THE ROLE OF THE IMF IN PROMOTING FINANCIAL STABILITY [1]

1. The globalization of trade and financial markets and the associated liberalization of international capital markets may be the most important economic development of the late 20th century. The benefits can 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 vulnerabilities in recipient countries, often in the form of unsound financial and banking systems and deficiencies in financial incentive structures, institutions, and policies. While the long-term benefits of financial liberalization and globalization are not in doubt, the intensified market discipline over financial institutions and the frequency of financial sector problems in a range of countries have underscored the need for countries to move quickly to international best practice in financial supervision and regulation.

2. In early 1997, a G-10 Working Party presented a report to the G-7 Finance Ministers outlining the key aspects of a sound financial sector and a market-based strategy for promoting financial stability. In the same period, the Basle Committee on Banking Supervision developed its *Core Principles of Effective Banking Supervision*. At the Denver Summit, the G-7 Finance Ministers asked the IMF and the World Bank to help encourage their members to adopt appropriate principles and guidelines in these areas. Moreover, the IMF has been encouraged to assist in detecting and preventing financial sector problems by strengthening its surveillance of the financial sector.

[1] Address by Stanley Fischer, First Deputy Managing Director of the International Monetary Fund at the Conference on Financial Stability and Prudential Standards, Hong Kong, September 22, 1997. I am grateful for the assistance of Garry Schinasi and Laura Kodres in the preparation of this draft.

The Role of the International Monetary Fund

3. The IMF with its near universal membership, has an important role to play in these international efforts to promote financial sector stability, not just in the emerging markets but across its entire membership. In its individual-country surveillance with members, the Fund seeks to improve the macroeconomic environment and policies through its regular consultation discussions. 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. IMF surveillance promotes financial sector policy frameworks consistent with internationally accepted standards, as developed by the supervisory community and other bodies; it also assesses progress in implementation.

4. 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.

5. Fund-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 central banking (including central bank and banking legislation), and the design and development of monetary, foreign exchange, and public debt markets and instruments. Also covered are the areas of prudential regulation and supervision; lender of last resort facilities, payment systems, and public sector guarantee arrangements;

reporting and disclosure requirements; and linkages between banking systems and fiscal policies.

6. Fund staff have been engaged in developing 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 paper titled, *Toward a Framework for Financial Stability*, was produced by Fund staff in collaboration with the World Bank and other key institutions to provide guidance for financial sector surveillance. The paper will also aid in the design of appropriate and consistent lending programs and in providing technical assistance.

7. The Fund's efforts are intended to raise the general awareness of authorities in member countries to the potential macroeconomic consequences of unsound financial systems, to promote principles of financial sector soundness, and to offer appropriate solutions to problems in selective cases where financial weaknesses may become a major concern. Of course, the Fund is neither a rating agency nor a banking supervisor and cannot be in the business either of certifying that a country's financial sector is safe and sound or alternatively of making adverse judgements on these issues. Further, Fund surveillance cannot address all of the areas in the financial system that may need improvement, nor can it be expected to provide specific assistance to the regulatory and supervisory authorities in meeting their day-to-day challenges.

8. On the topics covered in the Core Principles, the Fund has drawn to the maximum extent possible on the work of the Basle Committee. The Framework similarly draws heavily on the work of the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Committee (IASC). On the other hand, while the Framework was developed in consultation with the World Bank, the Fund does not cover, in detail, issues more appropriately dealt with by the Bank, as outlined in the presentation by Mr. Sandstrom of the World Bank, earlier this afternoon.

Key Aspects to the Framework

9. The Framework starts with the premise that a weakened banking system--stemming from weakness in the management of banks themselves, and in the structural environment in which they operate--is a source of vulnerability in all economies, but especially in developing and transition economies. More generally, an inadequate or weak legal and institutional infrastructure and a poor incentive structure can lead, *inter alia*, to excessive risk-taking and undermine corporate governance and market discipline, which are fundamental aspects of sound banking.

10. The Framework covers the key aspects of a sound financial system: transparency, public sector guarantees, prudential regulation, supervisory oversight, and supervision of cross-border banking. It attaches high priority to the increased transparency of banking information, a fundamental component of which is the realistic valuation of bank assets. To deal with incentive problems, the Framework provides ground rules for the provision of the financial safety net--detailing the best practices for lender of last resort facilities and deposit insurance. As well, it elucidates the issues involved in a credible exit policy and stresses the desirability of a system of prompt corrective action for troubled institutions. In the area of banking supervision, the Framework draws heavily on the Core Principles, supplementing them when warranted by the Fund's experience. While the details of prudential regulation and supervision are important, they are of little help if supervisors lack the capacity for implementation or the autonomy or authority for enforcement. The Framework takes a step back from the day-to-day responsibilities of supervisors and provides general advice on the prerequisites for an effective supervisory agency. Lastly, the Framework covers the international aspects of maintaining banking soundness. Most of this discussion is based on work of the Basle Committee, reiterating their past and more recent work on the supervision of international banking groups and their cross-border establishments.

11. Having outlined the key aspects of the Framework, I would like to close my remarks by briefly discussing another important aspect of the role of the Fund. The Fund, with its near-

universal membership, and in the course of its regular discussions with member countries is in a unique position to contribute to the dissemination of best practices and this process will, over time, contribute to a harmonization of financial policies and practices internationally. As part of its dissemination role, the Fund has published the Framework, attaching the Basle Committee's *Core Principles for Effective Banking Supervision*, IOSCO's *Principles and Recommendations for the Regulation and Supervision of Securities Markets*, and International Accounting Standards 30 and 32 from the International Accounting Standards Committee.

12. Another part of this dissemination role is to provide a nexus where the experiences of the Fund with various principles, best practices, and guidelines, gained through its surveillance and technical assistance activities with its members, can be shared with other international organizations, individual countries, and regional groupings. Coordination with other international organizations is of course a high priority in the period ahead and the Executive Boards of the Fund and the World Bank have recently discussed a joint Bank-Fund paper dealing Bank-Fund collaboration in strengthening financial sectors.

13. 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. 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.