Journal of Monetary Economics 22 (1988) 543–547. North-Holland

JELLE ZIJLSTRA, A CENTRAL BANKER'S VIEW – SELECTED SPEECHES AND ARTICLES
A Book Review

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Jelle Zijlstra was President of the Dutch Central Bank from 1967 until 1980 as well as the President of the Bank of International Settlements (B.I.S.) throughout those years. The present volume of selected papers, *Jelle Zijlstra, A Central Banker's View – Selected Speeches and Articles* edited by C. Goedhart, G.A. Kessler, J. Kymmell and F. de Roos (Martinus Nijhoff, Dordrecht/Boston, 1985), offers insights in the political economy of central banking in Western Europe.

1. Central Bank independence

Jelle Zijlstra's views on the independence of his Central Bank are those of a politician – he was Minister of Finance and of Economic Affairs for many years, as well as Prime Minister for a brief time just before his appointment as President of De Nederlandsche Bank – rather than those of a legal scholar. By contrast to most academic views, he maintains that a proper monetary policy requires a well-balanced fiscal policy as well as an absence of autonomous adverse factors in the labour and goods markets. Zijlstra writes: 'The three macro-economic instruments – monetary policy, fiscal policy, and a wage and price policy – must be able to correct each other's imperfections. No useful results will be achieved if reliance is placed on only one of the three. Excesses in one of the three fields cannot be counteracted and corrected by rigorously applying the remaining instruments, alone or in combination' (p. 201). Also: 'If we assume that the Central Bank is sufficiently independent not to be a toy for politicians, it will have a vital function. It must support healthy developments in the two other policy spheres, place a brake on harmful developments and, if the worst comes to the worst, as ultimum remedium, stop them' (p. 202).

In my view the degree of independence of the various Central Banks in the D-mark bloc has depended primarily on the exchange rate system. According to European Monetary System (E.M.S.) custom, the Central Bank Presidents meet on Saturday, and the Ministers of Finance decide on Sunday whenever it

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is time for a realignment of the parities. Occasionally, a conflict becomes public: at the March 1983 realignment, the Dutch government decided on a 2 percent devaluation of the Dutch guilder with respect to the D-mark, although the Central Bank had made its preference known for an unchanged parity.

A large part of the reluctance of the Bundesbank about further monetary integration in Europe is based on the fear that this would give more power to the politicians at the expense of the central bankers. More is at stake here than a simple battle of competences. Monetary integration may lead to a higher average rate of inflation in the participating countries. First, politicians have higher rates of time discount than central bankers on average, if only because the term of appointment of the central banker tends to exceed the period of office of the government. Also, monetary integration reduces the variety of monetary experience from which the public can learn, and in particular might eliminate the lower tail of the distribution of inflation rates across countries. With no independent low-inflation countries left, voters might have more difficulty visualizing the benefits of low and stable inflation. This Hayekian argument has been made forcefully by Vaubel (1986).

The trade-off, in my view, is different for a small open economy. A fixed exchange rate with some of its major trading partners implies that the rate of inflation will be determined abroad, as long as the exchange rate is not adjusted frequently and there is no erratic trend in the equilibrium real exchange rate. Zijlstra writes: 'What I would oppose is giving up the discipline of the balance of payments, which I have seen put a brake on inflationary demand forces on many occasions. And I would oppose also any presumption that the exchange rate is the first thing to be changed whenever balance-of-payments difficulties arise' (p. 59).

Holland tied its exchange rate of the D-mark, accepting regular small (2 to $2\frac{1}{2}$ percent) devaluations, that were quite frequent when monetary policy became more expansionary than in Germany after the first oil price shock in 1974. Since 1977 the guilder has been devalued less frequently (three times between October 1978 and June 1988). By contrast, Switzerland and Austria nearly always strive for a stable exchange rate with the D-mark, but do not participate in any official arrangement. Average rates of inflation in Holland, Switzerland and Austria over the period 1973–1987 have been 5.0, 3.7 and 5.1 percent, respectively. The cumulative change in the exchange rate with the D-mark over this period has been −7.0 percent (Holland), +4.3 percent (Switzerland) and +4.1 percent (Austria).

A virtuous monetary policy does not seem to require the operation of an official exchange rate arrangement. Conversely, participation in a fixed exchange rate club does not raise the political costs of regular devaluations to the point of making such events truly exceptional. Belgium and Denmark have been members of the 'Snake' and of the E.M.S., but the Belgian franc has been devalued eleven times between 1973 and 1987, with a total nominal depreciation with respect to the D-mark of 28 percent, and the Danish krone fourteen times, with a cumulative loss of 41 percent of its nominal value.

2. Costs of inflation

Zijlstra distinguishes three stages in the inflationary process:

(1) creeping inflation that does not exceed 5 percent and may be temporary,
(2) 'marching inflation' which is expected to persist in the 5–10 percent range, and
(3) 'galloping inflation' that exceeds 10 percent and is expected to accelerate.

The supreme cost of inflation is the risk of a runaway inflation that in Zijlstra's view leads ultimately to a dictatorship. More moderate inflations are costly, he maintains, not so much because the opportunity cost of using money for transactions has gone up, but in view of dislocations in the real sector. Correct setting of prices and wages gets more difficult as inflation increases. Usually, wages and other cost factors accelerate ahead of profit margins, thus eroding profitability, especially in the labor-intensive sectors. In the asset markets, according to Zijlstra, inflation leads to shorter maturities in the credit market, making new projects more risky to finance. Houses will become the most common anti-inflation hedge, leading to a bubble in the housing market (Dutch house prices fell for six consecutive years from 1978 until 1984 and declined by some 30 percent after the Central Bank reversed its inflationary stance in 1976–77). Stopping an inflationary trend causes large losses in welfare. Also, in Zijlstra's view, policy makers lack the latitude to respond counter-cyclically to external shocks if inflation is already high in the first place.

According to Zijlstra, with high inflation only a 'rigourous wage and price freeze' can provide the breathing space to fight inflation effectively (p. 182). Elsewhere, however, the author asserts that de-indexation of wages is also sufficient to break inflationary expectations. Several European countries in fact took this measure, often in the form of taking out the estimated effects of import price increases. Zijlstra sees the political costs of wage and price policies to break inflationary momentum as more injurious than the economic costs: 'All those who are disappointed in their expectations, they all turn to the government ... there is a risk that the economic system will move into a twilight zone, a half-way house between a social order based on private enterprise and a collectivistic economic system ... *gouverner, c'est subventionner*' (p. 181).

3. Political economy of inflation

Throughout the period of Zijlstra's Presidency Holland was on a fixed exchange rate with West-Germany. Thus, the Dutch current account in relation to the German current account provided a quick (but noisy) indicator of the stance of Dutch monetary policy.

Obviously, a restrictive monetary policy will (at least temporarily) improve the balance of payments, but depress the real sector. In Zijlstra's first Introduction to the Annual Report of the Dutch Central Bank he discusses the dilemma of the policymaker when both the current account and the economy are weak at the same time, as was the case in 1967. A devaluation in his view might be the appropriate response, but requires I.M.F. approval and may be unacceptable politically. Otherwise a restrictive monetary policy has to strengthen the international accounts, with obvious risks to short-term growth. Zijlstra writes about 'striking a careful balance between employment and balance-of-payments objectives' and about the risk that if policy-makers wait too long they 'are forced to give precedence to the balance of payments over their employment policies' (1968, p. 19). In short, the Central Bank has a responsibility for employment.

During his Presidency of the Dutch Central Bank, Zijlstra changed these views about the scope and aims of monetary policy. He entered his Presidency as a former Prime Minister, well used to expressing concern about many different issues at the same time. Zijlstra gradually became more and more reluctant to accept Central Bank responsibility for the poor showing of the Dutch economy. Halfway through his Presidency he declared himself a pragmatic monetarist and explained that monetary policy should aim at stable growth of some monetary aggregate in order to achieve price stability. In his final Annual Report Zijlstra limits the aims of monetary policy once again to achieving stable paths for financial variables and the national price level only (1981, pp. 19–20).

Central Bankers find themselves in an uneasy dilemma. If they disavow responsibility for economic growth and employment, the politicians may curtail their independence in order to set monetary policy within the context of wider socio-economic goals. But, if Central Bankers express some accountability for the real sector – beyond maintaining stable financial conditions that will be conductive to economic growth – they will be under even more pressure to compromise their anti-inflation policy.

4. Conclusions

These articles by a European economics professor turned politician and Central Banker clearly illustrate the substantial differences between Central Banking in the U.S. and in a small European economy (I assume that Zijlstra's concerns are similar to those of his European colleagues). As will be clear from the above, two principal distinctions are the fixed exchange rate and a tradition of political interventionism in the wage-setting process. Trade unions often deal with employers at a national level in Western Europe so that the politicians are accustomed to taking a stand on these negotiations, possibly going as far as to directly intervene (Margaret Thatcher's conservative government in the U.K. is the exception here). As regards maintenance of a fixed exchange rate, it obviously exposes monetary policy to uncontrollable influences from abroad and shifts power from the Bank to the politicians who decide about official changes in parities. But it also provides a mechanism against domestic pressures for ever easier policies.

The corporatist institutions in West-Germany, Holland, Austria, and all Scandinavian countries force the Central Banks of these countries to determine the optimal degree of involvement in national consensus-building. Zijlstra shows acute awareness of the difficult choices in this respect: an aloof Central Bank may be accused of not caring enough about employment, but an active presence in the corporatist circuit may make the Bank responsible for economic ills it cannot mend. Zijlstra himself withdrew to the proper concerns of monetary policy during his Presidency, and his book suggests that this was at least in part a personal learning process. His reactions to the complicated constraints on Central Bank strategy in a corporatist open economy make his book interesting and useful for readers interested in the political economy of Central Banking.

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