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THE PER JACOBSSON MEMORIAL LECTURE
delivered at Rome, November 9, 1966

THE ROLE OF THE CENTRAL BANKER TODAY

by Louis Rasminsky, Governor of the Bank of Canada

I. INTRODUCTION

When I was invited to give this lecture I did not hesitate even long enough to protest my own unworthiness of the great honour. Anything associated with the name of Per Jacobsson called for an immediate and positive response from me. I knew him well and admired him greatly. His own attitudes were invariably positive and constructive.

I first met Per Jacobsson in 1930, when he was leaving the staff of the League of Nations in Geneva to join the Bank for International Settlements in Basle. There he became the father confessor to the central bankers of Europe and I know that many in this room benefited from his wise counsel and were cheered by his good humour. I saw a great deal of him during his years as Managing Director of the International Monetary Fund, which he helped to move to the centre of the world stage of international finance. To his task at the Fund he brought qualities of leadership that surpassed even what those who knew him best expected of him. He had a deep sense of history, but his basic attitude towards problems was always forward-looking. He maintained a life-long conviction in the paramount importance of sound money in the process of economic growth. Firmly grounded as he was in economic theory, he also showed a sensitive grasp of practical matters and practical possibilities, and

he never allowed the best to become the enemy of the good. On a personal note, I can never forget his help during Canada's serious exchange crisis of 1962.

I have been asked to take as the subject of this lecture "The Role of the Central Banker Today". I propose to discuss some of the principal functions of the central banker as I see them, and to refer to some of the main problems with which he is confronted today and which he seems likely to face in the future. What I shall say is essentially based on my own experience in Canada in recent years. I ask you to bear this in mind because I would not wish to jeopardize my friendly relations with my central banking colleagues in other countries by pretending to talk for them. In saying this I have in mind both my colleagues in the highly industrialized countries and in the developing countries, some of whom I have had the pleasure of seeing regularly at meetings of the Governors of the Central Banks of the American Continent and at Commonwealth gatherings. The role of the central banker is necessarily greatly influenced by the system of government, by the stage of economic development, and by the organization of financial markets; indeed, in under-developed countries, which are chronically short of capital, a great deal of the effort of the central banker may in fact be devoted to improving the structure of financial institutions so that the maximum amount of domestic savings may be mobilized for economically constructive purposes

and the pressures for inflationary financing of development thereby reduced.

I am proposing to start this lecture with some very brief comments about the role of the central bank in the operation of financial markets. From there I shall move away from the world of finance towards the world of production and employment by outlining, again very briefly, my conception of how the monetary instrument operates and how it exercises its influence on the demand for and the supply of goods and services. This will lead me to a consideration of the relationship between monetary policy and other economic policies. In this section I shall develop the central thesis of the lecture. This is that since monetary policy is just one element, albeit an important one, in over-all economic policy the success of the central banker in using the instruments available to him depends primarily on the appropriateness of the whole set of economic policies: monetary policy cannot successfully compensate for the inadequacy of other policies. I shall then consider some of the practical problems that arise in achieving a proper coordination or mix of public economic policies. From this I shall move to some comments on the formal relationship between the central bank and the government. I shall then turn to some vexed problems of alleged conflicts between economic objectives and make some remarks about price stability and external equilibrium as objectives of economic policy.

II. THE CENTRAL BANK AND FINANCIAL MARKETS

In attempting a survey of the role of the central banker it is natural to begin with the position of central banks in the operation of financial markets. The powers accorded to a central bank, which enable it to influence the rate of expansion of the banking system, to act as lender of last resort to the banking system and the money market, and to act as banker and debt manager of the government, place it at the centre of the financial system. They make it a market-oriented institution. The central bank is naturally concerned that financial markets should function efficiently. They act as the channel through which the impact of monetary policy on the economy is transmitted and the channel through which the savings of the community are transferred to the ultimate users. In a world where a serious shortage of capital has become a chronic condition, concern about the efficiency of capital markets deserves high priority.

One way in which the central bank can make a contribution to the smooth functioning of financial markets is through the skilful handling of its own day-to-day operations. There is no set of rules to provide guidance here. A sensitivity to the working of the market is essential if the central bank is to take initiatives without producing perverse reactions and if it is to deal efficiently with disturbances that arise in financial markets for seasonal and other reasons. This sensitivity can be developed only through experience and must be supported by a steady flow of information

from widespread contacts throughout the market.

The expertise which a central bank can develop in financial markets is of value not only in carrying out its own operations but also in assisting the government with its financial policies and debt operations. When the central bank's market expertise is reinforced by competent economic analysis it is able to participate fully and usefully in discussions of over-all economic policy.

The historic role of the central bank as a lender of last resort, the ultimate provider of liquidity in a financial crisis, is fortunately one of which we have heard rather little recently, but it is one that can never be completely absent from the mind of the central banker. Situations involving the danger of a spreading loss of confidence in financial institutions can still arise, though their origin may well be different than it was earlier in the history of central banking. In many countries institutions have grown up which are very much like banks in the sense that they obtain funds by issuing their own short-term obligations to the public and proceed to lend or invest these funds at longer term. These institutions usually lack a lender of last resort and they also differ from banks in the provisions governing their supervision, inspection and liquidity. The central bank cannot, however, disregard any threat to confidence in the credit system, whether or not the source of trouble is an institution within the central bank reserve system. It cannot be unconcerned merely because it has no direct statutory powers or

responsibility. An important part of the role of the central bank continues to be that of limiting the potential damage of shocks to financial markets and preventing extreme financial conditions from developing. Its concern with the liquidity position of particular classes of institution may, on occasion, have to be permitted to affect the course of monetary policy.

The question of the quality of credit, which is closely related to that which I have just been discussing, is one with which central bankers and other monetary authorities in all parts of the world have found it very difficult to come to grips. To a certain extent, the soundness of credit depends on the prevailing economic circumstances: credits that are perfectly sound under prosperous conditions turn out to be deficient if there is a chill economic breeze. But that is not by any means the whole story. A period of sustained economic expansion involving a substantial increase in the amount of credit outstanding brings with it the risk of a deterioration in credit standards -- through the use of credit to finance basically unsound positions, or purely speculative positions, or positions involving an inadequate margin of equity, or through the use of excessive amounts of short-term credit for purposes for which long-term borrowing is appropriate. Though he is aware of these risks, the central banker can hardly refrain from encouraging an expansion of credit to facilitate sound economic expansion solely because of the possibility that some of the credit may be misused.

He must, however, always be mindful of the risk of encouraging credit conditions so easy that credit deterioration becomes a widespread danger. He must do what he can to remind credit-grantors of the need for prudence and to encourage investors, even and perhaps particularly in conditions of high prosperity, to apply searching and sophisticated judgments in their appraisal of credit risks.

III. MECHANISM THROUGH WHICH MONETARY INSTRUMENT WORKS

I pass now to some remarks about the mechanism through which the monetary instrument works.

The objectives of the central bank in financial markets, and the smooth functioning of the financial system itself, are of course intermediate rather than final goals. In the last analysis, it is output, employment and standards of living that matter. All central bankers must, therefore, proceed on the basis of some working assumptions about how the central bank exerts its influence on the level of economic activity. Views on this differ. Some central bankers concentrate their attention on the banking system for they regard it as the main potential source of monetary instability. They tend to focus attention on changes in bank lending and bank deposits, or the supply of money. For my part, coming as I do from a country where, in addition to banks, there are many financial intermediaries and other borrowers which issue claims on themselves of varying degrees of liquidity, I have found it useful to regard the central bank as exerting its basic influence through its impact on credit conditions generally -- that is, on the cost and availability of money throughout the economy.

The way I look at the matter, the central bank can exert a pervasive influence on the whole range of credit conditions by its operations in financial markets. It can directly influence the rate of growth of the banking system, of bank loans, bank holdings of liquid assets and private holdings of deposit claims on banks. If the central bank encourages an expansion of private money holdings, the growth of non-bank financial institutions is also facilitated. The expansion of banks and other financial intermediaries and the attempt by

the public to employ its money claims in other types of liquid assets exert downward pressure on interest rates and increases the availability of credit throughout the system. Similarly, if the policy of the central bank is directed to restraint, this tends to raise interest rates and affect the availability of credit throughout the entire financial system.

Decisions to spend money on goods and services are influenced to some extent by the conditions in financial markets which confront those who wish to raise money and those who may be willing to acquire financial assets as an alternative to spending money on goods and services. These decisions, in turn, affect output, employment and prices. Decisions to borrow or invest outside one's own country are also influenced by changes in credit conditions.

This, in greatly simplified form, is the way it seems to me the central bank exercises its influence on economic behaviour. It is only one of several possible ways of looking at the monetary process and the impact of central bank action. But no matter how one looks at it, one thing is very clear. The impact of central bank action on credit conditions, of credit conditions on spending, and of spending on employment, output, price levels and the external balance, is very complex. We need more reliable knowledge of the magnitude and the time path of the effect of central bank action. This can only come from intensive and sustained empirical research applied to statistics that are more up-to-date, more complete and of

higher quality than we now have.

A similar problem faces everyone with responsibilities in the field of economic policy. If policy actions are to influence the course of economic activity in the ways desired, the policy-makers must have up-to-date knowledge of what the economic situation is and they must know a great deal about all the main forces shaping economic developments. A decision to change some aspect of existing policies has to begin with an appraisal of the current position and a judgment as to what course future economic developments might otherwise take. In short, good policy requires good information and good forecasts.

The possibility of following rational economic policies depends crucially on a detailed and up-to-date knowledge of the facts, on the quality of the underlying economic analysis and on the ability to look ahead into the future with some measure of confidence. I have to admit that it is in these respects that central bankers, like other economic policy-makers, often feel most inadequate. There is a great deal about economic behaviour which we simply do not know. We have every reason to strive to get fuller and more up-to-date information, to understand it better, and to improve our ability to forecast developments. Impressive resources are being invested in continuing economic research throughout the world -- in central banks, in governmental and international organizations, at universities and elsewhere -- and we can look forward to a steady enlargement of knowledge and

understanding of economic relationships. But there is still no general agreement on how, and to what extent, and how quickly central bank action affects the behaviour of output, employment, price levels and the external payments balance. So policy decisions have, unfortunately, to be taken in very much less than full knowledge of their consequences. The best that the central banker can do is to operate on the basis of a working view of the impact of monetary action which seems to him to fit the facts most closely. In framing his policy, he has to have a view of where the major risks facing the economy lie, and to be willing to alter his view in the light of new information received.

A number of economists, discouraged by the lack of precise knowledge to which I have been referring and profoundly mistrustful of the judgment of central bankers, have suggested that attempts to apply monetary policy in a discretionary manner should be abandoned. They have suggested instead that specific rules or criteria on which to base monetary operations should be adopted. These economists fear that if central bankers try to use monetary policy to moderate short-term fluctuations in demand, they are more likely than not to produce perverse results over a period of time. In their more extreme form the proposals of these economists would have central banks follow some very simple automatic rule, such as ensuring that the stock of money on some specific definition increases year in and year out, or indeed quarter in and quarter out, by a predetermined percentage. I must acknowledge that I do not consider these proposals realistic -- I am

afraid that it is impossible to encompass and resolve the full complexity of economic life in one or two very simplified relationships. The central bank has a responsibility to avoid the development of extreme financial conditions which would jeopardize the functioning of the financial system. In discharging this responsibility it may on occasion have to react to sharp shifts in investors' appetite for liquidity in a way which causes considerable short-term variation in the money supply. There is, however, something to be said for the view that central bankers should try to avoid over-reacting to minor and temporary shifts in the pressure of demand in relation to the economy's potential productive capacity, and that they should concentrate on using credit policy to help prevent more serious and prolonged bouts of under-employment or over-heating of the economy.

No doubt in time the search for more reliable guides to policy will provide the central banker with a better knowledge of the facts and a better understanding of the precise impact of his actions on various sectors of the economy. Empirical research can be expected to do much to reveal the nature of these relationships. But I feel very certain that at the end of the day, after the computer has had its say, there will remain a continuing need for the central banker to exercise his judgment.

IV. RELATIONSHIP OF MONETARY POLICY TO OTHER PUBLIC ECONOMIC POLICIES

In the course of the present generation, I think that central bankers have increasingly come to regard themselves as being concerned not only with the management of the monetary instrument, but also with the way in which

monetary policy is combined with other economic policies in the attempt to attain the broad economic objectives of the community. The shift in emphasis has arisen in part out of the continued accumulation of central banking experience. In part it results from developments in economic thinking and knowledge. It has been encouraged by the major reappraisals of the workings of the financial system that have been carried out in a number of countries. For the most part, however, it reflects the greatly increased responsibility that has been assumed by the governments of most countries, especially since the end of the last war, for the attainment of specific economic goals, and in particular for the maintenance of high levels of employment and rising standards of living of all sections of the population. This development has been accompanied by massive increases in public expenditure and in taxation which have proceeded to a point where in most Western countries 30 per cent or more of total national expenditure is made by governments or passes through the hands of governments in the form of transfer payments to individuals.

With the growth of the public sector, government actions with regard to expenditure and taxation and the management of the public debt have come to have a very profound influence on the behaviour of the economy. Over the years, more and more attention has been paid to the way this influence can be exerted. I believe -- and I hope I am not being too optimistic -- that in recent years there has been a growing awareness that monetary policy is only one element in over-all economic policy, and that the chances of achieving desired economic goals depend very heavily on a proper combination of monetary policy and other elements in the totality of economic policy.

Since monetary policy is part of total public economic policy, its broad objectives must be the same as those of public policy generally. These objectives would be regarded in most countries as including high levels of employment and domestic and external monetary stability. Recently great emphasis has also been placed on growth and rising standards of living. The new emphasis on growth has had a useful result in focussing attention on policies which can increase the output of the economy by operating on the "supply" side, for example, policies which aim at increasing the mobility of resources and at improving the level of labour and management skills. As an inheritance from the 1930's, we have continued for too long to think of the maintenance of adequate monetary demand as the hall-mark of good economic policy. Enough demand is a necessary but by no means a sufficient condition of satisfactory economic performance. It is an encouraging development of recent years that governments are now prepared to consider very carefully the need for "supply" policies, including trade and tariff policies, because these have a vital part to play in exercising a restraining influence on rising price levels and in improving rates of growth.

By their nature, however, "supply" policies are long-range in character and cannot be altered quickly. While it is of the highest importance that they be given adequate weight in the total "mix" of policies, and that they be co-ordinated with other aspects of public policy, it is in the area of monetary, fiscal and debt management policies that the problems of

co-ordination arise in their most immediate and continuous form. This subject matter was dealt with very elegantly in last year's lectures and I do not intend to traverse the same ground again. I would like instead to refer to some of the practical problems that arise in attempting the co-ordination of monetary and fiscal policy.

It is only realistic for the central banker to recognize that there are a number of factors that inevitably work from time to time against the achievement of the best balance between monetary and fiscal policy. Fiscal policy is on occasion influenced by considerations other than the general economic considerations that apply to monetary policy. Changes in taxes and in government expenditure have very direct and specific impacts on groups within the economy and are therefore subject to many pressures. While there is increasingly wide acceptance of the doctrine that fiscal policy should seek to stimulate the economy (for example, through tax reductions) in periods of under-employment of resources and should help to restrain it (for example, through tax increases) when the economy shows signs of over-heating, it appears that the first part of the prescription can be relied on with greater certainty than the second. To the extent that there is inadequate use of fiscal policy when the economy is over-heating, an extra share of the burden of restraint falls on monetary policy and, more importantly, the total job does not get done.

There is also a purely technical reason why this is a recurrent

danger. This is the fact that in most countries, government expenditure plans are normally presented only once a year and tax rates are fixed by legislatures at that time. Between these annual dates, the burden of meeting any inadequacy of fiscal policy resulting from an original under-estimate of the task to be performed, or from unexpected developments in the economic situation, tends to fall on monetary policy.

The effective co-ordination of monetary policy with fiscal policy is unusually difficult in federal states. A large share of government expenditure may be made by regional governments who feel less responsibility than national governments to use their fiscal power with considerations of the over-all state of the economy in mind. Where regional governments account for a large share of the total government sector the central government can seek to obtain their co-operation, but there is no doubt that the process of obtaining an appropriate "mix" of policies is more difficult in such circumstances.

I think that the general experience has been that in most situations where the aim of public policy has been to "cool out" the economy and keep the aggregate of monetary demand from rising more rapidly than the economy's real capacity to expand, an undue share of the burden of restraint has tended to fall on monetary policy. This was one of the main themes of the Report of the recent Royal Commission on Banking and Finance in Canada. They said

> "Monetary policy is just not powerful enough to do the job by itself over any reasonable range of credit conditions, even if there were no international inhibitions about using it fully."

Most central bankers would echo this view. Indeed, the present situation in many of the large industrialized countries appears to provide a striking example of this. The main share of the load of trying to restrain the inflationary pressures which have emerged has again fallen on monetary policy, and interest rates have risen to levels which are very high by comparison with anything we have known in this generation. In many countries government financial requirements have increased the pressure on the capital markets. It seems clear that a different "mix" of policies to restrain the inflationary pressures would have been better in the circumstances.

There is much more involved here than the discomfort of the central banker in pushing the use of the monetary instrument too far. It has to be remembered that changes in credit conditions do not affect all parts of the community in the same way. Large corporate borrowers seem, on the whole, to be likely to feel the direct impact of credit restraint less and later than small borrowers: large corporations normally have substantial liquid resources they can draw on and they have more ready access to the capital market if bank borrowing becomes difficult. There are differences in the ease of access of different categories of

domestic borrowers in many countries to foreign capital markets or the Euro-dollar market and there are differences in the response of different sectors of the economy to changed credit conditions. Housing expenditures are particularly likely to be affected. In addition to these inequalities is the real risk that excessive reliance on monetary policy may result in the development of financial conditions so extreme as to impair the functioning of the financial system and impede the flow of funds for productive purposes through capital and credit markets.

I would conclude and summarize this part of my remarks with two general observations: The first is that since the impact of monetary policy is more direct and powerful on certain sectors of the economy than on others it should not be pushed to extremes. It should be supported by and co-ordinated with other policy instruments in an over-all economic policy aimed at a rational combination of objectives. The second is that the appropriateness or inappropriateness of monetary policy cannot be judged in isolation but only in relation to the other public policies being brought to bear on the economic problems of the day.

V. RELATIONSHIP BETWEEN THE CENTRAL BANK AND THE GOVERNMENT

I turn now to the relationship between the government and the central bank. The formal status of the central bank varies a great deal from country to country. In any case this is a field in which the real situation is

not likely to be revealed by the terms of the statute. Much depends on history and tradition and a fair amount even on the personalities involved. There is a variety of views as to the appropriate relationship between the central bank and the government. The extreme positions can be stated simply. At one end of the spectrum there is the view that the central bank should be little more than a technical arm of the Treasury, that no significant degree of independence for the central bank can be reconciled with the democratic process since the electorate must be able to hold the government responsible for every detail of public economic policy, including monetary policy. At the other end of the spectrum, there is the view that, human frailty being what it is, a wide separation between the power of the government to spend money and the power to create it is necessary if the latter power is not to be misused.

Between these two extreme positions there is room for varying degrees of independence for the central bank. My own opinion is that there are important advantages in arrangements under which the central bank has enough independence to insulate the management of its operations from the political side of government and to act as a formidable obstacle to the misuse of the monetary instrument. So far as basic policy is concerned, however, in most countries it would not be regarded as acceptable for the central bank to be able to thwart the government if the latter is prepared

to take complete responsibility for bringing about a change of monetary policy in a way that causes the issues to be placed before the public in a clear and open manner. Arrangements which provide this degree of independence seem to me to have the advantage of putting both the central bank and the government in a position where there is no way in which either can avoid assuming responsibility for the monetary policy that is followed.

In Canada, where as you know we have had our problems in this area, the central bank has been operating for a number of years under the general arrangements which I have just outlined and I believe that on the whole they have worked well. In order that the relationship between the Bank of Canada and the Government can be clarified in law, an amendment to the statute governing the Bank of Canada is now being considered by our Parliament. The amendment makes it clear that there must be, as there is now, continuous consultation on monetary policy between the Government and the Bank. It provides a formal procedure whereby, in the event of a disagreement between the Government and the Bank which cannot be resolved, the Government may, after further consultation has taken place, issue a directive to the Bank as to the monetary policy that it is to follow. Any such directive must be in writing, it must be in specific terms, and it must be applicable for a specified period. It must be made public. This amendment makes it

clear that the Government must take the ultimate responsibility for monetary policy and it provides a mechanism for that purpose. But the central bank is in no way relieved of its responsibility for monetary policy and its execution. It can be assumed that if the Governor were directed to carry out a monetary policy which, in good conscience, he could not regard as being in the national interest, he would, after taking steps to ensure that the issues involved were placed clearly before the public, resign.

As I have already indicated, however, I do not believe that the real position of the central bank in government is determined by the statutory arrangements under which it operates. In the final analysis the influence of the central bank on economic policy depends on the respect it can command for the objectivity and cogency of its views as judged in the light of experience and on the proven degree of competence it displays in performing its own specialized role. It depends too on the contribution that it is able to make to the public understanding of economic and financial issues in analysing, in understandable terms, the complex forces operating at all times on the economy and in elucidating the basic rationale underlying the policies it has followed.

VI. PRICE STABILITY AS AN OBJECTIVE OF ECONOMIC POLICY

In the past two decades most countries have been having considerable difficulty in keeping prices under reasonable control. Not only have upward surges in price levels occurred when the economy was clearly overloaded but there has also been a persistent tendency for prices to move up even when capacity was not fully utilized. To some extent these developments have been encouraged by the great stress which modern economic thought has placed on the maintenance of demand as the key to successful economic performance, and by the increased role of government in providing through social security programmes and in other ways, a firm underpinning of consumer demand. The maintenance of incomes has resulted in large flows of savings, but the persistence of inflationary pressures in many parts of the world, including some of the wealthiest, indicates a continuous danger that the flow of savings will tend to fall short of what is required. Rising population and incomes involve enormous demands for capital for agricultural and resource development, and even in the most highly industrialized countries the requirements for infra-structural development, for the provision of adequate educational facilties and for harvesting the fruits of modern large-scale technology will continue to grow. To this must be added the huge capital requirements of the under-developed countries.

A few moments ago I recalled that in most countries the goals of national economic policy are now taken to be high levels of employment, reasonably stable prices, a balanced external position and rising standards of living. Latterly, there has been a good deal of discussion on the question of whether these goals can in fact all be pursued with success at the same time, or whether some compromises -- or "trade-offs" as they are called -- may not be required. I am not proposing today to try to add to the extensive and scholarly literature that has developed on this subject, but I do wish to make one or two observations in what I fear some will regard as a rather dogmatic vein.

The question most frequently raised is whether there is not some inherent conflict between the maintenance of reasonable price stability and high levels of economic activity, and whether we should not be prepared to sacrifice the goal of stability in the value of money in favour of economic expansion. For my part, I think it would be more relevant and useful to ask whether maximum sustainable growth is possible if there are serious price increases.

The views that central bankers in all parts of the world have expressed from time to time about the development of inflationary pressures, have led some to describe us as being characteristically more alarmed about the threat of inflation than about the threat of high unemployment. I would deny this accusation. I do not think that it is in accordance with the facts

to regard the central banker as having an inflation "fixation", or as being determined to have price stability at no matter what cost in real output and unemployment. I suggest that the real difference between central bankers and those people who are not concerned about inflation is in their assessment of what can be achieved over anything but a relatively short period of time by tolerating a certain amount of inflation, creeping or even more rapid. It may well be the case that if rising price levels are tolerated, real output will in certain circumstances be raised for short periods of time. But the public authorities have an obligation to take a longer view. Once it became clear to everyone that public policy, even without any explicit admission, was prepared to allow prices to rise at, say 3 per cent a year indefinitely, then all members of society, including savers, would take whatever economic or political action was available to them to protect themselves against this erosion in the value of money. In this situation the stimulating effect of the 3% per year rise in prices would fade away and there would be pressure for additional expansionary measures. These would cause prices to rise faster than the "acceptable" rate and the policies needed to keep the rise within the 3% limit would appear to be "deflationary" and would be associated with just as much difficulty as the policies that were formerly necessary in the attempt to avoid inflation altogether. Where would the process stop? Would not the end of this course be greater and greater rates of price increase, involving more and more inequity -- since

all members of society are in actual fact not equally able to protect themselves against inflation -- and culminating in a major economic dislocation.

I find it disturbing to see some economists taking the view that everyone can adjust to inflation, and others trying to measure the costs of inflation in some past period in order to compare them with the costs of output foregone in periods of unemployment. These approaches assume that an inflationary system can produce better results over the longer run. I do not think it can.

It seems to me that what is needed is not to decide how much inflation can be tolerated but to concentrate on trying to find ways of making the economy work at satisfactory levels without rising price levels. It is clear that we have a lot to learn about living with prosperity without permitting it to degenerate into inflation. But I am not prepared to give up hope. We are not necessarily helpless because on frequent occasions in the past the economy has thrown up unacceptable rates of price increase when running at low levels of unemployment. Policies aimed at increasing the mobility of our resources and improving labour and management skills can help achieve stable prices by bringing about increases in productivity. Policies aimed more directly at relating the growth in incomes to increases in productivity and at limiting entrenched positions of market power may also be needed if we are to achieve a satisfactory combination of the goals

of high employment and price stability. I know that this question is a very thorny and difficult one. There is the powerful argument that if monetary and fiscal policies prevent the emergence of excess demand there is no need for any special policy on prices and incomes, and if they do not do so such a policy will break down. There are, moreover, few brilliant successes to which one can point where income policies have worked when put to a rigorous test. But a basic assumption on which monetary policy, as well as fiscal and other policies directed towards affecting the level of aggregate demand, depends is that if total demand is not excessive, competition in the economy will ensure that reasonable price stability is maintained. If competitive forces cannot be relied upon to ensure that technical progress in production is reflected in the pricing policy of corporations and to keep income demands within reasonable bounds, that is, within the bounds of what the economy can really provide in the form of goods and services at reasonably stable prices, clearly some workable supplementary measures must be found. These supplementary arrangements cannot be a substitute for over-all policies which keep the increase in aggregate monetary demand within the real capacity of the economy to expand. But the experience of many countries suggests that monetary and fiscal policies need to be supported by some technique which mobilizes the force of public opinion behind non-inflationary behaviour by those who are in a position to deploy strong market power.

VII. EXTERNAL EQUILIBRIUM AS AN OBJECTIVE OF MONETARY POLICY

I turn now, in drawing this lecture to a close, from the problems of domestic monetary stability to the problem of external stability. The two are obviously intimately related. If the authorities permit too great an erosion in the internal value of currency they are inviting a decline in its external value. The central bank is concerned with both.

In the heyday of the gold standard, half a century ago, central banks discharged their obligation to support the external value of their currency with surprisingly little in the way of gold and foreign exchange reserves. International flows of funds were very sensitive to movements in bank rate or to credit stringency produced by other means. Even if the mechanism of adjustment produced effects which were occasionally unfortunate on the domestic economy in terms of domestic levels of employment and output and prices, this was regarded as being in accordance with the rules of the game.

The situation today is completely different. The governments and peoples of all our countries are firmly committed to various goals in addition to exchange stability, and in particular to high levels of employment and economic growth. The central bank, as I have indicated, is one of the instruments for the achievement of the general economic goals of the community. Though it must continue to regard itself as being very much concerned with safeguarding the external value of the currency this is no longer its exclusive

aim. It has to seek, as best it can, to work for a combination of monetary and other policies which achieves external balance without sacrificing the other objectives of economic policy.

Since the end of the last war we have in fact devoted a great deal of effort to setting up institutional machinery which is basically designed to help countries adjust to imbalances in their international position without having to take action destructive of national and international prosperity. We may on occasion be inclined to lose sight of the enormous progress which we have made in this respect in all the attention that is focussed on the difficulties of particular currencies or on the need for further improvements in the international monetary system.

The International Monetary Fund stands at the heart of this system of collaboration. It has firmly established the principle that the level of exchange rates is properly a matter of international concern, it has established a code of good behaviour with regard to exchange practices, and it has mobilized large financial resources to help its members meet temporary balance of payments deficits and give them time to take corrective action when necessary. Under the Fund's General Arrangements to Borrow not only have large additional amounts of foreign exchange been made available which can be used to avert a threat to the international monetary system, but a forum has been provided in which, as in the Fund itself and in the OECD, the main industrial countries of the world can discuss in great frankness

and detail problems of international liquidity and adjustment, and the impact of one country's policies on others. Finally, the traditional collaboration among central banks has been greatly expanded. Market-oriented as they are, and having a particular responsibility in regard to foreign exchange, the central banks of the main industrial countries have shown themselves capable of very rapid action in mobilizing support for currencies under speculative pressure and maintaining exchange stability during critical periods. Under the leadership of the Federal Reserve System and with the useful collaboration of the Bank for International Settlements, there has developed a net-work of mutual currency holding or swap arrangements among leading central banks. In their nature these arrangements have to be of a short-term character. Central banks can hardly impose conditions on the recipient bank for the support they provide in these credits, since the corrective action required may fall within the purview of the foreign governments rather than central banks. These credits cannot therefore be treated as a medium-or long-term source of financing payments deficits. They can, however, provide the time needed to work out medium-term credits with the International Monetary Fund or elsewhere and for the authorities to initiate whatever corrective action may be needed.

The impressive development of the machinery of international collaboration does not eliminate the need that countries will be under from time to time to take domestic action to correct imbalances in

their international payments. No country can, over an appreciable period of time, carry out domestic policies which result in it using up real resources -- in consumption, or private investment or government programmes -- in excess of its own capacity to produce, except to the extent that foreign lenders or investors are willing to go on providing those additional resources. The fact that occasions arise when the need to maintain external equilibrium places some limitation on the domestic policies that can be pursued has led to a frequent allegation that there is some inherent conflict between domestic expansion and external balance, with the implication either that a country which is concerned with expansion should leave its external accounts to look after themselves or that the amount of international liquidity available should be so great that external considerations provide no limitation on domestic expansion. The latter is, of course, an illusion. International liquidity is a claim on goods and services, and there is no reason to suppose that the countries which would be called upon to make good these claims would be prepared to cover other countries' deficits on a continuing basis. The necessary pendant to international liquidity is balance of payments adjustment.

External balance is indeed a necessary condition of the achievement of the domestic goals of economic expansion and rising living standards, and in a world which has been as successful as ours has been throughout the post-war period in maintaining high levels of economic activity, it is a fundamental error to regard these objectives as being in conflict. It is true that if a

country is willing to ignore the external effects of its domestic policies, it has greater freedom of action in the short-run. But the foundations of future success in attaining the domestic goals of expansion are inevitably undermined by policies which lead to external deficits which cannot be covered on a sustainable basis, just as they are undermined by ignoring considerations of domestic monetary stability.

The task of reconciling the objective of external balance with domestic economic objectives is by no means a simple one and requires a willingness to deploy all the instruments of economic policy and to avoid excessive reliance on monetary policy. The simple case of a payments deficit which is due to excessive pressure of domestic demand does not raise any problem of conflict of objectives -- in this case the payments pressure serves as an early warning signal which alerts the authorities to the need for restrictive action both for domestic and external reasons. Other circumstances call for a more sophisticated combination of policies. A country experiencing payments pressure under conditions of only moderate demand pressure and less than satisfactory employment, and whose exchange rate is not out of line, may require a stimulating fiscal policy to encourage domestic expansion combined with a restrictive monetary policy to attract capital inflows. A country which is experiencing a payments surplus combined with excessive demand pressure may require a combination of a strong fiscal policy to restrain the demand pressures and low interest rates to encourage capital outflows. To meet the challenge of so-called conflicting objectives,

there is clearly need for enterprise in expanding the policy instruments and skill and resourcefulness in using them in concert. And this skill is needed not only in the countries which are experiencing deficits in their international accounts but also by those which are experiencing surplusses and are not subject to the same financial pressures to move in the direction of equilibrium.

I am afraid that we have not shown as much skill or as much determination in this respect as the situation has called for during the past few years. The great reliance which has been placed on monetary policy as the prime instrument for combatting inflation by countries which have been gaining reserves, as well as by those who have been losing reserves, has impeded the restoration of international balance and has led to a level of interest rates and a degree of international monetary stringency which carries with it all the disadvantages and the risks to which I referred a few moments ago. Not the least of these is the threat of a sharp strain on domestic and international liquidity leading to a major curtailment in the international movement of long-term capital for productive purposes from which the world has derived such great benefits during the past decade.

Central bankers have participated actively in the last few years in the extensive discussions concerning the next steps in the evolution of the international monetary system. These have focussed on the means of

making the creation of reserves a matter of international responsibility. I believe that sooner or later we shall have to take a major step forward in providing the machinery for creating reserves by deliberate collective action, and that it is important to resolve our differences about the precise form of such machinery as soon as possible. What we are seeking is more orderliness in the system of providing reserves and an enlarged scope for the exercise of judgment as to the amount and timing of changes in reserves outstanding. It would not be helpful, in my opinion, to create new machinery quite separate from the Fund for this purpose. On the contrary it is essential to preserve the central position of the Fund in the international monetary system. At the same time, the arrangements must be such as to ensure that the decisions taken are supported by a substantial majority of countries whose international trade bulks large in the total and whose currencies are widely used throughout the system. The form of new reserves is a question of less significance. What is essential is to retain flexibility and to move as circumstances permit toward the evolution of forms of international money that are generally acceptable. The aggregate supply should be brought under collective international control, and control should be exercised in such a way that liquidity is neither so scarce as to force countries to restrictive or harmfully deflationary action to balance their international accounts nor so plentiful as to encourage deficit countries to avoid dealing with domestic inflationary pressures and in so doing help to

spread inflation around the world. The success of any new arrangements we may agree upon will depend in large measures on the efforts of central bankers and their colleagues in government not only to deal effectively with their own problems but also to understand the problems of their opposite numbers in other countries, and to seek for solutions which take the general interest fully into account.

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The main theme that I have put forward in this lecture is that the central banker today is a public servant as well as a banker. His role is to operate one of the instruments of public policy for the attainment of the economic objectives of the community. He does not have a separate set of objectives of his own, though he must seek to influence the articulation of the objectives and the combination of policies chosen to attain them. He must also seek to reconcile his own and his country's policies with those of other members of the world community. I believe that this view of the role of the central banker was shared by Per Jacobsson who always urged central bankers to remember that monetary policy was only one aspect of over-all policy.

I have denied that the central banker has a fixation with respect to price stability, but I believe that many of us feel a special responsibility to act as the conscience of the community in this respect. No one else is

likely to do so. Inflation in its early stages is popular, it creates a feeling of ebullience and well-being which does not tempt the community to ask too many questions about the future. Keynes once said that the perfect standard of good manners for a gentleman attending a party is to maintain precisely the same level of sobriety or inebriety as the rest of the company. If this is so, then central bankers cannot aspire to be gentlemen. Their role, as Chairman Martin has said, is rather the unpopular one of acting as the chaperone at the party who has to take away the stimulant just when the party is getting into high gear.

The central banker works in an imperfect world, with an instrument whose influence is only imperfectly understood, in seeking to attain objectives that can be defined only in broad general terms. It is not surprising that the profession is full of interest but not free of uncertainty and anxiety. I think that most of my colleagues would join me, echoing Pastor Rheinhold Niebuhr, in saying that what we need to play our role adequately is the serenity to accept what cannot be changed, the courage to change what should not be accepted, and the wisdom to distinguish the one from the other.