Session I

Role of Monetary Policy

RICHARD D. ERB

Let us turn now to our first session. Each speaker will address a number of issues, including, for example, the question of whether there is a primary economic task for monetary policy: price stability, exchange rate stability, and growth. What are the relationships between those objectives? Are there differences between the short run and the long run in the pursuit of those objectives? How does the overall structure of an economy influence the role of monetary policy? These and other issues will be addressed in the context of this session, and this will then lay the basis for Session II, which will focus more specifically on issues concerning the implementation of monetary policy.

LI GUIXIAN

It is a great pleasure for me to have this opportunity to discuss the issues of monetary policy with Mr. Volcker and other distinguished guests. I am going to speak on the role of monetary policy and its relation to credit allocation and fiscal policy.

Monetary policy is one of the most important of the macroeconomic instruments. The objectives of monetary policy in a country can be quite different in various periods of time owing to differences of economic development, financial structure, and economic policies. Generally, price stability, full employment, economic growth, and balance of international payments are regarded as the basic objectives of monetary policy. In the present-day world, because consistency and conflict exist between various objectives of monetary policy, central banks usually lay different emphasis on different objectives. They make frequent adjustments to the policy measures in view of the status quo of their country’s political, economic, and social development. In this way, they maintain the equilibrium of aggregate demand and aggregate supply and promote balance and sustained economic growth.
China is developing its planned commodity economy. The central bank has persistently deemed monetary stability and economic development to be the basic objectives of monetary policy. We believe that the key to handling all four objectives is to prudentially balance the relationship between stabilization and development. In fact, stabilization and development are mutually conditional and complementary. Monetary stability is the prerequisite of economic development, and, in turn, economic development is the solid foundation for monetary stability. Monetary stability is regarded as the fundamental, dynamic, and long-term equilibrium of money supply and money demand, not excluding the temporary disequilibrium over time of price adjustment and price structure reform. Only through active stabilization can economic development be best promoted. On the other hand, economic development should proceed at a steady and sustained rate so that economic development cannot only be prevented from disturbing stability but can also help maintain stabilization.

To integrate the objectives of monetary stability and economic development, attention should especially be paid to the following aspects. Emphasis should be placed on a specific objective in a particular period in light of the existing situation. For instance, we have recently been exerting additional effort to tighten monetary policy and promote price stabilization and economic development. In China, the experience of recent years has suggested that monetary policy has developed into one of the main macroeconomic instruments in the Government's effort to transform direct control over the economy to indirect control. It has played an active role in controlling the scale of fixed capital investment, containing the excessive growth of consumption funds, channeling savings to investment, adjusting the economic structure, augmenting effective supply, maintaining price stability, and promoting balanced economic growth.

Apart from the choice of the objectives, the formulation and implementation of monetary policy also involve the issue of intermediate targets, instruments, transmission mechanisms, and the analysis of effects. I will address the relation of monetary policy and credit allocation.

Credit allocation is a selective monetary policy instrument distinct from quantitative control methods, such as required reserves and rediscount and open market operations. Since this instrument was first introduced in the eighteenth century by the Bank of England, central banks around the world have made use of it in one way or another at different times. Even today, although general quantitative methods have been extensively applied in the developed countries, some of them have not altogether discarded the instrument of credit allocation.
In the developing countries, including China, it remains the dominant one in the apparatus of central banks.

As far as I perceive, a country’s fund allocation system is determined by its economic and financial system, as well as by the maturity of its financial markets. In our case, banks are not only commercial entities conducting banking business but are also units empowered by the state to undertake policy lending—specialized banks especially, as the state banks are not supposed to operate for profit only or, rather, they are required to take on certain functions of macroeconomic regulation and control. Furthermore, as a developing country, China is constantly confronted with an ever-growing demand for funds and the urgent need to adjust its economic structure. Abandonment of the credit allocation system would leave unsecured the sufficient flow of funds to priority sectors and enterprises of economic development and structural adjustment. On the other hand, underdevelopment of financial markets severely limits the central bank’s ability to regulate the economy through open market operations and rediscounting.

Nevertheless, we are aware of the defects of a credit allocation system. We maintain that the key to the effective implementation of monetary policy in the present Chinese context is the coordination of different policy instruments. For this purpose, efforts should be made to perfect the policy instruments in light of the reality of China, while maintaining the system of credit allocation. For instance, steps may be taken to improve the system of loan quotas, special deposits, and required reserves and to adjust interest rates, set lending structure guidelines, formulate a social credit plan encompassing all credit demands, promote the growth of interbank lending market, etc. Much work is also needed to better coordinate the conduct of various instruments to make them support and supplement each other so that the role of each individual instrument will be brought into the most effective play.

Both monetary and fiscal policies are indispensable tools for aggregate demand management. Fiscal policy is effected through the distribution of national income and the change of budgetary expenditures; monetary policy is effected through the adjustment of the money supply. In my view, the combination of these two policies, whether to tighten or to relax both of them or to tighten one and relax the other is determined by the specific conditions of the economic system and the economic operation mechanism of the country in question.

The existing economic operation mechanism in China is quite different from the market mechanism in Western countries. The Chinese economy is an integration of a planned economy and market regulation. Monetary and fiscal policies are conducted not only for aggregate
management but also for the needs of structural adjustment. For instance, in view of the current excess of aggregate demand over aggregate supply, the overall direction of monetary and fiscal policy is set to both control aggregates and adjust the economic structure. Therefore, pursuant to the structural adjustment policy, sufficient funds will be granted to priority sectors and enterprises, and fiscal expenditures beneficial to structural adjustment will be expanded despite the fact that both monetary and fiscal policies have been tightened.

With respect to the resource allocation through monetary and fiscal policy, our approach is to maintain the individual balance of fiscal and credit resources, respectively, as well as their overall balance. For those construction projects that have total credit resources, funds will be provided as much as possible from banks. As for those projects that can be financed by neither credit nor fiscal resources, funds will be raised by issuing bonds, through the fiscal sector, to households, enterprises, and financial institutions so as to discourage the direct purchase of such bonds by the central bank. Finally, it should be stressed that the effective coordination and supplementation of monetary and fiscal policy require the concerted action of other economic policies, such as investment policy and the support of various means, such as administrative measures.

PAUL A. VOLCKER

I appreciate personally this opportunity to join this forum and this conference. As Mr. Erb emphasized at the start, China has had remarkable success with its program and process of reform and opening. It is fair to say that you also have a remarkable set of problems. One senses that you are at a particularly critical time in your economic development and, inevitably, have many questions unique to the Chinese economic and political situation. In reading about China before coming here and listening to Governor Li and talking with some of you, I was struck by the similarity of some of our problems, a similarity of problems with countries in quite different states of development. Let me say that, from my particular perspective, I understand it is much easier to give advice than to take responsibility. I am these days in the happy position of giving rather than taking advice, but I have greater respect for those of you who must not simply talk about problems but must act.

I listened to Governor Li's statement with great interest. He emphasized a unique combination of planning and regulation in China. Many of his comments sounded quite familiar. He described the multiple goals of monetary policy for full employment, for growth, for balance
of payments' equilibrium, and for price stability. I was struck by the fact that those very same phrases appear in all the directives of the Federal Reserve Board in the United States. Sometimes we engaged in great debates as to which of those wonderful four objectives ought to be listed first, second, and third, in particular situations. But, first of all, I want to draw a lesson from that.

Obviously, monetary policy authorities like to do good in all situations. They would like to see the economy operate with growth, full employment, balance of payments equilibrium, and price stability. We all want to be wise and flexible and adjust our policy instruments to achieve all of those objectives. But I am not sure that that is saying much more than as intelligent, humane people we want to do good. The question is whether we can always do good in all directions at the same time. Monetary policy is an important aspect of economic policy, but it is only one instrument of economic policy.

The unique characteristic of monetary policy is that it deals with money and, in dealing with money, it inevitably deals with markets. Money itself produces nothing, but without money there cannot be efficient markets, and, conversely, without reasonably efficient and effective markets, there is no real purpose in monetary policy. What is important, if we are going to have well-functioning markets, is that there be some sense of monetary stability. Without a sense of monetary stability, I do not think we can have a very effectively operating economy—one in which other participants can produce, will be willing to save, will be willing to invest in the future, and will be able to trade freely with other countries.

I am using monetary stability in a very broad sense. I am thinking of reasonable stability in exchange rates. I am thinking of continuity in financial markets so that one can plan today what might reasonably happen tomorrow. I am thinking of encouraging performance on financial contracts and providing for the repayment of debts on a planned basis, of providing for a basis for lending on reasonable terms, and, when I think of monetary stability, I am thinking, above all, of price stability.

A point that I would like to emphasize is that monetary stability is the first priority of monetary policy, and, when there is a choice of objectives, that is the one that should be emphasized. What that means more broadly is that central banking and monetary policy require a constant sense of placing limits on money and credit creation. Those limits may change from time to time depending upon economic circumstances, but we must always think in terms of appropriate limits because, when money and credit creation is excessive, we will lose the
monetary stability necessary for economic activity to perform optimally. That does not put central banks in a very popular position. One of my colleagues as chairman of the Federal Reserve Board used to put the point very simply: he said the function of monetary policy and the function of a central bank was to take away the punch bowl just when the party got good. Another American commentator, in a rather critical way, described a central banker as a person who is always fearful that someone else may be happy. The fact is that the function of the central bank is to set limits, to set a framework—which other people may not like—that provides an environment in which growth and stability may be achieved in the interest of the economy as a whole.

I want to quote two different authorities for that view. German monetary policy and central banking is often widely admired. One reflection of that is in the basic law of the German central bank, the Deutsche Bundesbank. A broad instruction given to that body is very uncomplicated; it says defend the stability of the currency; it does not say anything about economic growth; it does not say anything about the balance of payments; it does not say anything about full employment. I do not think it a pure coincidence that the Federal Republic of Germany has had a strong balance of payments or that it has had good growth and a strong economy during the postwar period. My other authority is quite different; I am thinking of Mr. Lenin, who reminded capitalist countries that the greatest danger to their stability would be inflation debauching the currency. The point I am trying to make is not a matter of economic ideology.

Let me just briefly turn to some characteristics of recent U.S. experience. By the standards of elsewhere, we, for many years, have had reasonable success in stability. At least, we have never had extreme inflation. But we did have serious inflation in the 1970s and early 1980s, in fact the most serious inflation in our entire short history—only two hundred years. We had that inflation partly because, with the best intentions, decisions were taken to create more money in the interest of economic growth and low unemployment. The lesson was that we ended up with more unemployment and less growth; once the inflationary process gained momentum, it was very difficult to restore stability without more economic difficulty and without still more unemployment and monetary instability than we would like.

If there is any reality to what I am saying, the second point that I would make is that it is very difficult to explain to the general public what is happening. In a simple way, more money in the pocket always seems good. If you have more money, you can buy more, and the connection between more money and more inflation, and more instability is not always clear, but if in fact that is the truth, I think it is
also the truth that a central banking organization, whatever its precise form, will need strong public support and strong public understanding. It will need to be able to explain itself to the public very clearly. It will need the understanding of other parts of the government, however unhappy some of the public or other government agencies may be when they too have to live within the sense of restraint that is implied.

I think that we in the United States are better off in this respect now than we have been for some years, precisely because we went through this difficult experience in the 1970s and early 1980s. The general public understands better than it did the importance of monetary restraint and of not permitting inflation to get a good head start. There may be some similarities to your recent experience.

A third point is that how monetary policy works in the United States or anywhere will depend upon other characteristics of the structure of the economy and other elements of economic policy. Let me take just two aspects of that from recent American experience.

As inflation in the United States reached high levels, the budget deficit got larger rather than smaller—the American economy is characterized by low saving. In fact I might say, as an aside, that I find some of the figures that I see for saving in China, as a percentage of income and as a percentage of GNP, unbelievable from an American perspective; as a fraction of income, you save several times what we save. In any event, our saving has been rather low for decades, but during the 1980s, the already low level of saving dropped further to the point that it was totally inadequate to cover both the budget deficit and even minimal investment needs at home. This encouraged a lot of capital investment from abroad; so we had the odd situation of the largest and richest economy in the world, with relatively low investment and high interest rates, being dependent upon the capital of other countries. I do not argue that that was a desirable situation, quite the contrary, but the operating question for the central bank was what to do about it. The central bank does not control saving, at least not directly; it does not control the fiscal deficit; what it can do is create money. But the judgment was made that the creation of money in this particular situation would only have added a third large problem, namely, inflation, to the already existing problems of budget deficits and trade deficits. I happen to think that that was a correct judgment, but I point out that it did not cure either the trade deficit or the budget deficit or the shortage of capital at home; we had to look to different policies, and some of those I think are now working to cure those particular problems.

Another aspect is the flexibility of prices or, looked at another way, the rigidity of wages and prices in an economy. It is clear that if we are going to have price stability overall in a reasonably dynamic economy,
some individual prices will have to go up to attract more resources into particular sectors, and as some prices go up other prices will have to go down. I think that it is logically correct that if no prices go down and some prices go up you cannot have overall stability. A lot of countries, including the United States, have not had much downward flexibility in prices. And when one thinks about the relative success of anti-inflationary policies in the United States in the 1980s, one would not look just to monetary policy.

There was an important, substantive, and symbolic event in 1981 in the United States: a strong trade union—the air controllers—that considered its members absolutely essential to keep aircraft flying in the United States went on strike for a variety of reasons; air controllers are public employees. I am sure they expected that the strike would be settled quickly because they were engaged in a vital service and that they would largely achieve their objective. Instead, the Government decided to draw the line; it felt the strike was illegal and even apart from any argument over the merits of their complaints, it decided it would not settle the strike, and instead started over again by hiring and training new air controllers.

I do not argue the specifics of that case, whether the Government was right or wrong in terms of the benefits the controllers were looking for, what I do argue is that the attitude of the Government toward that strike changed in a very important way the attitude of labor unions all over the United States, and really for the first time in the postwar period led to a different kind of wage determination, including the willingness of some labor unions to accept lower wages in order to keep jobs in industries that were doing poorly. That restraint in wages continues until today and has made it possible, I believe, to employ some twenty million more people in the United States today than ten years ago. That may not sound like much to a Chinese, but it is a lot for us—a 20 percent increase in employment during a decade in the context of economic growth, diminishing unemployment, and greater price stability.

My final point, just briefly, is a comment on the question of credit allocation and direct credit controls that the Governor mentioned, and, as he indicated, I think practically all central banks have had some experience in that area. It is also true, in the United States and in highly developed economies generally, that the idea of credit allocation and direct credit controls is rather out of fashion for several reasons. One is that from the viewpoint of the Federal Reserve, in particular, the temptation to rely upon direct credit controls will be seen very frequently by the public at large and by other government agencies as an easy substitute for restraining the overall money supply. But I think experience is quite clear that if we run a kind of two-horse policy, direct restraint
on credit but expansion of the overall money supply, we will eventually have both inflation and a distorted economy. That may appear somewhat different in a planned economy where credit restraint—direct credit restraints in some cases—may play a role, but I would bring to your attention not just experience in the United States but experience in the U.S.S.R. once again, where they certainly have a lot of direct credit restraints, but at the same time, they have had an enormous expansion in the money supply and the result, as nearly as I can judge at present, is rather a mess. I do not think that you can use direct credit controls as a substitute for overall restraint.

Let me look at the other side of the coin. Is there some role for credit allocation, for subsidies, for the central bank promoting a big supply of credit in critical areas of the economy? Again, I can only report to you the attitude and experience of those of us in the United States. The Federal Reserve has often been asked to provide credit on particularly favorable terms to sectors of the economy that either have special problems or are deemed to have special potential. Invariably, those requests are resisted, usually successfully. They are resisted for a simple reason: there has been a fear on the part of the central bank through the years that if you begin using the process of money creation through the central bank to support one area of the economy or another, it will be practically and psychologically impossible to, at the same time, restrain the creation of money generally. In sheer political or bureaucratic terms, it is difficult to drive a car in two directions at the same time, and if you create the impression that the central bank can use its funds for supporting particular areas of the economy, it is difficult to know how and when to stop, because demands will only multiply. Every sector of the economy feels that it is particularly oppressed or that it has particular potential. The whole point of limiting the money supply is that all of those demands cannot be met. So it has been argued in the United States that you better not start because you do not know where to stop. That does not mean that we in the United States, as in other countries, do not provide special privileges for particular areas of the economy, but those benefits are provided through the budget or sometimes through special laws and regulations. They are not provided through the process of money creation and through the central bank. I know China is in a somewhat different situation in that respect particularly with its needs for structural adjustment and for developing markets, but I tell you our experience for what it is worth.

Finally, I would report on another practical approach. Our experience increasingly is that direct controls do not work well in a developed market economy, for several reasons. We do not know enough in Washington or in the Federal Reserve to judge precisely what kind of direct
controls and what rules and regulations are suited to the great variety of markets and individual firms that exist in the country. I know from personal experience that it is extremely easy to misjudge the effects on the economy of direct controls, because the effect depends in part not upon what you intended but on what the population fears and thinks you might intend. One of the dangers is that a particular measure of restraint might be interpreted as a forerunner of further measures of restraint, and people will react as much to what they fear in the future as to what they see in the present.

One last bureaucratic or political point. If monetary policy is to be conducted through a series of direct controls on direct allocation of credit, at least in our country, it is an invitation to constant controversy between particular departments and particular sectors of the economy as to who is being fairly treated and who is being unfairly treated. Questions are raised to which there simply are no answers. Some of those judgments have to be made by any government, but again in our experience we find it simpler to make those judgments through the budget, where there is at least some clear sense that if extra money is extended to one person or one sector, some other sector has to pay for it. In that sense, a budgetary priority puts some discipline on the process. If the same intervention is attempted by the central bank, through money creation, that essential sense of discipline on the total may be lost. Again I realize that these are comments and lessons drawn from the experience of a highly developed market economy, but they are not entirely irrelevant to some of the concerns that you must have in this very large and growing economy.

Miguel Mancera

It seems to me that in discussing our subject it is useful to make a distinction between credit policy and monetary policy. These policies are closely linked to each other, but they are not synonymous. In my view, monetary policy is implemented through actions that have an effect on the balance sheet of the central bank. Credit policy is something wider: it includes monetary policy plus other actions of the authorities that may affect the volume or nature of the operations taking place in the financial system without changing the assets or the liabilities of the central bank.

The ultimate objective of economic policy is to achieve the aims of society in an efficient way, that is, at the lowest possible cost. In modern times, growth has usually been the primary aim in most countries; so, for the sake of simplicity, we may assume this to be the case in our discussion. Of course, this does not mean that there are not at the same
time other important objectives, such as the redistribution of income to make income more equitable.

If the main objective of economic policy is growth, the objective of the component parts of that policy, including the monetary and credit policies, should also be the same. The question is how they can best make a contribution to economic growth.

I have no doubt that in order to achieve growth, monetary policy should concentrate on achieving and maintaining price stability or, in other words, on achieving and maintaining a stable currency in terms of its domestic purchasing power.

This stability is crucial because the evils of inflation are countless. By making relative prices and incomes highly volatile, and therefore unpredictable, inflation increases the difficulty of making the right investment decisions. Consequently, the yield of many projects turns out to be unsatisfactory. Moreover, assessing the probable costs and benefits of a project may become such a difficult task that the investment process is inhibited.

Not only investment decisions but also savings decisions are much impaired by inflation. An important price that becomes volatile in times of inflation is the price of money, that is, the real interest rate. It has been found that when inflationary processes begin, real interest rates are often negative and that, for a time, this does not discourage people from saving. This is because, at that stage, people have not yet learned to distinguish between nominal and real interest rates. Over time, however, savers become aware of the distinction and thus become reluctant to hold debt instruments unless they foresee that a positive and satisfactory yield is obtainable. A new difficulty is then encountered because inflation makes real yields hard to forecast owing to the volatility of the rate of price increases, even within short periods of time.

A paradoxical situation arises: although observed real yields may have been extremely high, people may be reluctant to put their money into financial instruments. They may perceive that the likelihood of surges in the rate of inflation subjects future real yields to the risk of being dramatically diminished. Thus, a substantial difference appears between ex post rates, that is, the observed real interest rates in the past and ex ante rates, that is, the expected real interest rates. When ex post rates are high and ex ante rates are low, we have a most undesirable situation.

Another evil of inflation is that it provides very fertile ground for economic distortions to develop. As the population reacts angrily to price increases, the authorities may be tempted to establish price controls. This temptation comes in spite of the fact that quite often the
authorities are well aware that shortages will ensue, which will exacer-
bate the situation in the long run. Nevertheless, short-term pressures are very difficult to resist.

It is likely that the first prices that will lag behind economic real-
ities are those of goods and services provided by public sector enter-
prises. To prevent these firms from going into the red and eventually into bankruptcy, they have to be subsidized; thereby, public finances tend to deteriorate. This, in turn, increases the pressure on the central bank to provide excessive primary credit, which is usually the original source of inflation. To make matters worse, subsidies may not be re-
stricted to public sector enterprises. Private firms may also be among the beneficiaries. In such circumstances, pressure for additional central bank financing will become even stronger.

The widespread and abrupt fluctuations in relative prices that infla-
tion brings about causes the real economic outcome of contracts to be substantially different from the expectation of the contracting parties. This produces windfall profits for one of the parties at the expense of the other. This process is very inequitable and many times angers not only those directly involved in the respective transactions but also large sectors of the population. In these conditions, the business climate deteriorates markedly. Moreover, much effort and resources are diverted from the production of goods and services to forecasting and hedging to avoid heavy losses. Another undesirable effect of inflation on con-
tracts is that their terms tend to become shorter. Thus, economic ac-
tivity is conducted in an atmosphere of extreme uncertainty, as con-
tracts have to be replaced frequently. This clearly is detrimental to the economy.

Finally, it can be said that the propensity for the rate of inflation to increase is remarkable and, even worse, the evil consequences of infla-
tion tend to increase at a compound rate as price increases accelerate. At some point, the inflationary process utterly destroys the economic sys-

tem. As we can see, there are plenty of powerful reasons to pursue stability. Stability should not be pursued for its own sake, nor for doc-

trinaire considerations. Without it the ultimate goal of economic policy, sustained growth, is difficult to attain in an inflationary environment.

Since inflation is such a harmful phenomenon, it must be fought with all our strength. The correct monetary policy is a necessary, al-
though perhaps not sufficient, condition to achieve stability. In some instances, if monetary policy is correct, inflation can be avoided even when other policies do not contribute to stability. But if monetary policy is incorrect, in the sense that it is overly expansionist, inflation is bound to occur even when other elements of economic policy are con-
sistent with stability. Thus, there is no substitute for good monetary policy to keep prices stable.

In my view, exchange rate stability and balance of payments equilibrium should not be the final objectives of monetary policy, since the final objective is price stability. Yet the former can well be intermediate objectives, inasmuch as they may contribute to the achievement of the latter. In fact, when a country is closely linked to the international economy and there is a major foreign currency that is very stable, a policy of pegging the rate of exchange of the national currency to that foreign currency may be a very effective way to promote price stability.

The speakers at this conference have been asked to discuss the role of monetary policy in allocating credit. In this regard, I would like you to keep in mind the proposed distinction between monetary policy and credit policy. My opinion is that ideally monetary policy should not be used to direct credit allocation. The probability is high that if central bank credit is used to support specific areas of the economy, pressure to obtain central bank financing will mount, making it more difficult to conduct the central bank's operations in a manner consistent with price stability.

This is not to imply, however, that direct credit allocation is altogether undesirable. Credit policy, which is wider than monetary policy in the sense that the former does not only refer to the operations of the central bank, may well consider some direct credit allocations by institutions other than the central bank.

Direct credit allocation has been criticized since it has frequently involves interest rate subsidies, which are difficult to justify. Nevertheless, direct credit allocation does have a raison d'être. Commercial bankers, just like many other people, are sometimes reluctant to adopt new ideas. They may believe that granting certain types of credit or financing certain areas of economic activity is extremely risky. Yet this may not be the case when the appropriate credit techniques are applied. In such circumstances, the demonstration effect that can be provided, say, by a development bank is extremely useful. It seems to me that the most important reason for development banks to exist is the role they can perform as credit innovators and as instructors for the commercial banks and perhaps also for the securities houses and other financial intermediaries. This is why, as commercial banks and other financial intermediaries become more experienced and imaginative, the need for direct credit allocation and for development banks fades away. This has been the experience of the industrial countries. But please do not misunderstand me. The disappearance of development banks is by no means an immediate prospect. For developing countries, development banks—the World Bank included—will continue to play an important role for a long time.
To be efficient, direct credit allocation has to be limited. If extensively applied, it can cause more damage than good. This is because it is virtually impossible to determine the amount of credit that should be rationally allotted to each branch of economic activity within the limited total amount of resources available.

The credit allotted to a certain activity may be excessive, and as a result some part may remain unused, whereas credit allocated to another activity may be insufficient, posing an undue constraint on its development. On the other hand, since credit tends to move as if within communicating vessels, enterprises with the ability to borrow the excess credit allotted to them will become lenders to enterprises suffering from credit shortages. Although this may, indeed, be good for the economy, the purpose of direct credit allocation will be defeated. Moreover, this kind of allocation appears harmful, as it creates the need for a greater degree of credit intermediation than would otherwise be necessary.

Let me now make some comments on the relationship between monetary policy and fiscal policy. The action of the central bank with regard to the prevailing fiscal policy will depend to a large extent on the degree of the central bank's independence. There are unfortunate situations—which are not infrequent—where monetary policy virtually cannot exist, since the central bank must accommodate the government's demand for credit, no matter how large it may be. In such cases, one of the few constructive measures that the central bank can take—if allowed—is to implement a foreign exchange policy conducive to avoiding abrupt exchange rate fluctuations and major disruptions in the balance of payments.

Assuming the central bank enjoys a degree of independence, it can design monetary policy to compensate for certain actions of fiscal policy. For instance, if the government is running a surplus and deposits the surplus funds in the central bank, the latter could well provide credit to the market to compensate for the money-sterilizing effect of the deposits received from the government, and vice versa, if the government withdraws money from deposits in the central bank, the latter probably should absorb liquidity from the market.

By intervening in the credit market, the central bank has the ability to smooth out undesirable fluctuations of liquidity and thereby of interest rates. It cannot, however, create savings nor can it borrow indefinitely. Consequently, the central bank cannot determine the level of real interest rates at will, except for relatively short periods of time. Thus, if saving in a country is small while the borrowing requirements of the public or private sector are large, real interest rates are bound to be high even in the long run even if this can be avoided in the short run through central bank action. Moreover, nominal and real interest rates
are likely to end up even higher if central bank actions bring about inflation. We have already discussed this when referring to the ex ante and ex post interest rates.

To end this presentation, I would like to make a few comments on foreign borrowing and monetary policy. The effects of foreign borrowing depend on the nature of exchange rate policy. If there is a floating exchange rate, the inflow of capital will tend to appreciate the domestic currency and this, in turn, will tend to discourage exports and to stimulate imports. Monetary aggregates, however, need not be affected. On the contrary, if there is a fixed exchange rate or a crawling peg, then the inflow of capital will cause the monetary base to expand. If the intention is to take advantage of the inflow for increasing international reserves, the monetary effect of the inflow should be compensated for by means of reducing the credit of the central bank to the market. This will bring down the monetary base to where it was prior to the capital inflow. But if foreign borrowing is to finance development, the monetary aggregates should be allowed to increase so that demand is stimulated. As a consequence, imports will grow while exports may decline and more foreign currency will be demanded from the central bank. Consequently, other things being equal, we should expect the monetary base to go back to where it was at the beginning.

Monetary policy can take many courses depending on the circumstances of the public finances and of international capital flows. At all times, however, the monetary authorities should see to it that their actions contribute to monetary stability.

Jean Godeaux

I am speaking to you this morning against the background of the benefits and possibly the biases of two recent experiences. In recent months, I was, as were all the governors of the central banks of the European Community (EC) countries, a member of a committee that was set up by the European Council, under the chairmanship of the President of the Commission, Jacques Delors. With the assistance of another member of the commission and of three independent experts, all seventeen of us acted in our personal capacity and were asked by the European Council to study and propose concrete stages leading toward economic and monetary union in the Community.

At the same time, in my own country, the Government and Parliament were changing the constitution in order to move from a basically unitary state to a federal type of state. Among the tasks that were, in these circumstances, entrusted to the central bank was that of detailing for our politicians the conditions under which the decentralization
could be made compatible with the maintenance of the monetary unity of the country.

We had, therefore, on the European level, to discuss how starting from diversity we would move to unity, and, on the national level, how we would have less political unity but keep monetary unity. The two reflections were very complementary. We had to ask ourselves the same questions on the European level and on the national level.

The formulation of monetary policy, the determination of intermediate objectives, and the instruments of monetary policy do indeed vary according to the size of the economy, to the openness of the economy, to the relative importance of foreign transactions, and, finally, to the stage of economic development that the country has reached.

My direct experience comes from a small economy—the total population of Belgium is 10 million and the area of the country is very small indeed—and from a very open economy. There are, as you know, various ways for statisticians to measure the openness of an economy. We may take imports as a percentage of total final expenditures in the economy. In Belgium, this percentage is about 45 percent; in the Federal Republic of Germany, France, and the United Kingdom, it is on the order of 20 percent. By comparison, in the United States, it is on the order of 10 percent. As for the stage of development, we do belong to the industrial countries. With what is now Czechoslovakia, we were, after England, the first countries to experience the nineteenth century industrial revolution. This means that we are facing the problems of mature economies. These problems are well known. We have to adjust to the profound changes that occur in our economic structure, with heavy industry losing importance relative to new, lighter, high technology industry or services industry. That is our background.

But while we are a small open economy, we are also members of a large community of 320 million. In the Delors Committee, I had to consider this enlarged dimension. What is of cardinal interest is that the Delors Report was unanimously approved. It is significant that the governors who formed the great majority of the committee could, without great difficulty, come to unanimous agreement. We can thus find in this report the common preoccupations and judgments of the governors of the central banks of Western Europe.

It is important to observe that the first responsibility ascribed to the future European system of central banks was the objective of price stability. It is only subject to the foregoing that the system should support the general economic policy set at the Community level by the competent bodies. The second element of the common view of the committee was first that the central banking institution should “be independent.”
These are the two main lessons that governors together have drawn from their concrete experience. These were common lessons despite the fact that within the Community there exist substantial differences in levels of economic development between, say, on the one hand, the Federal Republic of Germany, and, on the other hand, Greece or Portugal. Even for countries for which economic development remains a paramount priority, it was felt unanimously that price stability was, as was eloquently explained by Mr. Mancera, a condition for achieving this economic development.

I believe that we can characterize the thrust of the Delors Report by underlining three words, three concepts that give color to the whole report. The first is *plurality*. Plurality means that we are very much aware of our differences within Europe, and that in a certain sense, these differences can be an advantage if they are reconciled with the level at which greater unity is necessary.

The second consideration is illustrated by the word *subsidiarity*. It is now part of the vocabulary of the Community to speak of the principle of subsidiarity, according to which the functions of higher levels of government should be as limited as possible and should be subsidiary to those of lower levels. For the purpose of our present conference, it is indeed important to distinguish in the field of monetary policy what can be decentralized and what by necessity must remain central. This I believe is a central issue, especially for this immense country of China with such a large population, large territory, and certainly great local differences in the degree of economic development.

The third important word is of less significance in this framework—still I might mention it—it is what we call *parallelism*. Ever since 1958, there has been a debate between the “economists” and the “monetarists.” The monetarists have been urging the use of the powerful lever of monetary unification to force the convergence of economic situations and policies. The economists have been arguing that we should first have sufficient economic convergence and that monetary unity would be the final achievement, the crowning element, of the whole construction. What the Delors Report stated was that we must move, in parallel, on both fronts.

A short passage from our analysis of the experience of the European monetary system shows the contribution that monetary policy can make to economic convergence. One sentence states that “the exchange rate constraint has greatly helped those participating countries with relatively high rates of inflation in gearing their policies, notably monetary policies to the objective of price stability.” Another sentence says that in part “the success of the EMS can be attributed to the participants’ willingness to opt for a strong currency stance.” And in passing,
the report unanimously pays homage to the beneficial role played by
the deutsche mark, as an anchor of the common policy that is being
pursued within the European Monetary System.

I would like to end with one conclusion. To be effective, a central
bank must be autonomous, but what is the basis of this autonomy?
What is the real foundation for this autonomy? It is not so much the
institutional aspects but the confidence that the central bank inspires—
a confidence that rests upon the quality of the analysis that the central
bank is able to make of the country's situation and the nonpartisanship
of the advice that the central bank gives to the government. In my
particular experience during my tenure as Governor there were four
successive ministers of finance, three of whom belonged to different
political parties. I was pleased and impressed that at the end of my
mandate, during a farewell party, these four ministers wanted to under-
line that I, and the Bank, had been telling them the same thing regard-
less of their own political preferences.

Technical competence and nonpartisanship, perceived by public
opinion, are the two foundations of the autonomy of the central bank.
Autonomy is, in turn, the foundation of the bank's effectiveness.

**SUMMARY OF DISCUSSION**

**RICHARD D. ERB**

First, let me say that the speakers spoke from a diverse set of cir-
cumstances and experiences, but there was an interesting consensus on
some key issues. First of all, speakers recognized that multiple objec-
tives—growth and development, full employment, balance of pay-
ments stability, price stability—face each government; Mr. Mancera re-
minded us that income distribution is also important.

With respect to the role of the central bank, Mr. Mancera put it in
an interesting way. He said that we all share these objectives and the
real question is in what way can the central bank make its most effec-
tive contribution. This leads me to the next general conclusion and that
is with respect to the role of the central bank. We heard from all
speakers that the primary emphasis, the priority, should be given to
achieving price stability; this is a way to achieve the conditions neces-
sary for saving, investment, and exchange rate stability—all of which
can contribute to economic growth. I thought that Mr. Mancera also
very graphically described what happens when a government loses con-

A third point was that monetary policy implementation and the
success in achieving price stability, and the other objectives, depend
importantly on the structure of the economy and other policies. As it
was put, good monetary policy is a necessary condition; but it is not sufficient. Other factors influencing the impact of monetary policy include the degree of price and wage flexibility, the private saving rate, other government policies, and, in particular, fiscal policies.

This leads me to what I think is the next major issue: What should be the relationship between fiscal and monetary policy? As each of our speakers pointed out, excessive fiscal deficits can make monetary policy more difficult, can crowd out other productive investments, and can result in too much domestic and external borrowing. With respect to what is an ideal relationship, some observations were made that both the central bank and the finance ministry, if they are the relevant fiscal institutions, should have considerable status in the government. Second, on the fundamental issues of the performance of the overall economy, those two institutions should be natural allies. At the same time, it was recognized that there may be times of open conflict between the two institutions.

Another general point of discussion concerned the role of the central bank in credit allocation. Here, I thought that there was a strong view among the speakers that the central bank should not directly involve itself in credit allocation. Many reasons were cited. For example, it is difficult to decide who should get the credit; too many risks are involved, including, in particular, the direct involvement of the central bank in credit allocation, which may undermine the ability of the central bank to control overall credit.

Another aspect of the issue of credit allocation that was discussed was the question of the overall role of the government in credit allocation. To the extent that there is involvement, it should be more specifically carried out through the budget. But I think all speakers recognized that the degree of direct credit allocation depended on the structure and objectives of each economy.

Let me just mention a couple of other issues that I am sure we will come back to in later sessions. The first issue concerns the importance of explaining monetary policy to other parts of the government and the general public. Another is the question of the degree of autonomy of the central bank. Other issues include the question of subsidiarity and what should be centralized—what functions should be centralized and what functions decentralized—and also the question of continuity and stability in policy implementation. Finally, I would like to come back to Mr. Volcker's statement that both the central bank and the finance ministry should have considerable status in the government and discuss more precisely what that means.