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Introduction

Since 1980, over 130 countries, comprising almost three fourths of the International Monetary Fund's member countries, have experienced significant banking sector problems (see Figure 1 and the annex to Part I). Developing and industrial market economies alike have been affected—as have all economies in transition. Their experiences demonstrate that chronic weaknesses and crises in banking can have significant costs and highlight the importance of a sound banking sector for macroeconomic stability and the efficient conduct of stabilization programs. They also underscore the influence of macroeconomic and structural policies on the soundness of a country's banking system.

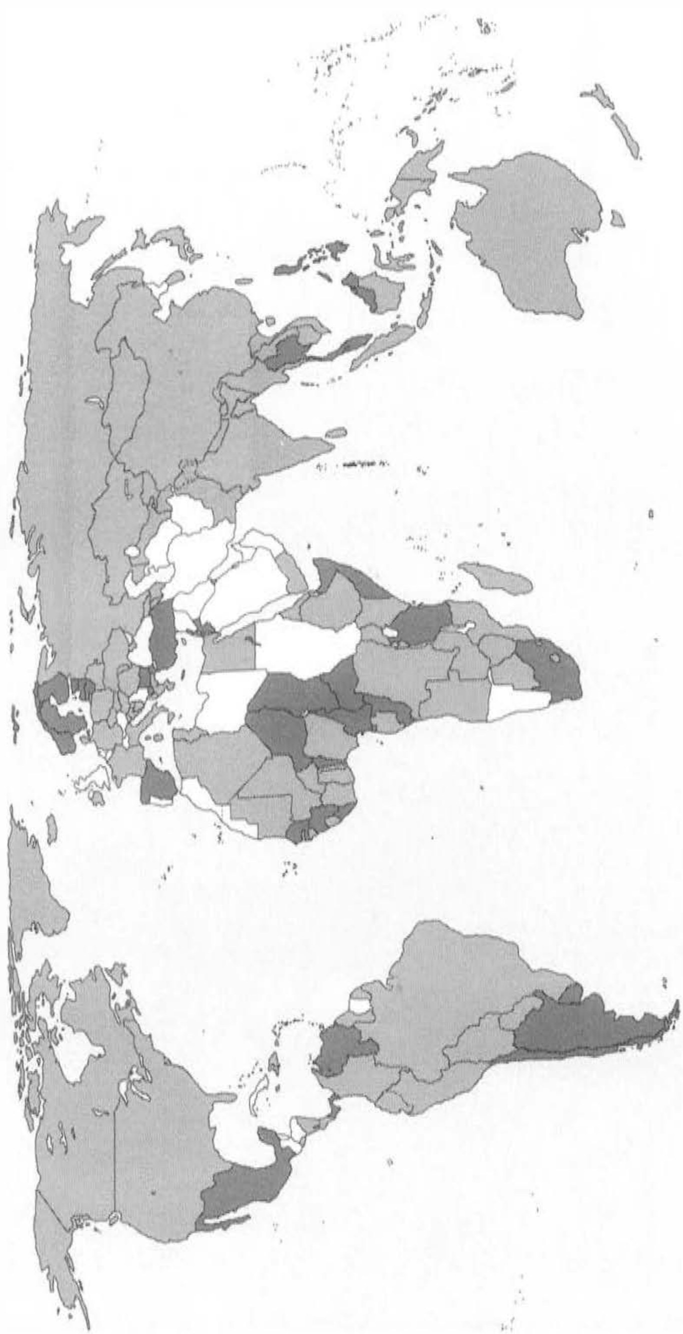
An appropriate macroeconomic policy stance is unlikely to be sufficient to maintain balance in the economy unless it is supported by sound underlying microeconomic conditions. This is true on the fiscal front, where expenditure and tax management must be adequate to sustain the fiscal stance, and in the external sector, where the ability of an exchange rate to anchor an economy on a sustained basis depends on whether it also ensures competitiveness. It is no less true in the monetary policy area, where maintaining a policy stance geared to price level stability requires a sound and competitive banking system to transmit monetary policy signals and ensure the efficient allocation of financial resources.[1]

This volume discusses the linkages between macroeconomic policy and bank soundness and places macroeconomic policy within the framework of policies and structural elements that are required to maintain a sound banking system. Part I outlines why banking is a particularly important activity in most economies and discusses how bank soundness may be defined, measured, and predicted.

[1] See Guitián (1993).

Figure 1. Banking Problems Worldwide, 1980–96

Banking Crisis
Significant Banking Problems
No Significant Banking Problems/Insufficient Information



Part II discusses the macroeconomic causes and consequences of unsound banking systems. Conditions and policies across all aspects of the economy may have an impact on the condition of a banking system. Banks cannot remain sound if the economy in which they operate is unstable, or banks' clients are themselves weak. In addition, some policies or policy instruments may have a particularly adverse effect on banks. The unsoundness of a banking system, in turn, will have important macroeconomic consequences, particularly in the monetary and fiscal areas. The behavior of unsound banks is often very different from that of sound banks: unsound banks tend to be less responsive to market signals, and this may impede the transmission of monetary policy. As most governments are reluctant to permit widespread bank failures, a fragile banking system often has significant fiscal consequences. The analysis presented is supplemented by references to a set of country cases presented in a series of tables throughout these and subsequent chapters.

Part III discusses the contributions of the operating environment, internal governance, market discipline, official oversight, and appropriate macroeconomic policies in supporting banking system soundness. Bank soundness depends crucially on the environment in which banks operate. However, internal governance in individual banks is the most important ingredient for sound banking. Internal governance is both encouraged and reinforced by adequate market discipline and external governance by regulators and supervisors. The balance between market discipline and traditional regulation and supervision may shift over time. As an economy and financial system develop, increasing reliance can be placed on market forces to regulate bank behavior; however, even in advanced market economies, internal governance and market discipline do fail. Thus official governance continues to play a role. In recent years, oversight by domestic regulators has increasingly been supplemented by various forms of international regulation, which are discussed in the concluding chapter of Part III.

Part IV concludes with an examination of the role of macroeconomic management in the two-way linkage between macro policy and banking system soundness. The effects of policy on the banking system may come to the fore in designing stabilization programs, choosing monetary instruments, pursuing fiscal balance, and coping with capital flows. At the same time, the presence of an unsound banking system may constrain policy choices. Thus banking sector soundness itself must be considered a goal of macroeconomic policy.