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Role of the IMF in Promoting Financial Stability

Role in Promoting Macroeconomic Stability

The thrust of policy efforts to strengthen financial sector performance has to originate with national authorities. But the Fund and the international community at large have an important stake in the success of these efforts, because banking crises have macroeconomic consequences and may generate significant regional and international spillovers. As more countries remove remaining restrictions on their capital account transactions, and as banking and finance assumes a more regional and international dimension, the cross-border impact of banking system problems can be expected to increase as well. These considerations have motivated broad international interest in contributing to the effort to achieve greater stability in banking and financial systems around the world, culminating in the statement by G-7 Heads of Government in Denver. The Fund's efforts to support the initiatives of many of its members to strengthen their financial system policies through its surveillance, lending, and technical assistance activities should be seen as part of this larger international effort now under way, and the Fund's work will have to be in concert with the endeavors of this broader international initiative.

The Fund's main instruments for promoting financial sector soundness are bilateral and multilateral surveillance, conditional lending, and technical assistance. In its bilateral surveillance activities, the Fund seeks to improve the macroeconomic environment and policies through a regular dialogue with the authorities of member countries and through discussions by the Executive Board of the IMF staff's appraisal of macroeconomic performance and policies. Since a stable macroeconomic environment and a sustainable external position are necessary conditions for a sound and effective financial system, this effort contributes significantly to the stability of the financial sector. At the same time, since a sound banking system contributes to macroeconomic stability, a focus on banking sector issues is also appropriate for the assessment of macroeconomic and balance of payments policy.

By extending its analysis of the banking system and, where necessary, broader financial system issues, the Fund's bilateral surveillance effort will also make a contribution to the wider international efforts to achieve greater stability in banking systems. The framework suggested here is, inter alia, meant to provide the Fund's staff with a broad guide for analyzing banking system issues by identifying key areas of vulnerability. Furthermore, the framework could be helpful in defining areas where corrective policies are called for, and it could provide guidance for policy discussions with authorities. Use of a framework such as that outlined here could help to make the analysis and policy discussions more consistent and transparent across a wide spectrum of the Fund's membership—although the focus on financial sector issues will need to be selective and due regard will have to be paid to the circumstances of individual countries. The increased focus of the Fund's surveillance on the financial sector will necessarily have to identify problems that are of potential macroeconomic concern. There is a need to develop soundness indicators for the key prudential areas discussed in this framework, to complement the relevant macroeconomic indicators.

The framework is to provide a broad basis for IMF staff to consider a range of issues that may be important, particularly in helping to identify circumstances in which a preliminary assessment may suggest potential benefits from further exploration. In the end, however, Fund surveillance will not be able to certify financial systems as "sound," or even reliably identify all instances in which difficulties in the financial sector may become a major macroeconomic concern. Rather, the objective must be to increase the awareness of financial sector problems, their potential consequences, and their appropriate solutions in selective instances where they may become a major concern. In this regard, as mentioned above, the framework suggested in this paper is clearly not a checklist of issues to be explored in every Article IV consultation, nor is it a diagnostic tool that could allow an assessment of the financial position of individual banking systems.

In its multilateral financial surveillance exercise, which is considered by the Executive Board in its discussion of the International Capital Markets Report, the IMF assesses systemic developments and risks in the global financial system. Such multilateral surveillance also seeks to identify financial problems and risks that have a potential for spilling over regionally or internationally. In considering banking system developments in systemically significant countries, these surveillance activities could also benefit from the consistent application of a framework for sound banking, such as the one suggested in this paper.

In addition to increased surveillance, efforts to strengthen banking systems and to deal with outright banking problems or crises have become a regular feature of Fund-supported adjustment programs in some countries. The IMF has often assisted in identifying and diagnosing banking system problems, in helping design strategies for systemic reforms and bank restructuring, and in ensuring that such strategies are consistent with, and supported by, appropriate macroeconomic policies. In several instances, a Fund-supported program has been contingent on major banking sector reforms or systemic bank restructuring. Such programs have at times been coordinated with loans from the World Bank and regional development banks in support of financial sector reforms or individual or systemic bank restructuring.

Furthermore, IMF technical assistance has helped to strengthen the financial infrastructure of many countries through advice on basic central bank and banking legislation; improvements in monetary and fiscal management; foreign exchange, money, and government debt market development; improvements in monetary statistics; the design of payment systems and deposit insurance arrangements; the development of prudential regulations and supervisory capabilities, and in particular the entry and exit of banks; and strategies for systemic crisis management and bank restructuring. These efforts have been aimed mainly at developing countries and economies in transition, but have also involved a significant number of other member countries.

Role in Disseminating and Adapting Best Practices

An indispensable ingredient in the international efforts has been the work of the various multilateral official and industry groupings to compile principles, best practices, and guidelines covering the relevant financial activities or arrangements. Furthermore, the experience gained in some of the major industrial countries in formulating and implementing guidelines, standards, and best practices for use in the financial sector can be helpful to the relevant national authorities in a wider spectrum of the Fund's members, and can contribute to the harmonization of rules and practices internationally.[8] The most successful of these initiatives has been the work of the Basle Committee on Banking Supervision, which has, inter alia, agreed on standards for capital adequacy and cross-border supervision of internationally active banks from the G-10 countries. These standards have now been successfully adopted (and in some cases adapted) by many emerging market countries and in numerous other countries as well, at least in form, if not always in substance. In cooperation with supervisors from emerging markets, the Basle Committee's Core Principles for Effective Banking Supervision are expected to be endorsed by a wide spectrum of non-G-10 countries. Regional groups of bank supervisors, supported by the Basle Committee, have been active in promoting harmonization and improvements in regulatory and supervisory practices and are expected to support that process. Furthermore, IOSCO is working on similar standards for the securities industry, and there are incipient efforts by IAIS for the insurance industry as well. In addition, the International Accounting Standards Committee is developing standards that are expected to be ready for international endorsement in March 1998. The standards, guidelines, or best practices being produced by these various expert groupings are crystallizing the experience gained over the past decade with formulating solutions to a wide array of problems in the financial system.

An increased focus on banking and financial sector issues by the IMF will contribute to the dissemination of best practices and will thus over time contribute to a harmonization of financial policies and practices internationally. At the same time, country experiences, as well as changing market conditions and other circumstances, will require that the framework suggested in this paper undergo regular revision. The experience that the IMF is gaining in its surveillance and technical assistance work can usefully be shared with the various expert groups. This suggests that cooperation and consultation between Fund staff and these groups are mutually beneficial.

Synergy Between the Two Roles

There is undisputed evidence that banking sector problems can be costly and disruptive to macroeconomic performance, and that the impact of such problems can make itself felt extensively across national borders. While national authorities have the primary responsibility for addressing banking problems, a concerted international effort, involving international financial institutions and expert groupings, is under way to reduce the incidence and cost of such problems.

The near-universal membership of the IMF and its mandate to promote macroeconomic and exchange stability suggest that the Fund is well placed to contribute to a strengthening of the financial systems in its members by enhancing its surveillance to cover developments in their banking systems, particularly where they exhibit problems with potential for generating serious macroeconomic disturbances. The continuous nature of the surveillance process is well

[8] See Goldstein (1996).

suited to monitor and support the sustained efforts required by national authorities to improve the soundness and the stability of banking systems in member countries. The conditionality applied to the use of the Fund's resources can be, and indeed has been, used to ensure that weaknesses in members' banking systems are dealt with in a timely and effective fashion. Finally, the IMF's extensive program of technical assistance can be used to ensure that member countries, in the process of liberalizing their banking systems, learn from the experience of others.

For the Fund's coverage of banking systems in its member countries to be as effective, consistent, and transparent as possible, it is desirable to have a framework of general principles of sound banking that can assist in the analysis and assessment of the performance of banking systems across the wide spectrum of the IMF's membership.

In arriving at an initial outline of such a framework, the IMF has drawn to the maximum extent possible on the ongoing work of various standard-setting international groupings. The efforts of the Fund to extend and strengthen its surveillance over the macroeconomic implications of the operation of banking systems builds on, and is consistent with, the work of these international groupings, and in particular the work of the Basle Committee in the specific area of bank supervision. In turn, the IMF's growing experience with surveillance over banking system issues can be used as input into the work of these groupings, and the Fund can help to adapt these standards and best practices to the varying circumstances of its wider membership.