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The IMF and the Financial Sector

Introductory Remarks by Stanley Fischer
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Distinguished guests. Members of the Executive Board. Colleagues.

It gives me great pleasure to join Stefan this morning in welcoming you to the Fund for this seminar. Probably the most useful thing I can do is to put the seminar in some perspective. I'll concentrate on describing the changing role of the Fund in the financial sector. I will then say something about the growing importance of international standards in this area and then touch briefly on a number of other issues that we and our members are having to address as understanding of the central role of the financial sector develops.

The Evolving Role of the Fund in the Financial Policy Area

The Fund, like everyone else, has had to adapt to the acceleration of globalization, particularly as it manifests itself in the capital markets. Technological advances, market liberalization and structural reforms in private markets are all helping to drive the process.

Notwithstanding the concerns that have been expressed - quietly or loudly - on the streets of Washington and Seattle in recent months, the Fund believes that globalization has long been a force for good - helping to deliver better standards of living for billions of people around the world. Our job is to help our members reap the benefits of globalization, not oppose it. But we recognise the risks and costs that come with it and try to help countries deal with them.

We do this through our surveillance, technical assistance and by providing financial help to countries pursuing good policies, typically in difficult circumstances. In the process we have encouraged the pursuit of low inflation, the use of indirect instruments of monetary management, fiscal discipline, sound debt management, current account liberalization, currency convertibility and price liberalization in commodity markets - to name but a few.

The crises that have swept emerging market nations in recent years should have left no-one in any doubt about the importance of a strong and well-regulated financial sector, in dealing with capital flows that can be very large and reverse very quickly. But in re-examining the proper role of the Fund in the wake of these crises, we must ask how we as an institution should incorporate structural and other policies into our normal activities without moving too far away from our central mission in macroeconomic policy? And to the extent that the Fund does address structural issues in the financial area, in cooperation with our members, on which particular aspects should we focus and how can we work best with other international organizations?

The rationale for the Fund's involvement in financial sector issues is straightforward: the effectiveness of the economic policies we support depends enormously on the state of the financial sector. So there has always been good reason for the Fund to provide advice on how to strengthen financial systems.

But globalization and financial sector liberalization have created a number of new challenges. What is it that we used to worry about when economies opened themselves up 20 years ago? Imported inflation and the transmission of recession - a focus entirely on the current account. But these have been overtaken as concerns by the frequency, depth and consequences of financial crises.

For the Fund, this has demanded a fundamental reassessment of our role:

- The way we diagnose and try to prevent financial sector crises;
- The way we try to manage and mitigate them when they arise;
- And the stance we adopt towards particular aspects of globalization, for example the liberalization of international capital movements.

When the Fund began to focus on helping countries improve their financial systems in the 1980s, we initially emphasized the need to strengthen the instruments of monetary management, as well as ways to deepen and integrate markets for money, government securities and foreign exchange. The aim was to enhance liquidity of financial instruments, reduce transaction costs and improve the speed and predictability of monetary policy. These issues are still around.

Many countries were seeking a smooth transition to the use of indirect instruments of monetary policy, as they attempted to liberalize their financial systems, focus monetary policy on the goal of price stability and enhance the independence of their central banks. In the transition economies, during the late 1980s and early 1990s, the challenge was even greater: to create two-tier banking systems from the mono-banking systems in place under central planning. This meant developing central

banking functions - as well as commercial banking - in effect from scratch.

This experience brought home the importance of the links between banking system soundness and the effectiveness of macroeconomic policy, particularly monetary policy. So in response, we strengthened our capacity both to assess the quality of banking supervision in member countries and to help improve it. We also intensified our cooperation with central banks and other supervisory agencies, enabling us to draw on their expertise.

The countries that come to us for help often have banking systems under stress. In these cases, it became increasingly clear over time that monetary and fiscal policy measures have to be accompanied by actions to strengthen both the banking system as a whole and the governance of individual firms. We responded not only by intensifying our focus on the basics of banking supervision, but also by building up expertise in the restructuring of banking systems. Together with the World Bank, we have frequently had to support country authorities as they work out major bank restructuring programs. These have involved closing insolvent banks, limiting lending operations, instituting loan recovery programs, securing improvements to the governance of particular institutions, and determining how the cost of restructuring should be shared between shareholders, depositors, and the government.

There has been an enormous change in the sophistication of our knowledge about what to do in the face of serious banking problems. In the past six years people have developed a much more coherent set of principles about how how to behave in crises. Why was this necessary, given that we had earlier been through the Scandiavian banking crisis and the US Savings and Loan problems? People were not sure if the same rules would apply in developing countries. We understand this a lot better now.

As the emerging market crises have unfolded, the Fund has expanded its work in other areas of financial infrastructure. This has brought to the fore the question of how best to work with other international organizations, including the World Bank, the regional development banks, the BIS, and IOSCO.

Among these other areas are the importance of transparency and good governance in private financial organizations other than banks or payment systems-such as securities and insurance firms. Transparency and good governance has also been shown to be vital in the public sector, especially in those agencies with regulatory and oversight responsibilities. Vital too are accuracy in reported data and compliance with international accounting standards. Hence, we have seen a shift in focus from banking system soundness and macroeconomic policies narrowly defined, to financial sector soundness and macroeconomic and

financial policies more broadly, including especially transparency and data provision.

In that light, we and other organizations have made a determined effort to better understand the sources of risk and vulnerability in the macroeconomic and financial system as a whole; the factors which determine the ability of financial systems to cope with stress; and the sorts of measures that can improve the safety, efficiency and stability of the financial sector. Drawing on the lessons we have learned, the Fund and the World Bank started our pilot project, the Financial Sector Assessment Program (FSAP) in 1999, about which you will hear more later in the seminar. The FSAP is designed to identify strengths and vulnerabilities in individual financial systems, with a view to preventing crises. Twenty-four countries will be involved in the pilot program, which early participants are already finding valuable. I think that of all the innovations that have emerged in the wake of the crises, FSAPs are one of the most valuable. Ministers and central bank governors welcome the opportunity to have outside experts give them detailed analysis of their financial sectors.

Financial System Soundness and Standards

As we help countries strengthen their financial systems, we need guideposts to judge what has been achieved and what remains to be done. This requires international standards against which to assess the soundness and stability of financial systems. There are many players in the international community with a keen interest in such standards, and their development requires the active participation of both private and official bodies, domestic and international.

Deciding in which the areas standards would be useful - as well as the content of those standards - has typically involved intensive discussions within and between countries to reach a widely shared consensus. The international financial organizations have had an important role to play in this consensus-building process. Different organizations have been working on different aspects of financial systems. But there has been a growing recognition of the links between their work and the consequent need for collaboration. Information now flows more readily between the organizations and cooperation is also more systematic. Representatives of these organizations sit on joint fora, such as the Financial Stability Forum, as well as on each other's task forces and consultative groups.

The standards that the international community is setting and promoting cover a wide range of topics, including data dissemination; the transparency of fiscal, monetary and financial policies; banking supervision and regulation; securities and insurance regulation; payment and settlement systems; accounting and auditing; corporate governance; and insolvency regimes. In a few cases, the Fund is playing a leadership role in the setting of the standards. In some others the Fund is an active

participant in formulating the standards, but under the aegis of some other body or bodies. For the remainder, the main contribution of the Fund is in encouraging the implementation of standards that have been determined by others and then using them in our work on the assessment of financial systems.

There is a concern in some countries that the Fund is pushing too hard for the implementation of these standards. Maybe it is true that we are sometimes risk overburdening their absorptive capacity. We must discuss this where it is an issue. But I do not think there can be any doubt that these standards should be useful to all countries. The question is the speed with they are implemented and how they are appraised.

Standards cannot be written in stone. They are bound to evolve in the light of experience. Let me illustrate what I mean. In 1988, the Basel Committee on Banking Supervision sought to bring some uniformity to the way in which bank capital adequacy was assessed, as a contribution to the effective management of credit risk. But this exercise left many complex issues for the future, including how best to incorporate diversification, netting and capital adequacy for marketable securities in the trading book. Several modifications have been necessary, facilitated by research, experience and extensive discussion. Progress has been made, but many issues remain - some of which you will be discussing here. For example, should some banks be allowed to use their own internal models to assess their capital requirements? And how should we take account of the interaction between credit risk and market risk? I am sure this discussion will be mirrored in what happens to other standards.

Some Policy Issues of this Seminar

Let me turn last to some of the policy issues you will be discussing in more detail later.

Fiscal support for troubled banking systems is one topic of particular interest. This is an issue that was important in the recent crises, but which has also been important for much longer. When is it warranted, what form should it take, and what conditions should be attached? The choices become more difficult when problems in the financial sector are combined with serious inflationary pressures, balance of payments and budgetary deficits. The seminar will discuss the analytical issues involved in this all too practical question.

You will also be discussing how best to assess the ability of a financial system to withstand stress and what sort of early warning signals we should use to predict the probability of financial crises? The health of individual financial institutions clearly affects the resilience of the financial system as a whole. But we also need to know what policy instruments authorities have available. Access to liquid funds under favorable conditions also help a country withstand stress, which is one

reason why we will be reforming our Contingent Credit Line facility to make it more user-friendly. Meanwhile, in forecasting where problems might arise, we need adequate, timely, and accurate data; sufficient transparency in the private and public sectors; and good policy-oriented models.

I am also looking forward to hearing your views on the implications of international capital mobility for financial sector stability. As you know, the Fund continues to hold the view that liberal arrangements for capital movements are beneficial to both domestic and global economic development in the long-term. But we also emphasize that the process of liberalization should be orderly and tailored to individual country situations.

Countries have been experimenting with a variety of strategies - monetary and exchange rate policies, as well as prudential limits on capital inflows - to shield themselves from financial instability originating abroad. Many also believe that capital mobility can have a beneficial impact on the achievement of domestic financial system stability. We can all benefit from further research and informed debate on all these issues. I am sure that the discussion at this seminar will help in this effort.

We have been cooperating with a lot of official sector bodies and that will continue. With the private sector, the Fund is fostering cooperation in crisis prevention and resolution, as well as engaging in constructive dialogue over a variety of issues of common interest. Our new Managing Director, Horst Köhler, has made it clear that he would like to see "constructive engagement" with the private sector in good times as well as bad, without giving up the principle that the private sector has a role to play in resolving financial crises. The private sector has been active in formulating some of the fundamental ideas that drive regulatory, supervisory and oversight policies; the analysis of country vulnerabilities; and the measurement and management of financial risks. That has been recognised by the Basle Committee.

Conclusion

Let me close by saying that I am delighted that so many people of diverse experience and expertise have been willing to accept the Fund's invitation to come and participate in this seminar. A key objective of these seminars is to have the Fund staff benefit from the experience and insights of others, and to help researchers and policymakers understand better some of the policy questions that confront us. To resolve these questions requires a combination of sophisticated theoretical and empirical analyses, as well as insights from the practical experienece of those who operate in financial markets. I hope, therefore, that you will all find this seminar as valuable as I know the IMF staff will and that you all end up not only taking away something valuable and

enlightening from the event, but also having contributed to it.