# IS THERE A CONFLICT BETWEEN ADDRESSING PROBLEMS IN THE BANKING SECTOR AND ENSURING SUPPORT FOR THE MACROECONOMY?

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1. Well before developments in Asia began to dominate the news, we at the IMF had been expressing the fear that the next major economic upheaval would have its origins in a banking crisis, or would be compounded by one. This was not particularly prescient for the evidence had increasingly shown that macroeconomic stability and sound banking go together. For this reason, the occurrence of major banking failures throughout the world has been a matter of great import for anyone concerned with the stability and prosperity of the world economy. The phenomenon has been remarkably pervasive. More than three quarters of the Fund's members have been affected during the last two decades. Over the last 18 months, events in Asia and elsewhere, including most recently Russia, have vividly illustrated the consequences of the combination of a weak financial system and inadequate macroeconomic policies -- with weakness in one area feeding on and exacerbating problems in the other.

2. Today I will first outline the general approach the Fund takes to banking and financial sector issues, and then discuss the specific issue at hand--whether there is a conflict between dealing with banking sector problems and ensuring support for the macroeconomy.

## The IMF's Approach to Banking and Financial Sector Issues

3. As a long-term matter, the globalization of trade and financial markets and the associated liberalization of international capital markets may turn out to be the most important economic development of the late 20th century. If this trend continues, and if it is managed well -- and its continuation depends on its being managed well -- the benefits will be measured ultimately in higher standards of living, as resources are allocated with increased efficiency and risk sharing is improved. However, the increased volume and volatility of capital flows have exposed critical problems in the domestic and international financial systems that will need to be dealt with, including financial sector vulnerabilities, often in the form of unsound financial and banking systems and deficiencies in financial incentive structures, institutions, and policies.

4. The frequency of financial sector problems in a range of countries has underscored the need for countries to move quickly to adopt international best practices in financial

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supervision and regulation. Capital account opening has to be accompanied by -- and preferably preceded by -- the strengthening of bank supervision and regulation so that the domestic financial system can cope with the complications that go with free capital movements. Moreover, recent events have reminded us that these are not issues for individual countries alone. A country that receives a large volume of capital inflows and does not make the necessary reforms and institutional improvements may not only fail to reap the full benefits of inflows and risk damage to the living standards of its people, by increasing its own vulnerability; it may also become the epicenter of contagion effects that can have significant adverse effects on other countries. Thus these are not just matters of domestic policy interest but are of concern for the international community as a whole.

5. By now, policymakers have a good idea of what needs to be done to strengthen financial systems, by improving supervision and prudential standards, by ensuring that banks meet capital requirements, provision for bad loans, limit connected lending, publish informative financial information, and by ensuring that insolvent institutions are dealt with rapidly. Implementing those changes, particularly in a banking system already in trouble, is frequently difficult, especially where political pressures hamper the supervisory authorities. The task is nonetheless urgent: it cannot be emphasized strongly enough that a healthy banking and financial system is essential for the growth of the economy, and that a weak banking system is both a standing invitation to a macroeconomic crisis and a guarantee of the severity of any such crisis.

6. The importance of this task has been well understood by the international community, which has responded among other ways by the introduction of the Basle Committee's *Core Principles* for banking behavior and supervision. Together with our colleagues in the World Bank, the regional development banks, the BIS, and the banking supervisory community, the IMF is increasing its efforts in the banking and financial areas. With our near universal membership, we can play an important role in international efforts to promote financial sector stability, not just in the emerging markets but across the entire membership. The IMF seeks to improve the macroeconomic environment and policies of member countries through individual-country *surveillance* with members -- our regular Article IV consultations with each member, and other visits to discuss problems in the economy and particular sectors, the results of which are then generally presented to our full membership -- through the provision of technical assistance, and by the publication of data and other reports. In addition to assessing the macroeconomic effects of any problems in the financial system, the policy dialogue has increasingly focused on identifying financial sector vulnerabilities with potential macroeconomic implications and on suggesting corrective policy steps. In our surveillance efforts, we seek to promote financial sector policy frameworks consistent with internationally accepted standards, as developed by the supervisory community and other bodies; we also assess progress in implementation of those standards.

7. In its multilateral surveillance--primarily through the *World Economic Outlook* and the *International Capital Markets* exercises--the Fund seeks to identify financial vulnerabilities and risks with a potential for generating regional and international spillovers. This work

involves identifying deficiencies in areas such as: systemically important banking systems; international aspects of financial supervision and regulation; the design and operation of wholesale payments systems; and the functioning of the financial infrastructures underlying the major international financial markets. There is also an increasingly important role for regional surveillance--policy discussions at fora involving policymakers from a particular region together with officials from international and regional institutions. The meeting last week of finance ministers and central bank governors from the Western Hemisphere with officials of the IMF, World Bank and the InterAmerican Development Bank provides a useful case in point.

8. IMF-supported adjustment programs often include conditionality related to financial sector reforms, such as legal and regulatory improvements, systemic bank restructuring, privatization of banks, and the introduction of appropriate monetary instruments and market based systems of monetary management. The Fund also provides technical assistance, at the request of members, focussing on key banking and financial sector matters.

9. Fund staff have developed a general framework for identifying the strengths and weaknesses of financial systems and have produced a distillation of widely-accepted views of what might constitute a framework for financial stability, focussing on banking soundness and pinpointing the deficiencies that have frequently led to macroeconomic repercussions. This work was condensed into a paper, *Toward a Framework for Financial Stability*, produced in collaboration with the World Bank, other key institutions and supervisors from various regions.[2] The paper provides guidance for the Fund's financial sector surveillance work and aids Fund staff in the design of appropriate and consistent lending programs and in technical assistance. And we are continuing to strengthen our collaboration with our World Bank colleagues, to ensure that the limited resources in this area of financial sector supervision are efficiently deployed.

10. Of course, the Fund's framework and approach to dealing with banking sector problems in crisis countries has been much on display over the last 18 months. In this presentation, I am not going to review the events of specific cases but rather will focus on the interaction between banking sector problems and macroeconomic performance.[3]

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[2] David Folkerts-Landau and Carl-Johan Lindgren, *Toward a Framework for Financial Stability*, IMF, September 1997, with the Core Principles of the Basle Committee included as an annex to the paper.

[3] For a detailed discussion of the IMF's work on banking and financial sector reform in specific countries during the recent crisis, see *Economic Crises and the Financial Sector*, Stanley Fischer, presented to the FDIC **Conference on Deposit Insurance**, September 10, 1998, also available on the IMF website (www.imf.org).

**Banking problems and the macroeconomy**

11. Do banking sector problems make it more difficult to prescribe remedies for the macroeconomy when they are needed? The short answer is "yes, in the short-run." Recent history suggests that, without a doubt, weaknesses in a banking sector impose many constraints on the formulation and implementation of macroeconomic policies, particularly, during crisis situations. Having said that, banking sector problems, and financial sector problems more generally, have to be addressed at some point—forbearance in this area almost never works. Consequently, in the long-run, it seems clear that conflict between ensuring support for the macroeconomy and dealing with banking sector problems is illusory. Taking care of banking sector problems today ultimately leads to a more stable macroeconomic environment in the future.

12. At this point, I would like to provide some examples of how banking sector problems can constrain policy options. Then I will address the issue of how to proceed in practice when decisions need to be made. At the outset, however, let me stress that poor macroeconomic policies can contribute to the emergence of banking sector troubles. Somewhat ironically, then, the constraints on macro policies imposed today by an unsound banking sector in turn are often the result of imperfect macroeconomic policies of the past.

**Monetary and exchange rate policies**

13 One primary way that a weak banking system constrains policy choices is by limiting the effectiveness of monetary policy. The classic case, underscored by recent history, is the inability of the monetary authorities to raise interest rates sufficiently to stem a speculative attack on the currency or to maintain a currency board arrangement, because of banking sector concerns. High interest rates can damage weak banks by lowering profitability when short-term funding costs exceed returns on longer-term loans and, ultimately, by increasing the number of defaulting borrowers if interest rates remain high.

14. While the inability to raise interest rates by enough to deter a speculative attack is an obvious constraint, there are other more subtle constraints to exchange rate policy that can occur in the earlier stages of a deteriorating banking system. For example, long-term over-valuation of an exchange rate can foster an environment in which banking sector problems may take root. If an over-valuation is permitted to continue, banks and their customers may borrow in foreign currencies without appropriately hedging the exchange rate risk. In some recent cases, banks seemed to be hedged (and may have believed themselves to be hedged) because they had onlent the foreign currency funds rather than holding the exposure themselves. However, the currency risk was just one step away and, when the exchange rate moved, unhedged bank borrowers suffered currency losses, leading to loan losses for the bank. Rapid exchange rate corrections often make banking sector problems worse--but, as this example shows, such a development reflects unsound practices before the exchange rate move, rather than the rate adjustment itself.

15. On the more technical side, an unsound banking system may also affect the efficacy of monetary policy instruments. For example, when banks are experiencing problems, segmentation may arise in the interbank market as sound banks are able to acquire interbank funds at low rates while (suspected) unsound banks cannot, leading to liquidity problems for these banks. Another frequent problem can be dysfunctional money market in which banks are not responsive to interest rate signals or are incapable of passing on interest rate changes, compromising the transmission mechanism for monetary policy. Further, if liquidity problems arise for some banks, when there are widespread banking system problems, typically it becomes more difficult--both for the market and the monetary authorities-- to distinguish between illiquid and insolvent institutions. For the monetary authorities, banking system problems make it harder to segregate lender-of-last resort support and to provide it only to illiquid institutions, but not to insolvent ones.

**Fiscal Policy**

16. Fiscal policy is another area in which banking troubles complicate the task of macroeconomic policy. Resolving banking system problems often requires government expenditures—and frequently these expenditures increase the longer it takes for the authorities to tackle the problem. In extreme cases, a banking sector needing recapitalization or restructuring may result in unexpected or unbudgeted expenditures and make it hard for governments to reduce fiscal deficits or to increase fiscal surpluses. Nevertheless, there is a sense in which this problem is more apparent than real. Assuming a well-designed policy response, the fiscal authority provides funding to help cover banking sector losses that have already taken place, while avoiding incentives for future losses. In this situation, the economic losses associated with the banking crisis have already been incurred and the process of covering them through the budget is simply a recognition of past losses. Under this analysis, the macroeconomic impact of recognizing these losses should be minimal. Nevertheless, banking-related fiscal costs are often not transparently accounted for and may complicate the formulation of forward-looking fiscal policies.

**Capital Flows**

17. The role of the banking system as an intermediary for capital flows makes it a key player in the macroeconomic framework associated with capital account liberalization. Banks with access to international interbank markets and other foreign capital markets can become constrained if the banking system is in distress. A structure in which inflows are intermediated through a banking sector that is inadequately equipped to monitor risks can contribute to excessive credit growth. Poor quality assets may be added to banks' balance sheets in a period of boom, setting the stage for a jump in nonperforming loans when the cycle turns down.

18. Moreover, reaping the benefits of open capital movements requires a well-functioning banking system. If a surge in capital inflows is to support long-run economic advancement, financial intermediaries have to be able to channel the funds to high-return investments, which will produce a stream of income available to support the service payments on the inflows

while also generating a surplus for the benefit of the domestic economy. If capital inflows finance low-return investments, perhaps because the financial system is not sufficiently able to identify high-return projects or perhaps because of long established practices of connected lending, then meeting the service payments will be difficult and the desired benefits for the domestic economy may not arise.

**What to do?**

19. Clearly, then, an unsound banking sector can impose constraints on the formulation and implementation of macroeconomic policies. Nevertheless, policy choices have to be faced and typically decisions need to be made fast and under the pressure of rapidly evolving events.

20. The assessment of how to proceed depends in part both on the magnitude of the banking sector problems and the state of the economy. If banking sector problems are identified at an early stage during a period of relatively benign economic performance, then the situation may be easier--not easy but easier--to manage. But dealing with banking sector problems is never easy--neither economically nor politically. There is a huge temptation to delay banking reforms in the hope that the problem may diminish, may go away altogether, or --perhaps most tempting of all--may have to be dealt with on someone else's watch. This temptation should be resisted. It is much better to take steps of banking reform when the problems are small and economic performance is good than in a time of crisis.

21. If reforms are delayed until a crisis erupts, then policymakers have few attractive options. Bank closures may well affect confidence adversely in the short-run if implemented in uncertain times. The answer however is not to allow insolvent institutions to continue operating. The lesson is the hard one that such steps should have been taken earlier and cannot be avoided now. This assessment may provide cold comfort to policymakers in the affected country -- but is a crucial lesson for other countries experiencing banking problems but where crisis has yet to break out.

22. One approach to macroeconomic shocks in the context of a weak banking sector is for the monetary authorities keep interest rates lower than otherwise, allowing the exchange rate to depreciate. Often it is hoped that with lower interest rates, banks may recover on their own without further attention. This approach, however, seldom works as well as hoped for. A second approach is to try to fix banking sector problems as fast as possible, while also continuing to pursue a restrictive monetary policy. An accompanying somewhat easier fiscal policy may help. A third approach is to marry the first two: keep interest rates lower than you would otherwise and allow fiscal policy to be somewhat more expansionary, and in addition, address the banking sector problems as quickly as possible.

23. In effect, it is this third approach that the Fund has advised its members to pursue. Interest rates in crisis countries, while high, have probably been kept lower than they would have been in the absence of banking difficulties, while the programs supported by the Fund

have acquiesced in an easing of fiscal policy as the depth of the output decline has become more evident.

24. In following this approach, however, there are numerous practical issues that must be considered. The solutions are likely to be painful, even when the thrust of the answers is in principle well-understood. Many of the judgements to be made will depend on the specific country circumstances--a general and simple recipe applicable to all countries simply cannot be provided. However, it does appear that prompt, comprehensive and decisive action that is clearly in the direction of resolving these problems--and that has the firm support of the political leadership--is most likely to arrest a deterioration of confidence. While in the short-run, macroeconomic conditions may be adversely affected as the financial sector problems are addressed, the longer-term benefits are likely to be larger and to accrue sooner if this approach is taken. Moreover, the risk of spiraling into a still-worse crisis is reduced and the future hindrances to macroeconomic policy choices are diminished if the financial sector problems are not permitted to fester.

**In sum**

25. Crisis management is difficult. This should not be a surprise. Early attention to both weak macroeconomic policies and deteriorating banking sectors can alleviate many of the stresses that accompany macroeconomic shocks. In the banking area, we at the International Monetary Fund are working in close collaboration with the World Bank, the BIS, the Basle Committee, and individual central banks. As we all know, but as each crisis reminds us, prevention is better than cure. In this regard, the Fund is enhancing its "preventive care" agenda. :

- The Fund together with national supervisors, regulators and other members of the international community is now in the process of disseminating and refining international principles and good practices for sound banking.

- The Fund staff has improved its capacity to provide advice and expertise to assist countries to develop sound financial systems within its surveillance mandate. For instance, the health of the banking system and its connection to the macroeconomy is now commonly discussed with country authorities within the context of the Fund's annual Article IV consultations with all member countries.

- Structural policy reforms aimed at improving the competitiveness of the financial services industry are encouraged, including, but not limited to, privatization of publicly-held commercial banks, entrance of foreign financial institutions with expertise, and labor market policies to increase flexibility of the work force. Structural policies to correct existing financial sector problems are also now part of Fund stabilization programs.

- Fund staff provide technical assistance in a wide range of financial sector areas, including: diagnosing the financial condition of financial institutions; improving financial regulations, asset classification, loan-loss provisioning; setting up restructuring and asset management agencies; and exit strategies for institutions that are not viable.

- Using multilateral surveillance, the Fund attempts to bring to the fore developments in national economies and systemically important financial systems that influence international financial markets and global financial risks, hoping to pinpoint areas of vulnerability and countries likely to experience financial sector difficulties.

26. Continued, concerted international efforts to promote financial stability are critical for countries to achieve the potential benefits of a more liberal and global financial system. As recent events have underscored, such efforts are also vital to reduce the risk of financial crises. Such crises can not only damage the individual country at the epicenter but, through contagion effects, can also have massive spillover impacts. Thus these are issues for all countries and for the international community as a whole. The Fund will continue to find the means, within its mandate and resource constraints, to promote financial stability and banking soundness in the financial systems of its member countries and in the international financial system. These kinds of unglamorous but immensely important preventive measures reduce the risk of financial crisis. And of course, when crises do occur--as they inevitably will, because not all risk of crisis can be eliminated--the Fund stands ready to do its duty, which is to help stabilize economies that may need financial assistance, provided they are willing to undertake appropriately ambitious economic reform and adjustment programs. In this work too, the Fund will do its best to ensure that the necessary bank and financial sector reforms are undertaken and implemented.

27. Finally, for the IMF to do its part, the envisaged 45 percent quota increase, equivalent to about $90 billion, needs to be implemented with dispatch. The world economy faces a spreading crisis, and the international community needs to be able to respond to the legitimate requirements of countries affected by the crisis. In the international system built up over the past fifty years, a system that despite periodic crises has been spectacularly successful in supporting growth around the world, the IMF has had the lead role in providing financing for countries needing international assistance and willing to take the appropriate measures. The Fund's ability to play its financial role, and with it the capacity of the international system to help countries in trouble that require international assistance, is now at stake.