

Commentary: Central Banks and the Financial System

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I am not sure whether I can rise to the level of mystique, but I will try nevertheless to echo some of the remarks very correctly made by Jerry Corrigan. It is certainly true that the situations in various countries in Eastern Europe are different and that those situations are very difficult to manage. It is equally true that when you look at Western central banks, you do not see something uniform. Instead, you see very extensive differences in the area of their activities and differences in the ways they act. We are very aware of that in Western Europe because we are now in the process of discussing organization of the future European Monetary Unit (EMU) and a future central banking system for this EMU. This leads us to look very closely at what we are doing, and this creates quite an interesting debate. So I also share the view of Andrew Crockett that we must have an attitude of humility when we look at these questions.

Nevertheless, there are some basic principles on which probably a lot of people would agree now, even if those principles have not developed in history in a very rational and continuous way. It is also true to say that during most of the time since industrial life appeared, there was no key role for central banks. Therefore, we have to focus on the most basic principles which presently justify the utility of central banks and see very pragmatically if they can be useful in Eastern countries. In this spirit, I am going to concentrate my remarks on three points.

First of all, the subject we examine today is very closely related to the subject of yesterday, even if this does not appear so obvious.

There is not a single reason to have a central bank, as Paul Volcker reminded us yesterday. But probably a lot of people could agree with the fact that central banks are a precaution that democratic governments take in order to protect their currency. They admit that management of the currency, which is an activity of collective interest and therefore should normally rest in the competence of the democratically elected government, requires special caution because it requires a very high degree of stability and continuity. The central bank is just the body which is in charge of providing this long-term view of stability. If this is admitted, all the activities of the central bank must be oriented toward stability. In particular, central banks could not accept a financial system and a commercial banking system which would not be stable and firm and would undermine the soundness of the currency.

If you accept that view, there are a lot of consequences. The question of credibility is a question which is common to all activities of a central bank aiming at stability. Credibility cannot be divided. Bad performance, for instance, in supervision of the financial system would weaken the position of the central bank in the field of monetary policy. The same can be said about expertise. Bad expertise in one field would reflect adversely on the central bank's (credibility) in other fields.

Many other links exist between the soundness of the financial system and monetary policy. In monetary policy, a key requirement for a central bank is to be in a position to appreciate what the monetary aggregates are and how they are moving. For that purpose, the central bank must be assured that liquidity is located somewhere precisely, mostly in the commercial banks. That is why it would not be acceptable for a central bank to have a situation in which a substantial part of the liquidity would be located in companies extending liquidity and credit facilities to each other according to imprecise rules. In that field, reforms need to be made in some Eastern countries. For the same reason, an extensive use of barter should also be banned.

The central bank, when it performs monetary policy, must be able to move interest rates. It is one of the most crucial decisions. In order to be able to move interest rates, the central bank must be sure that the financial system can bear it, that is to say there is no weakness of the financial system such that a move of interest rates could have disastrous consequences.

My second point is that in the Eastern European countries, or in the Soviet Union, the reform of the financial system cannot be separated from the reform of the economic system, specifically the reform of industrial companies. Granting credit is certainly the heart of banking activity: the banks are in charge of allocating savings. And only free banks can do a good granting of credit, a good allocation of funds; Jerry Corrigan has very rightly pointed on that. This happens only if funds are channeled to banks. For instance, all systems of barter, all **kinds** of swaps, are certainly a hamper to normal banking activity. Secondly for this activity of granting credit, commercial banks must be in a position to know the risk—that is to say, to make a judgment on companies. That is why a good accounting system is so important. In that respect, too, I very much agree with what was said by previous speakers. And maybe central banks can provide some services in that area, for instance, to know and aggregate the risks taken by all commercial banks on a given company and to be able to give this information to commercial banks. This service exists in many countries and is certainly a very important basic service for commercial banks.

But also, central banks must be in a position to count on a business attitude on the part of companies, rather than facing companies convinced that receiving credit is just a consequence of other decisions. It is why a lot has to be done in the other fields of reforms, reforms which determine the behavior of nonfinancial companies. Beyond their own merit, such economic reforms are also indispensable for a correct exercise of banking activity.

My third point is that there must be a minimum of supervision and regulation of commercial banks and that the central bank must have it in its hands. Of course, there is a **tradeoff** between safety and dynamism of the commercial **banking** system. Too much regulation

certainly kills dynamism, and finally also kills safety because safety comes in a substantial part from profitability. If commercial banks are not in a position to be profitable, there will ultimately be no safety.

Despite this tradeoff, a certain degree of regulation must exist. The first essential area of regulation is for the central bank to be able to license commercial banks individually and to have the final word on who is able to perform a commercial banking activity and who is not. The second thing is to be in a position to ensure a certain degree of competition between commercial banks. On that, I very much agree with Andrew Crockett that it is essential not to have too much specialization for commercial banks because this restricts competition and encourages borrowers to consider banks simply as a window to extend them the funds they think they need. Competition between banks is needed to incite both banks and companies to behave rationally.

There must also be minimum conditions required for accounting regulation of commercial banks so that the central bank can appreciate their situation. We know, in Western countries, how difficult it is to appreciate the situation of commercial banks, so everything must be made to facilitate this appreciation. And of course, a minimum definition of nonperforming assets is a very important element of this accounting regulation. Finally, there must be a minimum of liquidity rules and solvency rules. In that respect, a certain amount of owned funds, of capital, is a key element.

Let me conclude by saying that I have been struck during these two days of discussions by the fact that there are fewer and fewer arguments in favor of gradual solutions. And in that respect, I was very much struck by what Minister Klaus said yesterday. The few remarks I have made tend to the same conclusion: this is a global reshaping both of the financial and the economic system which is needed. Each element of this reshaping is necessary to make the others efficient; it is therefore difficult to imagine a gradual timing.