Mr. McDonough assesses the role of the central bank in ensuring a stable price and financial environment and fostering sustainable growth Remarks by the President of the Federal Reserve Bank of New York, Mr. William J. McDonough, at the Society of Investment Analysts in Dublin on 11/2/97.

I am delighted to have the opportunity to address the Society of Investment Analysts here in Ireland, home of my forebears. In my remarks this evening, I want to say a few words on a topic of great importance to both our professions: the role of central banks in ensuring a stable price and financial environment, and fostering sustainable growth. I would also like to offer some thoughts on the importance of a safe and sound banking system for the well-being of the economy.

As members of the financial community, we all recognize the importance of price stability to the successful long-run performance of the economy. Indeed, there now seems to be a worldwide convergence of views among central bankers and investors alike on the importance of price stability as the primary goal of monetary policy. For me personally, stable prices have always been the prism for making monetary policy decisions.

As I see it, price stability must be viewed in a long-run context as an ongoing goal, not a one-time objective. That goal requires monetary policy to be oriented beyond the horizon of its immediate or near-term impact on inflation and the economy. The primary purpose of near-term policy actions should be to set the economy on a long-term, permanent path to price stability and sound economic growth.

This orientation puts the focus of policy on inflation expectations over the long term -- the time horizon that is appropriate for most saving and investment decisions. Businesses and households are understandably concerned about the long-term consequences of inflation and price level uncertainty. This is the frame of reference reflected in the conceptual definition of price stability offered by the chairman of the Federal Reserve, Alan Greenspan -- that price stability is achieved when people do not consider inflation a factor in their business and economic decisions.

Long-term inflation expectations must be anchored to a transparent and rigorous commitment by the central bank to a well-defined standard of price stability, and unavoidable deviations from the goal of price stability must be explained with reference to that standard.

In my view, price stability is a means to an end -- the promotion of sustainable economic growth. Only with long-term price stability can the economy expect to achieve the maximum levels of productivity and living standards.

Price stability is both important and desirable because a rising price level, even at moderate rates, imposes substantial economic costs on society. These costs emanate from a variety of sources, including:

- increased uncertainty about the outcome of business decisions and profitability;
- adverse effects on the cost of capital resulting from the interaction of inflation with the tax system;
- reduced effectiveness of the price and market systems; and
- distortions that create perverse incentives to engage in nonproductive activities.

As a former commercial banker, I am especially aware of the negative effects of one particular type of nonproductive activity induced by inflation's distortion of incentives -- the overinvestment of resources in the financial sector. It is well known that, in high-inflation economies, the resources diverted from productive activities to nonproductive financial transactions are enormous. But even moderate inflation rates can cause substantial diversion to nonproductive financial activities, and this diversion deserves greater attention than it often receives in economists' list of the costs of inflation.

As I look back over the last ten years or so, I am pleased that the Federal Reserve and many other central banks have been successful in controlling price pressures and putting inflation on a long-run downward track. Success in dealing with inflation clearly enhances the credibility of monetary policy and policy makers.

From my perspective, the continuing challenge for central banks is to ensure long-term credibility for monetary policy by sustaining low inflation environments. Central banks are generally better able to meet this challenge if they are substantially immunized from short-term political pressures, and are firmly committed to price stability as the overriding goal of monetary policy.

Empirical research in recent years has shown that both the average rate of inflation and its variability tend to decline in tandem with increased independence for central banks. This is why so many governments, including those among the emerging market economies, have been providing their central banks with increased autonomy. Of course, it is possible to have low inflation or price stability even with a limited degree of legal central bank independence, but the record clearly shows that a country is more likely to have low inflation if its central bank is independent. One important reason for this is that the fiscal authorities in many countries have not proven to be highly disciplined.

Of course, some would argue that focusing on price stability as the primary goal of monetary policy means that central banks would no longer be concerned about output or job growth. I believe this view simply is wrong. A stable price and financial environment almost certainly enhances the capacity of monetary policy to fight occasions of cyclical weakness in the economy.

A central bank's commitment to price stability over the longer term does not mean that monetary policy can ignore the short-term impact of economic events. It is important to recognize that, even when an economy is set on the path to price stability, and price expectations are contained, it does not necessarily mean that all potential sources of inflationary shocks have been eliminated.

Moreover, while there is no long-run trade-off between unemployment, or output, and inflation, both formal evidence and common sense observation on wage and price rigidities attest to the existence of such a trade-off in the short run. In the long run, however, monetary policy's impact is only on inflation; potential output primarily is determined by advances in technology, growth in human and physical capital and other real resources.

Because of the uncertainty about the timing and significance of short-term monetary policy effects on economic activity, as well as all other uncertainties concerning the economy, there are always differences of view about the speed with which policy should be adjusted, and on the balance of risks in dealing with ongoing economic developments. These conflicts become more marked when an economy confronts supply shocks that drive up prices sharply and suddenly -- such as the two oil shocks of the 1970s. In those circumstances, from my perspective, the appropriate course, consistent with maintaining longer term price stability, should be to bring inflation down somewhat gradually, as the economy adjusts to the shift in relative prices.

As I see it, monetary policy must be formulated cautiously, and cannot ignore business cycle developments. In establishing price stability as the primary goal of monetary policy, therefore, it is best to recognize that monetary policy does affect output in the short run. A central bank can appropriately be assigned the task of promoting sustainable economic growth, while maintaining long-term price stability and ensuring the health of the financial system. This way of articulating policy goals has the advantage of meeting the public's need to understand the basis for monetary policy decisions, and may help, therefore, to enhance the democratic accountability of monetary policy.

Once monetary policy is firmly committed to price stability, how can a central bank best reach that goal? Clearly, at an operational level, no single formula or implementation strategy can be expected to succeed in all countries and under all circumstances; possible approaches can take many different forms. The choices depend on a country's history, economic conditions, traditions and institutions. But all successful approaches share two important features: first, they focus on a long-term time horizon and, second, they provide a clear and public standard for the assessment of policy.

What is most significant is not the specific way a central bank chooses to seek price stability, but rather the underlying commitment to that goal.

While monetary policy aimed at long-run price stability is critical to fostering sustainable economic growth, central banks' role in promoting growth and, more generally, a healthy economy goes beyond the conduct of monetary policy. Through involvement in financial regulation and supervision, as well as in the oversight of payments system operations, central banks play a key role in preserving and enhancing the safety and soundness of the banking and financial system.

All of these central bank functions are mutually dependent and, together, highlight the fact that the structure and workings of the banking system are integral to a country's financial stability and economic growth. Clearly, monetary policy cannot succeed in its mission if the underlying financial system is unstable.

The importance of an efficient, safe and sound banking and financial system for a country's long-term economic prospects cannot be overstated. In any market economy, the banking and financial system plays a central role in mobilizing a society's savings and in channeling these savings into investment and other productive uses. This intermediation process is one of the core determinants of the pace of a country's economic development. Moreover, the banking and financial system must facilitate transactions in an economy by ensuring that they can be effected safely and swiftly on an ongoing basis. Both buyers and sellers of goods and services must have confidence that instruments used to make payments will be honored and accepted by all parties.

These crucial functions of transforming savings into productive uses and making payments are often taken for granted. But, in fact, it can be difficult to ensure that the legal and institutional framework within which these functions are performed is consistent with the often conflicting goals of free choice, economic efficiency, safety and financial market stability.

Experience has proven that there is no easy way to shape financial institutions in a manner that appropriately balances these goals under changing economic conditions.

Today, numerous countries -- including Ireland and the United States -- are considering which paths to follow in reforming and modernizing their banking industries. These deliberations are of great importance, because a well-functioning and stable banking and financial system is a critical foundation for long-run growth and prosperity of an economy. And such reform is inevitably difficult, for reasons which are a classic blend of political and economic considerations rooted in the crucial functions the banking system must perform in a market economy.

Moreover, banking system reform is made all the more challenging by the fact that such reforms cannot be viewed in isolation from reforms in the central bank, or independent of those in the capital markets. In fact, the greatest challenge may lie in forging these individual pieces in such a way that they fit together in a cohesive whole that serves the dictates of stability, growth, and public confidence.

For a financial system to mobilize and allocate a society's savings successfully and facilitate day-to-day transactions, there must be a class of financial institutions and instruments that the public views as safe and convenient outlets for its savings. Of course, the single dominant class of institution that performs this crucial dual role as repository of a large part of society's liquid savings, and the entity through which payments are made is the commercial bank. This is true even in countries with highly developed capital markets, especially when it is kept in mind that participants in the capital markets rely heavily on the banking system for their financing facilities.

Banks cannot play an effective role in the financial intermediation process unless the public has the utmost confidence in the banking system. This confidence is a key reason why banking institutions and banking instruments are crucial to a country's economic growth and development. The combination of functions typically provided by commercial banks, however, also carries with it the risk that a loss of confidence in an individual institution can spread to the system as a whole, the so-called systemic risk phenomenon.

Instances in which a country experiences a loss of confidence in its financial institutions usually result in major damage to the economy. Given the indispensable role that financial institutions play in the success of a country's economy, governments clearly have a responsibility to subject financial institutions to some form of regulation or oversight.

But here again, there is need for balance. Restrictions placed on banks by the financial oversight apparatus cannot be allowed to discourage risk-taking per se, because risk-taking is an inherent part of banking and finance in market economies. To perform successfully, a commercial banking system requires a delicate balance between risk-taking and maintaining public confidence. Because of the importance and the difficulties inherent in the balancing act, banking systems are generally subject to a higher degree of official oversight and regulation than are most other forms of private enterprise, and supported by some form of a broad safety net.

While the specifics can differ appreciably across countries, these safety nets are usually constructed along similar lines. They generally include oversight of the affairs of banking institutions in the form of inspection and examination of the institutions for compliance with a broad set of safety and soundness standards; some type of protection against losses for small depositors and investors; and some form of emergency liquidity facility for banking institutions and, occasionally, for other financial institutions as well. Finally, the payments system, a crucial link in any financial system, generally includes some form of official regulation of or participation in its operations.

These important aspects of the safety net often feed into one or more of the functions performed by central banks. For this reason, the central bank usually plays a major role in the operation of one or more of these facets of the safety net. For example, the emergency liquidity facility is almost always the discount window of the central bank. In many countries -- including Ireland and the United States -- the central bank also plays an important role in the supervision of banking institutions and in the oversight of payments system operations.

The important role played by the central bank in helping to build and maintain confidence in the underlying stability of the financial system in turn implies that there must be a high degree of public confidence in the central bank itself. This brings me back full circle: achieving and maintaining that public confidence depends first and foremost on the success of the central bank in discharging its monetary policy responsibilities. A sound economy and sound money are virtually synonymous, which is why monetary policy stands at the center of central bank functions.

The importance of monetary policy is also the reason why central banks need special independent status within the governments they serve. In my view, it is particularly critical that the central bank not be directly responsible for financing government budget deficits; such a responsibility can, over time, compromise the financial integrity of the central bank, and thereby, public confidence in it. Note, however, that even without any involvement in direct financing of government budget deficits, central banks have a major stake in the development and maintenance of a smoothly-functioning government securities market, which can provide substantial benefits to the economy beyond those emanating from private sector financing of government budget deficits.

In closing, I want to stress that the commitment to price stability as the primary goal of monetary policy in no way implies that the health of the economy or of the financial system should be sacrificed. On the contrary, what is important to bear in mind is that by ensuring a stable price and financial environment, the central bank helps foster economic growth.

I believe that no central bank can maintain price stability over the longer term without public support for the necessary policies. Only with the confidence of the public in their policies and their own lasting dedication to non-inflationary growth together with a well-functioning financial system can central banks succeed in achieving and maintaining price and financial stability.