W A Wijewardena: John Exter – central banker for all times

Article by Mr W A Wijewardena, Deputy Governor, Central Bank of Sri Lanka, on the first anniversary of the death of Mr John Exter (Founder Governor of the Central Bank of Ceylon/Sri Lanka), issued to Sri Lankan newspapers, 28 February 2007.

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The first death anniversary of **John Exter**, Founder Governor of the Central Bank, falls on 28th of February. He died in 2006 after living a very productive life for 95 long years.

John Exter can be regarded as one of the history makers in modern Sri Lanka. He lent his wisdom, intellect and experience, without any reservation, for the establishment of the Central Bank of Ceylon, the name of the Bank at that time. The Bank was established in 1950 on the basis of the recommendations made by him as a one man committee, the report of which is now known as the ***Exter Report***. He made history once again by becoming the governor of that maiden bank at the young age of 39, an age normally considered as too low for that prestigious and demanding position. His task was to establish the bank, staff it and lead it in the first few formative years, so that it could eventually be taken over by a Sri Lankan management. His history making did not end there. As undertaken by him at the time of appointment, exactly after three years, he relinquished his responsibilities as governor to pave way for a Sri Lankan to occupy that high post.

The Central Bank is, forever, deeply indebted to John Exter. The rationale and philosophy of the central bank which he evinced in his report in the late 1940s are equally valid for today as well. His report is unique in that sense, because it carries a justification of each and every section of the Monetary Law, so that the later generations of central bankers would not have any ambiguity of what was meant by them. As a result, even today, the Exter Report is used by both central bankers and academics as their bible. Hence, by any standard, Exter is a central banker for all times.

The appointment of John Exter to a one man committee on the establishment of a central bank is also marked by an interesting legend. Edmund Eramudugolla, a former Senior Deputy Governor of the Central Bank, has narrated this legend in his ***Reminiscences of the Central Bank of Sri Lanka***. According to him, the government of newly independent Ceylon decided to replace the Currency Board System which it had inherited from the British with a more flexible central bank. Accordingly, the government decided to seek foreign assistance to prepare a blueprint for a central bank based on the country's specific position and future prospects. However, for reasons not very clear, this assistance was sought from USA and not from the UK, the traditional advisor of the country. Thus, the Federal Reserve Bank of New York was approached by the then Minister of Finance, J. R. Jayawardene, to obtain the services of a suitable consultant. The Bank, in turn, informed the government that it could not release its best consultant, namely, David L Gosse, for this purpose, because he had been occupied in some other assignment at that time. Gosse was considered the ideal expert for the job, because he already possessed the required experience for the job at hand by pioneering the work relating to the establishment of the Central Bank of the Philippines. However, Gosse was kind enough to recommend his assistant, John Exter, for the job. Hence, Exter was not the first choice, but an engagement done by default. Yet, the wisdom, erudition and professionalism shown by Exter in both making the recommendations and subsequent running of the Bank, is a testimony that he was the correct choice for the job at hand.

John Exter had an illustrious academic as well as professional career. After graduating from the College of Wooster, he completed post graduate work at both the Fletcher School of Law and Diplomacy and Harvard University. After a brief stint at MIT during World War II, he joined the Federal Reserve System as an economist. Then, in 1948, he was on release to serve the Government of the Philippines as advisor to its Secretary of Finance. It is from there that he came to Ceylon as the consultant on the establishment of a central bank, still on release from the Federal Reserve System. After serving his term as Governor of the Central Bank, Exter did not return to the Federal Reserve System. Instead, in 1953, he joined the World Bank and was offered the position of the division chief for the Middle East. After a year with the World Bank, he came back to the Federal Reserve System as its Vice President on international operations at the Federal Reserve Bank of New York. His career at the Federal Reserve System ended in 1959 when he decided to join the First National City Bank which later became the Citibank. From 1960 to 1972, he was the Senior Vice President of the Citibank in charge of its relations with foreign central banks and governments. With a huge fortune made on the gold market by using his own expertise on the foresight of irresponsible central banking and its inevitable consequences, Exter took an early retirement in 1972 and went into private consultancy work.

According to his own admission, the prospect for his fortune on gold dawned on him after a friendly debate he had in 1962 with his one time Harvard buddy and Nobel Laureate Paul Samuelson. In that debate on why the dollar was becoming weak and USA was losing gold, Exter gave his diagnosis which was based on his experience with the Federal Reserve System. "***Paul, it is very simple. The Fed is printing too many dollars and they flow out of the country into foreign central banks who demand gold***" Exter is reported to have said. But, Paul Samuelson did not accept it and wanted to explain the malady in terms of productivity differences between USA and other countries, namely, Europe and Japan. Samuelson's thesis was that the latter category of countries had a higher productivity than USA and therefore the dollar was becoming weaker. Exter says that he countered Samuelson saying that Japan was in more trouble than USA, because *"**the Bank of Japan was running its printing press even faster than the rest of the central banks around the world***" Exter had decided then and there that the irresponsible government expenditure by the Kennedy administration could not keep the dollar stable in the long run and one day, gold would become the preferred asset by the world's nations. Hence, he says that he converted all his savings into gold based assets and waited patiently. He was amply compensated in 1971 when the US government was forced to sever dollar's link with gold under the gold exchange standard and allow the gold prices to be determined in the free market. Overnight, gold prices doubled from $35 per ounce to $70 per ounce. So did the gold based assets portfolio held by Exter.

This wisdom which Exter demonstrated in his practical life could be discerned throughout the Exter Report and his later writings. He belonged to the old guard of economists who believed that economic prosperity cannot be attained by printing money. This was indeed going against the popular tides of the late 1930s and 1940s. At that time, Keynesianism had been accepted by the mainstream economists on both sides of the Atlantic as a new religion. It explicitly advocated the desirability of deficit financing as a strategy for attaining full employment. Exter doubted the validity of this claim both in his public speeches and writings. At one stage, even Paul Samuelson had teased him that 'though Exter may be right, he was lonely in his opinion'. The fact that there were no supporters for his view did not prevent Exter from making public what he believed to be true. On the very first day of the establishment of the Central Bank of Ceylon, in a press interview he gave as the first Governor of the Bank, he warned against the use of the Bank for things which it cannot fulfill.

"Today, we can only be filled with high hopes for the future. It would be a mistake to expect startling results immediately from the establishment of the Central Bank. There is no financial wizardry by which the Bank can suddenly pull out of a hat a higher standard of living for everybody. The Bank's contribution must necessarily be a long-run contribution. The Bank does not itself produce goods and services, but it should, by creating the right monetary conditions enable the country…" to do so.

What Exter repeatedly maintained was that the Central Bank was only a necessary condition for future prosperity. That necessary condition was to be created by maintaining price stability so that the economic agents could make economic decisions based on long run prospects. Since the central bank does not produce goods and services, it cannot directly get involved in economic activities. It is therefore the task of the government and the private sector to take appropriate measures to create wealth in the society. The Central Bank's only weapon is to print money and such money, by changing the price levels, acts only as an illusion. Hence, Exter thought it necessary to warn those who had been harboring the Keynesian type of ideology to raise governmental expenditure through printed money.

In the Exter Report, he argued that higher income created through money creation would simply stimulate consumption of imported goods and precipitate serious balance of payments difficulties. Given the underlying domestic production capacity, deficit financing may be an efficacious policy in developed countries that are largely dependent on foreign trade. But, it would not be the case with a developing economy. Hence, the Exter Report highlighted that, ***"this should serve as a warning to those who might hope that some of the policies growing out of Keynesian economics can be uncritically adapted to Ceylon***". As a safeguard, a provision was included in the Monetary Law prohibiting the Central Bank to engage in trade or otherwise have a direct interest in any commercial, industrial or other undertaking. In Exter's opinion, such interests would lead to money creation, generate conflicts of interest and prevent making investment decisions based on hard-core economic principles. As such, Central Bank's involvement in economic activities would be sub-optimal.

A central bank, by nature, is in a position to acquire assets by creating liabilities. These liabilities take the form of new money issued by a central bank. Hence, any asset acquisition by a central bank is done at the expense of its main objective, namely, price stability. As such, a central bank should not pursue profit making as a goal. Technically, profit seeking has no meaning, because a central bank could make any amount of profits by inflating the economy. Hence, profits may arise from the central bank's activities as a side product, but they do not form the main business of a central bank. As a result, a special procedure has to be adopted for the application of the profits of a central bank. Exter knew this requirement very well. In the Exter Report, he has argued that the Central Bank's profits deserved special attention because of the inflationary or deflationary effects which their payment or non-payment could have on an economy. He has recognized that when such profits are paid out and spent by the government, they would find their way into the reserves of commercial banks raising their multiple credit creating capability. In order to minimize the ill effects of using a central bank's profits for government expenditure, Exter has made special provisions in the Monetary Law regarding the application of profits of the Central Bank. Accordingly, out of the surpluses of the Central Bank, the first charges should be to build the reserves of the Bank to support the currency it issues. Any remaining balance should be utilized to retire the government's borrowings from the Central Bank or paid into the government as a normal profit transfer. However, it has to be done collaboratively by the Minister of Finance and the Monetary Board, having taken into account the inflationary impact of each such measure. As such, the government does not have the first claim on the profits of the Central Bank, though it is owned by the government. The profit criteria that are applicable to other governmental institutions are, therefore, not applicable to the Central Bank.

A general concern which has often been raised at numerous public fora has been the existence or the absence of the independence of the Central Bank. Many have found fault with Exter for making the Secretary to the Ministry of Finance a member of the Monetary Board. They have argued that this official member with his own self interest in funding the government expenditure programs would use the opportunity to dictate terms to the Monetary Board, thereby permitting the fiscal policy to override monetary policy. It has been equated by some critics to the case of permitting a child to put his hand into the cookie jar as many times as he wishes. While these criticisms may have some validity, Exter's wisdom has been to create an environment for both the government and the Central Bank to have a peaceful and amicable cohabitation. Exter has argued in his report that ***"...there are, however, many important problems of monetary policy, especially those relating to fiscal policy, on which a central bank should work in close harmony with the government"***. Accordingly, a degree of independence has been afforded to the Central Bank unlike other governmental bodies. This independence extends to the budget of the Central Bank, job security of the key central bank officials, and power to make monetary policy without consulting the government. The wisdom of Exter was that the central bank should as far as possible work in consultation with the government, rather than in isolation. He believed that the true independence of the Central Bank could be preserved only through that consultative method. In the words of Exter, **"*the ideal is … one in which there will be continuous and constructive co-operation between the Monetary Board and the government. The principal instrument for achieving this co-operation should be the Permanent Secretary to the Ministry of Finance whose membership on the Board will ensure at all times that his Minister's views will be made known to the other members of the Board*"**. However, Exter did not expect this arrangement to be effective at all times. Hence, he made the proviso that **"*it would depend on the men occupying the key positions*"** and not on any legal formula. He argued quite correctly that such complex and delicate relationships cannot be established full-blown by a piece of legislation. It must be the result of years of experience and the slow growth of political conventions.

The writer has been questioned on this point on many occasions at numerous public fora. The position taken by him agrees fully with that of Exter. This position requires the critics to compare central bank's independence with the relationship within a family unit. Both spouses have their personal interests, but work together for the well-being of the family unit. There are at times occasions where one spouse overrides the other. But, as a normal rule, the family unit moves forward without publicizing those internal family debates and sometimes family fights.

This is the main lesson which Exter has left for us in the twenty first century. That is, both the Governor of the Central Bank and the Secretary to the Ministry of Finance should know their rights and responsibilities well and act on an ethical platform in which they continue to appreciate the distinctive roles to be played by them for the well being of the country.

John Exter, in his wisdom, firmly believed that when laws fail, human beings working with **moral consciousness** could do wonders.