Chapter 3 stresses the importance of well-functioning financial systems for economic development in a market economy. It is no exaggeration to claim that the transition countries had to build up their financial institutions from scratch. In the planned economy money had no economic function and had to be re-established in the process of transformation.

3
Financial Institutions, Stability and Growth

The core of the monetary economy:
the central bank

Because of socialist ideology, communist states had no commercial financial sectors and money supply was administered by the government. The economy was organised quite contrary to capitalist systems, in the sense that money was not scarce, but could not buy much. The capitalist system, however, is (as Karl Marx quite subtly observed) characterized by apparently having an enormous wealth of commodities, but which is constrained by scarce money. In continuation of our previous discussion about stabilization we could say that money is the macroeconomic budget constraint of the economic system. On the other hand, money also needs the acceptance of the public. The general public needs to trust that money has a value. We can distinguish the four functions of money in modern market economies shown in Box 3.1.

The central bank has the monopoly over the supply of money, which is reflected by a vertical supply curve, as the amount of money in circulation
is issued by the central bank. The amount of money in circulation is measured in three aggregates:

- M1 comprises the traditional definition of money as a means of payment. It includes currency in circulation plus the checkable deposits in depository institutions (banks and thrifts). Currency in bank vaults and bank deposits at the central bank are not a part of M1, although they are part of the monetary base, sometimes designated M0.
- M2 includes M1 and adds retail non-transaction deposits.
- M3 includes M2 and adds wholesale deposits.

This money supply meets the money demand of the public and the clearing price on the money market is the rate of interest. There has been a long economic debate on whether or not the central bank is really in control of the money supply, because the equilibrium interest rate does, of course, depend on the money demand. For our purposes, we can simply say that the central bank acts as banker to the commercial banking system, which is also referred to as acting as the lender of last resort (LOLR). Modern central banks are independent from the government.

The newly created central banks in transition countries had to win the trust of the public in order to have their currencies accepted for the functions outlined in Box 3.1. This issue, commonly known as the ‘stabilization problem’ under the ‘Washington Consensus’ (see Chapter 2), requires the establishment of a sound institutional set-up which enables the central bank to carry out monetary policy in cooperation with the commercial private sector. While the functional criteria of stabilization – i.e. inflation and the exchange rate – are clear, the prerequisites for winning a reputation is less clear. As a minimum it can safely be stated that by definition such a process needs time. This is particularly crucial under the circumstances of the early years of transition, when inflation was high.

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**Box 3.1 The functions of money**

1. **Medium of exchange**
   - Money provides a medium for the exchange of goods and services which is more efficient than barter

2. **Unit of account**
   - Money provides a unit in which prices are quoted and accounts are kept

3. **Store of value**
   - Money can be used to make purchases in the future

4. **Standard of deferred payment**
   - Money is a unit of account over time: this enables borrowing and lending