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Book Review

George M. von Furstenberg and Michael K. Ulan's *Learning from the World's Best Central Bankers: Principles and Policies for Subduing Inflation*.

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> "the international and automatically working gold standard is a reasonable and prudent construction. . . . an important condition for social life is fulfilled, not despite but because little is in principle demanded of the human intellect . . . it remains true that the governor of the central bank has to follow the inherent logic of things, that he must not order but obey, even if he must obey like a highly intelligent servant" (Lutz, 1935, pp. 233–238).
> "a good central banker is a doer and a politician, for whom even ambiguity and inconsistency may sometimes serve his purposes. . . . He will use economic science as a commander of armies uses military science, namely as collected pieces of information and wisdom that, though often useful and sometimes indispensable, can never provide a recipe for victory. . . . a set of proven rules for monetary policy would be a contradiction in terms, because once its application is fully expected by everybody, it ceases to be effective. In monetary policy, as on the battlefield, it is the unexpected that counts most." (Niehans, 1978, p. 294).

Economics as a scientific endeavor strives to find general regularities, "laws," which are valid under as many settings as possible. But it also deals with a social, a man-made environment which can be changed again by human action. This is also true for monetary policies and their consequences. Part of this problem faced by economics has been solved by designing laws for different economic regimes. In monetary theory commodity standards like the gold standard with full convertibility versus a discretionary paper money standard come to mind as diverse monetary regimes. And with the latter, the different workings of monetary policy under the regimes of fixed and of flexible exchange rates have been described by monetary theory.

But this is not the whole story. For, as the two quotations from Lutz and Niehans suggest, the leeway offered by different monetary regimes like the gold and the discretionary paper money standard may diverge substantially.

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The latter provides much more room for action of central bankers (or ministers of finance) than the former. And this implies that the influence of personalities and of their idiosyncrasies on monetary policy may become quite decisive. Is economics then not at a loss to describe or even predict the general direction of monetary policy and of its consequences? One way out of this dilemma may be to design and to propose rules and institutions, like the gold standard or Friedman's monetary growth rule, which limit the discretionary powers of central bankers and politicians concerning monetary policy. But under which conditions will they be accepted by the political system?

Given the obvious fact that all current monetary regimes are based on discretionary paper money, and that many of them have institutionalized flexible exchange rates, the economist can certainly not escape the task to study what kind of monetary policies are pursued by individual central bankers and their boards as well as by ministers of finance. This task of reverse learning, as they call it, from central bankers, from gifted practitioners, has been one of the main objectives followed by von Furstenberg and Ulan in writing their book. But instead of looking at bad policies or at the policies of a random sample of central bankers and of ministers of finance responsible for monetary policies, they have decided to limit their attention to the governors of more or less independent central banks, who have been most successful in subduing inflation.

Even with this limitation in mind there remained the problem of which governors should be included in the selection. Here the authors asked the Canadian Governor John W. Crow to identify other governors around the world (p. XIV). As a consequence the list of persons whom they contacted and whose policies are described comprises besides Crow Roberto Zahler of Chile, Alan Greenspan of the USA, Helmut Schlesinger of Germany, Markus Lusser of Switzerland, Yasushi Mieno of Japan and Donald T. Brash of New Zealand. Now, though this selection certainly contains the names of important and successful governors, one could easily have proposed a different list. Names which at once come to mind are Paul Volcker for the USA or Hans Tietmeyer and Otmar Emminger for Germany. And for Switzerland, one may argue that Fritz Leutwiler has been more important than Lusser since he subdued inflation in the difficult period when Switzerland had moved from fixed to flexible exchange rates in 1973.

The book is very careful in describing the monetary policies of the respective governors; the economic, social and political conditions and the previous developments they faced; the consequences of their policies; and the evaluation of their work by the public. The authors do their best to let the governors speak for themselves concerning the aims, measures and motivation of their policies. And in this sense one learns a lot from these different experiences. But though the authors mention critical voices within the respective countries, their approach is, probably by design, not a critical one, except perhaps concerning some aspects of Alan Greenspan's agenda. This means that the authors themselves do not try to give a critical evaluation of the governors' policies.

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Let me take up two examples that are familiar to me, for which a critical assessment would have been helpful. It is mentioned that in Switzerland there were in "1988 to 1989 . . . large shifts in the demand for central bank money as reserve requirements for banks were, in effect, scuttled, and actual reserve holdings fell by two-thirds between yearend 1987 and 1989. . . . The introduction of a real-time gross settlements system for Swiss Interbank Clearing operations as well as a steep reduction in statutory reserve requirements on banks, also at the start of 1988, contributed to this development. By 1990, the central bank had decided to abandon annual money-growth targets in favor of announcing an expected average annual rate of growth of the monetary base . . . " (p. 158). In commenting on these developments, it should be mentioned that reserve requirements were changed from referring instead of to the end of month positions of banks, to monthly averages, which were much lower. Both this measure and the change of the clearing system came about at the initiative of the central bank. Second, the consequence of the strong reduction of the demand for central bank money (that is deposits with the central bank), by banks, led to a surge of inflation two to three years later, which was then fought with strict monetary restrictions. Now it is true that nobody could have foreseen the extent of the reduction of the demand for central bank money. But already in spring and early summer short-term interest rates went down to historically low levels and the exchange rate began to weaken. Because of these early warning signs Lusser and the Board of the Swiss National Bank should have tightened monetary policy. But they waited and acted only in the fall and then too weakly. One has thus to conclude that a serious error was committed which had to be paid for with belated and now much tougher monetary restriction which probably contributed to the long stagnation of the Swiss economy in the nineties (for an account of this episode see Bernholz, 1992).

The second example concerns monetary policy in Germany after the German reunification, which was certainly a difficult task. In this case "money-supply growth rose far above the upper limit [of the band pre-announced as target by the Bundesbank], reaching an annual rate of 9.5 percent from 1991 to 1992, the middle year of Schlesinger's presidency. Yet any inflationary consequences, net of price-level catch-up in Eastern Germany, proved rather mild, with inflation in the western part of Germany below 4 percent and falling after 1992. . . . Consequences for the price level were especially mild compared with the complaints of Germany's partners [in the European Monetary System, EMS] about being forced to mimic Germany's high-interest-rate policy or to give up on maintaining fixed nominal exchange rates under the exchange rate mechanism of the EMS." (p. 123). I do not know whether the last statement is meant as a criticism of Schlesinger's and the Central Bank Council's decision to maintain restrictive monetary policies in spite of the crisis threatening the EMS. The latter forced Britain and Italy to leave the EMS on September 17, 1992, whereas Finland, Sweden and Norway abandoned the unilateral pegging of their currencies to the ECU (European Currency Unit) during the same month. Spain and

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Portugal had to devalue their currencies within the EMS. The Central Bank Council, Schlesinger and Tietmeyer were heavily criticized especially outside Germany for their policies and some of their public statements (Bernholz, 1999). The former German Chancellor Helmut Schmidt even spoke of a de facto destruction of the successfully functioning EMS (Schmidt, 1996). I leave it open whether these critiques are warranted, but a critical discussion would have certainly been warranted.

A more critical evaluation of Governor Mieni's policies would also have been helpful. It is true that he successfully punctured the bubble economy of Japan. But looking at the difficult plight of the economy since then in the 1990s, it is not clear whether this aim could not have been reached by a somewhat different policy and by another timing. Would it not have been better and perhaps possible to reform the "peculiarities of Japan's banking system and the archaic laws governing the country's property market," which "fatally distorted" the boom (Wood, 1992, p. 20) before entering into a more restrictive monetary policy?

It has already been mentioned that von Furstenberg and Ulan express some criticism concerning Greenspan. They explain: "As yet . . . the devotion to fighting inflation is very much a personalized matter: it depends on the policy inclinations of the members of the Board of Governors, it has not been institutionalized—by either statute or convention." (p. 101). Thus, unless not changed by the President and the Senate "price stability in the U.S. economy cannot be taken for granted." (p. 102). As a consequence, an education of the public would have been necessary. And this "public-relations aspect of the fight against inflation is one area in which Alan Greenspan (like his predecessor) and his colleagues arguably could have been more effective compared, for instance, with the courageous and unremitting public-relations efforts made by Governors Crow and Brash in this regard." (p. 102). It is interesting to note that the Shadow Open Market Committee has recently voiced (September, 1998) a similar concern:

> "While the committee believes the conduct of monetary policy is much improved, it said more remains to be done to guard against a return to what it views as mistaken behavior of the past. 'The Federal Reserve has not made a formal commitment to long-term price stability, to be achieved at lowest cost. Once memories of the costs of inflation fade, or there is a change in membership and leadership, the Federal Reserve could return to past policies. Indeed, our statement today reflects the fact that recent discussions, pressures from the financial community, and from abroad encourage a return to the policies that failed in the past'. To avoid such a retreat to failed policies, the committee said, 'we will continue to urge the Federal Reserve to develop and adopt systematic rules for monetary policy. These rules should aim at the long-term goal of zero inflation. Several countries have moved decisively in that direction with good results. It is past time for the Federal Reserve to do the same."

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With these critical remarks we are back to the discussion of the importance of personalities vs. institutions. Even if we acknowledge the importance of personalities for good policies in discretionary paper money regimes with flexible exchange rates, the question remains how to preserve stable monetary policies when these people are no longer around. Here von Furstenberg and Ulan obviously agree with the Shadow Open Market Committee that this can be best accomplished by creating, in time, legal or informal rules and traditions which are binding on later governors and members of the bodies authorized to decide on monetary policies. But the authors discuss nowhere whether and to which degree this is possible, though the continuity of the monetary policies of the German Bundesbank and the Swiss National Bank would invite a comparison with the situation of the other central banks. Certainly Schlesinger and Lusser found themselves in a different environment than Crow, Zahler and Brash, since a stability culture had already been developed in the decades before and since a legal framework of independency had already been established, especially in Germany.

Von Furstenberg and Ulan also seem to be critical about Greenspan's handling of the supposed stock market bubble. For they explain that in a speech in 1996 he "worried publicly about the possibility of the U.S. stock market's reaching a point where stock price valuations zoom beyond reacting to improving fundamentals . . . Yet he did nothing publicly to clarify the matter by sharing the Fed's internal analyses or much of his own deep thinking on (1) whether there is indeed a bubble, and if so, (2) what, if anything, could or should be done to keep it from inflating further to its eventual breaking point, and (3) how to prepare for limiting the damage, should a sudden bursting of the bubble occur." (p. 102, 103). But it may well be that Greenspan as a shrewd central banker obfuscated the issue intentionally, hoping that his remarks would help to cool the market, and leaving further measures, which might hurt the real economy, in the dark for the time being.

Von Furstenberg and Ulan, moreover, abstain from systematically analysing yet another question they pose in the introduction: "How does a central bank win a following that could provide firm cover?" Their remarks that

> "financial columnists or economic commentators in the media frequently are important catalysts of public opinion. Some of them are able to draw the lessons of experience ahead of the general public. With luck, popular insistence on price stability may become firm, and institutions that reliably produce stable prices may be valued." (p. 14)

can scarcely be considered a satisfactory answer. Is it not necessary that the population has to experience a dramatic monetary crisis like high inflation and (or) devaluation before a sentiment favoring stability can develop? And are stable monetary institutions, independence of central banks etc. a consequence of such popular sentiments, or runs causality in the opposite direction, or is the

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process working in both directions? Central bankers like John W. Crow and Donald T. Brash seem to believe, as the latter put it, "...that building a public constituency in support of price stability is of fundamental importance." (p. 212), whereas others like Alan Greenspan seem to care less. Empirical research by economists, on the other hand, has led them to conclude that the more independent a central bank the lower the average rate of inflation of that country (see e.g., Eijffinger and De Haan, 1996). But this conclusion has been recently doubted by Vaubel (1999). Who is right? Unfortunately, von Furstenberg and Ulan do not help to solve this important question since a comparison of the different experiences addressed in their book is outside their intentions.

There are other questions which come to the mind of the attentive reader. First, does it not make a difference whether the country in question is a small open economy like Chile, New Zealand or Switzerland or a dominant country like the United States? Is the great concern about exchange rates mentioned by Governors Crow, Zahler and Lusser not related to the fact that they were working in small open economies? Second, is the gradualist approach to wipe out inflation, pursued by Governor Zahler of Chile, really the least damaging way to disinflate the economy concerning losses in production and employment? At least for high inflation, drastic institutional, budgetary and monetary reforms that change expectations as much as possible at once seem to be less damaging to the real economy (Sargent, 1982). Thus the question arises under which conditions one or the other approach lead to better results.

Let me finally mention one minor mistake. The authors state that Canada's "reputation is beginning to be as enviable vis-à-vis the United States as Switzerland's is with regard to Germany. Canada's average annual inflation rate over the ten-year period of 1987 to 1997 was 2.8 percent, while the U.S. rate was 3.5 percent" (p. 35). The supposedly better inflationary performance of Switzerland compared to Germany is nothing but a myth. For during the same ten-year period German average annual inflation amounted to 2.78 and the Swiss to 2.77 percent. This includes the years 1987 and 1997. If we exclude the latter, the figures are 2.545 and 2.645 percent. I have also compared thirty-year periods, and there is again no difference to speak of.

The critical remarks made above concerning the book by von Furstenberg and Ulan are not meant to distract from their highly meritorious contribution to the existing literature on monetary policy. This is especially true since they take a perspective sharply contrasting with that usually preferred by economists. It is true that there exist several interesting memoirs written by central bankers. But to my knowledge no other book is available which brings together the experiences and insights of several successful governors. Thus, I have learned much from it. Taken together with the volume of articles recently issued by the Bundesbank (1999)—which emphasizes more history and theory than personalities—von Furstenberg and Ulan's work strongly enriches our understanding of the art of central banking.

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