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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

PRESS SUMMARY

In his lecture Mr. Rasminsky discussed the role of the central bank in the operation of financial markets, outlined his conception of how the monetary instrument operates and how it exercises its influence on the demand for goods and services, considered the relationship between monetary policy and other economic policies and the practical problems that arise in achieving a proper co-ordination of public economic policies, commented on the formal relationship between the central bank and the government, and concluded by discussing the alleged conflicts between economic objectives, particularly in connection with the objectives of price stability and external equilibrium. The central thesis of his lecture was described in the following terms: "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." (p. 3)

Before beginning his lecture Mr. Rasminsky paid tribute to the late Per Jacobsson whom he had first met at the League of Nations in 1930.

The Central Bank and Financial Markets

Mr. Rasminsky noted that the powers accorded to a central bank 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." (p. 4)

In his discussion of financial markets Mr. Rasminsky referred to the role of the central bank as lender of last resort. "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... 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... 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." (p. 5-6) Mr. Rasminsky also made reference to the closely related question of the quality of credit. "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." (p. 6-7)

Mechanism Through Which the Monetary Instrument Works

Turning to the mechanism through which monetary policy operates, Mr. Rasminsky noted that all central bankers must proceed on the basis of some working assumptions about how the central bank exerts its influence on the level of economic activity, but that there were differences of view, partly because of differences in financial systems. "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." (p. 8) He explained how the central bank could exert a pervasive influence on the whole range of credit conditions by its operations in financial markets and that decisions to spend money on goods and services were influenced by the conditions in financial markets which confront those who wished to raise money and those who might be willing to acquire financial assets as an alternative to spending money on goods and services. It was clear that this process was 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." (p. 9-10) He noted that a similar problem confronted all policy-makers. "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 ... 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." (p. 10) He noted that impressive research efforts were being made with this objective in mind.

Relationship of Monetary Policy to Other Public Economic Policies

In discussing the relationship of monetary policy to other public economic policies, Mr. Rasminsky said he believed "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". (p. 13) He noted that since monetary policy is part of total public economic policy, its broad objectives must be the same as those of public economic 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." (p. 14)

It was an encouraging development of recent years that governments were now prepared to consider the need for supply policies as well as the policies that affect the demand side.

Mr. Rasminsky stated that while it was of the highest importance that "supply" policies be given adequate weight in the total mix of policies, and that they be co-ordinated with other aspects of public policy, it was in the area of monetary, fiscal and debt management policies that the problems of co-ordination arose in their most immediate and continuous form. "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." (p. 15) Monetary policy was not powerful enough to do the job by itself. Recently, in many of the large industrialized countries, "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". (p. 17) He pointed out that there were serious difficulties involved in pushing the use of monetary instruments too far because the impact of large changes in credit conditions on different parts of the community was quite uneven and because the development of extreme financial conditions could impair the functioning of the financial system and impede the flow of funds for productive purposes.

Relationship Between the Central Bank and the Government

In dealing with the relationship between the central bank and the government, Mr. Rasminsky stated that his opinion was "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". (p. 19-20) He went on to say that "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". (p. 21)

Price Stability as an Objective of Economic Policy

Turning to the subject of price stability as an objective of economic policy, Mr. Rasminsky noted that most countries have been having considerable difficulty in keeping prices under control and he gave some reasons for this situation. He discussed the question of whether or not there is some inherent conflict between the maintenance of reasonable price stability and high levels of economic activity. He denied the accusation that central bankers are characteristically more alarmed about the threat of inflation than about the threat of high 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..." (p. 24) He argued that there was no reason to believe that an inflationary system could produce better results over the longer run and that it involved serious risks. "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." (p. 25) He expressed the view 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." (p. 26)

External Equilibrium as an Objective of Monetary Policy

Mr. Rasminsky concluded his lecture with a discussion of external equilibrium as an objective of monetary policy. He reviewed the progress that has been made in the international monetary system, and referred to the role of the International Monetary Fund, the General Agreements to Borrow, and central bank co-operation. He emphasized that in their nature central bank arrangements had 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." (p. 29)

The impressive development of international collaboration did not eliminate the need for countries to take domestic action to correct imbalances in their international payments. "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." (p. 30-31) The task of reconciling the objective of external balance with domestic economic objectives was by no means a simple one and required a willingness to deploy all the instruments of economic policy. "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..." (p. 32)

Referring to the extensive discussions concerning the next steps in the evolution of the international monetary system, Mr. Rasminsky said, "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." (p. 33-34)

(Mr. Rasminsky's concluding remarks appear on pages 34 and 35.)