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The Role of a Central Banker

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The Role of a Central Banker

When I first discussed with Dr. Shapiro my appearance at this Symposium, he suggested that I speak to you on the subject "The Role of a Central Banker of a Key Currency Country". The title on the program, or at least my advance copy of it, now is shorter; it says nothing about any key currency. Perhaps this is simply a Freudian slip since after all the problems confronting the central banker of any country are basically much the same. Thus the abbreviation of the title of my talk may simply be an invitation for me to speak more broadly on some of the problems confronting a central banker than I might have done with the longer title. At the same time, I cannot avoid the viewpoint of the central banker of a key currency country because the dollar of course is just that: it serves as the principal means of payment throughout the world and as a major source of international reserves in many countries.

As I look back over the more than 25 years that I have been associated with our central banking system in the United States, I am impressed by the old French proverb that "Plus ca change, plus c'est la meme chose". Having said that, I would hasten to add that the role of a central banker first and foremost is, and of necessity has to be, one of adapting to meet problems that are constantly changing in a dynamic and changing society. At all times a central banker must be willing to change his own concepts with respect to his role, to try to devise and design new instruments and techniques to meet the challenges of a changing world. On that score, as you may know, the System is now engaged in special studies of the workings of its various instruments of monetary and regulatory policy. One such study involves a comprehensive re-evaluation of the lending function of the Federal Reserve Banks; another a joint study with the U. S. Treasury of the market for U. S. government securities--the market in which System open market operations and Treasury financings must take place.

The Concerns of a Central Banker

Frequently, the central banker of any country is accused of being preoccupied with inflation to the point of being insufficiently concerned with growth. Just a week before I joined the Federal Reserve Board in the fall of 1963, Professor Samuelson addressed a public letter to "My Son, the Central Banker". The concluding paragraphs of his letter of advice read as follows:

> "Stop being jockeyed into the underdog position of last defender of the stability of the price index. The universe was not created with a basic division of powers: The Government being under obligation to use its fiscal policies to produce high and growing real output; the Federal Reserve being under obligation to use its monetary policy to ensure stability of the price level.
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> "Such logic leads--indeed it did lead, even in the days before gold was a problem--to credit policies that are too tight and fiscal policies that have thereby to be so much the looser. The result, even at full employment, will be a bias against capital formation and a bias toward present consumption.
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> "The Founders of the Federal Reserve really didn't know what they were doing. But surely none

of them thought they were designing an engine that would be a bulwark against growth.

"Son, do something about it."

In fact, we in the Federal Reserve System have done a great deal about it. Along with fiscal policy, monetary policy has contributed to the longest peace-time expansion that this country has known. Thus, our presumed preoccupation with inflation simply does not exist. In those times when we have been concerned over inflation--and I am thinking of a time when inflation has appeared a real threat to Professor Samuelson along with ourselves and others--that concern reflects our belief that fundamentally inflation interrupts growth. And, as a central banker of a key currency country whose liabilities constitute international money, I am quite willing to state my belief that inflation in the United States can only serve to interfere with growth throughout the world.

From this standpoint, I make no apology for abhoring inflation in the United States. Not long ago my friend Henry Wallich said that he and some others were sitting around one evening rating Reserve Board Governors on their respective allergies to inflation on a scale of one to ten. While I apparently did not score quite as high as Chairman Martin, my own rated allergy was reasonably high on their scale. I cheerfully admit this because I believe that inflation has at least two adverse results. One, and most importantly, it undermines steady economic growth. Two, it brings about an imbalance in international payments which is particularly unfortunate for a country whose liabilities serve as the means of payment and reserves for others, and this, in turn, has adverse repercussions on the functioning of the international monetary system.

Examples of how inflation can undermine steady economic growth are studded all over the landscape of recent economic history, in every part of the globe. One of the most striking examples can be found here in the United States, in the record of the period from 1954 through 1964. This example is a particularly impressive one, I think, because it illustrates not only the proposition as I have stated it, but also it's converse, which is this: in the absence of inflation, economic growth can be uninterrupted and great strides can be made in raising a country's income and wealth.

The period from 1954 to 1960 in the United States and the period from 1961 to 1964 show some very striking contrasts despite the fact that both periods began with recession and high rates of unemployment. In the first span of six years--1955-60--there were two years of extremely rapid rise in U. S. industrial production, more rapid than in any single year of the later period. Yet the net advance in industrial production from the start of the upswing in the summer of 1954 to the end of the 1960 recession was only 21 per cent, an average of less than 4 per cent a year. This left a legacy of underutilized capacity and manpower which had to be absorbed in the national interest.

In contrast, from February 1961 to December 1964 the rate of industrial output increased 33 per cent, an average of 8-1/2 per cent a year, and it was still rising at the end of 1964. The vital difference between the two parts of this decade was that two recessions took place within the first six years, but no such setback occurred during the next four years. (I might have said during the next five or six years, but I want to draw a rather sharp distinction between the years just before and after 1964--for reasons that will become clear in a moment.)

Everyone knows that booms and recessions are very complicated phenomena. I do not want to over-simplify. But I do believe that our failure to achieve steady economic growth in 1955-to-1960 was in no small measure a consequence of the inflationary environment and atmosphere that prevailed in most of that period, despite the efforts of fiscal and monetary policy to lean against the inflationary wind. The wholesale price index for industrial products rose 12 per cent, and the consumer price index 11 per cent. Conversely, the general stability of prices and the absence of inflationary expectations from 1961 on into 1964 go a long way toward explaining the remarkable growth achievement of that period. Elimination of the inflationary atmosphere and expectations was crucial to subsequent uninterrupted growth, growth which was clearly facilitated by fiscal and monetary policies. The consumer price index did rise 5 per cent, largely because of the increasing cost of services, but the industrial wholesale price average was only a shade higher at the end of 1964 than it had been in February 1961.

In the non-inflationary atmosphere of those years beginning in 1961, economic expansion was remarkably well balanced--in great contrast to what happened in the mid-'50's. From 1961 on into 1964, the rates of growth of output and sales of consumer durables, of residential construction, and of business outlays for plant and equipment were at no time really out of line with the general rate of growth of GNP. Partly for that reason, none of these key branches of economic activity suffered any severe setbacks. Inventory investment was cautious and moderate. Productivity gains were substantial in industry, and these large gains in productivity continued long beyond the initial recovery period. Competition was active--within industries, between industries, and against imports. The stock market advanced, with some interruption, but its net gains over the period as a whole were based pretty solidly on rising corporate profits. Unemployment, while still too high to be tolerable, by the end of 1964 had shrunk to the 5 per cent level. The speculative fevers of an inflationary environment were largely missing during this period. And so we had favorably stimulative fiscal and monetary policies and steady growth, with no recession.

One cannot speak so confidently about the economic conditions that have developed in the United States since the end of 1964. Early signs have appeared of an incipient spiral of inflationary anticipations, inflationary demands and inflationary cost pressures. Inventory investment is no longer quite so cautious and moderate. Ordering and spending for industrial plant and equipment have been mounting, at a rate of acceleration that obviously is not sustainable. Demand-pull has been affecting prices, and there is cause to be concerned that cost-push may become increasingly active.

In short, the private economy and the public economy, taken together, have been trying to do too much too quickly, and the strain is showing up in a gradual rise of prices--though up to now this rise is still not at so rapid a pace as the price rises in most other industrial countries. If we are to get the various segments of the economy back onto a track of balanced growth at sustainable rates we must halt the incipient inflation of prices.

On a second front--the international as well as the domestic--the central banker, particularly in a key currency country, has cause for abhorring the emergence of inflationary conditions. He abhors the way inflation affects the external balance of payments.

There are of course many reasons why the U. S. balance of payments deficit soared, beginning in 1958, and why we have had difficulties since then in our efforts to redress the imbalance. But among the many reasons, surely one major one is the price inflation that we suffered in the mid-1950's, which worsened our international competitive postion both in the export and import fields. The possibility of something like that recurring and worsening our competitive position still further is a major reason for our present concern about inflationary pressures in the United States.

Inflationary pressures, however, can hurt the balance of payments even before any lasting harm has been done to the competitive position. Even before they bring overt inflation, excess demands suck imports into the country at an abnormal rate. This has been happening in the United States during the past year and a half. Our trade balance ought to have been showing further improvement, in order to close the gap in our over-all balance of payments. Instead it has been worsening because imports have risen more than exports. As a result, the restoration of equilibrium has once again been postponed.

To minimize inflation and maximize economic growth requires a harmonious blending of many sorts of policies--monetary policy and fiscal policy and the private policies of businesses and of labor unions. Ideally, the economy should be expanding along a steady path, always with enough spare capacity to avoid bottlenecks, but never with so much spare capacity as to cause a general slump in the current flow of outlays to enlarge or improve productive capacity. Individual prices should be flexible, so as to facilitate smooth adjustments of supply to changing demand; but broad averages of industrial wholesale prices should remain stable, so as to discourage speculative and unproductive uses of the country's resources. The efficiency and the productivity of the economy ought to be improving constantly.

To get the economy onto that kind of track, and then to keep it there, is indeed a challenging aspiration. But this grand design is not one that monetary policy can fulfill single-handedly. As I have said in recent speeches, good fiscal policy makes good monetary policy work better, and vice versa. Under present day conditions in the United States, as in many other countries, monetary policy is being called upon to carry too much of the burden of restraining demand and of avoiding inflation. Despite the potential for coordination of monetary and fiscal policies to provide the proper kind and amount of demand stimulus or restraint, such ideal coordination is not easy to achieve. Judgments of reasonable men can, and frequently do, vary as to the stage of the business cycle in which we find ourselves and, more specifically, as to just how understimulated or "overheated" the economy may be. Moreover, a whole panoply of policy judgments and social values must also be brought into play. The end result is that the intragovernment coordination of policies affecting aggregate demand can be almost as tricky--and occasionally almost as unnerving--as attempts to bring about some coordination of aggregate demand policies internationally through international cooperation.

Special Problems of a Reserve Currency Country

So far I have been speaking in very general terms. While I have made reference to our key currency status and drawn some examples from experience in the United States, most of what I have said could very well apply to any of the major industrial countries. I should like now to comment more specifically on some special features that arise when a country's domestic currency is also widely used in foreign exchange markets, and when liquid investments payable in that currency are not confined to domestic holders but also form a considerable part of the official monetary reserves of other countries.

One of these features that the central banker in a reserve currency country has to always keep in mind is that his monetary reserves are also serving, indirectly, as the monetary reserves of many other countries. This makes him extremely sensitive with regard to the liabilities of his banking system to foreign official agencies and private individuals. He is especially concerned that the growth of such liabilities not be so fast that it adversely affects the confidence of foreign holders.

A second special feature for a reserve currency country is that an improvement in its external current account--due, let us say, to a rise in its exports--can often be offset by additional capital outflows that are set in motion by the needs of other countries for financing <u>their</u> increased deficits. The reserve currency country is a large country, so when its balance of payments tends to improve there are bound to be some other countries whose balances of payments worsen appreciably. So other countries, whose balances of payments have worsened enough to become deficits, are very likely to come to the reserve currency country to borrow more.

A third related special feature--in my judgment in reality more of a "non-feature"--for a reserve currency country is found in the argument put forth by many Europeans that whenever a reserve currency country has an external payments deficit financed in part by a rise in its liquid liabilities to other countries, it is enabled by that rise to avoid monetary discipline and ipso facto "export inflation" to the rest of the world.

I find this argument not really very compelling despite its superficial appearance of reality. On the one hand, of course, I would assert vigorously that the United States has made every effort, and is still currently making every effort, to restore equilibrium in its balance of payments entirely independently of its reserve currency status. On this score, our position is clear--we intend to restore equilibrium. Thus we do not expect our liabilities to contribute in the same way as in the past to the needed growth of international reserves. But what is even more mysterious to me is why it seems to be so difficult for countries that have surpluses in their balance of payments either to correct the surpluses they claim are forced on them and producing undesirable monetary effects, or to neutralize their monetary effects in such a way as not to attract larger surpluses.

Certainly by facilitating imports or by opening up and broadening its own capital markets and assuming a greater responsibility for capital exports in the form of money rather than goods, a surplus country does not have to accept passively an imbalance between its receipts and payments.

True, a mere onward shifting of dollars, say to the Euro-dollar market, does not correct the underlying attraction that a country may have for capital. I recognize there may be a dilemma between the use of tight monetary policy to combat domestic inflation on the one hand, and the tendency of such a policy to attract foreign money. But our program of voluntary restraint on bank lending has operated to permit greater latitude to European monetary policies with less danger of attracting U. S. capital. Indeed, in some periods there has been a return flow of short-term funds to the United States.

Beyond that, the contribution of any surplus--whatever its origin--to a country's own domestic inflationary pressures depends on the kinds of steps that may be taken in the way of fiscal and monetary policies to neutralize such impact. For example, if the government were to siphon off such funds by borrowing or taxing without corresponding increases in expenditures, the economy would be left relatively unaffected. In a sense, it seems to me that the talk about "imported inflation" may basically reflect the inadequacies of fiscal policies in the surplus countries.

International Monetary Arrangements

A central banker, especially in a reserve currency country, is inevitably involved in those international monetary arrangements that are integrally related to the functioning of the international monetary system. International discussions on the subject of international monetary reform have gone far enough now to convince me that the really important issues tied up with this subject are not questions of the mechanics of a new system, but rather questions of objectives and of the spirit in which countries will cooperate to achieve their objectives.

No system for the financing of international payments imbalances, or for the creation and maintenance of value of monetary reserves, will succeed in the long run unless it contributes, in the international sphere, to those objectives which it has been the role of the central banker to strive for in the domestic sphere. These objectives are partly means to an end, and partly ends in themselves. The overriding objective, as the central banker sees it, is economic growth, to raise the levels of well-being for all. His subsidiary but closely related objectives can be summed up in the concept of financial stability, domestic and international.

The old gold-standard mentality will not work, in the long-run, any better internationally than on the national level. There is no automatic formula that can resolve once and for all the continuing problem of achieving growth without inflation.

On the other hand, international cooperation toward the goal of economic growth with financial stability depends on a willingness of nations to submit to some degree of self-discipline and, if necessary, some degree of international discipline. No change in institutional arrangements can automatically guarantee stability and discipline. No orderly system of international economic and financial cooperation can work unless individual countries do their part to maintain financial stability.

Concluding Comment

This brings me full circle in my remarks this afternoon on the role of a central banker. I began by stressing the central banker's concern with growth as well as inflation and the need for continued adaptation and ingenuity in meeting changing problems. And my main conclusion from these remarks is that the role of a central banker is constantly becoming harder instead of easier as the economic and financial environment becomes more complicated and the problems more complex. Thus I think the credo of a central banker might very well be the same as the words which as I recall are inscribed on the facade of the Harvard Medical School Building not too far from where we are now meeting, namely:

> Life is short
> And art long;
> Occasion instant;
> Experiment perilous;
> Decision difficult.

Central banking is indeed a long art and the occasions are often instant. Experiment is perilous but frequently necessary and decisions are always difficult.