

# Essays in International Money and Finance

Interest rates, exchange rates, prices and the  
supply of money within and across countries



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 **World Scientific**

## Preface

The 28 papers that I have put together for this book have stood the test of time. I published them over the course of 40 years and virtually all are still being cited. Six have been reprinted elsewhere and one more than once. They are therefore quite evidently of much more than historical interest.

I believe that there are several major reasons for this continued interest. The first, and perhaps most important, is that the questions they treated initially were important and that in one form or another have remained so. The second is that the papers share characteristics that have differentiated them from much else written over this 40-year period and for that reason have been found appealing. The focus in a considerable number of papers has been on the broad range of experience, using either time series spanning centuries rather than just a few decades or on cross-country panel data with underlying variability similar to that of the long-span time series. A good number of the papers also make use of natural experiments and did so long before that methodology became popular. The econometric analysis generally has also been rather different from the standard fare. It is, I believe, a good deal more transparent. In a number of cases, the principal results quite literally can be seen at a glance, being shown in a scatter diagram or other chart. The accompanying test statistics in these instances are simply complements that readers can use to calibrate their own internal probability calculators. Finally, the papers share a broadness in scope of another sort, with concerns for both history and in some instances, the history of economic thought and

with emphases on both open-economy and closed-economy models of economic behavior.

I was a graduate student in the economics department of the University of Chicago in the late 1960s and early 1970s. Chicago provided much of the intellectual toolkit for this research. It was also where much of my interest in the topics investigated in this book developed. The Great Inflation had just begun, Bretton Woods broke down soon thereafter and floating exchange rates, which up until then had been regarded as a theoretical curiosity, became a reality. Questions about what was happening on all these fronts loomed large, and in the case of exchange-rate behavior have continued to do so. Bit by bit, I began to delve into these questions.

At Chicago, Milton Friedman had a major influence on my work, both as a teacher in the classroom and more importantly as the leader of the Workshop in Money and Banking. That workshop was unique, even by the standards of Chicago. Papers were never presented. They were distributed the week before each meeting and then the next week critiqued in great detail, often page by page. Gary Becker, who as a student, was a member of the Workshop in Money and Banking and later as faculty member often participated in it, summed the experience up very well: “[G]iving workshops you learn a lot. You don’t come away feeling you did that well but when you think about it you got a lot out of it.” (Liberty, 2003).

Becker was right on both counts. The Workshop in Money and Banking was indeed arduous and no, you usually did not come away feeling you did that well when you presented your work there, which you were required to do each year you were a member. It did, however, teach me and my fellow students how to do good research. I wrote my doctoral dissertation, “The Demand for High-Powered Money” (Lothian, 1973) as a workshop member. I subsequently published the article version in the *American Economic Review* (Lothian, 1976). I have included that article here as Chapter 22.

My experience with Friedman in the workshop led me to reread much of his work quite carefully to get some further ideas about how to do research. Friedman’s *A Theory of the Consumption Function* (Friedman, 1957) and his and Anna Schwartz’ *A Monetary History*

of the United States (Friedman and Schwartz, 1963) are the two that stand out here. The focus on big problems, the integration of theory and empirics and the analysis of a wide range of data, which are common to both, and the historical approach and use of natural experiments, which are hallmarks of *A Monetary History*, have influenced my own work in major ways.

My other teachers at Chicago, whom I look back on as influential were George Stigler, Arnold Harberger, Larry Sjaastad and Lester Telser. All four were fine teachers and fine price theorists. I wrote my first papers at Chicago in Stigler's courses — one on John Wheatley's monetary economics for history of economic thought and another on airline regulation for public policy. Writing those papers was an excellent entrée to dissertation writing. Stigler's course in the history of economic thought gave me a lasting appreciation for that subject and for history more broadly, one that has carried over into my own work through the years.<sup>1</sup> Stigler's views on public policy influenced both my scholarly and my business-oriented analyses of the Great Inflation of the 1970s and '80s. It made me highly skeptical of the view that all that was involved was policy error on the part of the Federal Reserve.<sup>2</sup> Harberger and Sjaastad's Latin American Economics Workshop and Sjaastad's course in Latin American economic problems combined theory and empirical evidence in analyzing a wide array of economic issues. Like Friedman's workshop, they gave me a feel for how to do research and how to think about economic problems.

My interest in the major macroeconomic questions that I cited above increased when I took my first job, in summer 1972 in the economics department of what was then known as First National City Bank and later Citibank. It brought me into contact with a

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<sup>1</sup>Chapter 16 on Irving Fisher and UIP is one example. My other excursions into the history of economic thought include Citibank *Monthly Economic Letter* (1976) on Adam Smith, Lothian (1997) on the sixteenth century Salamancan writers, Lothian (2009, 2016) on Friedman and Lothian and Tavlas (2016) on Friedman and Schwartz.

<sup>2</sup>See Darby and Lothian (1983) and Citibank *Monthly Economic Letter* (1978).

practitioner-oriented world in which such issues were of considerable importance. At the same time, it provided me with an environment in which scholarly work was encouraged, and unlike many business economic groups, not just tolerated. In the 15 years I was with Citi, I published over 15 scholarly papers, one research monograph and close to 100 pieces of financial journalism.<sup>3</sup>

One very tangible outcome from my day-to-day exposure to traders and other financial practitioners was an appreciation for how financial markets worked and of the difficulties involved in forming expectations. It became apparent that they and the economists like me who advised them all too often saw little more than the shadows on the cave's wall. Errors were far from unheard of and learning from those errors and correcting course was a much more gradual process than many theoretical treatments of the subject envisioned.

Several years after I joined Citibank, I became a research associate of the National Bureau of Economic Research, which then was still headquartered in New York, working on a project investigating the international transmission of inflation. The result was the NBER monograph *The International Transmission of Inflation* (Darby and Lothian, 1983) and several journal articles. I have included two chapters from that book here as Chapters 24 and 25.

My interaction with my colleagues on the international transmission project at the National Bureau, Michael Darby, Arthur Gandolfi, Anna Schwartz and Alan Stockman and also Anthony Cassese, then a graduate student and Connie McCarthy, then a research assistant and a long-time valued colleague thereafter, was an important part of my early learning experience. So too was my contact with Phillip Cagan at the Bureau and in his workshop at Columbia. It is difficult to single out co-authors, but those with whom I have co-authored multiple articles — Darby, Gandolfi and Mark Taylor — clearly influenced my thinking and, I trust, I theirs.

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<sup>3</sup>My interest in current economic developments has continued. See, for example, Dwyer and Lothian (2011, 2012) on the slow recovery following the last recession.

My time at the Bureau also gave me an appreciation for the old Bureau approach to data analysis, the care taken in assembling and analyzing the data and a set of insights about time-series behavior that the Burns and Mitchell approach imparted, even though circa mid-1970s, it was no longer being used and deemed by many thoroughly outmoded and arcane, if not completely useless. It showed the importance of filtering data to separate shorter term movements — the “cycles” — from longer term trends and the necessity of long data spans for making inferences about cyclical behavior given that the cycles themselves were long-lived. These insights stood me in good stead when I began to examine exchange-rate behavior post-Bretton Woods.

In 1986 while still at Citibank, I became the editor of the *Journal of International Money and Finance (JIMF)*, then four years old. I continued as editor for 26 years, retiring in 2012. During that time the journal developed from fledging to a premier journal in the areas of open-economy money/macro and international finance.

In 1988 when I left Citi, I took *JIMF* to NYU for two and a half years while I was a visiting professor there and then in 1990 to Fordham where I have remained. Editing *JIMF* and participating in and organizing the regular conferences that *JIMF* sponsored and co-sponsored were extraordinarily valuable experiences.<sup>4</sup> It brought me into contact with a wide range of scholars from around the world. Continual interaction with authors, referees and paper presenters at *JIMF* conferences, as well as my co-editor Michael Melvin and my Associate Editor Cornelia McCarthy was a valuable source of ideas. I tried to provide my own guidance to authors where possible and doing so forced me to think more clearly myself. I believe that

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<sup>4</sup>Between 1990 and 2012, *JIMF* sponsored or co-sponsored 24 such conferences. Some of these were one-off or occasional. In three cases, however, *JIMF* conference sessions were part of a larger, on-going conference, the Emerging Market Finance Conference at Cass Business School, the Annual International Conference on Macroeconomic Analysis and International Finance at the University of Crete and International Rome Conference on Money Banking and Finance hosted for many years by the University of Rome Tor Vergata and now expanded to other universities in Rome.

much of what I wrote benefitted from all of this. The papers on real exchange-rate behavior in the second section of this book are prime examples. Seeing what others were writing and what major issues remained influenced that research agenda.

In several instances, my being editor enabled me to meet individuals with whom I went on to co-author. I was also a direct beneficiary of *JIMF* in another major way. I published a number of papers in *JIMF*, many of which are included here, that continue to attract scholarly attention.<sup>5</sup>

James R. Lothian  
March 25, 2017

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<sup>5</sup>The great bulk of these papers were solicited by co-editors of *JIMF* or by guest editors of referred *JIMF* special issues. Long-time *JIMF* co-editor Michael Melvin published two of these papers (Chapters 9 and 12 in this volume), *JIMF*’s current Coordinating Editor Kees Koedijk another (Chapter 15). Guest editors Michele Bagella and Iftekhar Hasan published Chapter 19, Richard Baillie Chapter 10, Gerald Dwyer Chapter 28, Cornelia McCarthy Chapter 16 and Kate Phylaktis Chapter 21.

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