Guy Quaden: Financial sector development and the role of central banks in securing financial stability in a globalised economy

Opening address by Mr Guy Quaden, Governor of the National Bank of Belgium, at the 2007 International Arab Banking Summit, Brussels, 28 June 2007.

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Chairmen, ladies and gentlemen,

I am very pleased to address the 2007 International Arab Banking summit. I would like to thank the Union of Arab Banks and the World Union of Arab Bankers for their invitation and congratulate them for their excellent organisation of this important event. As the issue of Euro-Arab banking dialogue takes centre stage, it is fitting that, after having met in Rome in 2006, you have chosen to meet this year in Brussels, capital of the Kingdom of Belgium and also of the European Union (EU). I welcome you in this city on behalf of the Belgian authorities and more in particular of the National Bank of Belgium, the central bank of our country.

You come here at a good moment: incoming data have confirmed that economic activity in the EU and the eurozone has continued to expand at a strong pace and the outlook for the second part of this year and next year remains very encouraging. Having regained more dynamism, the EU and the eurozone significantly contribute to the needed rebalancing in world economic growth.

The Arab region is a key partner for the European countries and both sides attach great importance to building strong, meaningful relationships. As you all know, the EU and its Mediterranean partners have in 1995 created the European-Mediterranean partnership, also known as the Barcelona Process, to lay the foundations of a new regional relationship. Also, the European Commission has entered into co-operation agreements with the countries of the Gulf Cooperation Council, in 1989, and with Yemen, in 1997, thus comprising the whole of the Arabian Peninsula.

The Eurosystem – namely the European Central Bank and the national central banks of the thirteen countries which have adopted the euro – has established a working relationship through central bank co-operation, notably with the members of the Gulf Co-operation Council and Egypt, as well as through the organisation of an annual seminar with Mediterranean central banks at the level of Governors.

Experience during the last few decades has learned that financial sector development is crucial for sustaining economic growth. A modern financial system promotes investment, mobilises savings and allows risks to be diversified, resulting in a more efficient allocation of resources. In this speech, I would like to briefly touch on two related subjects. Firstly, what reforms seem necessary to stimulate financial sector development and, secondly, how can central banks secure financial stability in a globalised economy? These questions are all the more relevant, given the emergence of international financial centres in Beirut, Dubai, Qatar and Bahrain, among others.

The increasing importance of cross-border financial flows means shocks originating in one financial market can quickly be propagated to other markets. To avoid contagion when financial instability occurs, national financial systems need to be adapted so as to be able to contain shocks originating in their own jurisdictions, while also being capable to weather external shocks.

The IMF-supported conference on Financial Sector Reforms and Prospects for Financial Integration in the Maghreb countries in Morocco in December 2006 concluded that over the last decade, all countries concerned have implemented reforms to modernise their financial sectors, allowing financial systems to develop and grow more resilient and sophisticated. However, according to the conclusions of that meeting, reform efforts should continue in the following areas:

- Firstly *Strengthening banking system soundness* by reducing banks' nonperforming loan portfolios, ensuring adequate loan classification and provisioning, and adhering fully to internationally accepted prudential rules.
- Secondly *Enhancing competition in the banking systems* by ensuring a level playing field for all banks, including through the restructuring of public banks and privatization, if warranted.
- Thirdly *Deepening financial markets* through strengthening the regulation and supervision of securities markets, broadening the investor base, and improving transparency.

- Fourthly *Strengthening financial sector oversight* by allowing greater autonomy to supervisory agencies and providing them with more resources to hire, train, and retain qualified staff.
- Fifthly *Bringing financial infrastructure in line with international best practice* by establishing commercial courts, strengthening corporate governance, and fostering a sound credit culture.

Regional integration can reinforce the progress made in financial sector reform. Useful lessons on regional financial integration can be learned from similar endeavours in other parts of the world. These experiences, particularly those of the European Union, suggest adopting a gradual approach and underscore the importance of sound macroeconomic frameworks and healthy domestic financial systems for successful financial integration.

I now turn to the second issue: the role of central banks in securing financial stability in a globalised economy. The objective of financial stability requires action on three fronts: prevention, surveillance and crisis management.

Concerning prevention, national and international authorities have concentrated on defining and working-out rules and standards aimed at improving the functioning of institutions, markets and infrastructures that are essential for the good functioning of the financial system. This includes not only hard laws, but also codes of conduct, standards and best practice, mostly designed at the transnational level. One of the key objectives of the IMF financial sector assessment programmes (FSAP), in which a number of countries present here have already participated, is to assess the observance of those standards and codes by member countries.

Prevention needs to be accompanied by a surveillance structure aimed at detecting leading signs of vulnerability at both the micro and macro level. Supervision at the micro level seeks to avoid the collapse of individual financial institutions in order to assure a high level of consumer protection. Central banks complement surveillance of individual institutions through a wide-ranging surveillance of the whole financial system, in order to avoid systemic, global crises that could slow down or disrupt economic activity.

Such crises can be the result of the breakdown of infrastructure that assures essential linkages between financial institutions. They could spread through a succession of defaults or because a large number of financial market participants all want to liquidate certain positions simultaneously.

Even preventative measures coupled to an efficient surveillance system cannot guard against all eventualities, throwing up the question of what role central banks have to play when a financial crisis erupts, especially in their capacity as lender of last resort.

Priority must be given to private sector solutions in order to avoid moral hazard, i.e. market participants should not be led to expect a rapid, even automatic, intervention by the authorities to solve problems before they grow any larger.

Intervention by authorities cannot be excluded altogether, but it must be viewed as a last resort aimed at limiting systemic risks. In any case, such intervention must be guided by the principle that the financial implications of any crisis resolution package must be borne, to the fullest degree possible, by the institutions in trouble, their management, stockholders and, the case being, their creditors.

Ladies and gentlemen, the challenges facing financial sector decision makers posed by globalisation are significant and manifold. However, they are not insurmountable. If handled skilfully, globalisation offers the prospect of increased prosperity for our economies. Co-operation and co-ordination among national authorities in the EU, the Mediterranean and the Middle East, as well as continued reforms to make financial systems more resilient to internal and external shocks seem to be two key elements of our response to these challenges.

I wish you all very fruitful discussions over the coming days. Thank you for your attention.