Commentary: Central Banks and the Financial System

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In the process of transition to a market economy, the creation of a financial system that can both mobilize savings for the investment that will be required for 'development and also ensure efficient decisions by private managers is an important first step. But it is unlikely that a new financial system can be successfully put in place without an important role for the central bank in the newly liberalized economies (NLEs). Why do we need a central bank? The answer comes, I believe, from an examination of the history of central banks. Indeed, in thinking about the role of central banks in the NLEs it is more helpful to look back on the evolution of central banks in market economies than to focus on the policy issues that have dominated discussion in the West in the immediate past.

From an examination of the evolution of central banks it becomes clear that Jerry Corrigan has hit the nail on the head when he stresses the role of the central bank in ensuring stability of the financial system. As Sayers (1976) put it in his history of the Bank of England,

> ''The complete central bank has to have some care for the health of financial institutions generally, a care that may be no more than that of a watchdog, but can in difficult times develop into a large part of its activity, and branch out beyond the narrowly financial to amount to intervention in the organization of industry and trade.'' (p. 501).

Most central banking institutions in Europe started life as privately owned commercial banks. The evolution of central banks represented a market demand for such an institution. In times of financial difficulty the need for coordination—and the difficulty of achieving this by cooperation between competitive commercial banks—led to the emergence of a single dominant bank that could play a coordinating role. But the conflict of interest between this quasi-regulatory role and the objectives of a profit-maximizing commercial bank led to the development of non-competitive institutions charged with the responsibility of managing the financial system in times of stress and preventing excessive note issue. The lender of last resort must be above the competitive battle. Even in the twentieth century this theme of evolution can be seen in Australia, where the Reserve Bank was created only in 1960.[1] It is difficult to imagine that a central bank could now retreat from these wider responsibilities. Since major problems in the transition to a market economy are likely to show up first in a financial crisis, central banks in the NLEs face an enormous challenge. The three key areas are likely to be: (1) the relationship between the central bank and the government, (2) management of the stability of the financial system, and (3) the implications of free trade in financial services for stability.

Some important lessons are provided by the "Montagu Norman school of central banking." For some time Montagu Norman has had a bad press. But in many ways he was a model for central bank governors in the 1990s. What are these lessons in the three key areas identified above?

Relationship with government

Montagu Norman believed in the independence of central banks. He had some useful ploys in dealing with government. At difficult moments he was inclined to disappear on long vacations and, since he was known to be willing to overrule his subordinates upon his return, hasty decisions were avoided that might otherwise have been mishandled in the heat of the moment. He once fainted in the arms of the Chancellor of the Exchequer—thus literally disarming his opposition (Boyle, 1967). Central bank independence has been a topical issue in recent policy discussions. The relationship between the central bank and government varies from one country to another. Attention has focused on differences in the constitution of central banks across countries. But the lesson of Montagu Norman is that this key relationship may be more sensitive to the mandate and constitutional position of elected politicians than to the formal status of the central bank. Central banks in the NLEs may find that there is a tradeoff between the independence granted and range of responsibilities afforded to them.

Financial supervision

As Jerry Corrigan notes in his paper, a central bank is expected to ensure stability of the financial system. In the context of the NLEs the involvement of the central bank with the economy as a whole is not a side issue. There have been times when concern with financial infrastructure has been more to the fore in the mind of the central bank than monetary policy itself. For example, in the 1920s and '30s the Bank of England played a leading role in the restructuring of the cotton and textile industry in Britain. As Sayers puts it, "In the mind of the governor himself, these problems of economic organization perhaps had more attention than the narrower field of monetary policy with which central bankers are conventionally concerned." (p. 502).

The experience of Montagu Norman in the 1920s has direct relevance to Eastern Europe today. The reorganization of industry will alter radically the structure of the asset side of commercial banks' balance sheets. The resulting losses will in many cases threaten the viability of the banks, and raise questions as to how far the central bank should intervene in protecting banks from the consequences of privatization of previously mismanaged state enterprises. The lender of last resort role is likely to be an extraordinarily difficult one in the transition from a centrally planned to a market economy.

It is difficult to imagine that in the NLEs central banks will be able to limit their concern to narrow technical issues of monetary policy. For example, central banks will surely be concerned to ensure the construction of a coherent explicit tax system in order to replace the revenue lost as a result of privatization. The transfer of state-owned assets to the private sector has in some cases resulted in a substantial loss of revenue. The trading surpluses previously accruing to the state have not been replaced by an explicit tax system. As McKinnon (1990) has pointed out, this loss of revenue has led in the Soviet Union to an erosion in government revenue and substantial budget deficits. The consequent loss of monetary control has led to serious inflationary pressure. In the absence of an effective tax system, the task of monetary control becomes more difficult.

Indeed, it is notable that in the debate on monetary union in the European Community, the report of the Delors Committee—comprised primarily of central bank governors—placed emphasis on the need for coordination of budgetary policies.

The sequencing of liberalization measures will also be of concern to central banks. Selective price de-control, coupled with the absence of hard budget constraints, can imply extremely volatile prices for financial assets, such as foreign exchange. Hence in the context of lender of last resort policies, the structure and sequence of a transition to a market economy must be a matter of concern to central banks.

There are many other areas in which the new central banks will have not only to learn from their counterparts in the West, but also be open to and ready for innovations in the financial system. Banking supervision already faces the challenge of the difficulty of distinguishing between banks and non-banks, and there will be further problems in distinguishing between the financial transactions of financial institutions, on the one hand, and non-financial institutions, on the other. The payments mechanism itself, the protection of which is one of the principal rationales of banking supervision, is subject to major change from innovations in technology. The growth of direct debit mechanisms may remove the granting of credit from the operation of the payments mechanism, hence altering radically the argument for regulation in this area. Central banks in the NLEs might be well advised to push the payments system in a direction that separates as far as possible the granting of credit from the payments system.

The international dimension

The growth of trade and financial services has increased the need for coordination among regulators in the market economies. The proliferation of regulatory bodies within each country has created the need for a "lead regulator" to take initiatives in liaising with their counterparts overseas. The central bank is a natural candidate for this role. The financial system is now more open to international capital flows than it has been for 50 years. This creates restrictions on the ability of any one country to pursue financial stability in isolation. For example, the most recent collapse of an investment bank in the UK—that of British and Commonwealth in 1990—was caused by a failure in a nonfinancial subsidiary in another continent. Domestic regulation of the parent company was insufficient to prevent a run on the bank. In the immediate aftermath of the 1987 stock market crash, coordination among regulatory authorities, and especially central banks, helped to prevent a spread of possible systemic failure. Cooperation among central banks was a major theme of Montagu Norman in the 1920s, and he played a major role in ensuring a successful launch for the Bank for International Settlements. Concerned lest the proposed BIS become dominated by the politics of reparations, he argued that the new institution should be a non-political central bank for central banks. The more rapidly central banks in the NLEs become full members of the international club of central banks and regulators, the greater will be the confidence of overseas investors in direct investment in the NLEs.

I have argued that in the market economies central banks evolved from commercial banks, largely as a result of the perceived market demand for such a coordinating institution. In the NLEs, the challenge is the reverse—how to create a system of privately owned competitive commercial banks from an existing centralized financial system. The principal difficulty that is likely to emerge from this process is that the central bank will be trying to create competitive independent commercial banks at the same time as it retains an overall regulatory responsibility for the financial system as a whole. In a number of market economies, the concern for control over monetary and regulatory policy has inhibited the development of a competitive banking system. This dilemma is likely to face the central banks of the NLEs in an acute form. They will have to be parents to a new competitive banking system, nourish their offspring, give them their liberty, and yet try to maintain the stability of the family as a whole.

In tackling the problem of trying to create a competitive banking system while ensuring financial stability at a time of dramatic industrial change, central banks in the NLEs will be a crucial ingredient for a successful transition to a market economy. The governors and the directors of the new central banks will require exceptional qualities—and more than their fair share of luck.

End Notes

[1] For further discussion of this topic, see Goodhart (1988)

References

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