

# Commentary: Central Banks and the Financial System

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There can be little doubt that the reform task facing policymakers in Central and Eastern Europe is the most daunting economic challenge faced by any government or central bank in recent years. It goes without saying that to fully understand this challenge requires a familiarity with existing institutional and political realities that few of us in the West can have. For both these reasons, any comments we might make and any advice we might offer to our central banking friends from these countries must be tinged with a considerable dose of humility.

Let me begin by saying that I agree completely with everything Corrigan has to say in his excellent paper. My own comments, which were largely prepared before I had the benefit of reading his paper, will, to a large extent, echo his analysis, but will also develop it in certain directions.

The reform of the financial system is central to the success of reform efforts more generally. Without an effective payments mechanism, the allocation of economic resources will be inefficient. And without an effectively functioning system of financial intermediation—that is, a mechanism for encouraging, gathering, and allocating savings—there can be little hope of mobilizing the real resources needed for the restructuring of the economies of Central and Eastern Europe.

The financial system is a network of institutions and markets that mobilize and allocate financial resources. In Western economies, financial resources are unrestricted claims on real resources. The efficiency of the financial system is therefore central to the successful functioning of the real economy. Financial efficiency is promoted by the market mechanism—with resource allocation guided by prices that move in response to the interplay of decentralized supply and demand decisions.

The starting point for the transformation of the financial system of the formerly centrally planned economies is quite different from this. In these countries, financial resources could not be regarded as unrestricted claims on real resources. The allocation of financial resources has traditionally followed, not preceded, decisions on the allocation of factors of production and of final output.

The transition to a market economy therefore implies very profound changes in the basic *raison d'être* of the financial system. I believe that central banks have an important role to play in managing the process of structural transformation. This role encompasses three functions: (1) promoting an efficient and competitive network of financial intermediation; (2) preserving stability in the financial system; and (3) promoting macroeconomic stability and, in particular, a stable price level.

I put price stability third, not because it is least important but because, in the process of financial reform on which the Eastern European countries are embarking, it grows out of the other two objectives. As Scott Pardee hinted in his observation in our opening session, if reform only delivers price stability, and is unable to show tangible benefits in other directions, it is unlikely to be politically durable, let alone economically efficient. And as Paul Volcker remarked yesterday, price stability is something that centrally planned economies have been **reasonably** good at.

It may be asked what business central banks have promoting the development of the financial sector. Surely their objective should be to assure price stability as the best environment in which the private sector can develop the institutions that promote growth.

But there is an important difference between the environment in which central banks developed in Western economies and the circumstances now faced in Eastern Europe. Most Western central banks emerged in situations where financial markets and institutions were already quite well established. The problem to be faced was one of systemic instability. And the solution to the problem was to give one institution, the central bank, the objective of promoting stability through its capacity to intervene in markets.

In Eastern Europe, reformers have a different starting point. The structure of markets and institutions has to be developed before central banks can perform the stabilizing functions that we in Western countries are accustomed to assign them.

Let me now be more concrete. What needs to be done to move the banking system of Eastern European countries to a level at which they can contribute positively to the economic development of these countries? I will identify four important elements in the process—though these are, of course, not exhaustive.

**A first** step—which has already been taken by many countries—is the separation of commercial banking activity from the central bank. Beyond this, however, an efficient banking system requires decentralization and competition. Monolithic banking systems have to be broken up and the newly created institutions allowed to compete with each other. This means, in particular, that commercial banks must not be assigned specific sectors of the economy in which they are given specific responsibilities and, in consequence, a quasimonopoly position. It also means that the problem of nonperforming assets must be dealt with before commercial banks are set free to operate on commercial terms. Foreign financial institutions also have a role to play in helping promote competition and efficiency.

Second, effective and efficient payment and settlement systems need to be introduced. Payments and clearing mechanisms are the nuts and bolts of the financial system. If they work well, we do not pay much attention to them. But if they do not, the entire machinery can seize up. Central banks have a clear leadership role, in my view,

in developing the payments system in the emerging market economies. Sophisticated, state-of-the-art systems are not required. What is required is a reliable mechanism so that payments and settlements can take place on an assured basis.

*Third*, efforts should be devoted to the establishment of short-term money markets. The mobilization and allocation of savings cannot be fully effective within the confines of a single financial institution. There must be ways of transferring surplus liquidity between institutions to meet fluctuations in the flows of funds, as well as to put liquidity at the service of other legitimate users, both in the public and the private sectors.

It should also be noted that the short-term money market is the most effective and efficient vehicle for monetary policy **implementation**. A functioning money market would help resolve the paradox identified yesterday by Bruce **MacLaury**. For it would no longer be necessary to use nonmarket techniques of credit control to underpin the stability of market-oriented reforms in the real economy. Market techniques would be available for monetary management also.

Fourth, prudential regulation of the banking system has to be given a major role. I can only underline the points made by Corrigan in this connection. The transition to a market-oriented banking system will place enormous decision making authority in relatively inexperienced hands. We have heard yesterday of the very large **nonperforming** assets on the balance sheets of the banking systems of the Central and Eastern European countries. These mistakes of credit extension must be avoided in the future, as must the other excesses that are typical in newly emergent banking systems.

But there is another, crucially important, function that can be served by an effective system of bank supervision. This is the development and standardization of accounting and credit appraisal techniques. Such techniques are at the core of the business of banking, and as yet they exist only in rudimentary form in most Central and East European economies. It is an important responsibility of a central bank to see that these basic skills are developed. The organization of training and technical assistance is one means

of doing this. Another is to use the mechanism of supervisory oversight to make sure that appropriate techniques are being applied in the field.

In conclusion, let me note that I have taken a "broad church" view of the role and responsibilities of the central bank in the financial system. This is somewhat at variance with the more restricted view that has become popular in recent years, in which central banks' responsibility has been seen to be increasingly focused on the single goal of price stability. But I believe Corrigan is right to emphasize the wider responsibilities of a central bank. This wider role is certainly very much within the historical tradition of central banks as they emerged in the nineteenth century. And it is fully consistent with the needs of the Central and East European countries as they face the enormous challenges of moving to a market-oriented system.