FINANCIAL STABILITY AND MONETARY POLICY

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The developments in the financial markets that began after 1980 and gathered momentum during the 1990s have also brought about some changes of direction in the goals of central banks, and required some concepts, procedures, and strategies to be revised. In particular the concept of financial stability has gained new importance due to the introduction of novel instruments into the international financial system, the geometric growth in the size of financial transactions, and the ever increasing costs of financial crises.

It is generally accepted that monetary policy must pursue two kinds of stability at once: not only monetary stability, but also financial stability.

The fundamental purpose of monetary stability is to protect price stability. Monetary policies are oriented toward the achievement of this goal in many countries. I would like to emphasize again that monetary policies should be strong and sufficiently independent to assure monetary stability, and for the developed countries, price stability means maintaining an annual inflation rate below 2 percent. Independent central banks protecting monetary stability are a phenomenon, and a necessity, of our era. Our understanding of their importance becomes clearer and stronger as time goes by.

In the charter of the European Central Bank, which has just recently begun operations, it is explicitly stated that its single goal will be price stability. In the years ahead, the responsibility for maintaining monetary stability, and through it, price stability, throughout the European Monetary Union will belong to the European Central Bank. The European Central Bank is preparing itself for this task as for a years-long campaign. It is already devising policies to address present problems and difficulties of application. Its first goal is to prevent the Consumer Price Index, presently 1.2 percent annually, from ever surpassing the rate of 2 percent.

The second objective of central banks is financial stability. Regardless of the different approaches used in various parts of the world, it is agreed in principle that a major goal of all central banks is to maintain a close, stable relationship between the financial system and the real economy. Instability in the financial system quickly affects the fundamentals of an economy. This causes serious problems at once for the real economy, and later on for the social economy as well. For this reason, many central banks give the issue of financial stability a permanent place on their agendas.

The term financial stability encompasses the stability of institutions, markets, and payment systems. Financial stability requires close, smooth interaction of all three, with each functioning correctly.

It is absolutely necessary for the institutions comprising the financial markets to deserve the highest degree of confidence. It is also essential that in all ways they honor their given word. If the financial institutions are stable and sound, the system of which they are part will also be stable and sound.

What we mean by market stability is an environment where participants can carry on transactions at stable prices with confidence in the good faith of the other players. Prices reflect macroeconomic policies and macroeconomic fundamentals. If the macroeconomic policy environment is sound, and there is no change in the fundamentals in the short term, then the prices will also be stable. But price volatility and high inflation make it problematical to enter into long-term contracts. When the markets operate smoothly and freely according to the rules, the system will function well.

Payment systems are also essential for financial stability. The monthly transaction volume of the electronic fund transfer system (EFT) established at the Central Bank of Turkey amounts to TL 30 quadrillion, and its quantity to 1 billion. Altogether, 76 banks and financial institutions are members of the system. In US dollar terms, the system's annual transaction volume is US$1 trillion. The system provides real-time gross settlement (RTGS) and is the guarantor of payments.

Besides being closely linked to the quality of institutions, markets, and payment systems, financial stability depends on the effectiveness of the central bank in preventing what we call "systemic risk," which is another name for the contagion effects of institutional defaults.

What steps can we take to promote financial stability? There are three kinds of measures:

First, we can draw up rules defining permissible and disruptive behavior, embody them in a legal framework, and require compliance.

Second, having established a system of rules, we can establish supervision to ensure the correct behavior of participant and gather information concerning the financial system.

And third, we can set up insurance systems and give guarantees in order to protect the financial system and its arrangements against mishaps and defaults.

The basic principles that should guide central banks in their exertions in support of financial stability are to assign the responsibility for maintaining financial stability to the markets as a whole, rather than to individual institutions; to ensure smooth operations of the payments system; and to provide liquidity to the system when needed.

But the level of central bank involvement in banking sector supervision which is necessary to ensure financial stability is still being debated. A look at practices worldwide shows wide variation. In Italy, for instance, bears the entire responsibility for financial stability, while in other countries, such as Canada, the central bank has nothing to do with supervision of the banks. By contrast with Australia and Norway, the central bank of the Netherlands shares the responsibility by performing an efficient supervision in the three largest banks. In some countries, including France, the central bank has assumed administrative or advisory responsibility, without benefit of any legal arrangement.

The most favoured system in recent years is to set up an autonomous institution to perform supervision and immediately convey the result to the central bank. The German and British systems are designed in this manner.

The development of financial systems in various countries and regions is closely related to the economic vicissitudes they have experienced. For example, the Federal Reserve banks of the United States became closely involved in bank supervision due to the historical abundance of small and medium-sized banks and the problems created for the system by bank failures. But in Europe, because all countries have experienced the damage done by inflation generally and because the central banks must protect their credibility, most have left banking supervision to other institutions, which are autonomous and have no connection with them.

In Turkey, financial stability is not evaluated in this way. The environment of persistent high inflation, the existence of deeply entrenched systems, and jurisdictional disputes among institutions have so far prevented any evaluation of the system as a whole.

It has often been observed how important financial stability is for Turkey, and the healthy relationship between the real and financial sectors has been tested many times. There is no need to discuss the philosophy that underlies this truth.

The most important requirement for financial stability is that the balance of payments, the financial institutions, and the markets should function in a sound and efficient manner. All of these are part of the system preventing the emergence of a systemic risk. It is essential that data should be collected, that supervision should fulfil its preventive role, and that any damages that might arise should be limited in advance. My own preference for protecting financial stability is to put these responsibilities into the hands of an autonomous agency, insulated from political influence. This agency would perform supervision, collect data and transmit them at once to the Central Bank, and apply sanctions where required.

Meanwhile, we at the Central Bank will do whatever it takes to preserve financial stability, based on the information we receive and the evaluations we make. For the sake of financial stability, it is mandatory to understand and analyze the system. Besides our fundamental tasks of attaining first monetary stability and then price stability, the preservation of financial stability is also our duty and will continue to be our responsibility within the framework I have just described.