Equalization Account (E.E.A.). When the E.E.A. buys foreign exchange, it obtains the necessary sterling by selling government securities, thus automatically destroying the monetary effect of the balance-of-payments surplus. Such operations (which are analogous to the gold sterilization procedures of the U.S. Treasury in the late 1930's) may lead to higher interest rates, unless the central bank intervenes. In other words, the only way in which imported inflation can occur in the U. K. is through its validation by the Bank of England. But this is precisely the point we have tried to make, namely, that a rigid interest-rate policy may give rise to a problem of imported inflation.

eventually, as Mr. Oppenheimer concedes, it can be made to bite today by multiplying the measures for restraint.

We are perplexed by Mr. Oppenheimer's contention that " Short of the limiting case, therefore, a given degree of monetary tightening requires a larger rise in interest rates if there is an induced inflow of foreign funds than if there is not ". We thought that the basis of his argument was that the supply of funds from abroad was perfectly elastic up to a point, and if that is the case, interest rates could not rise until this point is reached. If he is saying that interest rates will rise, we of course agree. Alternatively, if he simply means that a given rise in interest rates requires more monetary restraint when there is an induced inflow of foreign funds than when there is not, the observation is without significance. Apart from negligible administrative resources, increased monetary constraint is costless in the sense that there are no economic effects so long as inflows of foreign funds offset it. It is only necessary for the monetary authorities to restrict credit more rapidly so that the point at which the increasing-risk principle comes into play is reached sooner.

Mr. Oppenheimer challenges the increasing-risk principle at one point by stating that " *Ceteris paribus*, a country in balance-of-payments surplus will inspire a high and perhaps increasing degree of confidence in foreign lenders ". We do not know what is concealed by the *ceteris paribus* assumption, but we can be sure that there is some volume of external debt, attracted by a vigorous monetary policy, which will cause the surplus to disappear because of debt service payments (interest and amortization). The ratio of debt service to current account earnings, the king-pin of debt-servicing capacity, can always be made to rise. Furthermore, the balance of payments is only one of several conventional measures of debt-service capacity; others include the ratio of debt service to government revenue, to national product, to savings, and to compressible imports. As we noted in our original paper, all of these worsen in the case under discussion (2). These comments apply as well to his statement regarding speculative capital inflows.

(2) A tightening of interest rates in the Eurocurrency market may well be a signal that a country is pressing against the limit of credit lines available to that country through this market. Cf. Norris O. Johnson, *Eurodollars in the New International Money Market*, New York: First National City Bank, page 16. This shows that the increasing-risk principle applies to both long-term and short-term external debt.

With regard to Mr. Oppenheimer's comments on our discussion of the " internal constraints ", we also remain unconvinced. He asserts that reserve requirements cannot exceed 100 per cent, meaning, probably, average reserve requirements. In this case, we grant he is right because banks would cease to hold any claims on the private sector except, perhaps, those financed by the capital account. *Marginal* reserve requirements, however, could be raised above 100 per cent. There may, of course, be political limitations, but both Mr. Oppenheimer and we have agreed to put those aside. In effect, cash reserve requirements, whatever the percentage, reduce bank earnings so long as compulsory cash holdings exceed desired cash holdings. Required ratios in excess of 100 per cent are distinguished from ratios below 100 per cent only by the severity of this burden.

Concerning open market operations, Mr. Oppenheimer concludes that " ...the cost of credit is increased but its availability is not reduced, or at least not reduced by as much as it would have been in the absence of a foreign inflow ". The availability of credit, if it is to be distinguished from the supply of credit as a simple function of the interest rate, is determined in a complicated way by balance sheet constraints involving both borrower and lender. We submit that our critic must give much more thorough consideration to the factors involved before a plausible case for his position can be established. An inflow of foreign funds, for example, will not increase availability if the balance sheet effects are not appropriate. Indeed, in the case of Mr. Oppenheimer's speculative capital flows, the availability of credit might be affected adversely. That is, increased commercial bank holdings of foreign exchange in an atmosphere charged with rumours of appreciation of the domestic currency would surely have adverse effects on the availability of credit (3). However, for the sake of argument, suppose we accept his allegation. It is only necessary to add that the monetary authorities must undertake additional open market operations in order to reach the point where the increasing-risk principle applies and thus the availability of credit is no longer augmented through the response of foreign funds.

(3) Presumably, if the foreign exchange is sold to the central bank, availability effects are nil, since a central bank does not usually behave in a manner analogous to that of commercial banks.

As for Mr. Oppenheimer's view that our use of end-of-year numbers is fallacious, we reply that the technique we have employed is a common device used to eliminate the influence of seasonal factors. Furthermore, the reader is assured that year-to-year comparisons for the end of any quarter support the same conclusion we draw from end-of-year figures.

Mr. Oppenheimer is quite correct in saying that we take central bank policy to be deliberate. By attempting to deny this through citing Professor Mundell, he is simply continuing the error of assuming that the supply of foreign funds is infinitely elastic. And he misses our point when he says that the inflation of domestic assets was a conscious policy designed to facilitate balance-of-payments adjustment. According to the imported-inflation argument, monetary restraint *will not work*. Mr. Oppenheimer is saying that the authorities *did not want it to work*, which is a very different matter (4).

Bologna

IRA O. SCOTT, Jr.
WILSON E. SCHMIDT

(4) For an additional attack on the notion of imported inflation see WALTER S. SALANT, "Does the International Monetary System Need Reform?", *Money in the International Order*, ed. by J. Carter Murphy, (Dallas: Southern Methodist University, 1964).