Ajith Nivard Cabraal: Developments in the evolution of central banking and challenges faced by central bankers

Inaugural speech by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, at the International Course on Central Banking organized by the Centre for Banking Studies, Colombo, 22-23 May 2007.

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Ladies and Gentlemen,

I am pleased to be here to address you at the opening ceremony of this international course on Central Banking. Let me also welcome all the participants to the course and extend to the participants from overseas countries and Prof. Sinclair, a very warm welcome to our country.

The Centre for Banking Studies(CBS) has provided training opportunities for officers in the financial sector in Sri Lanka over the last 26 years. It also has past experience in coordinating a number of international programmes of the SEACEN Centre, APRACA and World Bank held in Sri Lanka. Also several officers of central banks in SARRC countries have participated in the scheduled programmes of the Centre, though they were not specially designed for an international audience. This Central Banking course in fact is the very first international programme designed and conducted by CBS. I am glad that there are 14 overseas participants at this first programme. I congratulate CBS for successfully organizing it. I am sure that there will be more overseas participants in the forthcoming international programmes. Our plan is to invite eminent resource persons to conduct these international programmes. I am glad that we were able to have the service of Prof. Peter Sinclair of university of Birmingham who h as served as Director, Centre for Banking Studies, of the Bank of England to conduct this programme.

Ladies and gentlemen, let me highlight some interesting developments in the evolution of central banking and some challenges faced by central bankers.

The role of central banks has evolved over past several decades. You may recall that the original task of central banks was not the conducting of monetary policy or supporting the banking system but financing government spending. The oldest central bank of the world, the Bank of Sweden was established in 1668 largely as means to finance military spending . The Bank of England was said to have been created in 1694 to fund a war with France. Even as recently as late 1940's a labour chancellor of the exchequer, Stafford Cripps was said to have described the Bank of England as " his bank". Today, it is a taboo for most central banks to finance government deficits.

Most countries have managed their affairs without a central bank for a long time. At the beginning of this century there were only 18 central banks. The USA managed without a central bank until 1913. Private banks issued their own currency notes and coins and banking crises were fairly frequent. The Federal Reserve Bank of USA was established mainly to supervise banks and act as lender of last resort. Today, only a few central banks, including Fed Reserve is still responsible for bank supervision. Others have handed this job to a separate agency.

In the 1960's the conventional economic wisdom was that monetary policy could reduce unemployment and directly promote economic growth. The theoretical basis for this was provided by the famous Phillips curve, which depicted an inverse relationship between inflation and unemployment in Britain; when unemployment was high inflation was low and vice versa. This appeared to have suggested that central banks could permanently reduce unemployment by tolerating a bit more inflation. In fact, many countries attempted to do so. We all have our experience in attempting to directly promote economic activities by releasing high powered money through various credit schemes and direct involvement in development activities. However, at the end we had more inflation, either visible or hidden, without an appreciable reduction in unemployment or improvement in growth. In fact, the rate of inflation associated with a given level of unemployment had risen through the 1970's and policy makers had to abandon the Philip curve.

This in fact was predicted by Milton Friedman and Edmund Phelps who challenged the Phillip curve. As they pointed out, the trade off between inflation and unemployment was only short term. As soon as people come to expect higher inflation they would demand higher wages, and unemployment would rise again . There is no trade off between inflation and unemployment. In the long run, monetary policy could influence only inflation. Today most central banks are concentrating their monetary policies on maintaining price stability; and maintaining inflation at lower stable levels.

John Exter, founder Governor of the Central Bank of Sri Lanka emphasized on the very first day of 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 ”.

Central bankers would like very much to have the ability of a captain or a pilot who knows exactly where he is heading, how his craft (i.e. economy) works and how his actions affect it course. Unfortunately we do not have that ability and as observed by some, we are more like early navigators who operate in a world of huge uncertainty with no reliable maps or compasses. Because of lags in the availability of statistics, we cannot know precisely, all the information we need. Policy instruments in our possession operate with time lags which are also not entirely precise. Over the years, we have acquired powers and independence, but there are limitations in any central bank’s ability to steer its economy with precision. Hence, central banking indeed is a challenging task, which requires continued efforts to explore how our economies work and how our policy instruments operate.

There is a school of thought that suggests the sole objective of central banks should be price stability. Accordingly many countries have adopted the inflation targeting approach in their conduct of monetary policy. Price Stability indeed is essential for sustained economic growth and there is no argument that it should be pursued. Moreover, the inflation targeting approach has the benefit of building up the credibility and commitment of a Central Bank. However, there is a risk that central banks may concentrate on achieving price stability as measured by a consumer price index, which may not necessarily guarantee economic and financial stability. With globalization and improvement in productivity, there has been a general tendency for inflation to remain relatively low. Though, price stability in terms of a consumer price index is achieved, there could be other imbalances arising from excessive demand pressure which may be reflected in assets price inflation and external payment imbalances. There could also be a danger of developing deflationary conditions which depresses growth. Therefore, it is important that central banks take into account other signs of economic imbalances in designing their policies, even though the sole objective may be defined as price stability. The Central bank of Sri Lanka has defined its key objective, not simply as price stability, but as economic and price stability. This is expected to prevent the Bank from trying to stabilize a price index rather than ensuring overall price stability in the economy.

Though some central banks have delegated the bank supervision function to a separate agency, it is vital that financial system stability is also ensured. This, in fact is the other objective of the Central Bank of Sri Lanka. It is important that the inter dependence of the price stability and financial system stability, is well recognized. It would not be possible for a central bank to use its instruments to ensure price stability without financial system stability as these instruments operate through a well functioning stable financial system. Further, if we failed to restrain excessive credit expansion and maintain price stability, it is likely to have a serious impact on maintaining financial system stability. We should also be mindful of the fact that an attempt to ensure financial system stability through an injection of high-powered money could greatly endanger the achievement of price stability.

Mr. Volcker, former chairman of the Fed Reserve Bank of USA has once said that “ The truly unique power of a central bank is the power to create money, and ultimately the power to create is the power to destroy”. Designers of central banks have well recognized the danger of this power. They have ensured that this power be exercised diligently by assigning the responsibility of maintaining price stability to central banks.

I hope that you will have a chance to deliberate these developments, concerns and challengers during your sessions today and tomorrow. I wish all of you a very fruitful learning experience.

Thank you.