Bank Soundness and Macroeconomic Policy

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International Monetary Fund

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Foreword

Globalization of economies creates opportunities and risks, but in this new global environment, it is clear from the vantage point of the International Monetary Fund that the soundness of banking and financial systems must be of worldwide concern. The banking problems experienced by Fund member countries in recent years have not just affected them individually: the global economy and the international financial system have also suffered from costly financial crises. This book is a welcome addition to the literature, because it takes a global view of the causes and consequences of banking sector problems and points to ways in which banking systems can be strengthened nationally and internationally.

In March 1996, the IMF's Executive Board discussed the papers that are the core of this volume. The discussion confirmed that concern over bank soundness is widespread, not only in economies that face banking sector problems, but also in every country that might be affected by spillovers from disturbances that originate elsewhere. It also made clear that there is broad agreement on the principles that must guide policymakers as they seek to strengthen their own banking systems and contribute to the stability of the international financial system: (1) the soundness of a bank is first and foremost the responsibility of its owners and managers; yet the soundness of a banking system is a public policy concern; (2) bank soundness is crucially linked to sound macroeconomic policies; (3) a framework for sound banking must include structures to support internal governance and market discipline, as well as official regulation and supervision; and (4) international cooperation and coordination can play an important role not only in strengthening the global financial system but also in improving the soundness of national banking systems.

The authors of this book have pointed to the need for further efforts by all concerned—national authorities, regional groups, and international bodies at all levels—to upgrade the standards of banking around the world and the structure of international cooperation so as to strengthen financial systems. The Fund, entrusted with particular responsibility for multilateral surveillance of its 181 members, will continue to do its part to assist in these efforts, not only through surveillance over member country policies but also through technical assistance programs, and any appropriate action its mem-

bers would agree on in order to ensure that banking and financial institutions continue contributing to global prosperity rather than imperiling it.

Michel Camdessus
Managing Director
International Monetary Fund

Preface

For some time now, it has been recognized that an appropriate macroeconomic policy stance, however necessary to attain balance in an economy, is unlikely to be sufficient to maintain it, unless supported by adequate microeconomic conditions. That a symbiosis exists between macroeconomics and microeconomics has not only been accepted as a general policy proposition, but has also been recognized as having a dual dimension in specific policy areas. In the fiscal area, durable balance will require, besides an appropriate fiscal policy stance (the macroeconomic component), efficient expenditure and tax management (the microeconomic component). The potential role of the exchange rate as a nominal anchor for the economy is very much an aspect of macroeconomic management, it is concerned with absolute price level objectives. Yet, the ability of an exchange rate to anchor an economy durably will depend on whether it also ensures external competitiveness, a key microeconomic concern in that it addresses a relative price issue. A similar duality arises in the context of external debt-management policy: on the one hand, recourse to foreign debt can allow for a higher level of domestic demand (a macroeconomic question); but, on the other, efficient use of foreign savings will enhance the economy's productive potential (a question typical of microeconomics).

Monetary policy also exhibits this bidimensional character, yet it is hardly recognized by most of the literature on the subject. For example, analyses of the microeconomic foundations of macroeconomics and of monetary theory have had limited bearing on monetary policy prescriptions. Instead they have emphasized the macroeconomic aspect of monetary policy: on its role to secure stability in the standard of value, either internally, through domestic price discipline, or externally, through exchange rate discipline.

Needless to say, such emphasis on the stability of the standard of value is essential for attaining balance in an economy. But it is by no means sufficient to maintain that balance. Besides an efficient mix of monetary and exchange policy instruments, sustained monetary equilibrium requires a sound and competitive banking sector, and more generally, a sound and competitive financial system. These are microeconomic aspects of monetary management, in that they focus on a specific sector rather than on the economy at large. While the significance of an efficient policy instrument mix is being increasingly recognized, the aims of a sound and competitive banking and financial sector have been rarely, if at all, perceived as inte-

gral aspects of monetary and macroeconomic policy. This book attempts to redress that deficiency by examining how the soundness of a banking system and macroeconomic policy are linked.

In recent years, the experiences of a broad range of countries, from industrial to developing and transition economies, have made clear the importance of bank soundness from a macroeconomic perspective. Such experiences illustrate the extent to which unsound, uncompetitive banking systems and inadequate institutional and regulatory frameworks weaken efficient credit allocation, distort the structure of interest rates, disrupt monetary policy signals, and impose significant fiscal costs, with adverse consequences for macroeconomic stabilization and balance.

These issues are of legitimate concern to the IMF given their linkage with macroeconomic management and performance. A clear illustration of this institutional interest is the technical assistance program of the Monetary and Exchange Affairs Department (MAE), which for some time now has been deeply involved in the supervisory and regulatory aspects of central banking. The IMF has also been addressing banking sector problems through its regular policy consultations with all of its members countries, as well as through its policy research. This volume is one product of that research effort, drawing upon the experience MAE has accumulated over several decades. The present work is based on internal policy papers that explore the macroeconomic implications of banking and financial sector issues and that were presented to the Executive Board of the IMF in March 1996. But it takes its place in a broader body of policy research that includes the papers gathered in *Banking Crises: Cases and Issues* (International Monetary Fund, 1991) and studies currently under way regarding payments systems risk management and systemic bank restructuring.

There can hardly be a more opportune time than the present to address the issues surrounding the linkages of bank soundness and macroeconomic policy. Not only is there a significant number of countries with vulnerable banking sectors or confronting banking crises, but there is also a renewed focus on the need for international cooperation in this area. The communiqué of the Group of Seven at their summit meeting in June 1996 in Lyons noted that the globalization of financial markets has created a more complex financial environment, in which improved prudential regulation and supervision in the financial markets are essential to preserve the stability of the international monetary and financial system.

Concern for such stability is at the core of the IMF's mandate to promote international monetary cooperation and exchange stability. It is hoped that the contribution of this book to the policy discussion will be of help to those involved with the interrelationship of the banking sector

with macroeconomic policy, and that it will add to the understanding of how structural and macroeconomic policies can be formulated to underpin safe and sound banking.

MANUEL GUITIÁN
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