ESSAYS IN INTERNATIONAL FINANCE

No. 45, May 1964

PROBLEMS OF MONETARY CONTROL

JACOB VINER

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
Princeton, New Jersey

This is the forty-fifth in the series ESSAYS IN INTERNATIONAL FINANCE *published from time to time by the International Finance Section of the Department of Economics in Princeton University.*

It is also the fourth in a group of essays based on hearings held before the Canadian Royal Commission on Banking and Finance in the summer and fall of 1962, and published in this series with the permission of the Royal Commission. Permission to publish in no way implies that the Commission agrees with any or all of the views expressed. The International Finance Section published, as ESSAY *No. 42, the Memorandum submitted to the Royal Commission by the late Sir Dennis Robertson, with a foreword containing a description of the mandate of the Royal Commission and of the program of this Section to publish some of the Memoranda of Evidence. The Memorandum submitted by Dr. Marius Wilhelm Holtrop was published as* ESSAY *No. 43, and the Staff Paper prepared for the Commission by Professor Harry G. Johnson was published as* ESSAY *No. 44.*

The author of the present essay, Jacob Viner, a native of Canada, is Walker Professor of Economics and International Finance, Emeritus, of Princeton University. He has taught and lectured also at several other universities, including the University of Chicago and the Institut Universitaire de Hautes Etudes Internationales of Geneva. He is the holder of a number of honorary degrees, and in 1962 he was awarded the Francis A. Walker Medal, the highest distinction conferred by the American Economic Association.

Except for the opening section, which was presented to the Commission in written form, Professor Viner's testimony is here presented in a revised version of its original oral exposition, on September 19, 1962, with the elimination of the questions asked by the Royal Commission and considerable reorganization of the material presented at the hearings. Professor Viner's original language has been retained as far as possible.

The Section sponsors the essays in this series but takes no further responsibility for the opinions expressed in them. The writers are free to develop their topics as they will. Their ideas may or may not be shared by the editorial committee of the Section or the members of the Department.

The submission of manuscripts for this series is welcomed.

FRITZ MACHLUP, *Director*
International Finance Section

ESSAYS IN INTERNATIONAL FINANCE

No. 45, May 1964

PROBLEMS OF MONETARY CONTROL

JACOB VINER

INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

Princeton, New Jersey

L.C. Card 64-20652

Printed in the United States of America by Princeton University Press
at Princeton, New Jersey

CONTENTS

PART I—FORMAL STATEMENTS

A. Preliminary Statement Submitted in Writing

Monetary control would face difficult problems and would have far from complete probabilities of success in a modern advanced economy even if it had a single objective. But it is commonly today expected to serve, or at least not to conflict with, at least four major objectives:

(1) Stabilization of the price level;
(2) Maintenance of relatively full employment;
(3) Maintenance or restoration of balance-of-payments equilibrium, often interpreted to include maintenance of approximately stable foreign-exchange rates in relation to gold-standard or near-gold-standard currencies;
(4) Maintenance or attainment of a desired minimum national rate of growth, aggregate or per capita, a rate which may require not only full employment but also a higher ratio of capital formation or saving to national income than has hitherto prevailed.

In practice, economic controls in democratic countries must conform to what I will label as the "distribution" requirement, that is, they must not appear to be differential or discriminatory in their short-run impacts as between different sectors of the national economy, such as urban-rural, big business-small business, and so forth, beyond the limits of tolerance set by the prevailing distribution of political power. To some degree also there will be a preference for indirect over direct controls except in times of major emergency.

Except by fortunate coincidence, no economy can attain completely all of these objectives simultaneously. Monetary control by itself can, at best, make some contribution to the attainment of *all* of these objectives, but if it is to make the maximum contribution it is capable of to any one of these it seems in principle necessary that it be left free to give priority to that objective even when it conflicts in some degree with one or more of the other objectives. This does not mean that government as a whole must, grave emergencies excepted, surrender pursuit of any of the other objectives, but it means that it must seek their attainment in some degree and perhaps mainly through other measures than monetary control, measures which do not make impossible, although they may make more difficult, the attainment of the goal which has been assigned to the monetary authority as its primary goal.

If the monetary authority is to pursue effectively its prior goal while contributing as much as it can consistent with priority of that goal to the attainment of other national objectives, it must have the power to use several different instruments of monetary control, and to use them in combinations and with timing and intensity of use which are flexible. Even if it gave consideration to only a single objective, it is probable that it could not operate satisfactorily in conformity to a single, relatively simple formula or rule adopted by itself or assigned to it, but would need to exercise a considerable amount of discretion and judgment from day to day—or at least month to month—in deciding upon the form and intensity of its operations. The more objectives it tries to serve, the greater will be the range of flexibility required in the choice and manner of application of its various instruments, but the greater also will be the danger of blurring of objectives and of inadequate action in the promotion of its prior objective through disproportionate attention to other objectives which appear to conflict but which are not, and perhaps should not be, a major responsibility for it. It should probably try to formulate for itself an order of relative priority with respect to the different objectives, but it should not be required to accept the national order of priorities as also its own operational code if it is to have a reasonable chance of achieving in high degree the one or more objectives for which it has special responsibility. All other relevant agencies of government should be alerted to the degree of responsibility they have both for not unnecessarily creating difficulties for the achievement by the monetary control of its special responsibilities and for seeking modes of achievement of those objectives constituting their special responsibility which interfere as little as possible with the objectives of the monetary control and which even perhaps contribute to their achievement. Most important here, of course, are fiscal-budgetary policy and debt management.

I do not claim that it is possible even in theory completely to harmonize all the legitimate economic objectives of government, or even to escape occasional fairly serious conflicts between objectives which can be resolved only by compromising or temporarily abandoning one or more of them. No agency, however, should be asked—or encouraged—to abandon an objective which is a prior responsibility for it until a high-level decision of the government declares that there is no tolerable alternative.

It is in this general setting that the international aspects of monetary control need to be discussed. For Canada, as for any country, they can be realistically discussed only on the basis of some assumptions as to the relative degree of emphasis to be given to the respective objectives, as to whether it is short-run or long-run programs which are under discussion, and as to what instruments or methods are acceptable or unacceptable on grounds other than their potential effectiveness in promoting the assumed set of objectives. Of high importance also is the weight to be given to the international obligations of the country as part of a world community when these call for some modification or compromise of purely domestic objectives.

Special attention, of course, needs also to be given to the particular characteristics of the national economy which make its international economic relations differ in any important respects from those of other countries. Four characteristics may be perceived which significantly differentiate the Canadian from the American situation.

Because of its economic size and its role as leader in the world diplomatic alignment, the United States needs to give more weight to the impact of its policies on the outside world than does Canada.

Because of the role of the U.S. dollar as one of the two international reserve currencies, the United States has limitations on its freedom and power to change the gold value and the foreign-exchange value of its currency; from these limitations Canada is substantially free.

Because of its economic size the United States has to take into account much more than does Canada that any action by it which has an adverse effect on the outside world will lead to imitative, defensive, or retaliatory action by other countries.

On the other hand, its international transactions are for the United States a much smaller proportion of its total transactions than for Canada, so that in terms of the stability of its own economy the United States is much less dependent on and has much less need of adjustment to events outside its own territory than is the case for Canada.

It is in the light of these considerations that the selection of objectives, the relative priority given to them, the instruments used to serve them, need to be examined. The problems are numerous and complex, and the one general statement that can be made with assurance about them is that there is no simple formula which can be discovered which provides in advance a guide to the decisions to be made or a code of working rules by which to govern the execution of these decisions.

B. Opening Statement in Oral Testimony

The problems of keeping an economy in order are complicated by the fact that normally an economy has a fairly elaborate set of objectives, is not fully conscious of just what these are, and has never made a systematic effort to decide just what relative weight it will assign to each of these objectives in case of any need of harmonization or reconciliation to resolve the conflict. In addition to that, the management of the economy, in so far as government is managing an economy, is usually assigned on historical grounds among different agencies in a variety of ways, and they are never particularly carefully planned out. These agencies have acquired traditions of their own and on occasions policies of their own, about which they may be fully aware but of which the rest of government and the community at large may not be.

In addition, the modern economy has to bear with the economists. They are there with advice, recommendations and solutions, but they rarely stop to ask what are the objectives of the economy and what the advice is being given for, and they tend, as specialists, to have chosen a goal themselves and to advise means for attaining it to the utmost, without very much consideration for the possibility that there may be other and conflicting goals.

Still another burden the modern economy has to bear is the confidence existing today in the possibility of quantified prophesying of future trends. Such prophecies command a degree of confidence which is not justified philosophically or historically. I do not have to go very far afield in time or place in order to find rather striking instances of over-confidence in statistical anticipations for the next few years, or next decade, of how an economy is going to operate.

In order not to choose an illustration too close to your home, I will cite the American experience in just this year 1962. What I think is probably the most ably staffed body of economic advisers the United States has ever had, for whose general technical skill I have the greatest admiration, started out early this year, with full confidence, to predict what the gross national product would be and what the course of the employment trend would be during the year. It took just a few weeks for these forecasts to show signs of having been sour, and now it is clear that they were very sour. Next year they will be prophesying in the same way, with unimpaired confidence in their skill. The forecasters are doing as well as human beings can, except for the readily available alternative of remaining silent.

They are attempting a performance for which there is no logical justification. The justification they present is highly technical, skilled, and highly learned, but it is relevant only to a world in which events are not the result of relatively few decisions by a relatively few powerful men, or are not dominated by a small number of variables. The techniques are suitable only for physical phenomena determined by a great number of variables which are substantially homogeneous and coordinate in weight, and where the universe as a whole is a stable one. This is not what a modern economy is like.

I am not saying: Don't look forward; don't take a long view. I do think you can foresee a lot and predict a lot, but impacts, not outcomes or events. You can predict, for instance, that if you use the printing press very heavily the direction of your impact on the national stock of money and the price level will be upward and not downward. The economists and the statesmen can predict, within limits, the direction in which a particular act of legislation or a particular event impinging on your economy from outside is going to affect or influence the economy.

What I believe neither the economist nor anybody else can forecast is what I call "events," which in combination constitute the whole conjuncture of the state of an economy. That conjuncture is always the result of a substantial but not unlimited number of variables which shift in importance through time, which are unstable through time. What we know, within limits which are unfortunately not narrow, is that a certain kind of action will produce an impact in a certain direction, but there may simultaneously occur other actions operating in the other direction, so that the net effect may be the reverse of the impact of the first action. I would not call this a false forecast, in that sense, if its limitations are recognized in advance and if "impact" and "event" are distinguished.

In addition to this is the problem in government of assigning functions to agencies. If the government has, as it will inevitably have, a fairly large set of objectives; if it has, as I say it will have, inadequate awareness of what these objectives are; if it is in doubt as to what relative weight to assign to these objectives; how does it assign mandates to its agency, particularly if it wants it to work under a very specific mandate, according to a rule or body of rules or a strict code? How can you reconcile plural and inconstant objectives with specific and constant mandates?

Basically, I think you cannot reconcile these, and you therefore have to feel your way by trial and error, using all the information, judgment, and wisdom you can marshal.

There is one thing you can adopt, as a pattern, or a general idea, which I think is very pertinent to the question of deciding what are the functions of a central bank.

A government, or a community, can make up its mind, substantially, that there is a certain goal to which it attaches great importance, so that it will stand by that goal and support it, even though at times it will seem to be conflicting with some other cherished goal or goals.

Let me assume that that goal is stabilization of the price level, of the purchasing power of the Canadian dollar. There may have been assigned to a central bank the function of using, to the best of its abilities and to its utmost powers, in the pursuit of this goal, all those tools which it is permitted to use in its operations. Then the mandate, if it were carefully framed, would indicate whether it is a long-run or a short-run assignment, or both—because it would be important for the operator to know. The central bank would have to be told: we do not expect you to assume responsibility for all the goals this country has. You should try to become aware of what they are; you may have alternative modes of operation, which will interfere in different degrees with other national objectives, and if such is the case, you should take this into consideration in choosing your procedure. But your assignment, until further instructions are received from government, is to do what you can to maintain a stable price level. The treasury may have other objectives which conflict pretty sharply. If they make your task harder, then work harder. If the treasury chooses, let us say, to finance on the basis of short-term maturities to lower the interest burden of the debt, whereas in the interest of the goal of stabilization of price levels long-term maturities would be more appropriate, then, whatever instrument the central bank chooses to use, it should use it more intensively to counterbalance the adverse impact on the price level of the treasury action. In other words, if it is national policy that an official agency pursue a particular goal, it must be permitted to operate at times against the immediate short-run objectives of some other agency of the government.

I take as an illustration debt management as an instrument which can be made to serve the objectives of a central bank, and yet for which a ministry of finance will often, and I would say inevitably, have in some degree different and conceivably conflicting objectives.

The internal objectives of a ministry of finance are sometimes very strange to look upon for an economist who is thinking only of the economy of a country as a whole. Very often the major goal seems to be to try to minimize the interest cost of the debt to the national economy. To me this seems the most minor of objectives, in the light of other goals which the economy, thinking of its problems seriously, would take into account, like price stabilization, full employment, ironing out the business cycle, and so forth.

It is possible, within limits, for a ministry of finance to have a debt-management policy which goes quite counter, say, to price-level stabilization, and for a central bank to pursue honestly and effectively a price-stabilization policy, and yet to eliminate inter-agency conflict.

I believe that the British pattern of operation, in principle, achieves this fairly systematically. As I understand it, the British Treasury decides independently what the maturity of its issues is going to be, as far as it is concerned, but it is the Bank of England which decides what the real maturity of a new issue is going to be, as far as the outside public is concerned; it takes over the issue, buys as much of it on its own account as it wants to, sells the rest of it to the public, and matches its own investment in that issue by sale of some other issue of a different maturity which it had in stock. The manipulation of the average maturity of the public debt held by the public is potentially a rather important instrument for monetary management. I think it has been underutilized because ministries of finance have had other objectives than monetary management and central banks have not been authorized or willing to neutralize the impact of the treasury's actions on the effective maturity of the debt by counteractions with respect to their own holdings. I would make more elaborate distinctions were this an operation recommendation, but in brief, I distinguish between the average maturity of the debt as the treasury issues it and the effective maturity, or the average maturity of that portion held by the public. The former, under my scheme of management, is of very little consequence except to the treasury itself. Most important is the average maturity of the debt in the hands of the non-banking public.

The point I want to make is that when there is a conflict of functions or goals between two agencies it may nevertheless still be possible for the central bank to accomplish the goal or objective which it regards as important. The central bank would need to be equipped with assets, and included in those assets of a central bank is the key asset of the printing press and also of the machine to cancel money.

Suppose the issue by the treasury is a long-term issue at a time when the central bank would like to have the average maturity of the debt as a whole shortened rather than lengthened. The bank absorbs the long-term issue heavily and refinances itself by selling some short-term bills it has on hand. The total holdings of government securities by the central bank might not change by one dollar. The treasury is happy because it has accomplished its purpose. The central bank would be reasonably happy because the state of its own finances is not important, or should not be, either to it or to the country. What it has done internally is to shift its holdings of government issues as between maturities. What it has done to the economy is not to permit the government financing to change the average maturity of the debt held by the public.

Now let me turn to another case where goals may be in conflict. Say a government has a balance-of-payments deficit. There are many alternative ways of curing a balance-of-payments deficit, whose relative merits depend on what you want. For many persons the most significant aspect of a short-term balance-of-payments deficit is that it puts downward pressure on the foreign-exchange value of the national currency where that is not held fixed or rigid. If, however, the economy is not very much concerned about the value of its currency on the foreign exchanges, then obviously that would not be a very significant concept for it, and it would want some other concept of balance-of-payments deficit, or pressure, or disequilibrium. It is a little inconsistent for a country that does not care about the stability of its foreign rate of exchange to care about its holdings of foreign liquid assets, because the immediate function of foreign liquid assets is to give you a means of meeting a pressure on your exchange when you do not want it to express itself in its natural way.

Many economists regard concern about the movement of the rate of exchange as substantially illegitimate, on the ground that the exchange rate should be left free to reflect in an orderly but flexible way in a healthy market pattern the relative status through time of your economy vis-à-vis the rest of the world. One can present a very persuasive argument for that in terms of "free-market" theory, because a rate of exchange is a price, and it is the function of a price to equalize the relevant demand and supply on the market. When the foreign-exchange rate is left flexible and unmanaged, it is a free price in a free market, and its fluctuations, therefore, must be presumed to accomplish a valuable social service. Therefore, you ought to let the foreign exchange "float."

On the basis of a set of somewhat ethereal assumptions, which abstract from many of the facts of the universe, of the actual world, I am a believer in a free market and in the useful function of flexible prices. That is where my biases lie.

However, it so happens that there are no two prices, probably, that are exactly similar or homogeneous in the world in the manner of their behavior and determination. In any case, the price of a national currency in terms of other currencies is a very peculiar sort of price in a number of respects. In the first place, it is ideally constituted for speculation. A national currency can be absolutely without homogeneity through time but usually is an absolutely homogeneous commodity at any one moment. A person in another country knows exactly what he is buying when he buys a Canadian dollar, at least for the moment. Therefore, it can be marketed easily, with no necessity for inspecting the particular parcel. This is, I believe, a little more than you can say even for number one Canadian hard. There is no problem of varieties of grade or quality in that sense.

Secondly, there are no tangible or definite limits to the range of the possible future exchange value of a floating currency. It is not tied