Roundtable on "Policies to Prevent Future Crises"
At Boston Fed conference on "Building an Infrastructure for Financial Stability"
Cape Cod, 23 June 2000

It is a pleasure to be here for this roundtable, in such a beautiful location.

The economic dangers that can lurk in the financial sector have been recognised for a long time. Thomas Jefferson once remarked "that banking establishments are more dangerous than standing armies". Goodness knows what he would have made of hedge funds.

But if anyone still had doubts about the importance of a strong and well-regulated financial system to economic health, the recent emerging market crises must surely have dispelled them. In Asia, long-standing weaknesses in national financial systems helped explain both the spread of the crises and the their sizable economic costs. Conversely, Latin America suffered much less than many people feared - in large part because its financial systems had become smaller, stronger and better regulated after the debt crisis of the 1980s.

Let me begin by putting the importance of financial system soundness in a broader context, describing how it fits into international crisis prevention efforts more broadly.

And then let me return to the financial sector specifically and talk a little about the healthchecks for national financial systems that we are now undertaking with our colleagues at the World Bank. I believe that these Financial Sector Assessment Programs are one of the most valuable innovations to have been prompted by the recent crises.

Naturally enough, strengthening crisis prevention has been a key priority in recent efforts to reform the architecture of the international financial system. Like death and taxes, financial crises are perhaps an unavoidable part of the human condition. But much can – and is – being done to make them less frequent than they have been in recent years.

Principally, this has involved strengthening the IMF's surveillance of national economic developments and policies. Surveillance is undertaken through our regular Article IV consultations with national authorities, as well as through various multilateral channels.

These include six-weekly briefings to the IMF board on world economic and market developments; regular briefings for the G7, APEC and other similar fora; plus published material like the World Economic Outlook and International Capital Markets Report. Increasingly, surveillance is taking on a regional dimension as well – with studies of common trends and policy issues in areas like the euro-zone and the Caribbean.

Meanwhile, the substance of surveillance has changed to suit a world of large and volatile capital flows. Our traditional emphasis on external viability through the current account has been supplemented by a focus on factors that might leave countries vulnerable to sudden crises of investor confidence and catastrophic capital outflows.

One obvious area of concern is exchange rate regimes. Almost every major financial crisis since the fall of the Mexican peso in 1995 has involved the collapse of a pegged exchange rate regime. As a result, we are seeing more and more countries move towards the ends of a spectrum running from a free float at one extreme to very firm fixes at the other – currency boards or dollarization. No single regime will be suitable for all countries at any one time – or for any one country all the time. But whichever regime a country does choose, it is vital that the other economic policies it adopts are consistent with that framework.

Surveillance needs to address this. But assessing the compatibility of exchange rate regimes and other policies is not as simple as it sounds. No-one would have argued that Ecuador met the preconditions thought necessary to make a success of a currency board, not least because of the weakness of the financial sector and the country's long-standing fiscal problems. But against the odds, and despite the fact that it was adopted as an act of desperation rather than careful consideration, dollarization seems so far to be working there.

Other policy areas on which there now a greater focus include the true state of foreign exchange reserves, the structure of external debt and the capital account regime. With regard to the last of these, there is now much greater recognition by the Fund and others that capital account liberalization has to be pursued in an orderly and well-sequenced fashion. Along the way there may be a role for prudential regulation of capital inflows, like those used in the past by Chile. But as Chile's decision to abandon them perhaps demonstrates, a fully liberal regime remains the objective to which well-prepared countries should eventually aspire.

In addition to the substance of surveillance – which of course also includes the focus on financial sector soundness to which I will return later – there has been a revolution in its openness. Some 80 per cent of Article IV consultations now end with the publication of a Press Information Notice that summarises the conclusions of the board discussion. Around 60 countries – one in three of our members – have now volunteered to have the detailed Staff Reports on which their Article IV consultations are based released to the public. The Letters of Intent and Poverty Reduction Strategy Papers of countries borrowing from the Fund are now also routinely published. And all this seems to have been achieved without materially affecting the candor of policy discussions between the Fund and its members.

As a further contribution to crisis prevention, surveillance also increasingly focuses on the extent to which countries meet internationally-agreed stanbards and codes of conduct. These standards include statistical dissemination, fiscal transparency and corporate governance, as well as a number covering different aspects of the financial system. Under a pilot scheme, the Fund and Bank are pulling together assessments of the extent to which countries meet these various standards in Reports on the Observance of Standards and Codes (or ROSCSs).

In addition to strengthening our surveillance, the Fund is also promoting crisis prevention by offering financial incentives to countries that take measures to make themselves less vulnerable. These take the form of Contingent Credit Lines, which are offered to countries that have taken a demanding series of crisis prevention measures, but which nonetheless fear being sideswiped by crises in other countries. So far no country has taken up this facility, but I am convinced that it can make a valuable contribution to crisis prevention. So we are discussing ways to make it more user-friendly and financially attractive.

Now let me turn to the Financial Sector Assessment Program, which was launched by the Fund and Bank on a pilot basis in May 1999. FSAPs are an attempt to address systematically the health of a country's financial system, with an emphasis both on potential vulnerabilities (which are an important input into Fund surveillance) and long-term development needs (which are useful to the Bank in planning its financial sector work). In addition to Bank and Fund staff, FSAP missions draw on expertise from other international organisations, as well as central banks and financial supervisors from 30 countries. As such, they involve a helpful element of peer review.

Twelve FSAP missions were completed by the time of our spring meetings, for countries ranging from Iran to Ireland and from Canada to Colombia. At the spring meetings, our shareholders then agreed to double the size of the pilot program to 24 countries. There has been no shortage of volunteers. Developed and developing countries alike are already finding these financial healthchecks enormously valuable. They allow the international institutions and national authorities to assess in a much more comprehensive way than before:

- the impact of macreconomic developments on financial sectors;
- the impact of financial sector developments on economic performance, and;
- the links between financial fragility, provision of financial services and economic growth.

For the Fund, these assessments then feed into the Article IV surveillance process, via what we call Financial Sector Stability Assessments.

The scope of the FSAP varies from country to country, depending on circumstances, but the main areas of focus include the following:

- The macroeconomic environment.
- The structure and soundness of financial institutions, which is assessed in part using stress-tests and sensitivity analyses.
- The structure and efficiency of money, foreign exchange and securities markets.
- Systemic risks in payments systems.
- The state of regulation and supervision, including the extent to which it meets international standards.
- Arrangements for crisis management, including the state of financial safety nets, intervention and workout mechanisms.

In all these areas missions identify vulnerabilities or departures from best practice. This allows a reform program to be devised and technical assistance needs to be identified.

As we are still in the pilot phase, FSAPs will no doubt continue to develop in the light of experience. The program raises several practical questions, not least the appropriate extent of transparency. Some countries are understandably concerned about publishing reports that might undermine confidence in particular elements of their financial system, for fear that the concerns they might raise could turn out to be self-fulfilling.

The debate is sometimes conducted in such a way that emerging market countries are accusing industrial ones of trying to impose a degree of transparency on them which they themselves would not accept if they were at a similar phase of financial sector development. We will have to address this concern over the coming months. But during the debate we must remember that the high standards and good practices we hope to promote are in everyone's interests, although there may be differences as to how quickly countries should be expected to achieve them and how public any shortcomings should be made.

I hope and believe, though, that this program can make a valuable permament addition to our arsenal of crisis prevention measures.