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**A Symposium Sponsored By  
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**CENTRAL BANKING ISSUES  
IN EMERGING  
MARKET-ORIENTED  
ECONOMIES**



## Overview

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*Alan Greenspan*

Being the last one on the program after two days of extended discussions, I am almost inclined to say I agree with everything that has been said and then sit down. However, what I intend to do is basically try to review some of the broader aspects with which we are confronted in this period of transition.

I would like to begin where I think the beginning is, namely to try to get some judgments about the nature of centrally planned economies and their financial structure and how that compares with a financial system that is market based. In one sense, the extreme version of centrally planned economies has no financial system. It has no prices, it has no money, it has no values as such. Therefore, there is no need for any financial structure to implement the allocation of resources.

This theoretical construct is in fact the basis of what we have seen in Eastern Europe over most of the post World War II period. In such an economy, the allocation of resources largely replicates the value systems of the leaders of the society, whether it be through a detailed physical input-output system or in a somewhat arbitrary manner. But in principle, if one is basically constructing a vector of demands that are thought to be the appropriate end result of the choices by leaders, one can mechanically calculate precisely what is required to produce the desired outcome. We need so many tons of heat-treatable aluminum plate, for example, to make so many MIG-29s. Or we need a certain physical amount of steel I-beams to build

certain bridges. But as Andrew Crockett pointed out earlier, in this type of system, finance does not drive the allocation process and indeed it has got very little purpose to it.

Now as a practical matter, it is fairly clear that this pure centrally planned system cannot work, has never worked, and in fact has really never been fully implemented. The obvious reasons are those which would have been discussed in many texts, over many years, and over many generations. Nonetheless, a version of the system with many of its problems has existed in the post World War II period in Eastern Europe, and throughout its history, until very recently, in the U.S.S.R. There are financial institutions, banks and a number of savings associations, and there are quasi-financial organizations. But their essential purpose is not to facilitate the allocation of goods and services that comprise a market economy.

Instead of using a physical materials vector imposed by the leadership of the society, a market economy uses the value preferences of the society to allocate resources. We are, of course, all familiar with how those value preferences, working through the financial system, allocate goods and services in a way which we presume to be optimally efficient.

But this is obviously not the purpose of finance in a centrally planned economy. Basically, the purpose is bookkeeping. The sole purpose of prices and financial claims in many of these societies until recently has been only peripherally to allocate or ration resources. When there are inadequate goods or materials, queueing does the allocation, thereby reconciling the production of goods and services with their consumption. Banks are essentially bookkeeping organizations which accept deposits and extend credit to government enterprises as part of the centrally planned allocation process. Under those conditions, you really do not have any particular purpose for financial institutions other than the types of financial "monobanks" which existed. Merely constructing them in that context adds very little to the system.

As Paul Volcker pointed out yesterday, the centrally planned economies did not until very recently exhibit any significant infla-

tionary processes. As many of the contemporary practitioners are now becoming acutely aware, such a system is biased fundamentally toward inflation since credit is not extended according to productivity criteria in a market sense, and competition is explicitly disallowed in these systems.

You end up with a very clear need for a financial system as you move from central planning to a market system. What we have heard in the last two days from our Western colleagues, our new Eastern colleagues, and those who have been practicing the art for a number of years is a general awareness of how this process is starting to function in practice. What we are observing is the evolution of a market system, as you begin to get the allocation process increasingly moving away from central planning toward market-based processes. As these market-based processes proliferate, the need for financial elements begins to emerge. You will begin to get not only commercial banks but also securities organizations and insurance companies of the Western type. You will also begin to get the whole panoply of various different financial instruments which evolve in our market economies as instruments to assist in the efficiency of the allocation process that a competitive market system tends to generate.

When one looks at this overall process, it becomes increasingly clear why commercial banking arose as market economies themselves evolved. In the contemporary as well as in the historic context, banks have a crucial credit rationing and resource allocation role, as Jerry Corrigan pointed out in his very thoughtful paper earlier today.

The crucial question for market economies, and increasingly for the Central and East European economies as well, is how do we know the commercial banks are doing it right? And here, we do have a test. Excluding subsidies to the commercial banking system, of which regrettably there are many, the ultimate determination of whether or not the commercial banking system is contributing to efficient allocation in a manner which creates wealth is the profitability of the institution. (Remember, I am stipulating there must be adjustment for the various subsidies which are in the system.) It is clear that in the underlying intermediation process by

commercial banks, what they basically do is to try to augment what the simple market model is producing.

The simple market model is one in which there is no intermediation process, no commercial banks, and no financial intermediaries. All savings go directly into investment, and the savers hold direct claims on those investments. What one finds in that type of activity is a real interest rate that is clearly higher than that which exists in an economy in which significant and effective intermediation exists. And the reason that occurs, of course, is that the commercial bank intermediation process involves the accumulation of a variety of investments in a manner in which diversification reduces the basic risk in the total portfolio relative to the individual items. Accordingly, a claim against that portfolio can be offered to depositors at rates below the average rate on the total investment portfolio. To the extent that the commercial bank is able to do that, it is clearly creating a risk reduction service to the economy as a whole. That service reduces real interest rates, increases investment, improves productivity, and raises standards of living. The crucial question is whether the commercial bank is able to sell claims against its portfolio at interest rates sufficiently below the average yield on the portfolio to cover not only the costs of banking services, but also the imputed cost of equity capital, which is a necessary part of the evaluation.

In theory, I think the issue is very clear cut. If the commercial bank is profitable, it is creating value, it is creating wealth, and it is improving efficiency. If it is not profitable, it basically should be disbanded. The problem here, obviously, is that even in the United States, where we have a generally free banking system, there are still significant subsidies. Those subsidies, which result from our safety net, distort the evaluation process. Much the same is true in Europe and the Far East. And I should hope that our colleagues who are constructing these organizations in the newly-emerging economies try to avoid some of the mistakes that I think we have tended to make. I will come back to this issue in a moment.

As was indicated earlier today, central banking evolved from commercial banking. The basic function that created the potential value of central banks was their ability to assist the commercial banks

in maximizing value added by intermediation, thereby creating wealth. A central bank does this by liquefying illiquid assets of commercial banks, or in certain instances, of other financial institutions. What is happening when we open the discount window and create loans is that we effectively are enabling a commercial bank—or in some rare instances, another type of financial institution—to convert a long-term claim to a demand claim.

The ability to have that service available enables commercial banking to be far more effective. As a result, the service contributed by the central bank has an economic value in the total market system. In some instances, the fee that is charged for that service is close to its implied market value. In others, such as in the United States where our discount rate is below market rates, at least for those individual transactions, there is a subsidy--although there is a long argument that we can make about offsetting elements involved in reserve requirements and the like, which make the net subsidy something less. But the point at issue is that the service of enhancing liquidity is what is crucial to commercial banking and was the major element, and indeed continues to be one of the most important elements, involved in what central banks do.

The issue of the central bank creating inflation, I think, requires breaking down this problem in somewhat more detail. I think it is fairly clear that when we had central banks under a gold standard, the issue of inflation did not come to the fore as a problem. Basically, gold points and a variety of other mechanisms essentially restricted the credit creation of the financial system and regulated through international gold flows the extent to which inflation could take hold. However, with contemporary central banking, domestic currencies are accorded value by fiat. It has thus fallen on central banks to preserve the value of the domestic currency directly rather than being able to look to automatic processes. As Allan Meltzer pointed out yesterday, however, there are innumerable such institutional arrangements throughout the world in which a "gold standard without gold," as he put it, can thoroughly function. And in such instances, I would suspect the inflation problem that we often associate with central banks is not something which we are particularly concerned about.

Obviously, also implicit in the monetary functions of central banks are the supervisory functions and oversight of at least part of the payments system, as well as a number of other collateral functions. The issue, however, that is important for us in the West to communicate to our colleagues in the East is that there is no single Western central bank model that is necessarily the one that we would recommend they follow. More importantly, merely because we have had what by all measures is a successful financial system, we should not presume that, therefore, the process by which the institutions all evolved were ideal and not subject to improvement. In fact, we have constructed innumerable institutions which are less than efficient in the sense of maximizing the value of intermediation. We in the United States have constructed numerous specialized institutions—banks, for example, that are unduly involved in agricultural credit only, or savings and loan institutions whose portfolios have been historically very heavily in fixed-rate mortgages. These specialized institutions essentially violate the principle that what a commercial bank should do is to create diversification and in the process, reduce risk, thereby adding value in the financial services area.

Finally, let me just say that I suspect the major problem which confronts our Eastern colleagues in the construction of market economies—and, specifically, of commercial and central banking institutions which are structurally supportive of those economies—is a fundamental issue that I guess one must term ideological. I think it is fairly clear that market economies have created practical success and are by all evidence clearly superior to centrally planned economies. What is not clear is that the value systems of the Eastern European societies have also shifted. Competition, profit, speculation, and entrepreneurship generally are still pejorative terms in the East and, regrettably, also in a number of areas in the West. I think an essential element in the evolution of market economies in the East is going to have to be a major education effort. At lunch yesterday, Vaclav Klaus made it clear that time cannot come too soon.

## The Attendees

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