

The Role of Central Banks

Paul A. Volcker

I must say that it is a pleasure to be back with this group after a lapse of eight years. The scenery remains superb, the fishing is still good, and the company is stimulating. In my former position, I must confess I had some difficulty in squaring all this with my personal idea of what a true-blue central banker should do. You know: austerity, discipline, restraint, hard work, pinstripes, and all of that. I do not notice any of that in this company. But I do think it is important that our Central and Eastern European central **banking** friends do understand one thing that is symbolized by this conference. The simple empirical fact is that central bankers—and I include finance ministers for this purpose as well—have always found the most agreeable places to meet. I think it is all justified under the general rubric of promoting international financial cooperation. Who can protest such a cause as that?

I am free of all official responsibilities these days, but I am supposed to say something profound and provocative in these 15 minutes. And I have to tell you, I find that more difficult after having left government. Somehow the thoughts and ideas seem to have come easier when I could call on good colleagues and superb staff for their participation—and, not unimportantly, for a few facts. These days, I sit in a lovely office on the 40th floor, with a nice view, way above the steamy streets of New York. But I am in intellectual isolation, at least about central banking. For all the glories of my investment **banking** friends, I have to tell you they are not very big on the role of central **banking** in emerging market economies, which is what I

am asked to talk about today. In fact, when I mentioned to one of them that I was supposed to talk about central banks in emerging market economies, they told me that was an antithesis in terms. Central banks are not exactly the harbingers of free market economies.

As I thought about this subject, I had a little difficulty. I do not question the emphasis that has been placed upon central banks and central banking in Central Europe and Eastern Europe. And not just there, but also certainly in China where I spent a week last January, and in Latin America—which has many similar problems to those of Central and Eastern Europe. In all of these places, there is a tremendous interest in central banks, in encouraging central banks, and in strengthening central banks. And it does not, of course, stop there. The same process seems to be under way in the U.S.S.R. itself. And what interests me is that Mr. Yeltsin apparently wants a central bank in Russia and I guess the Lithuanians want a central bank, and the **Kazaks** want a central bank. Every province in China, I can tell you, wants its own central bank, too. I began wondering why. What is this all about?

There are obviously a lot of priorities that these countries face in moving to a market-oriented economy. They face the challenge of inoculating the basic idea of markets, the basic idea of private property in their economic systems. They have that enormous challenge of privatization. They have to introduce accounting systems, commercial law, and financial instruments. You can go on and on. Where does central banking rank in that hierarchy of priorities?

And as I began wondering and looking at central banks in the Western world, I realized they were not at the cutting edge of a market economy; they were Johnny-come-latelies. With a few notable exceptions—like the Bank of England and the Bank of Sweden, which go back some 300 years—central banking is almost entirely a phenomenon of the twentieth century. And there were market economies long before the twentieth century. Indeed, to some extent, central banks were looked upon and created as a means of financing the government, which I do not think people have in mind when thinking about central banking today. The Federal Reserve

itself was not established until 1913; the Bank of Italy, later than that; the Bank of Switzerland, not much before that; the Bank of Canada, in the 1930s. (I would get all these facts right if I were still in the Federal Reserve System, but I think they are roughly right.) Similarly, the central banks of Australia and New **Zealand** were also creations of the last 50 years. And if you say a central bank is essential to a market economy, I have to ask you about Hong Kong, which has no central bank at all in the absolute epitome of a free market economy. Yet it does quite well in terms of economic growth and stability. So the question remained in my mind.

And it also occurred to me that we forgot until quite recently, and even today, how much central banks in the rest of the world rely upon direct administrative and selective measures to control money and credit. Total bank credit ceilings were not exactly an unknown technique, even in Western Europe's central banks, as recently as 10 or 15 years ago. Administrative guidance and selective credit controls are still not unknown—even in the United States from time to time. It is only in the past couple of decades that interest rate ceilings, formal or informal, have gone by the boards, and they are not entirely by the boards even today. Now, all of that has changed with the integration of capital markets internationally and with a worldwide move to deregulation that goes far beyond financial markets and central banks. But my point is that these are quite recent developments. They did not lead market economies; they followed.

And I also might mention that for all the talk about central banks today, I think it is fair to say that the authority and prestige of central banks in the industrialized world, though fairly high now, has not always been so high. A lot of de facto authority was lost in the 1930s and 1940s in the midst of depression and war; and a lot of central banks lost their statutory independence as well in that period. Only in the past decade or so has monetary policy again been at the cutting edge of national policy.

Well, if all of that is true, what is driving all this interest in central banking? What critical role does it have in these emerging market economies? Well, the answer that kind of leaps to mind automatically, at least to the mind of a central banker I suppose, runs

something like this: the transition to a market economy from a centrally controlled command economy is going to be fraught with a lot of problems, but one of the central problems will be inflationary dangers; inflation is bad and destabilizing and threatening; central banks are against inflation; Q.E.D. We had better hurry and create a good central bank to deal with the potential inflationary problem. But even then I have to say, wait a minute.

There are other potentially more effective ways to get a handle on inflation than a central bank. And I do not have to cite any greater authority in this room than Wayne Angell. When he went off to Russia, he did not recommend the creation of a new Federal Reserve System. Rather he said, "Go on the gold standard." Alternatively, one might say "adopt convertibility." Or one might say, as Alan Walters seems to be saying these days, "have some kind of a currency board" for emerging economies. A central bank might be attractive to those here, many of whom are central bankers. But it is not the only way you can deal with inflation. In fact, as you well know, a central bank can become an engine of inflation rather than the reverse.

I have to point out that historically, until the past 10 or 15 years, socialist economies, though having many other deficiencies, did not have a bad record on inflation. They did not have a central bank in the Western style, but they disliked inflation. I sometimes wish Keynes had said as much about the evils of inflation as Lenin did. We would all be better off if he had. But in fact socialist economies were pretty sensitive to the inflation problem. Mr. Alkhimov, a predecessor of Mr. Gerashchenko at the Gosbank, told me 10 or 15 years ago, "You know, we deal with this monetary problem psychologically in quite the opposite way that you Westerners do. You are always worried about inflation and creating too much money, so you talk about the importance of an independent central bank. I have to tell you that the people who run the U.S.S.R. are very suspicious that those of us in the Gosbank will create too much money. So, we have to get permission from the Politburo once a quarter to agree to a proposed increase in the money supply that we think is appropriate."

It brought a vision in my mind somehow of the Open Market Committee meeting last Tuesday, **looking** at M2 and all the rest and **looking** at the economy, deciding maybe the money supply ought to be increased a little bit in terms of everything going on. But having to say, no we cannot make that decision right away. Mr. Greenspan will have to ask for an appointment with the President and go over and see Mr. Bush, maybe with Mr. Brady and Mr. **Boskin** in the background, and say, "Please Mr. President, the Open Market Committee has come to the conclusion that we would like to increase the money supply a little bit. Would that be acceptable to you in the Administration?" only to find a little growling on the other side! It is quite a different way of **looking** at things.

Well, inflation is part of the story, but it seems to me there is something else going on here. And the reason there is so much talk about central banking is that it is very much tied up with ideas of sovereignty, of autonomy, of discretion, and of economic **policy**-making. And here I guess I would cite no less an authority than Margaret Thatcher. She is not, I think, protesting entry into the European Monetary System—which might mean in some sense the dissolution of an independent Bank of England—because she thinks a Bundesbank-led consortium is going to create more inflationary problems than they already have in the U.K. No, she is worried about Queen and sovereignty and parliament and whether she is in control of things. And I think that is probably what Mr. Yeltsin thinks of when he talks about a central bank for Russia. And I think that is what a lot of people think of when they are **talking** about a central bank. It is not that Mr. Yeltsin wants a more solid rouble than the **U.S.S.R.**rouble. Rather, he wants some control over the destiny of his particular republic. So the essence of a central bank seems to be a little bit ambiguous. Sure, it deals with inflation, but it also has the authority to inflate. The very discretion implied by that term creates some ambiguity.

There are clearly some more mundane, more concrete reasons why nations want a central bank. These emerging market economies are **going** to want competitive financial systems, effective financial systems—that certainly go hand-in-hand with a market economy. They need some **kind** of a banking system. They had a banking

system, but it was not suitable for a market economy. But rather than starting from scratch, they took the big banks they had, broke them up, and created some commercial banks. And it is quite natural then to say that somebody has to supervise those commercial banks. We will take part of that old machinery and make a central bank out of it, and it has clearly got a role as a supervisor, a regulator, a lender of last resort. And I think starting from scratch in that particular case, the central bank may also have a self-interest in promoting and facilitating a market system in the financial world so that it itself can operate.

I think it is also true—a very much related matter—that there is a need for a more efficient payments system in the economies of Eastern and Central Europe. The central bank is a natural focus for achieving that objective. It is not the only focus you can think of, but it is a natural focus for improving the payments system. I think those things are true and they are all important. But again, I do not think they account for the urgency of all the talk about central **banking** in these economies. All those things I am talking about—supervision, regulation, payments system—lie somewhere in importance I suppose between a new telecommunications system and a new steel plant. They are very interesting and very important, but one would hardly have a conference attracting all you people to Jackson Hole to discuss them.

There is another much more subtle reason for central banks, a reason which may be on nobody's mind except mine. But let me just mention it because I think it grows out of observation of the experience of a good many countries. And it is a point that is seldom explicitly discussed. But I do not think it is just a figment of my imagination. Central banks around the world share certain common characteristics. They have a continuity of policy and staff and some degree of insulation—greater in some countries than in others—from the political process. It seems to me they are typically centers of economic professionalism and training within governments and sometimes within countries. And partly because of those qualities, they are a natural focal point for international contact and interaction—away from the political forums like summits and G7 meetings. All those things are quite important for the world at large and for

individual countries. I think it obviously varies a lot from country to country, but they can provide a very unique and valuable resource for a country, and I think particularly for a country in the midst of development and arrival on the world scene.

I would just give you two examples of the kind of thing I have in mind. One is south of us in Mexico, a developing country where the Bank of Mexico has clearly been a center of professionalism and education and responsibility for many decades—indeed, less so now because they have been so successful. The Bank of Mexico has supplied most of the talent to economic parts of the rest of the government. And I think another example on the continent of Europe is Italy. The Bank of Italy is not independent in any formal or legal sense. But in a country that has had a government that has not been characterized by an enormous amount of continuity, the Bank of Italy has provided a continuing focal point for effective and successful economic policy.

Well, none of that tells us precisely what a central bank ought to do about its primary job in an emerging market economy, which is something about economic policy. I am not going to get very complicated about that because I do not think it is really a very complicated question. I do not think there is any cookbook that supplies the answers to all of these countries across the board. I think judgments necessarily have to take account of political as well as economic factors. These factors have to be judged by the people there on the scene, people who are part of that political process, part of that economy.

But I think what can be said with some certainty is that given the kind of inflationary pressures inherent in the transition, if these central banks are going to be successful and if their countries are going to be successful in the transition, they are going to be tough. They are going to have to be tough—tough in the sense of keeping some kind of limits on the growth of money and credit **sufficient** to keep inflation under control. It seems to me that if price stability is not attained rather early in this process, establishing credibility and stability later on will become progressively more difficult, which could jeopardize the successful transition to a market system. There

are a lot of horror stories, particularly in Latin America, that I could cite to reinforce that point.

I do not think achieving that rather simple, direct, brutal, and maybe difficult purpose requires a lot of fancy tools. I would not counsel a lot of preoccupation with developing liquid government securities markets, futures markets, forward and options markets, or an efficient stock market. In fact, small countries may never have terribly effective markets in all those respects. I think there are positive advantages in fact, at this stage, in keeping as much of the intermediation as possible inside the **banking** system. You do not have to force feed financial market development. It will come naturally enough from abroad and from within. But I think there is going to be a lot of effort on training bankers and getting the commercial banking system to operate more effectively, in line with the needs of a market system. I also think interest rates are going to be very difficult to interpret and that money supply data are going to be difficult to interpret. This is not an area in which you are going to have much opportunity for successful fine tuning.

These are all considerations that point toward what may be thought of as fairly crude tools like convertibility and a par value system so it can act as an anchor to expectations. This **kind** of anchor would be a great help in making the point that stability is going to be maintained even if those particular techniques seem to diminish the discretion and policy role of the central bank. In fact they may provide the most practical guide to policies in the short run.

In conclusion, I think what all this talk about central banks ought to boil down to is this: It is crucially important to get the message through to the public **and the** political leaders that restoration of a sense of price stability is indeed vital to the success of this great experiment in moving toward a market economy. As a practical matter, it is true that building the independence and the stature of the central bank may be the best way to make that very simple point. That is the fundamental issue in talking about the role of central banking in these emerging market economies.