

W A Wijewardena: Central Bank – why “economic and price stability”?

Speech by Mr W A Wijewardena, Deputy Governor of the Central Bank of Sri Lanka, at the Association of Professional Bankers, Colombo, 23 March 2007.

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An amendment effected to the Monetary Law Act in 2002 requires the Central Bank of Sri Lanka to pursue “**economic and price stability**” as one of the two core objectives of the Bank. This is somewhat a departure from the central banks in the rest of the world which have been mandated to attain only “**price stability**”. Hence, it may be puzzling to many whether the Central Bank of Sri Lanka has been given an additional objective to attain. It is, therefore, timely to identify the precise meaning of this phrase “economic and price stability” in the context of a central bank.

The amendment to the Monetary Law came as a part of the modernization program which the Bank commenced in 2000. One of the essential ingredients of that program was to update the Monetary Law to be on par with the emerging global best practices. Up to that time, the Central Bank had been entrusted with a multitude of objectives: attaining price stability, participating in economic development, preserving the external value of Rupee, protecting banks from collapse and maintaining the financial system stability etc. These objectives were not very clear and were often in conflict with each other. They also posed difficulties in monitoring the progress or assessing the success. Many critiques had pointed out, and the technical staff in the Bank had experienced, that the Bank could not succeed in its main task of taming inflation and bringing about price stability, if it was saddled with other tasks that would go against its main objective. Hence, there emerged a general consensus that the central bank should do only what it can do effectively and not otherwise. That consensus required the Central Bank to pursue a single objective, viz., the attainment of price stability.

Following this consensus that emerged through the consultative process involved in the modernization, the technical staff of the Bank proposed an amendment to the Monetary Law by mandating the Bank with the task of attaining two core objectives. They were the attainment of both “price stability” and “financial system stability”. When the draft law was submitted to the then Governor, Mr. A. S Jayawardena, for clearance, he had changed the “price stability” to “economic and price stability”. The puzzled and bewildered technical staff flocked into his room seeking a clarification, since it was not in line with the accepted international trend. The writer recalls that even the Resident Representative of the IMF too was puzzled by this seemingly inappropriate mandate being added to the Bank’s objectives.

But, Mr. Jayawardena, assuming his usual erudite and serious posture, offered a different explanation which had never occur red to the technical staff. The writer recalls him saying “...if you have only price stability, then you would fall into the trap of attempting to stabilize a price index which is not what is meant by price stability, in the context of a central bank. The attainment of price stability for a central bank means elimination of both excess demand and excess supply in the market so that the market is free of potential inflationary or deflationary pressures”

At that time, many in the Central Bank, including the present writer, did not fully understand the wisdom enshrined in that statement. It even led to confusion by many that the Bank had been mandated to stabilize the growth rate as well, in addition to the stabilization of prices. Accordingly, some even charged that the Bank had failed in its tasks, when there was a negative growth in the economy in 2001. In hindsight, it can now be discerned that Mr. Jayawardena’s wisdom was to present the price stability in its totality rather than as a sub part of the issue.

We could illustrate this point as follows:

An economy produces goods and services, numbering millions, for use by its members. The total of these goods and services, when they are offered in the market, is called **the aggregate supply**. This aggregate supply consists of real goods and services which the users can consume or use as inputs for further production. Hence, it is known as a **real quantity**, quite distinct from an imagined or assumed quantity. This real quantity has to be exchanged among members of the society. Since it is practically impossible to trade one commodity for another commodity in a modern complex economy, there arises the need for adopting a common medium of exchange. “**Money**” offers the service of this common medium of exchange at the cheapest cost to conclude the transactions running into billions.

Money, unlike the real commodities, is a peculiar animal. Its usefulness arises from its ability to acquire real goods and services which people can enjoy. If money does not have this ability, no one would be interested in having money. Hence, the value given to money is simply an **imaginary value**. As a result, money bears a **nominal** feature, as against the real feature borne by other goods and services. That is why any value measured in terms of money is also known as a **nominal value**.

We may illustrate the role played by money in an economy by considering the operation of a **simple economy** where there are only **two commodities**, say, coconuts and money. Everybody has to use money to get coconuts or use coconuts to get money so as to store their wealth (for getting coconuts in the future).

Suppose there were 10 coconuts and 100 units of money. Then, each coconut has to be exchanged for 10 units of money per coconut. Now, suppose, through a miracle, the money endowment of people doubles to 200 units, while the number of coconuts remains unchanged at 10. Then, the price of coconuts in terms of money rises to 20 units from the earlier 10 units. What has happened here is that when the amount of money doubled, while the production of coconuts had remained unchanged, the prices too have doubled.

What would happen to the price level, if the number of coconuts too doubled along with the doubling of money? Then, 20 coconuts would be exchanged for 200 units of money. Hence, the price level would remain unchanged at 10 units of money per coconut.

Now, suppose that the number of coconuts doubles to 20, while the amount of money remains at 100 units. In this case, the price level has to fall from 10 units of money to 5 units of money.

Let's consider one more possibility. Suppose that there has been a merciful hurricane and it destroys exactly a half of the original number of coconuts, leaving the balance half intact for use by people. Now, in this economy, there are only 5 coconuts against 100 units of money. It is not difficult to discern that the prices would rise to 20 units of money per coconut. What would happen if the amount of money too is raised to 200 units in this scenario? Then, the price of coconut would skyrocket to 40 units of money.

What was considered here was a very simple economy for ease of clarity. But, the broad results derived are equally valid to a modern economy with billions of transactions. These results can be summarized as follows:

First, if the money supply increases, while the output remains unchanged, then, the general price level will tend to increase.

Second, if the money supply increases at the same rate as the increase in the output, then the general price level remains unchanged.

Third, if the money supply does not increase, when the output has increased, then, the general price level will fall.

Fourth, if the money supply has remained unchanged or even raised when the output has fallen (a negative supply shock), then the prices would rise to a still higher level.

In the above example, coconut constituting real output represented the aggregate supply of goods and services, measured in real terms. The total amount of money in the hands of the people represented the demand for coconuts. Since the money value of coconuts is an imaginary concept, that demand could be described as the nominal aggregate demand for goods and services. What would happen to the general price level will depend on the interplay of these two demand and supply forces.

The rest of the analysis follows the normal **microeconomic theory**. If the aggregate demand is higher than the aggregate supply, there will be an excess demand in the economy. That excess demand will generate pressure for the general price level to rise. Similarly, if the aggregate supply is higher than the aggregate demand, the resultant excess supply will put pressure for the prices to fall. Then, it follows that, if someone desires to have price stability, he should try to equate the nominal aggregate demand with the given real aggregate supply.

The price stability, in the context of a central bank, means the maintenance of a zero excess demand or excess supply in the total economy, commonly known as the **macro economy**. In that situation, all incentives for prices to rise or fall are non-existent. What is meant by economic stability in the broad objective of the Central Bank is the attainment and maintenance of this state. A central bank cannot be complacent until it has attained this level of stability. The way to attain that level of stability is to control the nominal aggregate demand by controlling the main force affecting that aggregate demand:

the quantity of money in the hands of people. This is because in the long run, the general price level moves exactly in accordance with the movement of money supply. It led the Noble Laureate **Milton Friedman** to remark in his Noble Laureate Oration that “inflation is always and everywhere a monetary phenomenon”.

What are the manifestations of the absence of that level of stability? There are two manifestations.

First, people on average may not expect the general price level to remain stable in the future. They make that expectation by considering the past trends and what is happening right now. If they expect that the prices on average would rise, then, they can be said to be harboring high inflation expectations. A central bank can gauge this situation by conducting periodical **inflation expectation surveys**.

Second, **a consumer price index**, compiled to measure the changes in the cost of living of a given group of people, may show a continuous increase over a substantial period of time. It indicates an unstable situation in the macro economy leading to an upward movement in the general price level.

The presence of either situation requires a central bank to go into action against fighting inflation. This means that, even if the consumer price index shows stability or a relatively low growth, the central bank cannot stop taking inflation fighting measures. What a central bank should do is to eradicate the cause rather than pampering with the symptoms. It is similar to a physician who does not take delight when he observes that the high fever of a patient has subsided. The physician would not stop his curative treatment, until the cause of that high fever is totally eliminated.

There appears to be a general tendency for equating increases in the **cost of living** with inflation. An increase in the cost of living occurs when the basket of commodities consumed by a given group of people entails a higher cost. As mentioned earlier, this is measured by compiling a consumer price index. A central bank cannot do anything about the increases in the cost of living, since it does not produce goods and services. That is why **John Exter**, the founder Governor of the Central Bank, remarked in his very first press interview that “...the Bank does not itself produce goods and services. It will facilitate it by creating right monetary conditions ” Implicit in these “right monetary conditions” is the need for attaining economic and price stability in its totality.

Inflation is a much wider phenomenon than the cost of living. It entails the absence of stability in the macro economy leading to an increase in all the prices at the same time. A consumer price index measures the price impact on a consumption basket consisting of only consumer goods. In contrast, inflation occurs when the prices of all goods, consumption, intermediate, investment and inputs, rise at the same time. It elevates the general price level to a higher level, including those of the consumer goods.

The above misunderstanding may lead to the pitfall of a central banker trying to stabilize the value of a cost of living index through artificial means. It can be attained by fixing price ceilings or granting price subsidies. But, it does not cure the malady of generally rising prices generated by rising nominal aggregate demand over the real aggregate supply. A subsidy could ease the burden on the cost of living of a given consumer or a group of consumers. But, if the subsidy is financed by incurring a loss elsewhere, it does not help to fight inflation. That is because at the place where the loss is incurred, there exists a deficit supply creating pressures for prices to rise. Similarly, price controls may keep the cost of living index under control. But, as long as there is excess demand in the macro economy, it does not help to contain inflation.

Then, what about negative supply shocks such as a temporary fall in the output of agricultural products or increases in the prices of imported goods? They would reduce the real aggregate supply creating an excess demand in the macro economy. It would lead to the increase in the prices of certain consumer goods raising the cost of living of those who consume them. But, that is not inflation. For these one-off events to become inflation, the nominal aggregate demand should also rise continuously over the real aggregate supply. In other words, the macro economy should be characterized by the presence of an excess demand for goods and services. The elimination of this excess demand is the path for curing the malady of inflation.

When there is no excess demand or excess supply, then, the macro economy is said to be in balance. Such a balance eliminates the pressure on prices to change. The public having observed the general stability in the overall price level would form low expectations on future changes in the prices. This would lead to future price stability as well. For this to happen, all sources of increasing money in the hands of people should be constantly kept under control. This is the wisdom enshrined in “economic and price stability”.