The Role of Central Banks and the Financial System in Emerging Market Economies

by E. Gerald Corrigan

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Good morning, ladies and gentlemen. I am pleased to appear before you today to discuss the role of central banks and the financial system in the specific context of the recent efforts on the part of a number of Eastern European countries and the Soviet Union to shift their economies toward more market-oriented and competitive systems. I am especially pleased to have the opportunity to discuss these issues in the presence of the distinguished group of central bank governors from those nations who are gathered with us today.

For the sake of emphasis, let me begin my remarks by citing several propositions that, in my judgment, are central to the discussion as a whole. These propositions are:

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- *First,* the stability of the banking and financial system is an absolute prerequisite for the growth and stability of the economy at large.
- *Second,* of all the elements of structural reform that are necessary in the transition from a centrally planned and controlled economy to a market economy, none is of greater importance than the reform of the banking and financial system.
- *Third,* while the development of capital markets —especially an efficient market and secondary market for national government securities—is clearly important, the highest priority should be placed on the reform and adaptation of the commercial banking system.

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- *Fourth,* successful reform of the commercial banking system presupposes parallel reform in the central banking system. At a minimum, this reform should take central banks out of the business of directly financing government deficits and provide mechanisms through which central banks can increase or decrease liquidity in the economy without allocating credit for specific purposes or functions.
- *Finally,* and most importantly, at the end of the day, commercial banks and central banks have only one asset that really matters, and that asset is public confidence. Accordingly, the task of reform—in all its detail—must be approached with enormous weight given to this overriding consideration. Indeed, the confidence factor will become all the more important over time as the

ownership of banking and financial institutions shifts to private hands. The crucial question is not whether particular reforms will work as a matter of theory or abstraction, nor even whether a particular approach has worked in other countries.

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Rather, the bottom line is the issue of whether specific reforms are likely to work *and* to build confidence in the specific context in which they are applied.

Before discussing these issues in greater detail, I should make two important qualifications: first, my thinking about these very difficult issues is naturally conditioned by my own experience and environment. Thus, much of what I have to say reflects how things have—and have not—worked here in the United States and in other western industrial countries. I say this because I am acutely mindful—in part from my association with reform efforts in developing countries in Latin America and elsewhere—that successful elements of structural economic reform cannot be insensitive to traditions, customs, cultures, and histories in the reforming countries. On the other hand, there are certain basics—even when considered in the light of national histories and cultures—that are essential in virtually any setting.

The second qualification follows from the first: namely, I do not consider myself an expert on the details of the commercial or central banking systems in any of the countries whose officials are gathered here today. But I do know enough about each and enough about reforms already under way to know that much of what I have to say will not apply equally in all cases and in some may apply in only limited ways. However, even where the latter is the case, I am quite convinced that there is value and discipline to be gained in going back to basics.

Against that background, I believe it is fair to say that it is universally recognized that a particularly important function of a banking and financial system in a market economy is to help mobilize a society's savings and to channel those savings rigorously and impartially into the most efficient and effective uses or investments. That process is, of course, the very lifeblood of economic development and rising standards of living. As a corollary, it is also universally recognized that the banking and financial system must provide the vehicles through which payments for goods and services can be made quickly, efficiently, and safely in a context in

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which both the seller and the buyer of such goods and services have confidence that instruments used to make such payments will be honored and accepted by all parties to that transaction and to subsequent transactions. Without that confidence, the system simply cannot work. Stated differently, these crucial economic functions of mobilizing savings and making payments are often taken for granted. In reality, however, it is very difficult to forge a set of legal and institutional arrangements within which these functions are performed that would be consistent with the often conflicting goals of free choice, economic efficiency, and safety and stability.

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Indeed, economic history tells us in wholly unmistakable terms that no society has found it easy to forge its financial institutions in a way that these goals are appropriately balanced. Even today, within and among the most successful industrialized countries of the world, there is great debate as to how best to go about that task. Certainly, that is true here in the United States. The reasons for the inherent difficulties in this area are an almost classic blend of political and economic considerations that have their roots in the crucial functions the banking system must perform in a market economy.

As an illustration, take the example of the typical household. Clearly a society's long-term economic prospects are best served when such households make the decision to freely save some of their current income. But that is not enough, since there must also be a way in which those savings can be mobilized and put to work in productive investments. That, of course, means that the household must see not only an inducement to save freely but also an inducement to entrust those savings to someone or something else that can directly or indirectly put those savings to work in sound and productive investments. Under any circumstances, the household will see some risk in parting with its savings and it will expect to be compensated accordingly. But, and this is a very large but, under *any* circumstances, *any* household in *any* society will also want to maintain some fraction of its savings in the form of highly liquid assets, including assets which can easily be used to finance day-to-day and week-to-week transactions needs.

A household's willingness to entrust its savings — especially its highly liquid savings — to some institution presupposes that it has confidence in the financial integrity of that institution. If that confidence is not there in the first instance, the society's ability to mobilize its savings will be compromised and its ability to reap the benefits of economic specialization in the production and distribution of goods and services will be undercut.

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This, of course, is why confidence in banks is so crucial, and this single factor goes a very long way in explaining why banking institutions and banking instruments have evolved in the way that they have over centuries. What this says, of course, is that no matter what the precise legal and institutional financial framework in a particular country, there are certain preconditions that must exist if the financial system is to be able to perform its essential tasks of mobilizing and allocating savings and facilitating day-to-day transactions. Thus, there must be a class of financial institutions and financial instruments that the public views as safe and convenient outlets for their savings, where at least some fraction of those savings are highly liquid and can be used to make payments. The problem, of course, is that any institution that provides the public with access to financial instruments having those characteristics must be one that invests the public's savings carefully and prudently, but also invests those savings in a way that promotes economic efficiency and growth.

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In virtually all countries, the single dominant class of institution that has emerged to play this crucial role as both the repository of a large fraction of the society's liquid savings and the entity through which payments are made is the commercial bank. Indeed, even in mature industrial countries with highly developed capital markets — such as the United States — the commercial banking system is still the most important single element of the financial system, especially when it is kept in mind that the capital markets rely very heavily on the banking system for day-to-day and standby financing facilities.

But from the earliest days of commercial banking, experience has repeatedly shown that the *combination* of functions typically provided by such institutions carries with it the unique risk that a loss of confidence in individual institutions can spread to the system as a whole. This, of course, is the so-called systemic risk phenomenon. And as the broad sweep of history tells us, there are many instances in which the loss of confidence in financial institutions has caused major damage to the real economy. In other words, systemic risk is not an abstraction; it can be quite real.

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It has long been recognized by all governments that banking and financial institutions must be subject to at least some form of regulation or official oversight because the functions they provide are indispensable to economic success, even though these same functions by their very nature introduce potential risks that are capable of undermining the prospects for such economic success. I am fond of pointing out — and I will do it again in this context — that Adam Smith forcefully took this position in *The Wealth of Nations*.

In most countries there is either an explicit or a tacit recognition that one of the crucial functions of the central bank is to help preserve and enhance the stability of the banking and financial system. Indeed, while the primary task of most contemporary central banks is viewed as the conduct of monetary policy, many central banks — certainly including the Federal Reserve — were established largely with a view toward preventing or at least containing financial shocks and disruptions.

My own vision of the role of the contemporary central bank...is one in which the central bank houses a trilogy of functions. At the center of the trilogy is, of course, monetary policy. But there are two other crucial functions of the contemporary central bank that are closely related to monetary policy and constitute a single theme. These other two functions are the broad oversight of the financial system and the oversight of and/or direct participation in selective aspects of the operation of payment systems.

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But if it is appropriate to think of the role of the central bank in the context of this trilogy of functions, and if it is fair to suggest that financial stability is a necessary — but not sufficient — condition for economic growth and stability, then it must follow that the structure and workings of the banking system are of great importance to this process as a whole. Looked at in this broad light, the challenge of reforming the banking system is formidable indeed, especially since the paths chosen to effect such reform cannot be viewed in isolation from reforms of the central bank. Neither can they be viewed independently of emerging developments in capital markets, in particular the need to develop mechanisms whereby central governments can more effectively finance budget deficits in a manner that does not constrain the monetary policy process. None of this is easy, but the greatest challenge may lie in forging the individual pieces of the reform effort in such a way that they fit together into a cohesive whole that will serve the dictates of stability, growth, and confidence. From this perspective, it seems clear to me that the first priority is the mobilization of private savings.

The challenge of reforming the banking system is formidable indeed, especially since the paths chosen to effect such reform cannot be viewed in isolation from reforms of the central bank. Neither can they be viewed independently of emerging developments in capital markets, in particular the need to develop mechanisms whereby central governments can more effectively finance budget deficits in a manner that does not constrain the monetary policy process.

This, in turn, brings one's attention immediately to the liability side of the balance sheet of the major financial intermediaries — the commercial banks. Indeed, in the short run, I would argue that the design of the transactions-like and savings-like liability instruments of the banks is more important than the design of the overall structure of the system. And it is not simply the design of the instruments that is important but also the design and workings of the broad infrastructure that goes with such instruments. For example, for transactions-type accounts and especially for interbank movements of funds, efficient, safe, and speedy collection and payments systems are a must if confi-

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The ability of the banking system to mobilize savings by attracting deposits is one thing. But its ability to retain such deposits and to put them to good use is quite another, which of course brings me to the asset side of the balance sheet. The bank's choice of its assets is crucial for two reasons:

> First, if the bank is careless in the credit it extends, it will incur losses and will not be able to honor its obligations to its depositors. If its ability to honor its deposit obligations is in question, the bank will always be subject to the risk of deposit runs. This is the subtle genius of the banking system, for it is a key feature of the banking system that creates the incentive for the bank to extend credit wisely, judiciously, and impartially.
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> Second, even where capital markets are well developed, the credit decisions of the banking system remain the single most important element determining how the society's savings are deployed. Those credit decisions therefore determine which firms, which farms, and which entrepreneurs will receive the credit and which will not. If the system is working correctly, those who receive credit will be the most efficient, the most competitive, and the most profitable. Therefore, they will be the most capable of producing the stream of goods and services that will permit the economy to grow and standards of living to rise.

It should be clear that the objectivity and impartiality of the credit decision-making process are absolutely indispensable features of an efficient and market-oriented banking system. Partly because of the obvious problems of political pressures, but for other reasons as well, the government or the state is not well equipped to make these decisions.

It should be clear that the objectivity and impartiality of the credit decision-making process are absolutely indispensable features of an efficient and market-oriented banking system. Partly because of the obvious problems of political pressures, but for other reasons as well, the government or the state is not well equipped to make these decisions. To be sure, the state can establish tax or other incentives for certain activities — something we see in all societies — but the decision as to who gets credit and who does not must be left to private initiative in a context in which those making the decisions have a major stake — their own economic livelihood — in the credit decisions they make.

This is also one of the more fundamental reasons that the development of sound and internationally acceptable accounting systems in emerging market economies is so vitally important. Accounting systems serve a variety of purposes, but none is more important than their role in helping creditors make the rigorous decisions as to which enterprises can meet the market test of efficiency, competitiveness, and profitability that will permit those enterprises to meet their obligations and, in turn, permit their creditors to meet their obligations.

Another subject of importance in regard to the structure of banking institutions is the size and composition of the bank's capital account....[The capital base] creates a constituent group of individuals or institutions that has a direct interest in the profitability of the bank, which in turn should strongly reinforce the impartiality of the credit decision-making process.

Another subject of importance in regard to the structure of banking institutions is the size and composition of the bank's capital account. The capital account, representing the ownership interests in the bank, serves two obvious purposes: first, it is a source of permanent funding, and second, it provides a cushion for absorbing losses. But the capital base also serves another, more subtle function: namely, it creates a constituent group of individuals or institutions that has a direct interest in the profitability of the bank, which in turn should strongly reinforce the impartiality of the credit decision-making process.

For these reasons, it should be obvious that private ownership of banks is the preferred arrangement. Having said that, I would add that it is also true that government ownership of commercial banks is quite common in developing nations and, in fact, is also to be found in some major industrial countries. Also, in virtually all countries — the United States included — special purpose banking organizations entailing government ownership, guarantees, or sponsorship are not uncommon. I mention this only because the drive for private ownership of banks may — particularly in the short to intermediate run — have to be tempered with some realism as to what kinds of arrangements are workable. Thus, some or all of the initial capital stock of commercial banks may have to come from the government — an outcome that can be acceptable if three conditions are also met. Those conditions are:

> *First*, the management of the bank is independent of the government such that the government does not direct credit decisions and allocation. In other words, government ownership must not preclude competition.
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> *Second*, having provided the initial capital, the government is not responsible for the overall funding of the bank.
>
> *Third*, the government's ownership interests are structured such that at some later date they can be easily sold to private interests.

While individual countries have considerable latitude with regard to the precise legal and organizational structure of their commercial banking system, the basic functions are common to all countries. And by their very nature, those functions entail risk taking on the part of individual institutions and the system as a whole. In the face of that risk taking and the need to maintain public confidence in the banking system, banking in all countries is subject to a higher degree of official oversight and regulation than is the case for most other forms of private enterprise. As an extension of that, all countries have put in place some form of a so-called safety net that is associated with the operation of the banking and financial system.

In practice, the specific form of the safety net — in both de jure and de facto terms — can differ appreciably from one country to the next. In generic terms, however, the safety net is usually designed to provide the following functions: first, the regulation of the affairs of banking institutions, usually including the inspection and examination of such institutions; second, some form of protection against loss on the part of at least small depositors and investors; third, some form of emergency liquidity facility; and finally, some form of official regulation of or participation in the workings of the payments system.

I would place a particularly high priority on the need to develop a strong program of bank supervision, especially in the early phases of the changing role of the commercial banks....The central bank can also play a highly valuable role in the early development of critical aspects of the payments system such as the interbank deposit market and the emerging markets for government securities.

In virtually all countries, the central bank plays a direct or indirect role in the operation of one or more of these central features of the safety net. For example, the emergency liquidity facility is almost always the discount window of the central bank. In many countries — including the United States — the central bank also plays an important role in both the supervision of banking institutions and in either or both the regulation and the operation of the payments system. Given the concept mentioned earlier of the trilogy of central bank functions, it will come as no surprise when I say that I strongly believe that central banks should play an important role in both of these areas. In this regard, I would place a particularly high priority on the need to develop a strong program of bank supervision, especially in the early phases of the changing role of the commercial banks. Similarly, the central bank can also play a highly valuable role in the early development of critical aspects of the payments system such as the interbank deposit market and the emerging markets for government securities.

Regardless of how broadly or narrowly, how explicitly or implicitly the legal mandate of the central bank is drawn, it seems to me inevitable that the central bank will always have an important role in helping to build and maintain confidence in the underlying stability of the banking and financial system. In turn, that necessarily implies that there must be a high degree of public confidence in the central bank itself. Achieving and maintaining that public confidence is, in the first instance, squarely related to the success the central bank has in the discharge of its monetary policy responsibilities. That is why monetary policy stands at the center of the trilogy of central bank functions. It is also the reason that central banks must have special status within the governments they serve. At the very least, that special status implies that central banks should not be expected to finance the budgetary deficits of governments directly. It also implies that the central bank normally should not be responsible for the direct financing of other types of enterprise. Indeed, such arrangements run the clear risk that the central

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bank's balance sheet can become weighed down with low-quality assets. In such circumstances, confidence in the financial integrity of the central bank can only suffer.

Having said that central banks should not be responsible for the direct financing of government deficits, I should add that it is also true that central banks typically are major holders of government debt. But in the ideal order, a central bank's holdings of such government debt should arise in connection with its orderly efforts to supply liquidity to the economy as a whole through open market operations or other suitable vehicles. This is one of the many reasons that the development of a market for government securities — including a viable secondary market for such securities — is such a high priority. Indeed, a well-functioning government securities market will serve three vital purposes: first, it will provide a more market-oriented way to finance budget deficits; second, it will facilitate a more effective approach to monetary policy and the strengthening of the balance sheet of the central bank; and third, it will provide the foundation upon which other elements of capital markets can be developed. But as with all markets, the development of a smoothly functioning government securities market presupposes that there is a complete infrastructure that will support an emerging secondary market for such securities that, at the least, provides the liquidity whereby such securities can be readily bought and sold by the central bank and other market participants. Without that infrastructure and liquidity, it will be very difficult to design government debt instruments that institutions and individuals will find attractive as investments and it will be equally difficult to free the monetary policy process from the need either to directly finance government deficits or to engage in various forms of credit allocation, or both.

A well-functioning government securities market will serve three vital purposes: first, it will provide a more market-oriented way to finance budget deficits; second, it will facilitate a more effective approach to monetary policy and the strengthening of the balance sheet of the central bank; and third, it will provide the foundation upon which other elements of capital markets can be developed.

I said at the outset that the task of reforming the banking and financial system was one of the most important tasks facing the countries of Eastern Europe and the Soviet Union. It is also one of the most difficult. In part those difficulties are technical, in part they are economic, and in part they are political. But most fundamentally, these difficulties arise from the fact that the reform of the banking system must come to grips with that great intangible — public confidence. It is in this area in particular that the role of the central bank is vitally important not only in the context of its monetary policy responsibilities but also with regard to the inherent responsibility of the central bank to help ensure the essential stability and viability of financial institutions and markets.