August 29, 2003
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 03/51

10:00 a.m., June 2, 2003

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

E. Aninat, Acting Chair
S. Sugisaki, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Alazzaz
	A. Al Nassar, Temporary
	F. Vermaeten, Temporary
	C. Faircloth, Temporary
	R. von Kleist
	B. Reichenstein, Temporary
M. Callaghan	G. Francis, Temporary
	S. Boitreaud
	A. Requin, Temporary
	I. Alowi
	A. Rogers, Temporary
	B. Andersen
	I. Kupca, Temporary
	A. Baukol, Temporary
	N. Epstein, Temporary
	I. Ábel, Temporary
	K. Sazanov, Temporary
G. Le Fort	C. Pereyra, Temporary
	A. Segura, Temporary
A. Mirakhor	S. Rouai, Temporary
	Y. Lissovolik, Temporary
	I. Zakharchenkov, Temporary
	L. Rutayisire
	A. Ismael, Temporary
L. Martí	O. Garner, Temporary
	B. Bossone, Temporary
M. Portugal	V. de los Santos, Temporary
Y. Reddy	R. Jayatissa
	R. Gauba, Temporary
	M. Brooke
	J. Droop, Temporary
	K. Sakr, Temporary
	K. Nauphal, Temporary
	J. Kanu, Temporary
Wei B.	X. Wang
	X. Zhang, Temporary
	H. Litman, Temporary
	T. Rookmaaker, Temporary
	T. Miyoshi, Temporary

T. Sekine, Temporary
W. Szczuka
N. Davletov, Temporary

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
H. Mooney, Assistant
M. Pedroni, Assistant
W. Rahman-Garrett, Assistant

Also Present
IBRD: Y. Park, Senior Economist; L. Promisel, Senior Advisor. ECB: R. Ritter. Asia and Pacific Department: W. Tseng, Deputy Director; B. Bingham, C. Browne, D. Citrin, A. Fujita, R. Kronenberg, A. Richter, S. Schwartz, D. Velazquez, A. Wolfson. External Relations Department: G. Bhatt, P. Reynolds. Monetary and Exchange Affairs Department: S. Ingves, Director; U. Baumgartner, Deputy Director; V. Sundararajan, Deputy Director; P. Brenner, A. Maechler, M. Swinburne, M. Tamagawa. Middle Eastern Department: S. Creane, N. Farhan. Office of Budget and Planning: C. Vehorn. Office of the Managing Director: R. Nord, A. Tweedie. Policy Development and Review Department: N. Blancher, D. Desruelle, M. Hadjimichael, R. Kincaid, I. Lukonga, C. Mulder. Secretary's Department: P. Cirillo, P. Ramlogan. Statistics Department: C. Carson, Director; C. Enoch, Deputy Director; E. Ayales, G. Barinshtein, A. Brousseau, R. Heath, R. Kohler, R. Krueger, L. Laliberte, P. Papadacci, A. San Jose, G. Slack, F. Tanase, X. Zhao. Western Hemisphere Department: M. Dehesa. Advisors to Executive Directors: F. Haupt, K. Kanagasabapathy, P. Moreno, C. Sia. Assistants to Executive Directors: L. Cao, C. De Silva, B. Gulbrandsen, M. Jamaluddin, J. Kwakye, R. Sonde, D. Prasad, A. Stuart, S. Vafaev.

1. SAMOA—2003 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2003 Article IV Consultation (SM/03/178, 5/16/03); and Selected Issues and Statistical Appendix (SM/03/186, 5/22/03)

Staff: Bingham, APD; Hadjimichael, PDR

Length: 55 minutes

The staff representative from the Asia and Pacific Department (Mr. Bingham) submitted the following statement:

> This statement describes the 2003/04 budget which was presented to Parliament on Friday, May 30. The staff appraisal remains valid.
>
> The staff's preliminary assessment is that the 2003/04 budget, overall, is stronger than the provisional budget framework presented to the mission in March. The key features of the announced budget are as follows:
>
> The budget targets a deficit of 1½ percent of GDP, compared with 2 percent in the provisional budget framework. Domestic financing is expected to be limited to only 0.1 percent of GDP, well within the ceiling discussed with the authorities during the mission.
>
> The revenue projections are broadly in line with the estimates presented in the staff report. As expected, no new revenue initiatives were announced in the budget. The authorities remain committed to the tax reform agenda under their program which focuses on broadening the tax base and strengthening tax administration.
>
> The more ambitious budget targets reflect largely efforts to curb recurrent expenditure, following a thorough review of the operational budgets of Ministries. Development expenditure is also lower than expected, reflecting primarily lower grant-financed outlays.
>
> Net lending is in line with expectations, with the budget containing an allocation equivalent to 2 percent of GDP for Polynesian Airlines (half of which is to be used to repay a government-guaranteed bridging loan extended to the airline in April).
>
> Public funding for the major capital projects has been sharply reduced. No budget funds have been allocated for the hotel project (although the National Provident Fund is still expected to provide around 1 percent of GDP to the project this year) and the project to construct new headquarters for the Development Bank has been deferred.

The authorities announced in the budget that they are considering a range of fiscal incentives for the tourism industry, although no details were provided. The budget also included a special tax incentive to encourage private sponsorship of the 2007 South Pacific Games.

The authorities have agreed to the publication of the Staff Report, the Selected Issues papers, and the Statistical Appendix.

Mr. Callaghan submitted the following statement:

Key Points

Notwithstanding a slowing in economic activity in 2001/02, Samoa remains one of the best performing economies in the Pacific. This is a testament to the authorities' sound economic and financial management.

The authorities recognize that economic development will require forceful continuation of structural reforms, the maintenance of a sustainable fiscal position and monetary policy directed towards the maintenance of low inflation and a stable external position.

This was an effective Article IV consultation mission, which was well targeted on the key issues facing Samoa. The authorities appreciated the advice they received from the team and this has been taken on board.

The 2003/04 Budget will aim for a deficit of 1.5 percent of GDP, which is considered to be sustainable.

The Central Bank has moved to reduce excess liquidity in the banking system and is committed to more aggressive measures if necessary.

The financial difficulties of Polynesian Airlines will impact on the budget, but the authorities are taking the necessary steps to put the airline on a sustainable financial footing.

The authorities continue to implement an ambitious and comprehensive development plan, which is based on the maintenance of macroeconomic stability.

Samoa remains one of the best performing economies in the region. There was a significant slowing in economic activity in 2001/02, but this followed a number of years of robust economic growth. Moreover, the economy has started to recover over the course of 2003.

Samoa's relatively strong economic performance is anchored in its stable political environment, sound macroeconomic management and comprehensive structural reforms, particularly in the public and financial sectors.

The challenge for the government is to maintain macroeconomic stability while promoting structural change and private investment so as to generate sustained, strong economic growth. Efforts to diversify the economic base of the economy will continue.

Samoa strongly values its association with the Fund and the opportunity offered by the Article IV consultation mission to address the key policy issues facing the government. This Article IV consultation was no exception and, as clearly highlighted in the report, the advice offered by the mission was well taken by the authorities. Significantly, the authorities recognize the importance of, and are committed to, the maintenance of macroeconomic stability. This commitment will continue to guide future policy actions.

Economic Activity Set to Recover

Samoa has achieved high economic growth rates in recent years, with particularly strong growth between 1999 and 2001. There was a marked slowing in growth in 2001/02, the result of a downturn in agricultural production and the completion of some major public works projects.

Economic activity has started to recover over the course of 2003, supported by the commencement of new public works and increased agricultural production, with the coconut oil industry becoming fully operational, increased taro production, and expanding fruit exports. Fishing production will increase with new fishing boats entering the fleet. However, as with other small island economies, Samoa's economic prospects will be significantly influenced by international economic developments and the vagaries of the weather.

Inflation rose in 2001/02, the result of increased oil prices and rising food prices following unfavorable weather conditions. The Central Bank is keeping a close eye on inflation and expects it to fall to at least 2.5 percent by mid 2003, mostly as a result of lower food prices, although lower oil prices have also contributed. Over recent years, Samoa has enjoyed strong growth with low inflation and the Central Bank is committed to ensuring that such conditions are maintained. Accommodative monetary policy was appropriate given the sharp slowdown in the economy in 2001/02, however, more recently the Central Bank has expanded sales of Central Bank securities in order to reduce the excess reserves in the banking system. The Central Bank has also indicated that it is prepared to aggressively tighten monetary policy if considered necessary in order to maintain macroeconomic stability.

Continued Sound Fiscal Policy

Samoa has pursued a sound and responsible approach to financial and economic management and this was maintained in the 2002/03 Budget. The 2002/03 Budget targeted an overall deficit of 1.9 percent of GDP. Key expenditure initiatives included education, health, support for agricultural development, infrastructure and tourism development.

On the revenue side, there was a package of measures including an increase in the VAGST by 2.5 percent, reduction in tariff rates, an extension in income tax to commercial fishing and an increase in excise taxes and registration fees.

In delivering the Budget, the Minister for Finance highlighted that it was not possible to meet community aspirations for continued strong progress in developing Samoa's community services, infrastructure and to maintain a sound budget outcome without an increase in taxes and charges. The Minister also noted that part of Samoa's success lies in its commitment to macroeconomic stability "... for it has provided us with the flexibility to implement wide ranging reforms which have proven untenable and difficult to carry out in other countries. It is a winning formula we should continue to follow."

The staff report notes that there are significant fiscal pressures ahead, particularly from the deterioration in the financial position of Polynesian Airlines. Maintenance of stable airline services is essential to an island economy, and particularly one seeking to increase tourism. As also noted in the report, the authorities are mindful of the need to maintain a sound budget outcome and have taken action to ensure that the government's accounts can absorb the fiscal implications of support for Polynesian Airlines. Moreover, contingency measures will be introduced if necessary.

The budget for 2003/04 is set against the background of maintaining a sound and stable macroeconomic environment of low inflation and a sustainable external position. The budget is based on a projection of real GDP growth of around 2-3 percent in 2003/04. The overall budget deficit is expected to be 1.5 percent of GDP, which is considered sustainable given that a large part of expenditure is to finance investment projects. On the revenue side, the government is pursuing minor technical amendments in respect of import duty which will have a minor revenue impact. The 2003/04 budget provides a provision for the recapitalization of Polynesian Airlines. The amount provided is less than that requested, and the Government will be seeking the airline to extract economies from its operations so that it may continue to operate on the resources available. The funds provided to Polynesian Airlines will be offset by a contraction in the operational budget of Ministries.

A Competitive Financial System

Samoa liberalized its financial system in 1997, with the result that it now has a more efficient financial market which has helped support economic growth. In particular, market forces and the private sector were given an enhanced role in financial sector development. Banking competition will be enhanced with the granting of a fourth commercial bank license early in 2003.

As noted in the staff report, supervision of the financial sector has also been strengthened with the extension in the coverage of Central Bank supervision to non-bank financial institutions. The Central Bank is also developing its capacity to improve its supervision of commercial banks, including through on-site inspections.

Samoa undertook to fulfill its commitments under the OECD's Harmful Tax Practices Initiative on the understanding that it would apply equally to all offshore jurisdictions. They would emphasize their concern, however, with the recent EU Savings Tax Directive which exempts a number of European countries from core tax information exchange requirements. My authorities believe that there is an urgent need for a review of the OECD Initiative given these developments.

An Ambitious and Comprehensive Development Agenda

The Government's policy initiatives are taken in the context of its Strategy for the Development of Samoa, 2002-04 (SDS), which has the theme "Opportunity for All". The objective is to build on the positive economic growth of recent years and provide the opportunity for every Samoan to share in the benefits of national development.

Importantly, at the heart of the SDS is the maintenance of macroeconomic stability. The key objective of the public sector reform program is to raise the effectiveness and efficiency of public service delivery. Performance management systems are being improved in order to monitor departmental performance and the enactment of the Public Finance Management Act 2001 adopts many modern public finance principles and practices. Good governance has been substantially instilled through the Cabinet Development Committee and this will be further enhanced in future years. The establishment of the Law Reform Commission also paves the way for all legislation to be reviewed and provides a framework to support the reform program in a transparent and accountable manner. In addition, the number of government departments has been reduced from 28 to 14 Ministries and five constitutional offices.

The SDS provides for the continuation of the privatization program, with the aim of selling all remaining shares in at least five public bodies. In addition, the provision of infrastructure and services will be enhanced, along with a greater focus on maintenance of the environment.

The authorities' objective is to ensure the maintenance of an overall economic environment that will facilitate the expansion of private sector activity. In particular, the tax and tariff structure is being refined to support competition and Samoa's compliance with the WTO and Pacific Islands Country Trade Agreement. Investment approval processes are being streamlined.

Communal land ownership is often cited as a barrier to private sector investment. The Government will be looking at options that will address this, including the establishment of an agency to negotiate customary land leases on behalf of investors, and a clear legal framework that will provide protection not only for the landowners, but also for investors.

Conclusion

Samoa continues to benefit from sound economic and financial management. It remains the best performing economy in the region. While there are a range of pressures on the authorities, and many challenges ahead in order to develop the economy and in particular diversify its export base, the authorities will not loose sight of the importance of macroeconomic stability. They greatly appreciate the advice and support they receive from the Fund and would like to thank the Article IV consultation team for all their efforts.

Ms. Indrawati submitted the following statement:

We thank the staff for the detailed and well-written report and Selected Issues paper. We also thank Mr. Callaghan for his informative preliminary statement. We are in general agreement with staff, and will therefore comment only on a few issues.

For several years the Samoan economy has enjoyed strong economic performance, with high growth rates, low inflation, a stable real effective exchange rate, sound public finances and a comfortable external position. The authorities are to be commended for its sound economic management and structural reform program which led to this impressive achievement. Although economic activity slowed in 2001/02, this was mainly the result of a steep decline in agriculture—weather-related—and a sharp contraction in construction activity, due to the completion of projects, and not due to any underlying economic or policy deficiency. It is pleasing to note that the economy has since started to recover. Underlying inflation remains low and buoyant remittances and higher capital inflows have helped to maintain reserves at around 4½ months of imports. Overall, quite a success story.

However, as highlighted by staff, the outlook is clouded, and Samoa remains confronted with many of the challenges inherently faced by small island economies. In particular, the economy is heavily dependent on private remittances and foreign aid, FDI remains low and the economy's export base is narrow. The main challenge for the authorities now is to lay the foundation for long-term sustained growth, while diversifying the economy's structure and reducing its external vulnerabilities.

We note the risks highlighted by staff, particularly that of the financial difficulties plaguing Polynesian Airlines. Whilst the near-term budgetary support to keep the airline operational may have been unavoidable, we concur with staff that a strategic decision is needed on the airline's future, and viability, before more capital is committed. Also, it is important to fully ensure that the Management of Polynesian Airlines has the necessary business acumen, so that the airline will not require capital injections in the future. A comprehensive review of the airline's options is certainly called for. We are heartened that action has been taken to ensure that the government's accounts can absorb the fiscal implications of support for the airline, as stated in Mr. Callaghan's preliminary statement. However, we would like to ask staff whether this type of "bailing-out" by government is becoming the norm, in which case we would be more concerned.

On structural reforms, we join staff in commending the authorities for remaining committed to their wide-ranging reform program. It is important that the authorities continue to press ahead with their structural reform program, keeping in mind though the limited absorptive capacity of the economy, and the private sector's ability to create employment and expand its role in the economy. The plan to "rightsize" the civil service, launch a comprehensive privatization program and reform the communal land management system, as well as the development of a comprehensive strategy for the tourism industry are impressive. The successful implementation of ongoing structural reforms will improve the business and investment climate further, promote a competitive export sector and enhance the availability of free-hold land for private sector development.

On the communal land issue, while we respect the cultural importance of communal land holdings, the customary land tenure system is nevertheless one of the major constraints to private sector investment and growth. It is pleasing therefore to note that the availability of land for investment purposes has improved and that the limitation on using customary land as collateral for bank loans has been addressed. In addition, the government's initiative to take on the principal lease on communal land and sublease it to investors will greatly assist in freeing up land available to the private sector. We urge the authorities to proceed with further land-reform initiatives.

We are pleased to note that after a period of rising deficits the budget deficit has stabilized at around 2 percent of GDP and welcome the authorities' intention to reduce this further to 1.9 percent of GDP in 2002/03. The authorities should consider reducing this further over the medium term. This will help address the public indebtedness, which, at 55 percent of GDP, remains high compared to other countries in the region. Whilst the debt burden may not be significant now given the concessionary nature of most of the debt, and as it has largely been used to finance development projects, the burden of repaying the debt in the future may strain the budget.

Bringing down the deficit will require stricter expenditure prioritization and should focus on reducing the level while improving the quality. Emphasis should also be placed on development spending that will facilitate the growth of a strong, viable private sector. The intention to scale back outlays on non-essential domestic projects in the remainder of the year is a prudent one, and we urge the authorities to also reduce the support given to loss-making public enterprises. We applaud the authorities on the huge savings in the wage bill achieved by the reorganization of the Public Works Department. A leaner civil service will also bring down costs and combined with savings from the reform of loss-making public enterprises, as well as improvements in expenditure efficiency by reducing low-priority expenditures, will allow for a healthy increase in expenditure towards better targeted areas of health, education and infrastructure development.

Whilst we do agree that the authorities should review the planned expansion of publicly funded capital construction projects given the pressures on the budget and balance of payments this would engender, we do, however, see some justification in the joint venture with private investors to construct a major new hotel as it is obvious that the government is strongly pursuing development of the tourism industry. We do not see this as a reneging of government's commitment to private sector-led growth, as in a small island economy the private sector's capacity to expand its role in the economy is quite often limited, and evolves slowly. Although every effort should be taken by the government to facilitate private sector growth, it is oftentimes necessary for government to "fill the gap" in driving growth in a sector, which has huge, largely un-tapped, potential. However, we believe that the government's role should remain catalytic, that private sector interest should not be compromised and that the private sector should take over the project fully as soon as feasible. Admittedly, though, the timing of this venture is inopportune given the public funding also required by Polynesian Airlines.

On monetary policy we concur with staff that the central bank should stand ready to tighten policy promptly if signs of inflation or balance or payment pressures develop in the period ahead.

We note the soundness of Samoa's banking system and welcome recent efforts to improve the oversight of the financial sector. We are pleased to see that the Central Bank of Samoa is now responsible for the supervision of the nonbank financial institutions, particularly as the financial condition of these institutions are somewhat weaker, and as problems here could have major implications for the financial system at large, given their dominant size. The finalization of the prudential guidelines for these institutions, however, needs to be expedited to allow the central bank to commence this supervision. The authorities should also further strengthen its supervision of commercial banks, particularly by commencing on-site bank examinations and by strengthening regulations related to connected lending. Technical assistance would aid the building of the necessary supervisory capacities. We also welcome the government's plans to further improve the oversight of the offshore banking system.

Samoa has made good progress in tariff reduction and we encourage the authorities to move further in this direction, taking into account any budgetary implications. Improving compliance with WTO rules and regulations will facilitate Samoa's accession to the WTO.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Wei submitted the following statement:

At the outset, we thank the staff for a comprehensive report and Mr. Callaghan for his very helpful preliminary statement. Since implementation of the economic reform program in 1996 and the renewed economic strategies, Samoa has transformed into one of the best performing economies in the Pacific. Amid the global economic slowdown, Samoa's economy has been resilient with growth recovering in 2003 after a slowing in 2001/02.

The authorities are commended for their commitment to macroeconomic stability and to taking comprehensive structural reform measures contributing to a favorable domestic environment and stable political environment with robust growth, low inflation and a comfortable external position. Since we broadly concur with the thrust of the staff appraisal, for emphasis, we will confine our statements to four major areas—fiscal policy, monetary and exchange rate policy, the financial system and future developments.

Fiscal Policy

The 2001/02 budget deficit fell to 2.1 percent of GDP from its previous higher level and the 2002/03 budget targets a deficit of 1.5 percent of

GDP. While the key expenditure initiatives described in Mr. Callaghan's preliminary statement are all in critical areas, staff suggests that public sector outlays should be further examined. The authorities have begun to address some public sector related issues—streamlining government departments which will lead to eventual expenditure cuts. However, to ensure the targeted public sector deficit, only essential projects should be considered. On the revenue side, the package of tax reforms in Box 2 is encouraging; all these measures will further strengthen the revenue base.

Regarding staff's concern on the provision of additional capital to Polynesian Airlines and its impact for the fiscal budget, we fully share Mr. Callaghan's view that the "maintenance of stable airline services is essential to an island economy, and particularly one seeking to increase tourism". As tourism is Samoa's most important comparative advantage, it is vital that the related services are in good order. A comprehensive strategy to support the airline will be needed. We welcome the option to seek advice from the IFC and hope the authorities can solve this issue. We are reassured by the authorities' intention to offset funds provided to the airline by a contraction in the Ministries' operational budgets.

Monetary and Exchange Rate Policy

Monetary policy has served the economy well. However, as agreed by staff and the authorities, the easing of policy to boost economic growth during 2001/02 needs to be reconsidered. We welcome the authorities' decision to tighten monetary conditions through open market operations and further measures, if necessary, such as raising interest rates. The pegged exchange rate regime has served the economy well and should be maintained.

Financial System

Samoa's banking system is sound and will be enhanced by further supervisory measures such as the introduction of on-site inspections. The 2001 Financial Institutions Act extended the central bank's supervision to nonbank financial institutions and together with the International Banking Bill provide a welcome legislative foundation for the financial industry as a whole.

Future Developments

We believe the authorities are on the right track in the reform process: macroeconomic stability lies at the heart of the Strategy for the Development of Samoa; public sector reforms are being set up, good governance initiatives are in place; the Law Reform Commission has been established; tax and tariff reforms are being set up; and the privatization program is ongoing. We are pleased that the communal land ownership issue—regarded as a barrier to private sector investment—has been addressed by the government and options are being sought to solve the problem.

The authorities are encouraged to exploit their comparative advantages to boost economic growth with particular focus on the tourism and agriculture sectors. We welcome the implementation of the tourism task force and a clear tourism development strategy. Similar steps need to be taken for the agriculture sector. In addition, we welcome the authorities' progress in applying to the WTO, which will not only expand Samoa's trade and cooperation with other countries but benefit its economic growth in general.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Vermaeten made the following statement:

According to Mr. Callaghan's helpful statement, the staff had fruitful discussions with the authorities and appear to agree on most issues. Since I very much agree with the staff's recommendations, I want to focus on a few issues.

I commend the Samoan authorities for continuing their track record of impressive performance. It seems that the authorities have been doing almost everything right; they follow prudent fiscal and monetary policies, they have undertaken significant civil service and financial sector reform, and have made many other changes which have enhanced the efficiency of the economy. In fact, Samoa's track record is so impressive that the country could serve as role model for other island economies. It almost makes me rather envious of Mr. Callaghan; of course, do not tell my boss that.

The main challenge facing Samoa is to invigorate growth while maintaining fiscal control. After years of strong economic performance, growth has slowed slightly and there is a temptation to use government investment—such as the government joint venture with private investors to construct a new hotel—to spur on economic growth. We strictly urge the authorities to resist temptations to use government investment to stimulate economic growth; it is a road that many small, island economies have taken, and it often leads to a dead end. Government investment ventures do not pay off and leave large debts after a few years, which burden the economy. Samoa cannot afford a large budget deficit. The only certainty facing a small, island economy with a sizable debt is that it will be hit by unforeseen shocks; the authorities need to build a financial cushion for that day.

Rather than actively undertaking investments that the private sector should be doing, we encourage the government to stay on the same successful path they have been on for a number of years. This includes continuing with reforms emphasized in the staff report that will enhance the workings of the economy, such as improving public sector efficiencies, removing impediments to trade, implementing tax reforms, launching a privatization program, and continuing with financial sector reforms. A particularly important element of for the authorities' strategy is to undertake reforms that make the most of their comparative advantages in tourism and agriculture.

We value the cultural importance of communal land, like Ms. Indrawati; however, steps can be taken to assure long term land access without undermining the values of the Samoan people. Like Ms. Indrawati and Mr. Wei, we are encouraged by the government's initiative to take the principal lease on communal land and sublease it to investors. These kind of arrangements, as well as other land reforms, should do much to encourage inflows of FDI for tourism and revitalize the agricultural sector.

Annex II of the staff report assumes that the authorities will essentially stay on the path of prudent economic management and continue with their structural reforms, and forecasts a growth rate of 3 percent over the medium term. Although a 3 percent growth rate is not spectacular, it seems appropriate for an island trying to find the right balance between a favorable business climate and protecting its traditional values.

The staff report could have been even better if it had included more information on cross-country experiences. Many small, island economies are facing the same challenges and choices as Samoa, and could benefit from this cross-country comparison information. In addition, I suspect that a comparison of small, island economies with larger economies would likely show that the small, island countries benefit less than the larger economies in the medium term from allowing the private sector to take the lead.

Related to the issue of government intervention is the topic of Polynesian Airlines. We are glad that the planned government financial support for Polynesian Airlines will be contained during the next two years. From the description in the staff report, it seems the authorities made mistakes on a number of occasions by investing in an area that was better addressed by the private sector. We would like to join staff in encouraging the authorities to commit no new capital to the airline at this time and welcome the government's intention to undertake a comprehensive review with the assistance of the IFC.

On monetary policy, I am in full agreement with staff, Ms. Indrawati, and Mr. Wei that the pegged exchange rate system has served the economy well and should stand up well to potential pressures.

We would like the authorities to make the financial system more efficient. Like staff, we encourage the authorities to strengthen the regulatory framework for the key areas identified in the report on the bank and nonbank financial institutions. The authorities have come a long way in strengthening the oversight of the offshore banking system and have developed an effective framework. A number of countries in our constituency share Samoa's concerns that, as noted in Mr. Callaghan's statement, some European countries have been exempted from certain provisions under the OECD's Harmful Tax Practices Initiative. In regard to data, we encourage the authorities to improve their statistics and subscribe to the GDDS.

In conclusion, let me make three points. First, I want to thank the staff for a well-written and thoughtful report. I encourage them to provide more cross-country comparisons to identify best practices in future reports, which would help guide other countries. Second, I urge management and staff working on the Caribbean islands in our constituency to consider Samoa as a role model, and to encourage the other islands to follow the same prudent macroeconomic management and public sector reforms. Third, I encourage the Samoan authorities, who may be tempted to take a more interventionist role when economic growth slows, not to go down that road. Instead, I encourage the authorities to follow the current path of improving the investment climate. If growth slows slightly from time to time, remember the opening line from the *Hitchhiker's Guide to the Galaxy*: "don't panic."

Mr. Segura made the following statement:

As usual, we would like to thank the staff for an interesting set of papers, and Mr. Callaghan for his helpful preliminary statement. We agree with the staff's assessment on Samoa's economy, therefore, we will only concentrate on a few issues we consider should be emphasized.

The economic reform program initiated in 1996 is worthy of praise. A simple analysis of the evolution of the main macroeconomic indicators demonstrates a turning point, for the better, in the mid-nineties: per capita income (albeit it started in the earlier part of the decade), inflation volatility, fiscal and current account balance, stock and service of the public debt, among others, improved. All of these were possible due to the launching of the government's Institutional Strengthening Program (ISP), aimed at public sector reform; and the first generation structural reforms; recently supported by the Statement of Economic Strategy (SES). Samoa is running a sound economic program.

On the way forward, it is important to push with second generation reforms, as well as to maintain macroeconomic stability. In this sense, we feel reassured by Mr. Callaghan's claim that the authorities recognize the continuation of structural reforms and the maintenance of a sustainable fiscal position as key components of their development strategy. The communal land ownership seems to be a factor that has to be dealt with sooner rather than later, as it is a missing link to facilitate an increase of the much needed private investment and a full development of the island's tourist potential. We are, therefore, pleased to notice that it is a priority in the authorities' agenda. While we also agree that adequate infrastructure and services are essential, however, some warnings are warranted in this issue. We wonder if adequate cost-benefit analyses have been done regarding the major construction projects the government apparently has on the pipeline: new headquarters for the development bank (3 percent of GDP), a joint venture for a major new hotel (3-4 percent of GDP), and rehabilitation of offices for SamoaTel (1.5 percent of GDP, already underway). At least on paper, these investments, beyond their considerable magnitude and consequent deleterious impact on the current and future budgets, seem superfluous as well. In all three cases, we are basically talking about new/improved buildings. We wonder how this will enhance the efficiency in the economy. In this sense, we feel reassured by the staff's latest news regarding postponement of at least one of these projects.

With regard to fiscal policy, in addition to the aforementioned projects, we are also concerned about the impact that restructuring of Polynesian Airlines might have on the balance. We agree with Mr. Callaghan's statement that stable airline services are essential to an island economy. However, this is not the first rescue the airline is facing, hence, we wonder if any alternatives are being considered for a publicly run enterprise. On the revenue side, we agree that the recent package of measures was appropriate, and would like to highlight the fact that Samoa has been able to implement a sensible and well-balanced tax structure, including the tariff reform, and in the future, gains would come mostly from improvements in tax administration. Finally, we coincide with the authorities' view that the ongoing process of reducing the public debt burden should be one of the main goals of fiscal policy.

Having said all this, we wish the authorities success in the tasks lying ahead.

Mr. Mirakhor made the following statement:

The well-written report and the Selected Issues paper together with Mr. Callaghan's informative statement describe well the recent economic developments as well as the short- to medium-term challenges of the Samoan economy. It is important to signal to our smaller members that they are important to us. In this context, I am pleased to note from the number of speakers that we have made considerable progress since the days when there were hardly any speakers in Board discussions on Article IV consultation with small island economies. I am also pleased to note from Mr. Callaghan's statement his appreciation of the Fund mission, and complement Mr. Bingham and his colleagues for their work with Samoa.

I join Mr. Wei, Ms. Indrawati, Mr. Segura, and Mr. Vermaeten in commending the authorities for their management of the economy in recent years and the implementation of extensive structural reforms that have provided the economy with enough resilience to weather the recent external and domestic shocks. It is encouraging that growth has begun to recover, and, barring any new shocks, the short-term challenges are manageable, given the strong commitment of the authorities to the maintenance of macroeconomic stability as well as their determination to forge ahead with implementation of further structural reforms.

In the fiscal area, the authorities' determination to limit fiscal deficit and net domestic financing for 2002/03 and 2003/04 is appropriate and necessary for maintenance of macroeconomic stability. In this regard, I am pleased to note from the statement of the staff representative that the 2003/04 budget is stronger than the provisional budget framework. Moreover, the package of tax reforms, outlined in Box 2 of the staff report, should lead to further strengthening of domestic resource mobilization, crucial for reducing dependency on external financial assistance.

It is appropriate that the authorities have taken steps to ensure that provisions are made in the budget to absorb the fiscal implication of assistance to the Polynesian Airlines to remain operational. While agreeing with the staff that a review of the airline's financial operations and development of options for its future are in order, I agree with Mr. Wei that, if tourism is to be promoted and the economic base of Samoa diversified, there is a need to assure that supportive services are provided. The operation of the airlines is crucial to that effect. Nevertheless, there is an urgent need for a comprehensive strategy to restore financial soundness to the airlines. In this context, I am comforted by Mr. Callaghan's assurances that steps are being taken that will lead to the financial viability of the airlines.

Of more concern are the budgetary and fiscal implications of the planned public investment projects. Like Ms. Indrawati, in absence of full participation by the private sector, I see some rationale for the construction of a hotel for the same reasons stated earlier, namely increase in revenue and diversification of the economic base. I am not as pessimistic as Mr. Vermaeten, and believe that the strategy of state-in-state-out could work, provided that the strategy is implemented prudently. Nevertheless, as suggested by Mr. Segura, it appears that there is a need for prioritization of projects requiring public participation on the basis of their magnitude, timetable, long-term viability, and economic benefits, with due attention to implications for fiscal sustainability and macroeconomic stability. Like Mr. Segura, I am pleased to note that, as stated in paragraph 23 of the staff report, the remedial actions proposed by the authorities in this regard have now resulted in concrete steps.

Monetary policy has been well-managed. Interest rates have shown a welcome decline, although high costs and low competition have prevented spreads from declining as much as expected. There is a need to continue to refine the framework for monetary policy to enhance its effectiveness and efficiency. Broadening the range of instruments and investor base should help to deepen the securities market and the development of secondary market activity. Greater clarity in the choice of targets would improve monetary policy transparency and credibility. An interest rate indicator—rather than the quantity of securities—would seem to be a better signaling device that could also enhance the transmission mechanism of monetary policy. Furthermore, given the high susceptibility of headline inflation to agricultural shocks, core inflation would appear to be the more appropriate target. Enhancing financial intermediation requires higher lending efficiency and safeguards. Plans to streamline the legal framework for loan security and the use of customary land as collateral are, therefore, steps in the right direction. The banking system remains sound, with well-capitalized and profitable banks and a low level of nonperforming loans. The non-bank financial sector, however, requires more attention, and the plan to strengthen oversight of the sector as well as the offshore banking system is welcome.

Actualizing Samoa's growth potential requires that the momentum of implementation of the reform agenda be sustained, especially in the reform of public sector and public enterprises. Mr. Callaghan reiterating the authorities' commitment to this end is reassuring. Reinforcing the privatization program, public sector reform, and land management reform should enhance economic efficiency and attract the much-needed private investment. That said, I sympathize with the authorities in their concern for lack of sufficiently strong private sector investment response to extensive reforms already implemented. Staff's and other Directors' response to the authorities' concern (page 50) is that they should continue with the reform agenda. However, one wonders at what point implementation of reforms would reach a critical mass that could induce private sector response.

With these remarks, I wish the authorities all the best, and join Mr. Vermaeten in encouraging them to stay the course.

Mr. Droop made the following statement:

Like other Directors, we congratulate the authorities for their achievements to date. We fully understand their concerns about raising the level of growth and we agree that it is a priority. However, we concur with the staff that growth is less likely to be increased through public sector stimulus and more likely to be achieved by pressing ahead with institutional strengthening, and modernization the economy. Like Ms. Indrawati and other Directors, we consider modernization of the land system to be an especially rich potential source to unlock growth.

In addition, we join staff in welcoming the progress on financial sector supervision and we encourage the authorities to proceed with the implementation of reforms highlighted in the staff report. We also note the scale of remittances and their importance to the economy, and welcome staff comments on whether there might be ways to enhance the beneficial impact on these remittances on the development process.

On the fiscal side, we welcome the 2003–2004 budget recently presented to parliament. However, we wonder whether enhancing the medium term framework for the budget and public debt would help reduce the risk of recurrence of the volatile deficits of the 1970s, 1980s and early-1990s. Like Mr. Mirakhor and Mr. Segura, we encourage the authorities to assess the financial, economic, and social costs and benefits of the proposed capital projects and to use this information to guide decision making in these projects.

Finally, we welcome the authorities' decision to agree to the publication of the staff report, and we wish them well for the future.

Mr. Requin made the following statement:

Let me thank the staff for the serious analysis they have provided, as well as Mr. Callaghan for his informative statement.

I would like to commend the authorities for their commitment to maintain the prudent economic policies that have served the country well over the past ten years. Samoa is an example of wise management and reforms for the other countries and islands in the region. The GDP per capita growth achieved since the early 90's as well as the evolution of social and demographic indicators are truly impressive.

Since I agree with the thrust of the staff appraisal, I will only stress the following points, very much in line with those highlighted by Mr. Vermaeten:

- On the state's financial support to the Polynesian Airlines: while the assistance to the company is unquestionable, considering the absence of private options for maintaining airline services, recapitalization should however only be provided after an extensive audit has been conducted. Based on the audit findings, provisions should be taken so that the company be prevented in the future from taking financial commitments likely to endanger and imbalance public finances equilibrium.

- The authorities should remain cautious as well on other publicly funded projects such as the joint venture hotel. If we concur that Samoa's tourism potential is currently underdeveloped, we recommend that the authorities proceed with caution in the undertaking of this project. The reform of communal land management and the definition of a global strategy undertaken by the established task force are other promising ways to foster tourism development.

Regarding those two issues, we are however somewhat reassured by supplementary information provided by Staff regarding the 2003-2004 budget.

- On financial regulations, efforts made by the authorities in terms of strengthening banking supervision and enhancing fiscal cooperation are to be commended. The removal of Samoa from the OECD list of non-cooperative tax havens is fully deserved, and should serve as an example for other territories in the region. We also welcome the significant strides made by Samoa in improving its AML-CFT legislation and allocating adequate means to ensure its effective enforcement, as well as the government's plan to reinforce the oversight of the off-shore banking system.

In conclusion, I have no doubt that the long-term reform agenda followed by the authorities will foster the expected private sector investments, which in turn will maintain Samoa on the path of steady growth and human development the country has been enjoying for ten years.

Mr. Baukol said he agreed with most of the comments made by other Directors. On the issue of the Polynesian Airlines and the public investment projects, his chair agreed with the comments of Mr. Vermaeten, Mr. Segura, and Mr. Requin, and noted that, given the various shocks to tourism in the region, it was not surprising that private sector growth had not increased as much as hoped for in the past couple of years. Also, the budget had very substantial amounts of foreign financed development projects, which would help develop the private sector in the future.

In Annex II, the staff presented an illustrative medium-term scenario that was based on implementation of reforms and showed relatively positive results, with the debt level falling and increases in GDP growth per capita, Mr. Baukol continued. Although that scenario was labeled a reform scenario, it was also similar to the baseline scenario. Could staff comment on how the reform scenario would differ from the current baseline trends, and whether any stress testing was done to present a more negative scenario to the authorities?

Mr. Rookmaaker stated that, as he largely agreed with Mr. Vermaeten's statement, he would be brief. Like other Directors, his chair agreed that the authorities should not go down the road of interventionism in the economy. In regard to Polynesian Airlines, did staff have an opinion on possible substitutes to having a national airline? For example, would providing a tender to a foreign commercial airline be a good idea?

The staff representative from the Asia and Pacific Department (Mr. Bingham), in response to questions and comments from Directors, made the following statement:

There were three groups of questions. On Polynesian Airlines, there were two sets of questions: whether the airline could potentially represent a long-term drag on the budget, and whether other alternatives are being pursued to put the airline on a viable footing. Also, the question was asked about what strategy is being pursued to convert remittances from income support to direct investment and whether we pursued any stress testing and presented alternative scenarios to the authorities.

On the airline, I think the government is committed to placing the airline on a commercially sound footing. The government has already returned one plane as an immediate cost saving measure, and they signaled quite strongly to us that they were going to strictly limit any new funds to Polynesian Airlines until a viable restructuring plan was in place.

The IFC review, however, is important, because it will offer the government the opportunity to get advice on how best to achieve stable airline services to the country without placing an undue burden on the budget. As the Fund staff does not have the expertise, we did not enter into discussions with the authorities on what the alternative options could be, but we understand from the IFC that there are more flexible arrangements for purchasing capacity than the 10-year leases that the government entered into in 2000 and earlier. So, there are a range of more flexible possibilities available to the government, which the upcoming IFC review will address.

Another point we emphasized in our discussions with the government was that it was important that future investment decisions in this area be made purely on a commercial basis, free of strategic considerations relating to development of the tourism industry. The airline management and its board should be free to make investment decisions based purely on commercial grounds.

On the second set of questions relating to remittances, one of the key objectives of the government's reform strategy is to try to direct remittances progressively towards investment opportunities in Samoa. One major element of the reform program is to attract investment from Samoan emigrants in New Zealand, Australia, and the United States to build the capacity of the economy.

In regard to the growth scenario, although 3 percent growth does not seem particularly high, it would be a reasonably good performance for an island economy. In terms of the medium-term scenario, we did discuss a bleaker scenario that was closer to 0 percent growth. Although the debt dynamics still look reasonable under that scenario, the authorities were more concerned about whether they could generate enough employment opportunities to absorb the new entrants into the labor force under such a scenario rather than their ability to preserve macroeconomic stability.

Another stress test that we conducted was much more speculative, relating to the movement in the exchange rate, but it was not the main feature

> of discussion as it has a very low probability of occurring. However, even with fairly significant depreciation, the debt dynamics did not appear to be too negative. Clearly if the depreciation was substantial, that picture would change.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael), on the issue of the importance of remittances and how they could be more helpful, commented that remittances to Samoa currently provide a major cushion to domestic demand, both for supporting consumption and investment. In addition, remittances played a major role in providing a significant source of foreign exchange earnings and helping to balance the financial accounts of the country.

The existence and strength of demand was a major factor affecting the private sector's investment decisions, the staff representative continued. The existence of expatriates in Samoa's neighboring countries was also a potential source of human capital if the investment climate improved further. From that point of view, the existing large volume of inflows could be a contributing factor to the development of Samoa, offering further possibilities to provide human capital while continuing to support the balance of payments.

Mr. Bossone wondered how any mechanism to convert income support to investment would work, bearing in mind that any attempt to force such a conversion might negatively affect the level of remittances.

The staff representative from the Asia and Pacific Department (Mr. Bingham) replied that it was not a case of forcing remittances to be converted from income support to investment. Rather, the idea was that if Samoa could become more attractive for investment, then the potential for converting those remittances—and even enhancing their flows—from income support to foreign direct investment would be a natural process.

Mr. Callaghan made the following concluding statement:

> I would like to thank the Directors for their comments this morning, and Mr. Bingham for answering the questions that have been raised. Mr. Vermaeten is absolutely right that this is an easy, small island economy to represent; unfortunately other countries—not only in the Caribbean, but also in the Pacific—are not all like Samoa.
>
> The main point to highlight is that this was a very successful Article IV consultation mission. The Board has spent a lot of time talking about enhancing surveillance. It is important to go through the motions, but also to have a process that adds value to each country concerned. I am glad to say this was a successful Article IV mission, and was not simply a case of going through the usual politeness of thanking staff. The consultations were very effective and the advice was well targeted, with the mission focused on the key issues the authorities were grappling with—mainly, the pressure on the budget from Polynesian Airlines and from the capital projects.

The discussions between the authorities and the mission were very useful in developing the authorities' thinking about the risks and implications of policy, as is apparent in the staff statement that refers to the 2003/2004 budget. As Mr. Mirakhor has highlighted, the budget presented on Friday is much stronger than the provisional budget that was discussed with the mission. The new 2003/2004 budget is responsible and is more in line with staff's advice; the budget targets an overall deficit of 1.5 percent of GDP and constrains expenditure. Although the budget includes allocation of funds to Polynesian Airlines, this is necessary as we highlighted, and is being accommodated by cuts to other ministries.

The authorities have picked up on exactly the points that have been discussed this morning, and that were highlighted by Mr. Bingham. The authorities understand it is important to have a management structure for Polynesian Airlines that will ensure the future viability of the airline and prevent repetition of the current experience. Also, currently, no budget funds are allocated to capital projects such as the hotel venture.

The team under Mr. Bingham did a very good job with the Samoan authorities in terms of targeting the advice and making it relevant. The Article IV consultation process is not always that easy for small, island economies, but it is a consultation process whose success depends on both parties—staff and the authorities. The economic team in Samoa is very good and competent, and it shows in the way the economy has performed. This competence also translates into the way the authorities approach the Article IV consultation process; they prepared well for it, sought to get the most from the process, and were receptive to the advice that was offered. The staff report in many respects is a record of the effectiveness of Article IV consultations. A point we keep highlighting is that this is an example where effective consultations influenced the authorities' thinking.

The comments that Directors have made are very important, and they will be passed on in full to the authorities. As Mr. Mirakhor said, the importance of getting comments from the Board to the small island economies, is in many respects the most direct impact that the Board can have. In fact, last Friday the Finance Secretary of Samoa called me and was very keen to know what might come up in the Board meeting. I would like to know how many other authorities in other countries, particularly in some of the larger countries, would be so keen to know what Directors might be saying.

It is very important to give national authorities encouragement. The authorities know the importance of macroeconomic stability and a favorable economic environment for private sector activity, so they have liberalized the economy and are in the process of implementing a very comprehensive reform agenda. However, the authorities would like to see a bit more payoff from the reforms, in particular in terms of FDI flows, which would help strengthen the private sector and export base. There is some frustration that although the authorities are undertaking these reforms, they are still waiting for the payoff. Where is the promised increase in private sector investment? It reminds me of the movie "The Field of Dreams" where they say if you build it, they will come. If you have seen the movie, you will know what I am talking about. But in Samoa's case, the authorities wonder if they implement the reforms, will it attract private sector investment?

Keeping the faith in terms of sound economic management is tough even for good managers. This is not something unique to Samoa, and it is important that we encourage the authorities that they are on the right track. I would like to extend a big thank you to Mr. Bingham and his team, and as the staff have noted, the authorities have agreed to publish the report and selected issues paper.

The Acting Chair (Sugisaki) welcomed the assiduousness of the authorities on the Article IV consultation process and expressed appreciation for Mr. Callaghan's positive comments on the staff's work.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for their commitment to sound economic management and structural reform, which had led to robust growth, low inflation, sound public finances, and a comfortable external position. Several Directors considered that Samoa's policies and performance could be emulated by other small island economies. Although economic growth had slowed in the recent period, owing in part to unfavorable weather conditions and the completion of several major public works projects, economic activity had already begun to recover. Directors were of the view that over the medium term, Samoa's economic prospects remained favorable, provided that macroeconomic stability was maintained.

Directors cautioned, however, that it was essential not to let this generally positive outlook be marred by the ongoing difficult financial situation of Polynesian Airlines and the plans to launch several major publicly-funded construction projects, which could result in a significant expansion of the public sector deficit.

Against this backdrop, Directors commended the government's commitment to reduce the fiscal deficit, and welcomed the government's budget for 2003/04, announced on May 30, which sets out a deficit target of 1½ percent of GDP. Directors endorsed the government's aim of fiscal balance over the medium term, so as to allow public debt—which remains relatively high by regional standards—to decline as a share of GDP.

Expenditure consolidation and moving forward with the tax reforms envisaged by the authorities would be important in this regard.

Directors supported the government's intention to undertake a comprehensive, IFC-assisted review of Polynesian Airlines' future options. While Directors accepted that keeping the airline operational in the near term would likely require budgetary support, they were of the view that no further capital should be injected until the airline's strategic future had been decided. Directors welcomed the recent intention of the government to scale back the level of public funding for major construction projects, as these would have placed significant pressure on the budget and the balance of payments.

On monetary policy, Directors welcomed the Central Bank of Samoa's decision to absorb the excess liquidity that had accumulated in the system. They urged the central bank to stand ready to raise interest rates, if balance of payments pressures arose in the period ahead. Increasing the clarity in establishing monetary targets would enhance transparency and encourage financial saving.

Directors were of the view that Samoa's exchange rate regime continues to serve the economy well as a nominal anchor. With the real effective exchange rate remaining broadly stable and external reserves at a comfortable level, Directors considered that the peg was presently appropriate.

Directors shared the government's concerns regarding the slow response of private investment to Samoa's extensive structural reform program. In order to catalyze private sector activity, Directors underscored the importance of continuing to follow a strategy focused on improving public sector efficiency and removing impediments to trade and investment. Ongoing efforts to restructure the civil service, push ahead with privatization, and improve compliance with WTO rules and regulations were considered particularly important for improving prospects for export-led growth. Directors also viewed ongoing efforts to increase the availability of land for investment purposes as important for stimulating the development of commercial agriculture and tourism.

Directors encouraged the government to press ahead with efforts to enhance the financial sector's supervisory and regulatory framework. With central bank supervision having been extended to nonbank financial institutions in 2001, the priority now is to finalize the guidelines governing this supervision. Further steps are also needed to strengthen the regulatory framework for commercial banks, notably with regard to connected lending. Appropriate technical assistance would help build the needed supervisory capacities.

Directors took note of further progress in strengthening oversight of the offshore banking system and welcomed recent progress in strengthening the capabilities of the financial intelligence unit. They also encouraged the government to work closely with partner countries to develop a robust and equitable system for the exchange of tax information.

Directors noted that the quality of Samoa's economic statistics compares well with that of other countries in the region. Nevertheless, they encouraged the government to continue its efforts to address remaining weaknesses in the quality of their statistics, particularly in the areas of government finance and the balance of payments. The authorities were urged to subscribe to the General Data Dissemination System.

It is expected that the next Article IV consultation with Samoa will be held on the 24-month cycle.

2. FINANCIAL SOUNDNESS INDICATORS

Documents: Financial Soundness Indicators and Comments on Draft Compilation Guide (SM/03/175, 5/14/03; and Sup. 1, 5/29/03); and Background Paper (SM/03/176, 5/15/03; and Cor. 1, 5/30/03)

Staff: Enoch, STA; Sundararajan, MFD

Length: 3 hours, 20 minutes

Mr. Kanaan and Mr. Sakr submitted the following statement:

We thank the staff for their substantial work in examining the linkages between financial soundness indicators (FSIs), preparing the draft FSIs *Compilation Guide*, and presenting us with progress in this area since the Board meeting of June 2001. Improving the ability of member countries and the Fund to effectively monitor the soundness of financial systems is undoubtedly desirable. Having said that, however, we believe that our effort in this regard should be focused, rather than unduly exhaustive, in order to be effective. This important principle, as well as the well-known imperfections of FSIs, will guide our comments on the main proposals of the staff paper.

We have the following main points: (1) We would caution against raising unrealistic expectations about the predictive power of FSIs; (2) The FSIs core and encouraged lists should remain as focused as possible and member countries and the Fund should be selective in the weight they assign to the different FSIs depending on country specific circumstances; (3) Any use of FSIs should be appropriately complemented by a qualitative assessment; (4) Publication of FSIs should remain strictly voluntary; (5) We find the paper's assertion that staff's proposals can be implemented, in a large part, without allocating new staff resources to be unrealistic; (6) Priority should be given to providing the substantial technical assistance needed to help countries improve statistics and build capacity.

We shall elaborate below on some of these issues as we address the specific questions raised by staff.

We find the plan for the finalization, and eventual endorsement by the Board, of the draft FSIs *Compilation Guide* appropriate. However, we have concerns about the resource implications of the proposed coordinated compilation exercise involving up to 60 countries, which seems to be overly ambitious. The Statistics and Monetary and Financial Systems Departments are already overburdened, including with the very resource-intensive FSAP review exercises as well as pressing demands for technical assistance. Before adding to their heavy workload, it is incumbent on us to carefully weigh the value added of new tasks against a realistic estimate of their cost and against possible alternative uses of scarce staff resources. If, after a careful cost-benefit analysis, the proposed exercise was still deemed essential, consideration has to be given to starting with a smaller number of countries and to realistically limiting the objectives of the exercise. In this connections, we would welcome staff's clarification of what is meant in practice by the statement that the coordinated compilation will be conducted "under the auspices of the Fund" in terms of the degree of Fund involvement and staff resources required.

The paper also proposes increasing reliance on a cross-country FSIs database in Fund surveillance and encouraging FSIs dissemination, including by adding them to the SDDS. We recall that the Board expressed serious concerns regarding such proposals during the last meeting on this subject. These concerns were based on the insufficient understanding of the analytical aspects of FSIs, as well as the unavailability of continual time series of many of these indicators, the likely added burden their compilation would place on member countries, and the possibility of their misinterpretation by markets. These concerns remain valid today. Accordingly, we would like to stress once again the importance of considering a broad range of factors, including country-specific circumstances and differences in the legal and regulatory frameworks, when analyzing FSIs. The significance of these indicators for risk assessment should be determined on a case by case basis. The exclusive reliance on any set of quantitative indicators to assess the financial sector can obviously be misleading and may do more harm than good. Of course, it is also well to note the limitations of making meaningful comparisons of FSIs over time and across countries in view of these country-specific factors. It is therefore important to fully acknowledge the limitations of FSIs and to temper our expectations of their predictive value. They are an imperfect tool and must be handled with caution.

The above conclusion has direct implications for judging the degree of importance the Fund and individual countries should attach to compiling, maintaining, and disseminating a comprehensive database of these indicators and the amount of resources that should be dedicated to these objectives at the expense of other competing priorities. It also highlights the considerable risk that dissemination could involve in terms of misleading the market or precipitating crises in the name of transparency. Statistical limitations, particularly in developing countries, can exacerbate this risk as they adversely affect the reliability of the FSIs and can thus raise false alarms which would be amplified with automatic dissemination. Our focus should be on encouraging countries to produce relevant FSIs to help them monitor their financial systems and avoid crises. Putting pressure on countries to publish these indicators is not only undesirable, but could also be counterproductive. We therefore continue to strongly believe that the matter of publication should be left to the discretion of each country.

With regard to the framework for financial stability analysis presented in Figure 1 of the Board document, while we find the framework adequate, we would stress the need for selective emphasis on different FSIs depending on each country's specific circumstances. The staff should therefore be encouraged to optimize the use of their limited resources by focusing on selective areas of vulnerabilities depending on the circumstances of each country. Likewise, in encouraging country authorities to enhance statistics compilation capabilities, specific country-related vulnerabilities should guide the determination of the data set and the frequency of its various components. We would, therefore, favor keeping the core FSIs set as focused as possible, and treating the encouraged set as a flexible set, of which only a subset could be considered relevant depending on each country's circumstances. We would also caution against over-expanding the encouraged list in order to ensure a reasonable degree of focus.

Finally, while we share the view that the Fund should collaborate with other specialized organizations in developing and enhancing the various standards and methodologies that are relevant for assessing the soundness of financial systems, we do not believe that the Fund should take a leading role in each case. For example, we wonder if the Fund has the technical expertise, or the core responsibility, to assume a leading role in the international effort to develop real estate price indices. Similarly, we believe that other specialized international institutions should be playing the leading role in areas such as insurance, securities, accounting, and corporate governance, in order to provide the appropriate expertise and to alleviate the burden placed on the Fund. We also wonder if the BIS and the Basel Committee on Banking Supervision should not play a larger role than currently envisaged in leading the effort in the area of FSIs in general. The staff's comments are welcome.

Mr. Callaghan and Mr. Reddell submitted the following statement:

Key Points:

- The development of FSIs should help in assessing the strength of financial systems.

- To encourage the compilation of FSIs, it is necessary to not only develop consistent data systems and a conceptual framework through the *Compilation Guide*, but also to promote with countries the role FSIs can play in supervising financial systems. Greater efforts are needed on this front. Countries will only incur the cost of compiling FSIs if they see the additional data as being important.

- Given that there is a substantial task ahead in promoting the use of FSIs, we would be wary of expanding them beyond key indicators/sectors.

- The proposal for FSIs to be included in the SDDS needs to be carefully considered. The stricter coverage, frequency, and timeliness requirements of the SDDS may mean that the current state of collections of FSIs in many countries is below the SDDS standard.

Financial Soundness Indicators (FSIs) should make an important contribution to assessing the financial strength and vulnerability of a country's financial sector. They are, however, no more than "indicators" in that they provide a signal that further analysis is required. Moreover, once vulnerabilities are identified, the crucial next step is developing the appropriate policy action.

The Compilation of FSIs is Patchy

When a country has undergone an FSAP, a set of FSIs will normally have been compiled and analyzed. Outside the FSAP, the compilation of FSIs seems to be very patchy. The 2000 Survey of Macroprudential Indicators suggested that 90 percent of respondents collect data series needed to compile at least one indicator in some of the core FSI categories. However, as the staff report notes, countries active in FSI-related work were more likely to have responded to the survey, resulting in a positive self-selection bias. The conclusion of the review of the dissemination of FSIs through staff reports and national data websites and publications was that there are considerable obstacles in finding FSI data and their associated meta data for virtually all member countries, and there is a lack of centralized dissemination. Consequently, there is a significant task ahead in encouraging the compilation of FSIs.

A Compilation Guide is Sensible

Certainly this task will be assisted by the preparation of a *Compilation Guide* for FSIs. It is important to develop a conceptual framework and data series for FSIs consistent, to the maximum extent possible, with existing statistical conventions and accounting concepts so that the burden on compilers and respondents is reasonably contained. This is relatively straightforward in the case of macroeconomic indicators since the conventions for compiling national accounts data are well established. It is more problematic in areas dealing with prudential and banking data and there remain important differences between international and national accounting practices. For this reason, the *Guide* will need to remain flexible.

Greater Efforts are Needed to Encourage the Use of FSIs

Preparing a *Guide* on the compilation of FSIs is important and the work program on the *Guide* appears sensible; however, countries will ultimately only compile FSIs on an ongoing basis if they consider it useful in supervising their financial systems. This is acknowledged in the *Guide*, which notes that in determining the need to collect new data and incur the increased costs, the countries will have to make a judgment as to the likely importance of the additional data to surveillance. As such, we would suggest that greater effort needs to be directed at demonstrating to countries the benefit that can come from compiling and disseminating FSIs.

With this in mind, the staff propose that a coordinated compilation exercise involving both supervisors and statisticians be conducted under Fund auspices, after finalization of the *Guide*. Such a comprehensive trial is sensible. It will help refine what should be in the core indicators (for example, liquidity should probably be excluded). However, in the overall task of encouraging the compilation of FSIs, it is important to include those responsible for financial supervision and stability of the financial system. This provides the opportunity to not only address statistical concepts and definitions of FSIs, but perhaps more importantly, to emphasize the role FSIs can play in the supervision of PSIs.

The framework for financial stability analysis outlined in Figure 1 of the Board document is cast in the widest possible terms. In practice, each country needs to select the macroprudential indicators that are most relevant to its particular situation and ensure that these are analyzed on a regular basis and that any “early warnings” they provide are communicated to economic decision-makers more generally.

Considerations Before Expanding FSIs

Given that there is still a substantial task ahead in promoting the use of FSIs, we would be wary of expanding FSIs too far beyond the key indicators/sectors at this stage. Any expansion should be considered in cost-benefit terms (i.e., the cost to the national regulators collecting the data and the associated respondent burden on financial institutions). In particular, the extension of FSIs to the insurance sector needs to be weighed carefully. For most countries and in most circumstances, we wonder whether the failure of an insurance company will generate the systemic consequences associated with the failure of a deposit-taking institution.

The proposal for FSIs to be included in the SDDS needs to be carefully considered. In particular, the stricter coverage, frequency, and timeliness requirements for SDDS would mean that the current state of collection of FSIs in many, if not most, countries is well below the SDDS standard. The staff's timetable—five years–to include the core FSIs or a subset of the core FSIs as required categories is admittedly lengthy, and this should provide time for refinement and enhancement of compilation standards. However, if the objective is to encourage more countries to subscribe to the SDDS, it is unwise to constantly keep adding to the SDDS such that it becomes something of a "moving target."

There are also issues that need to be addressed in the "mechanisms" of the SDDS when the coverage is expanded. Currently only one NSDP is allowed under the SDDS, and in most countries this is likely to be maintained by the statistical agency. Should the SDDS be extended to include FSIs, in many cases the source of the data will come from the supervisory agency, which raises logistical issues if the statistical agency has to start to maintain prudential data. There are issues that need to be addressed as to how a broader SDDS would be managed and maintained.

Finally, it is worth drawing attention to the international dimension. In a world with increasing cross-border ownership of banks, national FSIs take one only so far. For a country whose banks are heavily foreign-owned, and especially if the ownership is concentrated in a single country (the situation in New Zealand, for example), FSIs from the parent country, and a full understanding of the risks that country may be exposed to, may be at least as important as the home country's FSIs in assessing systemic stability. Of course, this is another argument in support of good quality, readily comparable, FSI data.

Mr. Martí and Mr. Moreno submitted the following statement:

We thank staff for the reports they have prepared for the discussion on Financial Soundness Indicators (FSIs). They provide a useful update of the status of the FSI *Compilation Guide* and the consultation process behind it. Additionally, the documents provide a preliminary overview on a number of analytical issues regarding the applicability of FSIs within the financial stability analysis, the interpretation and linkages between FSIs, their interaction with the Basle Core Principles and with stress testing techniques, and their integration on Fund surveillance.

The document raises a number of practical and theoretical issues on the specific characteristics of FSIs. We will focus our comments in three areas: the list of core and encouraged indicators, the information requirements to member countries, and the integration of FSIs within Fund surveillance and the financial stability analysis. While looking at this areas we will have the opportunity to answer the specific questions raised by staff on the issues for discussion.

Before entering in these aspects let us make a few general remarks on the FSIs process. The FSIs have been designed to be used as very valuable new tool for the Fund's macroeconomic surveillance, and should be adequately enhanced. Nevertheless, we should not be too ambitious in trying to push the FSIs agenda. Like any new instrument, we believe that their introduction should be made gradually to allow a smooth implementation that takes into account country-specific circumstances. As the working paper on the Availability of Financial Soundness Indicators points out, we are still far from a generalized use and compilation of FSIs among member countries and further from an homogeneous production. Here we think that the principle of availability should come before that of comparability. Being at a first stage, we should first ensure that FSIs are effectively compiled, and that will most likely happen if it is done with the available data, and then work on their homogenization. Even more, FSIs should be mainly understood as a tool for assessing individual country's financial soundness.

Furthermore, the introduction of FSIs should be done through a widespread consultation process that ensures broad country ownership. In this respect, we value positively the consultation process that has been carried on so far for the development of the FSI *Compilation Guide*. However, we have missed the same consultation efforts on the analytical approach of FSIs, which is a necessary complement to the *Guide*. The analytical sections have not yet gone through any dissemination or discussion process similar to that of the *Guide*, and therefore, it is possible that their conclusions might not reach the same level of consensus or ownership that the *Guide* is achieving. Furthermore, we believe that it would have been appropriate to have assigned time to the discussion of FSIs for macro prudential analysis, or to their role in Fund surveillance during the consultation process of the *Guide*. More needs to be done on the consultation of the analytical approach; in this regard, the proposed conference on Financial Stability Analysis in the fall of 2004 is a welcome step. Given these considerations, we believe that the contents of the

FSI Report should not have been presented to the Board on an equal footing, as we consider the analytical sections as largely preliminary, while the *Compilation Guide* is close to a final draft.

Core and Encouraged Indicators

The *Guide* establishes core indicators as relevant for all countries and encouraged indicators as relevant according to country-specific circumstances. While sharing the general idea that core indicators should be understood as more essential and should be applied to the largest number of countries, we believe that there should be certain flexibility in order to consider different core lists of indicators for different countries. As an example, the indicators of sensitivity to market risk, which are only compiled by very few countries, could be required only where there are available data. Additionally, household indicators should probably be considered as a core indicator mainly in advanced economies. These indicators, particularly the household debt service, entail significant calculation difficulties as they require econometric analysis beyond direct collection of data.

With respect to the procedures for changing the lists of core and encouraged indicators, it will be important to establish a system of constant monitoring of FSIs that ensures that they remain relevant and capture the ongoing financial innovations. Surveillance must keep an open eye to these innovations and detect how they should be included in the numerators and denominators of the indicators. The FSAP reviews and Article IV consultation exercises will be important sources of this monitoring process. Additionally we believe that periodical reviews, both by financial and statistical experts and by the Board, are warranted and should be institutionalized. These reviews should ensure that a wide consultation process is carried out and wide consensus is reached before changes on the lists are decided.

Concerning the specific changes on the list proposed by the staff, before making any decision, a process of large international consultation and further analytic and data development work should be undertaken, as the staff suggests. We have nevertheless the following comments:

We are somewhat skeptical on the possibility of designating effective indicators to measure the soundness of the insurance sector. It is difficult to capture the complexities of the insurance sector in a few indicators, for instance, the potential liabilities stemming from insured capital. The solidity of an insurer relies to a great extent on the adequacy of its reinsurance arrangements and the solidity of its reinsurers, a set of factors that defies representation by means of conventional indicators. It is important therefore that the Fund should insist on the need for strict surveillance on this sector, the more so because many countries tend to conduct insurance supervision by standards of administrative compliance rather than of financial macro prudence.

The Basle Capital Accord requires large exposures to capital to be reported at the consolidated level. Given that this is an already required indicator, it might be appropriate to maintain it in the core set. At least it should be kept as a core indicator where it is relevant.

We also have reservations on the movement of corporate sector FSIs to the core set as there is no widespread compilation of this kind of data and it might be very costly for some countries. Furthermore, in many countries there are legal restrains that would not allow to collect the required information on the corporate sector to compile the indicator. An alternative could be to include them in the core set for all those countries where there is available data that is in line with international accounting practices.

Two-Way Approach to Compile FSIs

We would like to make an additional comment regarding the two-way approach to compile FSIs proposed by the *Guide*: first, with a domestic consolidation of deposit-takers; and second, with a cross-border consolidation. We think that further analysis should be made in order to determine and clarify which indicators are core and encouraged for the domestic economy, and which ones for the cross-border consolidation, as probably some of them will be more relevant for one set than for the other.

For example, the encouraged FSI include a few indicators that should probably only apply to the domestic economy, such as the spread between reference lending and deposit rates, the total debt to equity, the leverage ratio of the corporate sector, or the household debt to GDP. It is far from evident how these indicators would be compiled in a cross-border consolidation (which would involve interest rates in different currencies and countries, GDP of different countries, and so on) and even less evident how they would be interpreted. In the same vein, the differences between the compilation of FSI for the domestic and cross-border consolidation should be clearer in the case of the capital and reserves FSIs, regulatory capital or Tier I capital.

This analysis should lead us to determine two subsets of information requirements (domestic and cross-border), and decide which countries should publish them. As a minimum, countries with a strong presence in the international financial system should be required to report their cross-border consolidated core FSI.

Information Requirements

The staff proposes two basic practical measures to enforce the compilation of FSIs: their inclusion in the SDDS and the establishment of a centralized compiling and disseminating agency. We have reservations in both proposals.

On the integration of core FSIs in the SDDS by the end of 2008, we believe that at this stage it would be wiser to wait for the feedback on practical compilation problems from the coordinated compilation exercise envisaged for 2005. On the basis of the experiences shared in this exercise, we will be on a better position to determine whether a fixed date for inclusion of core FSIs in the SDDS should be considered. The conclusions of the survey on availability of FSIs is quite clear on the considerable obstacles in finding FSI data and their associated metadata in virtually all member countries.

A priori, centralizing the compilation and dissemination of FSIs seems an unnecessary institutional change. Countries that have different institutions that are efficiently collecting and disseminating FSIs should not be required to change their institutional setting. Clearly identifying what are the different institutions responsible in each case should be enough to cope with transparency and accountability concerns. The idea of a centralized web site of FSIs might be more viable and less costly.

Integration of FSIs in the Financial Stability Analysis and Surveillance

As we have stated before, we believe that further efforts need to be undertaken to ensure a higher participatory process and larger ownership on the analytical work of FSIs and their integration in the financial stability analysis and surveillance. This will require more consultation seminars and probably additional Board meetings.

Notwithstanding the development of this participatory process, we would like to make some specific comments:

Surveillance should be used to ensure the reliability of the FSIs. As part of the surveillance exercise, the staff should take a close look to the different components that make up each indicator to ensure that they contain all, and only, the information that is significant for the definition of the indicator. For instance, in many countries repos were initially excluded from the balance sheets of commercial banks, and therefore were not included as liabilities. Indicators that require information on liabilities were missing a significant piece of information.

This surveillance exercise will become all the more important as the definition of indicators has been designed flexibly so as to accommodate different types of data from diverse sources. A surveillance that focuses on the reliability of FSIs, and encourage the use of metadata to identify the deviations from recommended practices, will help to make the comparisons.

On the integration of FSIs into the analytical framework for financial stability, Figure 1 of the Board paper appears as a good summary of many macro financial links. However, the staff seems to be taking mainly a domestic-based approach, when one of the presumed intentions of the *Guide* is to place the international dimension of financial links in the front burner and, therefore, the cross-border consolidation approach is called for. The non-resident sector is not mentioned in the figure, making it difficult to understand the linkages between macro and financial conditions affecting financial institutions operating in different countries.

Mr. Padoan and Mr. Bossone submitted the following statement:

We commend the staff for this excellent set of papers, the progress achieved to date in pushing forward the Fund membership for the compilation and use of Financial Sector Indicators (FSIs), and the work program proposed for the future.

We fully support the staff proposals and wish to offer a few comments and suggestions.

Despite the progress noted, the report indicates that much needs be done in the area of data collection, compilation and dissemination. Judging from the considerable obstacles that users face in finding FSI data and metadata for virtually all member countries, relentless action is needed to motivate member countries to intensify efforts in strengthening their statistical capacity. Indeed member countries may not be fully aware, or they may become aware too late, of the need to act in this sense.

The need for action on motivation is well illustrated by the survey results showing that economies that have not experienced recent banking crises tend to have the least developed systems in place for collecting FSI data, while countries that have experienced banking crises use a much larger proportion of collected data to compile FSI ratios than their non-crisis counterparts. It is also revealing that countries do not widely collect information outside the traditional supervisory data sources and macroeconomic statistical frameworks, leading to inadequate use of important financial vulnerability indicators, such as those on market risks and asset quality. This suggests that data collection in some cases may be carried out more as a bureaucratic duty than as the basis for financial sector analysis and policy. Efforts to stimulate motivation in data users could change attitudes significantly.

Indeed, we believe that a lot of the much needed action on motivation should be directed at publicizing among financial sector supervisors and policymakers, worldwide, the relevance that FSI information has for their surveillance activity, and especially for crisis prevention. Outreach exercises aimed at explaining the framework for using FSIs for financial stability analysis would serve such a purpose well, by inducing a demand-driven process of information-production locally: desirably, the creation of adequate statistical capacity and intelligence should become endogenous to the demand for data from policymakers and supervisors. The Fund could help considerably in this process. The recent review of the FSAP, for instance, has shown that stress-testing exercises benefit considerably from more and better data provision when the authorities are involved in close cooperation with the staff. Evidence showing that better data availability does have a significant impact on the cost of credit and on international ratings could be used to support the effort to strengthen motivation.

The endogeneity of data provision is the main reason why the distinction between core and encouraged FSI lists should not be taken as given and should instead be considered dynamically. As policymakers increasingly value financial sector information and come to master the knowledge to use it, countries should set out to expand their list of core indicators beyond what is internationally agreed on as a minimum standard. As for the Fund, through its periodic reviews of FSIs it should revisit the composition of the two lists and revise them according to the better understanding of the underlying phenomena.

In this regard, while we support the staff's recommendation to move the large-exposure FSIs from the core to the encouraged list, we would suggest that the core list be expanded to include the currency mismatch FSIs that currently belong to the encouraged set. We would also suggest that maturity mismatch FSIs be included in the core list, in view of their significance as vulnerability indicators. Further, we would urge that corporate sector indicators—especially those reflecting its debt repayment capacity—be integrated in the core list as essential tools for financial surveillance. In our view, this should proceed in parallel with the development of analytical methodologies based on the balance sheet approach to financial surveillance.

Finally, we support the proposal to incorporate the essential insurance FSIs identified by the staff in the encouraged list. However, the experience using these FSIs, and consultation with member countries where the insurance business has already a significant presence, or is developing rapidly, could serve to assess whether insurance FSIs should move up to the core list. Greater emphasis on insurance FSIs is also justified by the increasing interrelations between insurance and banking, as noted in Box 3 of the staff report. These interconnections suggest that tests should be designed that would allow supervisors to evaluate the impact of insurer failures on financial sector stability as well as to assess the impact of corporate risk on the insurance sector, especially as the use of credit derivatives supplied by insurers becomes more widespread.

We fully share staff's view that the interpretation of FSIs benefits crucially from the assessments of standards. Such a link reinforces the importance of structural analysis for Fund surveillance, and most notably for its action on crisis prevention. We wish to emphasize that the synergies from FSIs and standards assessments will be stronger the deeper the understanding from domestic supervisors and policymakers of the framework for using FSIs for financial stability analysis is. Their increasing involvement in FSI analysis is essential both to achieve better provision of relevant data, over time, and to extract more and better signals from their use.

On the framework itself, which is well illustrated in Section V of the staff report, we notice that while it emphasizes the risk for public debt arising from shocks to the financial sector when this holds large shares of government securities, it does not consider the risk for the banking sector deriving from sovereign debt problems in those cases where banks hold large positions on government securities. To fill this gap, we suggest that the public sector, and its related FSIs, be integrated within the macro-prudential segment of the framework as a possible source of risk.

Finally, as to the timeframe for IFIs' compilation and dissemination, while we support the need to encourage country efforts, we recommend that the completion of the *Guide* take on board all elements that could be relevant to it and that might emerge from the finalization process of the New Basel Capital Accord. As to the proposed target date for including FSIs in the SDDS, we notice that it might be too ambitious and we therefore recommend it be subject to further consideration.

Mr. Le Fort and Mr. Pereyra submitted the following statement:

Key points:

- We agree with the work program for the completion of the *Compilation Guide* by end-2003.

- We support the staff's proposal to organize a coordinated compilation exercise involving supervisors and statisticians in 60 countries, and underscore that systemic considerations should be kept in the selection process.

- FSIs should be included as part of the SDDS as of end-2008.

- We welcome the comprehensive, forward-looking approach to the analysis of FSIs summarized in Figure 1 of the staff report.

- The list of core and encouraged FSIs should be updated broadly along the lines suggested by staff, given the need to reflect the enhanced risks and uncertainties in the world economy.

- We support the staff's proposals for developing the role of FSIs as a tool in surveillance and for assessing the capacity of countries to compile FSIs.

We thank the staff for a very informative set of papers containing a comprehensive analytical framework for Financial Soundness Indicators (FSIs), as well as proposals to encourage their use in the membership. At the outset, we agree with the work program for the completion of the *Compilation Guide* by end-2003, as detailed in paragraph 40 of the staff report. In particular, we attach importance in keeping a continuing collaboration with standard setters, and to take every chance to enrich the document with the experience drawn from the FSAP review exercises, Basel core principles assessments, and, in general, Fund surveillance. In addition, given that outreach programs are useful in underpinning the introduction of new statistical practices, maybe the staff could provide more information on the regional coverage of the series of seminars launched in April, as well as on the activities involved.

We support the staff's proposal to organize a coordinated compilation exercise involving supervisors and statisticians, once the *Guide* is completed. Given the prevailing global uncertainties, it is essential to promote increased awareness in the membership regarding the value of FSIs in surveillance. Moreover, we concur that the coordinated effort should emphasize the need to enhance international comparability of FSIs in the medium term and to compile FSIs on a continuing basis, and support the staff's suggestion to seek collaboration with experts from international agencies in order to benefit from their expertise.

However, the question remains of how to select the 60 countries that would participate in the exercise. We agree in principle with the staff's suggestion to include SDDS subscribers, which could be regarded as a first step towards incorporating FSI as part of the SDDS. Also, consistent with our remarks on the review of the FSAP, priority should be given to those economies with a systemically critical impact, since a main objective of the initiative is to contribute to global financial stability. However, this should be balanced with the need to encourage the compilation and use of FSIs in less developed financial systems, prioritizing those that are at significant risk and whose conditions could have significant regional implications.

From the experience with FSAPs and the use of FSIs in surveillance work, substantial progress has been made lately regarding the use of FSIs among the membership. Moreover, it is to be expected that use of FSIs will increase considerably with the coordinated compilation exercise, and that it will be strongly encouraged in surveillance work. Therefore, we find merit in the proposal to include the core FSIs as part of the SDDS as of end-2008. At the same time, the results of the compilation exercise will help to establish the final subset of core FSIs that could realistically be considered for the 2008 deadline. Accordingly, the said subset of core FSIs in the SDDS could be included as encouraged items as of end-2006. Also, we can support including the rest of the FSIs in the SDDS as encouraged categories.

We appreciate the staff's analysis of the integration of FSIs into the framework for financial stability. In particular, the experience with financial crises and financial innovation in the last years has prompted a comprehensive, forward-looking approach to the analysis of FSIs. In the broader framework of vulnerability assessment, these need to be qualified and complemented with early warning indicators, macro-financial linkages, and qualitative information regarding financial infrastructure and supervision. Figure 1 of the staff report is a useful summary of these complementarities, which are essential to determine the likelihood of a shock and its actual impact. This view is appropriately geared to reinforce the Fund's efforts in crisis prevention. Since we support the staff's approach, we will limit ourselves to a few comments.

We attach importance to the emphasis on the role of non-financial sector FSIs as a leading indicator, given the effect of losses in the corporate sector on banks' asset quality in the event of a shock. We also find merit in monitoring of peer groups to establish the degree of risk concentration.

Beyond financial sector vulnerabilities, the proposed framework also stresses the usefulness of FSIs in assessing the impact of the latter on macroeconomic conditions through different linkages: the provision of bank financing to the non-financial sector; deposits and wealth placed with the financial sector; and the role of the financial system in monetary policy transmission.

In addition to the latter macro-financial linkages, the staff points out the importance of taking into account the borrowing by non-financial sectors from the domestic banking sector and from foreign-owned banks active in the country to assess the possible impact of problems in the financial sector. BIS consolidated banking statistics can be instrumental to measure the latter exposures, since they show the borrowing by every country's private and government sectors from the banks in each BIS reporting country. At the same time, as highlighted by this chair on previous occasions, care is warranted in elaborating foreign indebtedness figures using BIS information. Under some presentations, the latter includes borrowing from foreign bank branches—which rely significantly on local depositors and equity financing—and therefore its use would result in an overestimation of a country's debt burden. This is particularly important for those countries with a well-developed domestic financial system in which foreign banks have an important participation.

We concur with the staff's suggestion to update the list of core and encouraged FSIs, given the need to reflect the enhanced risks and uncertainties in the world economy, and broadly agree with the proposed changes. In this regard, we would like to make the following remarks:

We note the staff's arguments to move large exposures from the core to the encouraged set, considering that, in developed financial systems, aggregating banks' large exposures to individual counterparties often results in very small percentages of the sector's total exposure, and therefore provides very limited information. However, the opposite is true in less developed financial systems with few large enterprises and banks, as noted by the staff. Therefore, even though we can agree with the staff's proposal, the relative importance of this FSI should be highlighted on a case-by-case basis as part of Fund surveillance.

Since compilation of market risk FSIs—duration of assets and liabilities and net open foreign exchange position—is still limited, it is essential to promote its use in FSAPs and ongoing surveillance. This is an aspect that should be emphasized in the compilation exercise. We agree that stress testing is useful as a substitute for market risk FSIs in FSAP review exercises, but note the staff's observation in paragraph 72 of the report that it may not be practical to rely on it for continuing monitoring.

Previous Board discussions on international capital markets, as well as Box 3 of the main staff report, provide enough arguments to include FSIs for the life insurance sector initially as part of the encouraged list, in particular the strong linkages between banks and insurers, and the latter's increasing use of banking-type products. At the same time, its compilation and use should be prioritized without delay in developed economies, in light of the risks currently faced by their insurance sectors and their systemic ramifications. Also, consideration should be given to FSIs for property and casualty insurers, given their significant role in the economy.

The criticality of corporate sector FSIs is clear from the analytic framework for financial stability summarized in Figure 1 of the staff report. Therefore, surveillance work and the envisaged 60-country exercise should seek to overcome compilation problems in participating countries, in order to move this group of FSIs to the core list as soon as possible.

We support the proposed further development of the FSI database to maintain a continuing surveillance of financial systems. As the staff points out, that such enhancement of the database will rely on the proposed efforts to encourage compilation of FSIs among the membership, mainly Article IV and UFR missions, focused FSAP review updates, the compilation exercise and collaboration with standard setters. We note that these initiatives will be accommodated within the budget, but that, given the available resources, a substantial increase in technical assistance would not be possible. Finally, we support the elaboration of a guidance note on using FSIs.

Mr. Kremers and Mr. Litman submitted the following statement:

We welcome the opportunity to discuss the work on financial soundness indicators. We agree with the majority of the staff's recommendations, and we will concentrate on a few comments and suggestions.

Financial Soundness Indicators Sets

The Core Set should include two additional FSIs, which are included in the BCP:

(a) Large exposure to capital. There are many definitions of large exposure and the staff outlines a few of them in the *Compilation Guide*. The staff proposes to allow some flexibility in the application of definitions. We urge the staff to act in the same way as when it dealt with non-performing loans. We are sure that during the consultation process, the staff found a large variety of definitions of problem loans. Nevertheless, the staff, rightly, decided to adopt a specific, rigid definition of NPLs. Therefore, we would like to suggest to adopt a rigid definition of large exposure as a credit exposure to a group of linked borrowers of over 10 percent of the bank's capital (the definition proposed in paragraph 6.33 in the *Compilation Guide*). As the nominator of the FSI, we suggest a sum of the large exposures. Such FSI should continue to be included in the Core Set.

(b) Connected lending to capital. In many countries lending to connected parties has been identified as the single major reason for banks' failure. We support the staff's proposal to undertake a process on international consultation and further analytical and data development work, and urge the staff to include in this process the task of formulating a correct definition and the FSI for connected lending. Such FSI should be added to the Core Set. We are aware of difficulties to compile data on connected lending, as such data necessarily would rely on corporate reporting and disclosure which may follow different than banks standards.

(c) Duration. Instead of duration of assets and duration of liabilities it is preferable to use the "gap" analysis. Moreover, until the staff will decide to choose one of the approaches described in the *Compilation Guide*, duration should be moved from the Core Set to the Encouraged Set.

(d) Corporate sector debt-to-equity ratio. In paragraph 63 of the staff report, the staff proposes to use the corporate leverage FSI as a leading indicator of asset quality. The staff bases this proposal on its finding of a statistically significant relationship between assets quality (expressed by NPL to loans) and the corporate leverage: a 10 percentage points increase in the corporate leverage is associated with a 1.8 percentage point increase in NPLs/loans, after one period. It is a curious finding. The plots in Figure 2 of the staff report are mostly concentrated in leverage levels between 0.3 to 0.5 corresponding to NPLs/loans from 0.00 to 0.03, so in most cases the plots were of low leverage and low NPLs. However, there seems to be no connection between high leverage (above 0.7) and NPLs. The banking practice seems to support our misgivings over the econometric results presented by the staff. The ability of a corporation to repay a loan depends on its cash flow or collateral it provides. There are sectors, like construction, which depend on debt, while others operate almost without debt. Given the non-compatibility of the definition of capital in different countries and different sectors, running regressions based on such data may not produce very robust results. Therefore, until additional studies will support the staff assessment, we propose not to include such FSI in the encouraged set, yet we support to include the other corporate sector's FSIs in the set.

Public Dissemination of FSIs

The core set of FSIs focuses on the banking sector, which is usually better monitored than other sectors. In many countries, the banking supervision has a role in deciding which data should be included in banks' auditors reports. If so, banking supervision may request the banks to include the core set of the FSIs in their audited reports. Doing this may achieve not only the dissemination of individual FSIs, which are more meaningful than consolidated FSIs of the banking sector, but also improving the quality of data as auditors would audit the FSIs published in the report.

We encourage, in principle, including the core set of FSIs in the SDDS, because it will provide very useful feedback to the institutions that compile the data. However, before deciding whether, how and when to include the FSIs in the SDDS we encourage the staff to review the reporting requirements, and examine the feasibility and the likely timeframe for such an extended SDDS.

Analytical Framework for Financial Stability.

The presented framework for financial stability analysis is useful to gain a better insight into likely transmission processes. Furthermore, a structured analysis helps to focus macro-prudential surveillance on key vulnerabilities. However, the framework may not cover all possible shocks and macro-financial linkages. For example, the presented framework suggests that shocks are only transmitted through the banking sector. This is widely true in continental Europe, where corporation are borrowing mainly from banks. However, elsewhere, like in the United States, alternative transmission channels are imaginable. Shocks in the corporate sector may disrupt the functioning of financial markets and thereby the allocation of funds in the economy, without destabilizing the banking sector. Therefore, some correction taking the aforementioned into account is advisable.

Mr. Lushin and Mr. Lissovolik submitted the following statement:

We thank the staff for a comprehensive set of papers on Financial Stability Indicators (FSIs). Since the last Board review a greater scope for analyzing the usefulness of FSIs in the context of ongoing surveillance has enabled the staff to elicit some important gaps in the current framework. Addressing these gaps (including those ones pertaining to the compilation of FSIs across countries) should take precedence over any efforts to expand the array of FSIs or to unnecessarily compress the timeframe for integrating these indicators into the SDDS and the regular data reporting practices of Fund members. With these introductory remarks, we now turn to issues for discussion.

We generally support the work program for the completion of the *Compilation Guide*. We note in particular the need to devote significant attention to the harmonization of the *Guide* with the evolving norms of the relevant international standards (as detailed in paragraph 41 of the staff report).

We welcome the intention of conducting a coordinated compilation exercise, although we note that, as detailed in paragraph 95 of the staff report, the set of countries targeted for this exercise include those subscribing to the SDDS, i.e., those already enjoying a significant technical and administrative capacity to compile FSIs. In this respect, while recognizing the trailblazing effect of the participation of advanced countries in this exercise, we also believe that it needs to take into account the needs of those countries that may lack the experience and the resources to operationalize the *Compilation Guide* in their policymaking.

With respect to the target date for including FSIs in the SDDS, we believe that the evidence accumulated thus far does not warrant any rigid deadlines in this area. Indeed, there is still some ambivalence on the part of the staff regarding the optimal set of FSIs to be employed. Also, as recognized in paragraph 45 of the staff report, there remain significant gaps in the compilation of FSIs and their dissemination across countries. Addressing these and other outstanding issues needs to take precedence over efforts to accelerate the incorporation of FSIs into the SDDS, lest the still influx framework of the former could undermine the transparency and coherence of that of the SDDS.

We also note that the operationalization of FSIs within the current dissemination standards needs to be inclusive and if some time frame is indeed to be introduced with respect to the incorporation of FSIs into data dissemination standards, there may be a rationale for involving the GDDS countries in this process as well. On the one hand, restricting these efforts to SDDS countries is unlikely to produce a significant impact on the effective use of FSIs in view of the already relatively high technical capacity of these countries. On the other hand, the inclusion of GDDS countries into this process would have to take into account the lack of technical and administrative capacity on the part of some of the GDDS subscribers, which in turn would call for a very limited set of FSIs to be included on an encouraged basis.

The analytic framework as reflected in Figure 1 of the staff report appears to be coherent and well-tailored in elucidating the role of FSIs in the sphere of financial stability. We would have also explicitly included stress testing as one of the instruments employed in the analytic framework for financial stability. In this respect we note that the use of stress tests appears in many cases to serve as a substitute for FSIs, a substitute that, as the staff rightly points out, is not a perfect one. As mentioned in paragraph 53 of the staff report, stress tests are not a practical device for ongoing surveillance, and in terms of compiling the relevant data that is harmonized for cross-country comparisons, the use of stress tests yet again does not appear to be practical. Accordingly, stress tests need to complement FSIs, which should be compiled for harmonization purposes even in those cases where short- to medium-term exigencies render stress tests preferable.

We agree with the staff's proposal to move the large exposures FSI from the core to the encouraged list in view of its low degree of operationalization. With respect to the insurance FSI we note that the importance of this indicator is set to increase in the future, particularly given the emergence of bancassurance. On the other hand, insurance remains in many countries underdeveloped, which limits its usefulness in terms of identifying key risks to the financial system (particularly, given the resource constraints faced by many countries in compiling FSIs). Under these circumstances prioritization concerns may militate against the introduction of insurance indicators into the list of FSIs. In quantitative terms the addition of insurance indicators would expand the overall set of FSIs, thus further putting into question the issue of the Fund's adherence to the fine balance between quantity and quality in devising FSIs.

With respect to moving the corporate sector indicators into the core set, we see a need to further refine the use and compilation of these indicators among Fund members before moving ahead on this front. Furthermore, with respect to paragraph 97 of the staff report, we disagree with the reference made to the possibility of applying core sets of indicators "for some countries in the future," for we believe that their application across countries should be non-discriminatory, i.e., applicable to all Fund members.

We believe that rather than simply advocating the need for active use of FSIs across countries, the best way to increase the usefulness of FSIs in the surveillance process is to explore in each particular country case and clearly articulate how surveillance stands to gain from FSIs. We also note the importance of strengthening the collaboration with regional institutions in operationalizing the use of FSI. The role of the revised guidance note and the FSI database would serve to facilitate this process through country-specific recommendations.

Finally, we agree on the need and the modalities of assessing countries' capacity to compile FSIs. This in effect represents an important tool for evaluating the pace and the scope of further initiatives that may be undertaken in this sphere in the future.

Mr. Reddy submitted the following statement:

We welcome this discussion on Financial soundness Indicators (FSIs) and we congratulate the staff for the set of papers reflecting thoroughness and rigor in distilling the experiences and bringing out a very clear analytical framework for both compiling and interpreting data sets of FSIs. We particularly commend the staff in attempting to delineate the macro-financial linkages and using real sector variables as lead indicators for assessing potential and emerging risks in the financial systems. Having said that, we would like to express at the outset, that in developing the approach for carrying the work forward there seems to be a need to avoid mix-up and attain clarity of objectives and purposes. In this regard, we tend to agree with many of the points raised by Mr. Kanaan and Mr. Sakr and other Directors.

Role of FSIs

First, a clarity about the role of FSIs is essential. The FSIs so far have been developed and strengthened as part of the analytical framework in the FSAP/FSSA exercises which attempt to assess the strength/weaknesses of domestic financial systems and to a certain extent as part of standards assessments in particular relating to core principles of Banking Supervision. This naturally explains the criticality of the banking sector in financial sector soundness and in the overall risk assessment. Banking sector, providing a vital link through integrity of payments and settlements has also close linkages with the real sector in maintaining the flow of credit, in particular liquid funds to the corporate sector. In that sense, the overall weaknesses of the economic and financial system, is first reflected in the form of liquidity problems emerging within the banking sector. From this angle, the overall emphasis upon deposit taking institutions as part of core set of indicators is well taken. Carrying forward this approach, we would urge that the role of FSIs in Financial Stability Analysis and Standards Assessments should continue to remain important and we welcome the refinements in the analytical framework of using FSIs in these exercises brought out in the background paper.

Second, as a corollary to the above, and given the fact that FSAP/FSSA and standards assessments ought to be undertaken at longer time intervals, there is pressing need for strengthening member countries' own capabilities to compile, monitor and assess risks of financial systems as part of their internal supervisory and regulatory reviews. Perhaps, based on such internal review and assessments, countries may be encouraged to bring out semi-annual or annual financial stability reports, as brought out by several countries as selectively listed in Box 1 of the Background Paper. On this basis, the development of a *Guide* for compilation of FSIs and also enlarging the coverage of FSIs to corporate and insurance sectors to the extent feasible are welcome.

Third, as part of strengthening bilateral surveillance, and given the crucial role of Article IV consultations in this regard, the experiences and findings with countries which have undertaken FSAP/FSSA and standard assessments should be carried forward in strengthening the analytical framework for assessing risks and vulnerabilities in financial systems as part of bilateral surveillance. To the extent the FSIs become a strong basis for Article IV reviews, in the concerned member countries, the role of repeat FSAP/FSSA and follow-ups should gradually become minimized. In prioritizing the standards assessments also, this aspect should duly be taken into account.

Fourth, in a forward-looking approach, assessments of risk and vulnerabilities and strengthening surveillance through use of FSIs should not be mixed up with promotion of data dissemination standards by countries. The objective of SDDS and GDDS is to strengthen comparable macroeconomic and financial and fiscal indicators among member countries and the individual countries should have the complete discretion to disseminate FSIs as part of financial stability reports when prepared or as part of FSAP/FSSA standards assessment reports.

Fifth, while we encourage the guidelines for compilation issued for inviting public comments and support finalization and dissemination of these guidelines for use by member countries to strengthen their own internal monitoring arrangements for risk assessments and also as part of use by the Fund for FSAP/bilateral surveillance, it will not be desirable to think in terms of making these exercises effectively as part of multilateral surveillance and global financial stability reports and in any case it is very premature at this stage. We should review the effectiveness and homogeneity of data compiled under these exercises for some time before planning any coordinated surveys in about 60 countries proposed. As mentioned earlier, the dissemination and publication of FSIs as part o FSAP/Article IV consultations should continue to remain voluntary and at the discretion of member countries; and SDDS should never get mixed up with FSIs which are part of prudential monitoring and risk assessments in individual jurisdictions.

Specific Comments

We offer on the basis of the above thrust in carrying the work forward in regard to FSIs, the following comments on the specific issues raised for discussion:

We agree with the approach to the preparation of the *Guide* for compilation of FSIs by member countries. Prima facie, the paper has raised several conceptual and practical issues in compilation of FSIs, some of which are being debated, for example, valuation of financial instruments and accounting procedures and definitions of threshold levels in many cases. In both letter and spirit, the *Guide* initially is only a “guide” and not a “standard.” Experience with member countries in the use of the *Guide* should periodically be reviewed before homogenizing their exercises. As long as there is clarity in the accounting and other procedures, there is perhaps no need for looking to homogenization. Secondly, the primary purpose of this *Guide* should be to strengthen member country assessments internally or though FSAP/Article IV consultation process and attempts to develop any cross-country analysis following a uniform approach to compile data from member countries, may not be desirable and in any case definitely premature at this stage.

For reasons already stated, we do not support the intention of conducting a coordinated compilation exercise. If advice is sought for compilation by member countries, the Fund could consider providing technical assistance on case by case basis or as part of the FSAP review exercise.

As we do not support the mix up of FSIs with SDDS, the question of fixing a target date for including FSIs in the SDDS does not arise. Incidentally, since FSIs exercise itself is in an experimental stage, and may require refinements based on further experience and emerging market developments, we do not think it appropriate that a 'firm' view be taken by the present Board with respect to a preparation of data set as late as five years hence, that is, 2008.

The framework for financial stability analysis as contained in Table 1 of the staff report has been very thoughtfully prepared, after a rigorous analysis of linkages. We have some suggestions. First, while the core and encouraged data sets are well taken, there should be flexibility in respect of individual countries to add more items in the core set or to shift some encouraged set to core set, depending upon the financial structure and markets. Country specific features to be considered in this regard would include: whether the system is banking-oriented or capital-market oriented; whether the economy is trade-oriented and small, or strongly domestic-oriented and large; and whether the economy is open and dependent upon international capital markets or relatively closed. These factors will have significant influences in identifying sources of risks and hence help in defining the canvas of FSIs appropriate for effective monitoring. To illustrate, in our view, in relatively more dollarized economies, either in currency or liability sense, the items included in encouraged set like foreign currency-denominated loans to total loans, foreign currency-denominated liabilities to total liabilities, and net open position in equities to capital should become part of a core set of indicators. Similarly, the coverage of institutions or institutional groups should be flexible and also be very clearly defined. Deposit taking institutions should cover only the banking sector or institutions which are part of the payments system.

As the framework for financial stability analysis in individual jurisdictions is very sound an appealing, macro-prudential surveillance at the country level using FSIs in its framework would be welcome and useful in further refining this framework based on country experiences. As we mentioned earlier, we are averse to a coordinated compilation exercise and reconstituting of group of experts from international agencies to promote FSIs and initially to oversee a coordinated compilation exercise. The coordination between agencies should purely be in technical areas and institutions like BIS will have significant and independent roles in the area of monitoring and development of banking related and cross-border related data and market developments.

We recognize the importance of segmenting foreign bank operations or operations of branches of foreign banks, since they have the ability to bring in capital from abroad. However, for purposes of assessing risks, on a consolidated basis for the banking system as a whole, such operations should not be excluded. Because, exclusion of such operations will underestimate the risk. We however agree that to the extent these entities have the capacity to cushion risks from injecting capital from abroad, the risk-mitigating factor becomes large. Such risk-mitigating factors may also possibly be weak if some of the foreign entities have restricted practices in relation to foreign subsidiaries and branches. Risk assessment should be distinguished from assessment of risk mitigating factors and should be covered as such separately and shown appropriately.

Continued technical analysis and reviews of experience for refining the framework for financial stability assessments would be a welcome approach. These refinements could be at the individual country level in initial stages. The inclusion of corporate, insurance and real estate sectors will depend upon the stage of development in a particular member country and significance of real estate and insurance markets. As in the case of other principles, here again a "one size fits all" approach will need to be scrupulously avoided.

Dissemination

At present, participation in SDDS is voluntary as also in FSAP/FSSA and standards assessment exercises. Publication of Article IV staff reports also remain voluntary. In our view therefore, dissemination of FSIs which are part of essentially these exercises, should remain totally voluntary. Secondly, several countries have been participating already in SDDS on a voluntary basis, and now are committed to disseminate an array of data. We do not agree with the proposal of staff to integrate FSIs into SDDS nor its proposal for dissemination of FSIs on national websites and linking it to Fund's internet gateway. The regional monetary authorities or supervisory authorities should have their complete discretion in dissemination of FSIs, depending upon the nature and scope of such regional arrangements and there is no specific need for the Fund to promote or publicize this idea.

Need to Build up Qualitative Data Sets

In further refining the framework for FSIs, we would suggest that mere quantitative indicators may not suffice and such quantitative indicators should be supplemented by qualitative indicators. Firstly, the linkages between real sector and financial sector are not easy to establish. In this regard, supplementary information based on empirical works would be needed before drawing any inferences or conclusions from quantitative indicators. Secondly, the quantitative indicators will pertain mostly to organized sectors. In many countries, informal sectors play a key role and in low-income countries, in particular, even the degree of monetization is likely to be very low. Thirdly, the role and existence of parallel economy will be equally important. Operations of parallel economy will either overstate or understate quantitative indicators as part of FSIs. Fourthly, the risk assessment based on quantitative indicators should be supplemented by information on risk mitigating features in the form of sound risk management systems and practices, liquidity management policies of the central bank and public policies towards contagion and institutional failures and quality of supervisory practices, in particular, features like consolidated supervision, risk-based supervision, and prompt corrective actions. All these features must be reflected in terms of a qualitative assessment best made by the country concerned while drawing conclusions on financial stability assessments based on FSIs.

Conclusion

FSIs should be viewed as excellent technical exercises and countries should be encouraged and enabled to adopt this gradually and as appropriate to each country. Any element of centralized assessments as distinct from individual country's own assessment, compulsions, homogenization and the cross country comparisons would not be desirable and may prove to be counterproductive. In particular, to the extent several qualitative assessments are warranted, they are best undertaken by the country authorities themselves.

Mr. Rutayisire submitted the following statement:

We welcome the ongoing work on the preparation of an FSI *Compilation Guide*. We view this work both in the framework of our continued efforts to strengthen the Surveillance exercise and as contributing to crisis prevention. Indeed, as the recent financial crises have shown, we need to expand and develop new set of indicators to better follow developments in the financial sector.

We agree broadly with the idea of promoting comparability of FSIs between countries. To this effect, we support the efforts to promote the adoption by countries of internationally agreed accounting, supervisory, and statistical standards. However, we would like to reiterate a point that we have made in the past, that countries have different characteristics with differing legal and regulatory frameworks. In the financial sector, in particular, the level of development varies and this can have implications on the way their vulnerabilities are assessed, and should be taken into consideration in the compilation of the concepts and criteria and the development of the analytical tools. Indeed statistical and efficiency indicators are rather different across countries. Moreover, the indicators may not be comparable, unless we have the same level of developments, and industry efficiency across countries. Financial ratios in the banking industry in low income countries may not have the same meaning as in middle or advanced economies. There is therefore a need to establish indicators that reflect the typical performance conditions of the sector in each country.

We can go along with the major themes of the *Guide* and with the conceptual framework described in the staff paper. Overall we agree with the work program for the completion of the *Compilation Guide* as presented in paragraph 40 of the staff paper. However, given the changes that are occurring in the setting of international standards, and the need for additional research on some topics identified in paragraph 42, we wonder if the Fall 2003 deadline is not too ambitious. While some of the new results could be promulgated through supplements, it might be worthwhile to make the first main *Guide* as comprehensive as possible.

The paper appropriately notes that the FSAP review exercise has been helpful to many countries and have helped them to develop FSIs, and we agree that the authorities in these countries should be encouraged to compile the FSIs on a continuous basis. However, such an exercise will require the development of technical capabilities which they may not possess. We, therefore, agree with staff's proposal that a coordinated compilation exercise be conducted under Fund auspices, after compilation of the *Guide*, and its distribution. However, this exercise will require resources, and it would be useful to have an assessment of the additional resources that are needed to help the membership develop the needed capacity for the development of the FSIs.

On the issue of dissemination we think that it is an important building block in the prevention of crisis. We can go along with the strategies proposed by the staff in paragraph 92 of the report. We find the idea of developing a Fund internet gateway as providing a single entry point for assessing FSIs for all countries as very appropriate. This will also help other countries which are trying to compile FSIs to have a good source of reference and examples. In view of our above comments on the need to look at each country's specific circumstances, we would caution against a too rigid timetable regarding the inclusion of FSIs in SDDS. This should remain voluntary and the time table decided by the country.

As regard the framework for financial stability analysis, we are of the view that the core FSIs should be kept to a minimum, with emphasis on those that better predict financial vulnerability, while the encouraged set should remain flexible and be dependant on each country's circumstances, with emphasis being placed on leading indicators.

More generally, we note that most of the indicators are backward looking, with the stress test being perhaps the only forward looking indicator. Therefore, on the set of indicators that are being proposed, while they may help the Surveillance exercise, it is not clear how they can help us with crisis prevention. We are of the view that staff should analyze carefully the recent financial crises and draw the appropriate lessons from them, and find out what indicators more appropriately captured the crises.

On the individual indicators in Table 1 of the staff report, under earnings and profitability, we note that staff is recommending the use of return on equity. We wonder if it is not more appropriate to use a risk weighted return on capital. Similarly, under sensitivity to market risk, we note the use of duration of assets and duration of liabilities. However, if the duration of assets and liabilities were the same, the net effect will be zero. Perhaps there is a desirable level of either duration of liabilities or assets but not both that should be considered, or better still the indicator should rather be the duration of equity. Staff comments will be appreciated. Also, we think that off balance sheet liabilities should be part of the list of indicators, as they can pose serious risks to the system.

Finally, as we have noted, this project will call for additional technical assistance to the membership. We support the provision of this assistance, but we would like to reiterate our position that this should not be at the expense of our traditional assistance in the fiscal and monetary sectors. Additional staff resources should be provided to meet this additional need.

Mr. Usman submitted the following statement:

We thank staff for the set of papers and for their important contribution towards strengthening Fund surveillance. Indeed, FSIs are vital in assessing the financial strength and vulnerabilities of a country's financial sector. Therefore, its compilation and dissemination also supports the goal of increasing the transparency of the international financial system and helps to strengthen market discipline. In as much as we broadly concur with the report, we would like to limit our comment on the issues outlined below.

We concur with the work program for the completion of the *Compilation Guide*. However, considering the rapid changes taking place in the international environment and the requirements for further research, we consider the 2003 deadline as being overly optimistic.

We support the intention of conducting a coordinated compilation exercise to assist countries in compiling FSIs and to help refine advice on compilation procedures. We are of the opinion that such an exercise would be useful and we therefore encourage staff to include some of our member countries. However, like Mr. Kanaan and Mr. Sakr, we consider the exercise to be ambitious because of the resource implications, considering the number of countries to be involved.

The adherence to both the SDDS and the GDDS, and the inclusion of metadata in Fund Bulletin Board were always voluntary and should remain so. We are of the view that the indicators should not be extended, considering the risk of a country losing its position on the Fund Bulletin Board. This could have negative signal to the market about the overall performance of a country. We would rather suggest that even the inclusion of such indicators to SDDS and GDDS should be on a voluntary basis. The Fund should not set targets for countries to include such information.

Continuous analysis by the Fund on the core as well as the encouraged sets of FSIs should be based on the needs of the countries and how they use them. The staff should continue the analysis of how countries make the data available and the impact of these indicators on the financial transactions of the countries. We would not like to overburden our members to provide the Fund with information that is hard to obtain and not at the same time readily available. We are of the view that countries should be encouraged to produce FSIs that are relevant in helping them monitor their financial systems and as such provide warnings that may enable them avoid a crisis situation.

On the proposals for developing the role of FSIs as a surveillance tool, we encourage staff to go ahead, but to use the indicators in the same manner in surveillance as when they go about doing FSAP review exercises. Most importantly, surveillance should benefit the authorities to make the appropriate adjustment in the financial market but not necessarily for public utilization since some of these indicators, when published, may have a negative effect on the markets.

We can support the staff proposal to assess the capacity of countries to compile FSIs. The intention to encourage countries to develop their capacity through the channels stated in the report is therefore welcome.

Ms. Indrawati and Mr. Alowi submitted the following statement:

We welcome this opportunity to discuss the paper on Financial Soundness Indicators (FSIs), and we thank the staff for the well-written paper. The paper presents the progress of work on FSIs and provides a discussion on the use of FSIs within a framework for financial stability analysis as well as proposals for taking the work forward to strengthen Fund surveillance using FSIs. Given the importance of strengthening the assessment and monitoring of vulnerabilities in financial system through Fund surveillance, the compilation and the use of the FSIs is crucial and staff is commended for the progress made thus far. We note that the FSI *Compilation Guide* is expected to be finalized by the end of 2003 but more needs to be done on the analytical work and in enhancing the role of FSIs in Fund surveillance and macro-prudential analysis.

Our comments on the issues for discussion, as raised by staff in the paper, are as follows.

Issue 1: We broadly agree with the work program for the completion of the *Compilation Guide* as highlighted in paragraph 40 of the paper. As pointed out by staff, the *Guide* was posted on the Fund's website in March

2003 with a deadline for public comments of June 20, 2003. In addition, a call for comments was also issued to central banks and other related agencies of member countries, market participants and other interested users in the private sector. In this regard, staff should ensure that all comments and views including from the central banks and government agencies of the developing countries be considered thoroughly before finalizing the *Guide*. Given the importance of their feedback, if necessary, a reminder letter to the member countries should be issued as we approach the due date.

We support the intention to organize a series of regional and outreach seminars on this issue. In conducting the seminar, besides giving priority to central banks and other government agencies, equally important is the participation of financial analysts, in particular those in the securities houses and credit rating agencies from the developing countries. Besides seeking their views on the *Guide*, the seminar could also enhance their understanding of the indicators, and thus could improve their ability to utilize and more accurately interpret the information in their assessments. In this regard, in organizing the seminars, staff should seek assistance from the central bank or the relevant government agencies of the country, to ensure these groups and other related parties have the opportunity to participate in the seminars.

Issue 2: We welcome the proposal that a coordinated compilation exercise involving both supervisors and statisticians be conducted under the Fund's auspices after the finalization of the *Guide*. This exercise will help participating countries develop FSIs necessary for surveillance and improve staff's understanding of FSI data compilation procedures. Given the limited resources, staff envisages that the exercise would involve a maximum of 60 countries working toward compiling and disseminating a set of FSI data. We are of the view that priority should be given to countries that already have relatively good databases and the capacity to compile FSIs, in order to avoid too much time and effort being spent on the data collection stage. We agree that a group of experts from international agencies be constituted to oversee the implementation of the exercise but should also include regional experts with experience and knowledge about countries in the region.

Issue 3: On the proposed date of inclusion of the FSIs in the SDDS, our view is that it should be left open and not date-capped, given that many countries still have slack data compilation practice particularly on the encouraged FSI set. More importantly, the inclusion in the SDDS and the dissemination of the FSIs should be on a voluntary basis. We are also of the view that it is premature to consider this issue, given that the work on establishing the FSIs has a long way to go. The more important issue, which should be given priority, is to assist countries in building their capacity in establishing FSIs, as well as improving the quality and reliability of their data. Enhancing the ability of the authorities to identify financial sector vulnerabilities is the main objective of this effort. There are many less developed countries that have low capacity, as regards the compilation and dissemination of data, therefore their ability to provide reliable data is constrained by limited financial resources and manpower. These countries need the support of, and technical assistance from, the Fund, to put in place the required infrastructure and reporting systems to compile, use and analyze such FSIs.

Issue 4: We are in broad agreement with the proposed framework for financial stability analysis as illustrated in Figure 1 of the staff report. Nevertheless, we wonder why the effect of the stock and derivatives markets are not included. We believe that the impact of these markets on the financial sector and the economy is significant particularly in the economy with developed financial markets.

Issue 5: The staff's proposal on the work to adjust the core and encouraged sets of FSIs, in order to ensure they continue to correspond to evolving surveillance needs and priorities are generally acceptable to us. The FSIs should continuously be improved, based on developments in the global financial market. Nevertheless, flexibility should be an integral part of this work and should take into account the importance of the indicators to the particular country. To some countries, indicators on the corporate sector could be classified as core indicators rather than encouraged indicators, given the high dependence of the corporate sector on the banking system. Similarly, indicators on the insurance sector may be applicable only to developed countries and some of the emerging countries and may not be of much significance in the less developed countries. Therefore, the relevance and applicability of an indicator should be considered on a country-by-country basis, as it would vary depending on the structure and development of the financial sector and the importance of a particular sector in the individual country. Given the limited resources and more work needs to be done, the focus should be on improving the agreed FSIs rather than expanding the FSIs.

Issue 6: We agree that in developing the role of FSIs as a surveillance tool in Fund surveillance, a guidance note on using FSIs and continued development of an FSI database are important to facilitate more continuous surveillance of financial systems by staff. We also go along with the staff's proposal on the additional activities that could be undertaken to enhance the usefulness of FSIs in Fund surveillance. The statistical technical assistance mission is important in particular to the developing countries.

Issue 7: We agree with the proposal to assess the capacity of countries to compile FSIs, and to encourage them to develop their capacity through the channels, including FSAPS and focused FSAP review updates, Article IV consultations, and UFR missions, the coordinated compilation exercise, technical assistance and workshops and through cooperation with standard setters and other international and regional organizations. In conducting the assessment, factors such as institutional capacity as well as constraints in the manpower and financial resources should be taken into account and improvement in these areas be made through technical assistance. Nevertheless, the compilation and dissemination of the FSIs should be on a voluntary basis consistent with a country's specific capacities and limitations.

Ms. Jacklin and Mr. Epstein submitted the following statement:

We welcome today's discussion on the review of the Fund's work program on financial soundness indicators (FSIs). The development, compilation, and dissemination of FSIs are key to our goal of enhancing the overall effectiveness of Fund surveillance, and we commend the staff for the progress made so far on the development of the FSI *Compilation Guide* and on the analytical work to strengthen the role of FSIs in macro-prudential analysis. We agree with the broad objective to further integrate FSIs into Fund surveillance as a means of supporting the staff's analysis of the risks to financial stability.

We also need to assure that this effort does not become an inappropriate proxy for sound financial sector supervision, nor an instrument for prescribing international accounting standards. We need as much as possible to "inform" the financial sector supervisors and accounting standards-setters of relevant IMF analysis, but accept that the FSIs will inevitably have divergences from country to country due to differences in accounting and bank supervision rules. Moreover, the FSIs will evolve as those rules evolve.

The analytic work underway and earlier surveillance experiences in member countries, including through the use of FSIs in FSAPs, have clearly shown the important application of the agreed core and encouraged sets of FSIs. But in order to ensure that the two FSI sets continue to reflect the evolving priorities of Fund surveillance, we agree that there is a need to reassess the selection of core and encouraged indicators. The selection also needs to be based on a relative assessment of the capacity of countries to compile, and the relative importance of the indicators to surveillance. In this regard, we agree with the proposal to undertake a process of international consultation and further analytical and data development work on this issue. We also support the proposal to routinely assess the capacity of countries to compile FSIs, and to encourage them to develop their own capacity to compile. This can be done through the normal channels of engagement, including those described in paragraph 99 of the staff report.

Revised FSIs in the *Compilation Guide*

The new *Compilation Guide* is a welcome step forward, and we found the draft version and the description of the progress made to date, including on the consultation process, to be useful. We have some concern, however, as to the cost of compiling some of the proposed indicators. Moreover, several of the core FSIs may not be sufficiently informative to merit mandatory compilation. Finally, we should focus on the compilation of the most significant indicators as a priority task. We therefore need to make sure that the list of recommended indicators is as streamlined as possible and consistent with the overarching objective of strengthening surveillance modalities.

The staff notes that very few countries compiled data on the duration of bank assets or liabilities and on net open position in foreign exchange to capital, and many developed countries questioned their usefulness. Instead, stress tests were used to assess market risks. In addition, the FSI on large exposures to capital is only infrequently collected and of potentially limited value. Therefore, this indicator should not be included as core FSI, and instead ought to be compiled as country circumstances warrant, or in the category of encouraged FSIs.

Flexibility and Conformity to Accounting Standards

We would like to emphasize the importance of flexibility regarding how FSIs are compiled. The draft *Compilation Guide* refers to the need for flexibility "in the short term," which suggests to us that flexibility might not be applied in the long term. Yet without flexibility, reporting burdens could be extremely high, both in absolute terms and relative to the value of standardized reporting. Although the draft *Compilation Guide* expresses flexibility on accounting issues, such as the use of market value accounting for non-traded instruments, the flexibility is often expressed as a short-term policy. The implied long-run policy seems to be a convergence to the accounting principles expressed in the draft *Compilation Guide*. If this is indeed the intended long-run policy, we believe the staff is misinterpreting the Fund's mandate. It is a convergence toward internationally accepted accounting standards (under the purview of the standards-setters) that will result in greater data uniformity. Meanwhile, FSIs need to respect current national generally-accepted accounting principles (GAAP) and the international accounting standards (IAS). Indeed, we believe that it is impractical for countries to compile balance-sheet and income data on the basis of anything other than their national GAAP.

Therefore, we strongly recommend that the final version of the *Compilation Guide* indicate that countries with established high-quality national GAAP are expected to compile FSIs according to the national GAAP standard. Countries that lack a well-developed national GAAP ought to be encouraged to adopt high-quality accounting standards, such as IAS. The disclosure of detailed information on the country's relevant accounting standards and methodology will be essential, regardless of the degree of harmonization between countries.

Inclusion of FSIs in the SDDS

Given the high reporting burden associated with many of the FSIs and the fact that the development of the FSIs is still a work in progress, we would recommend that in the initial stage only a highly selective subset of the proposed FSIs should be added to the SDDS. The subset ought to be limited to those variables viewed as most informative about financial system soundness. Thus, we recommend that eight of the fifteen proposed core FSIs be included as required indicators in the SDDS. These are: regulatory capital to risk-weighted assets; regulatory tier-1 capital to risk-weighted assets; nonperforming loans to total gross loans; return on assets and return on equity; nonperforming loans net of provisions to capital; liquid assets to total assets; and liquid assets to short-term liabilities.

As to the timing of the proposed inclusion of core FSIs in the SDDS, while we would endorse this set of eight indicators to be included in the SDDS, we nonetheless prefer to see a timeframe that is earlier than 2008, and we wonder if the staff can indicate whether a target of end-2005 would in fact be achievable.

Mr. Andersen and Mr. Gulbrandsen submitted the following statement:

General Remarks

We thank staff for an informative set of papers, giving a welcome update of the progress in bringing the FSI work forward, particularly with regard to implementing the tool in the Fund's macro-prudential surveillance, and the work program proposed looking ahead. We also welcome the process of undertaking extensive outreach in this area and thank staff for the supplement circulated regarding comments on the draft *Compilation Guide*. Our discussion could perhaps even have benefited from taking place after the June 20 deadline for submitting comments on the draft *Guide* has expired.

We would also like to commend staff for the work they have put into the FSI initiative, and their efforts in promoting greater transparency of the international financial system and strengthening of market discipline. We are in broad agreement with staff's suggestions. A priority at this stage will be to obtain the core set from as many countries as possible. We believe it is important that the Fund in this process emphasize that the core set is an important tool in the analysis of the soundness of the financial sector. It should, however, also be stressed that information on the core set not necessarily is sufficient to identify risks to the financial system.

The international collaboration that has taken place among experts from various international agencies and standard setting bodies should also be welcomed, and the importance of achieving comparability of FSIs between countries in the international financial system can not be overemphasized.

Compilation and Dissemination of FSIs

We agree with the work program for the completion of the *Compilation Guide* around the end of 2003, but believe the efforts to encourage member countries to compile and disseminate the core and relevant encouraged FSIs could be strengthened. The survey in the background paper shows that there is still a lot of work to be done to provide the core FSIs for a majority of countries. It should be a priority to obtain the core set from all countries. In this process, the quality and reliability of the data must be ensured to guard against the risk of ineffective and misleading FSIs.

It is also of great importance that the reliability and relevance of the FSIs are preserved, as particularly capital markets and financial instruments are developing rapidly and new sources of risk constantly are emerging. We believe that member countries by increasing their public dissemination of data collected on the core and encouraged indicators, and by making sure they are easily accessible, will help in keeping the *Compilation Guide* up to date, especially regarding changes in the accounting principles.

As mentioned in the Supplement, several seminar participants have noted the sometimes central role of foreign controlled banks in their financial systems. In this regard we would appreciate if the staff could elaborate on their recommendations with regard to consolidation and country comparisons for countries where foreign controlled or foreign owned subsidiaries and branches play a major role in the financial system.

With regard to the periodicity of release of data, there was a general consensus in favor of the principle of quarterly dissemination of FSI data at the consultative meeting held in September 2002. However, several concerns were raised whether the current dissemination was too frequent and might cause a too heavy compilation burden. We would, therefore, prefer quarterly or perhaps even less frequent dissemination, as many indicators can be expected to be largely unchanged between quarters. Annual compilation could be sufficient for indicators that are based on balance sheet data and annual reports.

We see merit in the idea of setting a preliminary target date for including FSIs in the SDDS, and staff's suggestions in paragraph 94 of the report seem to strike a reasonable balance between the need for being both ambitious and realistic. To strive for significant and continued progress in the provision of timely, comprehensive and reliable information is crucial for effective surveillance, including with respect to macro-prudential surveillance. Apart from broadening the SDDS with relevant FSIs at some stage, it is also important to accelerate the number of countries subscribing to the SDDS. In this respect, we remain concerned that the number of countries subscribing to the SDDS only increased from 50 to 51 during 2002, and data inadequacies are still to frequently an issue raised in staff reports.

Further Integration of FSIs into Fund surveillance

We consider it necessary to develop the role of the FSIs as a tool in Fund surveillance as the globalized economy has become increasingly complex. We find the framework for financial stability analysis as illustrated in Figure 1 of the staff report to be appropriate, and we support the proposal to integrate the macro-prudential surveillance using FSIs into this framework. However, the credit linkages could be clarified more specifically by illustrating that one link concerns the ability to service debt and another link concerns the value of the collateral. The accounting linkages could be clarified by distinguishing between mark-to-market and an accrual based value. Furthermore, we believe that a revised guidance note and an operational FSI database will be a valuable contribution to the Fund surveillance as the tools used to monitor the international financial system have to be under constant scrutiny.

We agree with the staff's proposal that it would be useful to assess the capacity of countries to compile FSIs and to encourage them to develop their capacity through the channels as outlined in paragraph 99 of the staff report. Undertakings of statistical technical assistance missions to countries to assist in the collection of relevant data and compilation of FSIs should be one element in this capacity building.

We are also in favor of effective collaboration with other international organizations in order to promote the FSIs and to continue developing indicators that are relevant, such as for real estate, and the corporate and insurance sectors. We strongly support the intention of conducting a coordinated compilation exercise involving both supervisors and statisticians to be conducted under Fund auspices in order to assist countries in compiling FSIs and to help refine advice on compilation. Experts from international agencies, including the Bank of International Settlements, should be involved in the exercise in order to benefit from their experiences in relation to FSIs.

Further Development of FSIs

We agree with staff that the analytical work should continue to focus on developing FSIs as a surveillance tool and the Funds capacity to use them with other tools, including stress testing.

We support incorporating essential life insurance FSIs into the encouraged set when member countries are prepared to do so, and we are in favor of developing further the role of the corporate sector's FSIs as an important surveillance tool, with the view of moving them into the core set in due time. However, it should be observed that the compilation of FSIs for the corporate sector can be challenging for many transition economies.

We also agree with staff that it will be useful to enhance the Fund's capacity to assess market risk using FSIs by better integrating the analysis of stress testing and FSIs in FSAPs. Furthermore, we would like to add that perhaps the *Compilation Guide* could elaborate a bit more on how to execute stress tests since they appear to be substitutes for the FSI on sensitivity to market risk.

It is necessary for the Fund to always be vigilant and to continue to consult with international experts in the field to ensure that the core and encouraged sets of FSIs continue to reflect surveillance priorities and needs. We believe that the priority of the FSI exercise should be to develop a well functioning core set. At this stage, we think it is appropriate to consider moving the large-exposures FSIs from the core to the encouraged list and also dropping the sensitivity to market risk FSIs (that is duration of assets and liabilities) from the core set since so few countries are reported to compile those indicators (Table 2 in the main report), at least if the suggested SDDS timetable is adhered to. We have some sympathy with the views expressed by Messrs. Kremers and Litman on the issue of connected lending, but would also like to underscore the difficulties in compiling the necessary data.

Extending his remarks, Mr. Martí made the following statement:

I would like to emphasize, after reading colleagues' statements, one of the points that we consider to be of special relevance. We give unreserved support to the staff in the effort to secure widespread compilation, dissemination, and use of FSIs as an analytical tool. We would like to comment, however, on two of the issues for discussion: the setting of a target date for including FSIs in the SDDS; and the assessment by the staff of the capacity of countries to comply with this exercise. The compilation exercise is not a straightforward exercise: accounting records of some banking operations may be open to different interpretations; financial innovation often entails new challenges for compilers; changes in Basle rules or in accounting standards or best practices will normally require a new set of rules; and individual deposit-takers sometimes find ways get around the rules. Public debts are an example. A case can be made to record them off-balance sheet—this is what many banks in my country did at the start of this type of operation there, before the central bank ruled that these debts should be recorded as liabilities. The point is that the efforts of supervisors to ensure the high quality of the indicators has to be consistent. Indicators lose analytical relevance if the primary data are not subject to regular monitoring by domestic supervisors.

The Fund has an essential role to play here in assessing the capacity of countries and, as Mr. Padoan and Mr. Bossone have pointed out, in motivating the authorities to strengthen their statistical capacities through FSAPs, Article IV consultations, as well as targeted conferences and seminars. Concentrating efforts and resources at this stage—to train staff and provide technical assistance to authorities—should rank higher than creating timetables for including FSIs in the SDDS. First, we need to be sure that member countries are strongly motivated to compile data according to high standards. The insufficient capacity of many countries to deliver reliable data seems to be a fact, and Ms. Indrawati and Mr. Alowi have referred to this. Similarly, Ms. Jacklin's and Mr. Epstein's statement recommend that, at the start, only a selected subset of FSIs be added to the SDDS, in view of the reporting burden that FSI compilation would impose on member countries. This is not a plea to do away with timetables; rather it is a plea for flexibility for some member countries as they refine their statistical tools and supervisory capacities by drawing on the experience and the expertise of the Fund.

The Acting Chair (Mr. Aninat) noted for the members of the Board that the Deputy Director of the Monetary and Financial Systems Department (Mr. Sundararajan) would be moving on to other endeavors shortly.

The Deputy Director of the Monetary and Financial Systems Department (Mr. Sundararajan) made the following statement:

It would be useful to briefly recall the evolution of this project. I fully agree that there is still a long way to go in developing financial soundness indicators, but we have also come a long way.

The work on FSI began in parallel with the work on the Financial Sector Assessment Program in late 1999. At that time, we wanted to review the data needs for systematic assessment of financial vulnerabilities in countries. In January 2000, we sought the Board's endorsement of a broad work program. The Board endorsed the staff strategy to develop over the long run comparable indicators on financial soundness while working with existing, relatively unharmonized national data in the short run. The Board also approved at that meeting the conduct of a survey of country practices in compiling financial soundness indicators, and provided some guidance on the analytical work that would be needed. We conducted the survey, and came back to the Board in June 2001 with proposals for classifying what at that time we called macro-prudential indicators, and which we now refer to as financial soundness indicators. The Board endorsed the classification into a core set of widely-applicable, analytically-relevant, and potentially available indicators from member countries. These indicators were found useful by member countries, on the basis of the survey results. The Board then endorsed a subsequent work program involving a consultative process to get feedback from member countries, and an analytical process to sharpen our understanding of the indicators.

Since the Board endorsement in June 2001, we have convened an expert group, and our work with this group subsequently is summarized in Box 1 of the staff report. We have undertaken a highly intensive consultative process involving expert groups from all the standard-setting institutions, and we have used our engagement with members through the FSAP review missions and Article IV consultations to continue to improve our understanding of the issues related to the compilation and analysis of the indicators.

Going forward, we will continue to maintain a vigorous consultative process, and a rigorous analytical process. We have taken note of all the suggestions from Directors, and they will be very useful in our work in the coming months.

The Deputy Director of the Statistics Department (Mr. Enoch) made the following statement:

I shall respond to two issues that have been raised in the statements. There was a question on consolidation, which is a somewhat complicated issue. The best way to answer this question is to draw your attention to a diagram on page 105 of the *Compilation Guide*, which is a background document for this meeting. There is general agreement that consolidation is essential to eliminating the double-counting of intragroup capital, income, and assets among financial institutions in a system. There are broadly two methods of consolidation, and it is now clear, after discussions with the experts, that no single method will satisfy every purpose. The *Compilation Guide* itself requires compilation based on cross-border consolidation to better gauge the risks, vulnerabilities, and soundness of financial systems. For example, Citibank is a consolidation issue for U.S. authorities because it comes under the jurisdiction of the Federal Reserve; U.K. supervisors would look at the entire consolidated picture of Barclay's Bank or another U.K. bank. Consolidation thus captures the risks and soundness of domestic-controlled financial institutions regardless of where their business is conducted. This is consistent with national supervisory practices, and with the BIS's consolidated international banking statistics. It is therefore relatively easy to access the data because these are essentially the same data that supervisors generally monitor.

The broader consolidation is domestic consolidation, which looks at all the activities in a particular economy. For instance, we could be interested in Citibank's activities in the United Kingdom, regardless of the fact that it is a U.S. bank. This is perhaps of more relevance when one is looking at the entire economy not just the financial system itself. For instance if you are looking at the economy, the nonperforming loans held by foreign banks in a country are relevant.

There are various ways of consolidating financial information. As the diagram shows, various boxes could be put together to get hybrids. Where there are no foreign banks, and domestic banks have no foreign activities, the two are the same. If there are no domestically-owned banks, as in the New Zealand case, then essentially domestic consolidation consists of looking at domestic activities of foreign banks. In terms of accessibility of data, international consolidation is easier, because broad international supervisory practices are already in place.

A number of Directors have suggested additional indicators or substituting indicators, for example, risk-weighted return on capital instead of return on equity, duration of equity instead of duration of assets and liabilities, connected lending, and various issues related to duration. As Mr. Sundararajan said, these are all very helpful exercises. I would not discuss each of these indicators individually here, as they are rather technical, but I would be happy to have bilateral discussions with interested Directors. What we would suggest is for these comments to be submitted to the staff together with other suggestions on the *Compilation Guide*. We will look at these suggestions closely, first among the staff, then with our experts in October when we reconvene the group that Directors helped us form.

To recall, the criteria that we used for selecting the current set of core indicators included: parsimony, data accessibility, and amenability to straightforward analysis and aggregation. We are certainly open to modifying this set, and this is part of the ongoing work program.

Mr. Portugal made the following statement:

Let me start by thanking the staff for this set of papers, and also Mr. Sundararajan for the presentation here today, which shows how we will miss him, and I wish him well in his new assignment.

We support the Fund in deepening the analytical work in this area, we accept the approach that the Fund is using, which locates financial soundness indicators within a broader multidimensional framework and also takes into account qualitative and institutional aspects. We are aware of the high quality data inputs that this framework requires, which in some cases will not be at the reach of a number of member countries. Let me go to the various issues for discussion.

We welcome the progress made in the *Compilation Guide*, which will play a very useful role in assisting authorities to compile, fill technical gaps, and provide a common frame of reference. We are also very pleased with the ingredients of the consultation and outreach that have been taken. But, on this, I would like to suggest that the deadline for comments on the draft *Compilation Guide* be extended for another 30 or 60 days, and, as suggested by Ms. Indrawati and Mr. Alowi, that a new communication be sent to countries inviting comments. I make this suggestion because I saw that only seven letters and electronic mails have been received so far with comments, which either indicates that the *Guide* has achieved a very high degree of consensus, or that probably countries have not focused yet on this.

In terms of how to go forward, we support very much the proposal in paragraph 88 of the staff report to organize a coordinated compilation effort, once the *Guide* is finished. We stress that participation in this work should be fully voluntary, but we agree that preference should be given to countries that are currently participating in the SDDS, and we also believe that this coordinated compilation exercise should be focused on the core set. I would like to hear from the staff if they agree that this exercise should be limited to the core indicators, and participation would be voluntary.

On the issue of inclusion of FSI in the SDDS, the Board had considered in June 2001 that this was premature, and the situation has not changed substantially since then. Like most other Directors, and as Mr. Martí mentioned this morning, my opinion is that it is still premature to establish a date. We have not yet finished the *Compilation Guide*, the completion of which would depend on the evolving new Basle capital accord, as the staff has said. Second, it is important that these financial soundness indicators mature more and gain both effectiveness and credibility in a careful process of implementation before they are included in the SDDS. The data that are now included in the SDDS comprise mainly mature statistics that are very well understood, have been used for a long period, and are based on broadly harmonized definitions. Despite all our efforts, a long way remains ahead for the financial soundness indicators.

And there is a third reason, as mentioned by Mr. Callaghan and Mr. Reddell. If the objective is to increase participation in the SDDS, then we should refrain from adding new requirements that would make the SDDS a kind of a moving target. But if and when the time come to include the financial soundness indicators in the SDDS, it would require unanimous consent by all subscribers at that time. Countries have joined the SDDS under the assumption that their commitments were limited to an existing set of data. It is very expensive and costly to leave the SDDS, so I would expect that any changes in the reporting framework would be based on a consensus among the existing subscribers. The way that is suggested in this coordinated exercise is the right approach. Rather than establishing deadlines, we should help countries to start compiling and disseminating the indicators, and once a large number of countries already disseminate, that would be the appropriate time for including FSIs in the SDDS.

With respect to the framework, for financial stability analysis mentioned in Figure 1 of the main paper, I agree with what Mr. Callaghan and Mr. Reddell have said that it seems to have been designed in the widest possible terms, which perhaps is right. But, like others, we believe the application of that framework should be selective, based on specific circumstances and the existence of data in different countries. The framework envisages examining conditions in the corporate sector, real estate, and the household sector, and using balance sheet data and the structure of private debt. Most of these information are not available for a large number of countries. These components of the framework should be applied mainly in advanced countries, and here I agree, again, with the point made by Mr. Martí and Mr. Moreno that perhaps the consultation efforts should, in addition to the *Guide*, also encompass the analytical framework.

With respect to the list of core and encouraged indicators, we do not favor any additions to the core set. We would agree with the flexibility suggested by the staff only if it means reducing the current core set. Like Messrs. Kremers, Litman, and Andersen, we believe, for instance, that duration should be moved from the core set to the encouraged set. We could accept a move of large exposure to the encouraged list. Corporate sector indicators, which are already in the encouraged list, should remain in that list for the foreseeable future. We would not favor a consultation process with respect to these indicators of the corporate sector, whose objective would be to move them to the core set. We could, however, support the consultation process for insurance indicators, if they would be incorporated only in the encouraged set. We agree with the staff's proposal to assess the capacity of countries to compile financial soundness indicators, but we would like to stress that such assessments should be done for the use of the country concerned, and should not be seen as a new ROSC, because as Mr. Reddy has said, the *Guide* is just a guide, and not a standard.

Finally, this paper does not meet the requirement of the Board that any new initiatives should be fully costed when presented to the Board. Paragraph 101, which deals with this issue, is not complete. I would ask the staff to be specific about whether or not the proposals presented in this paper will require additional resources, either in the present, or in future fiscal years, and if so, how much these resources would be, and whether they are going to be financed by redeployment of existing resources, in which case I would like to know from where, or, if they are going to be financed by expansion.

The last phrase of paragraph 101 of the staff report, which says that it is not expected that other new projects can be supported within the existing resources during the next year, is perhaps a not very clear way of saying that additional resources would be needed. But, I would like confirmation of this from staff, because like Mr. Kanaan, I think that it is unrealistic to think that these initiatives could be undertaken with the existing resources, given that some departments are already quite overstretched.

The Acting Chair (Mr. Aninat) agreed with Mr. Portugal that the period for receiving comments from capitals and from the general public on the *Compilation Guide* should be extended by 30 days.

Mr. von Kleist made the following statement:

We very much welcome today's Board discussion, and I thank the staff for their extensive work in the context of the elaboration of financial soundness indicators. This tool is a most promising and important strand of our ongoing joint efforts to improve the international financial architecture. This chair fully supports the staff's efforts to bring this work forward. We can also largely endorse the staff's proposals on how to further proceed, though we will make a few qualifications. I shall come back to these, but before that, I shall make three comments of a more general nature:

First, while the potential benefits of the various indicators are significant and undisputed, their relevance differs across countries and some of them entail sizeable resource costs of compilation. Like Ms. Jacklin and Mr. Epstein, we feel that this needs to be kept in mind when considering how fast this work is to be brought forward and which indicators are to be included in one FSI set or the other. That said, we agree that more can and should be done to encourage compilation of those indicators that are relevant in the respective countries.

Second, the problems of cross-country comparability of indicators arising from differences of definitions, accounting practices and the handling of supervisory requirements should not be underestimated. We welcome the flexibility embodied in the *Compilation Guide*, which accommodates the use of existing data sources until national practices have been fully harmonized internationally. However, this approach lends added importance to the preparation of metadata which will likely need to be rather extensive. At the same time, even with metadata, there will be the risk of misinterpretations of national FSIs, since metadata typically do not receive the same amount of public attention as the actual financial data. Against this background, a due amount of realism will be needed in the absence of more harmonized international practices. This applies both to the application and the dissemination of FSIs.

Third, we agree with those Directors who underscore the need to further heighten public awareness of the benefits of FSIs.

Turning to some of the specific issues raised in the paper, on the completion of the *Compilation Guide*, we generally agree with the proposed work program. We would add that the *Guide* warrants further careful reviews to remove any inconsistencies. This work should not fall victim to the agenda outlined in paragraph 40 of the main staff report.

As regards the coordinated compilation exercise, we welcome this as a very useful proposal. Similarly, we are in general agreement with the proposed overall framework for financial stability analysis. We would add that this framework should be handled flexibly over time, allowing for adjustments if need be.

However, we differ with the staff on the setting of a target date for including core FSIs, or a subset of these, in the SDDS. It is true that time limits generally have the merit of keeping up the momentum of the work in question. This should also be an important aim in this case. However, important issues remain to be resolved to allow a more informed judgment on exactly which indicators are suitable for inclusion in the SDDS. The experience to be gained under the coordinated compilation exercise will be particularly important in this regard. It would therefore be premature, in our view, to set a target date at this stage.

The other main point where we take a slightly different position than the staff relates to the specifications of the two sets of indicators. We remain of the view that indicators should be highly relevant in a wide range of countries and that the requisite data should be available, in order for the indicators to be adopted as core FSIs. This does not seem to be the case, for instance, with the market-risk indicators, as shown by the experience gained in the FSAPs and the results of the Survey on Macroprudential Indicators. In this regard, the result in Table 2 of the staff report, whereby 57 percent of all FSAPs reported at least one indicator in this group, is somewhat misleading, since two indicators in this group, namely those on asset and liability duration, were reported by only a very small percentage of FSAPs. We therefore have a strong preference for moving this group of indicators to the encouraged set for the time being. For similar reasons, like Mr. Martí and Mr. Moreno we find it appropriate to keep the corporate sector FSIs in the encouraged list. These indicators are no doubt important and should be monitored. However, given the fact that data availability in the non-financial sector typically lags behind that in the financial sector and given the considerable resource costs involved in compilation, including these in the core list appears to be overly ambitious. As for insurance sector indicators, we see merit in incorporating these in the encouraged list. We agree with many others that the FSIs should be reviewed on a regular basis, to ensure that they remain relevant and commensurate to the evolving structure of financial markets.

As regards the establishment of an operational data base, we can support this idea with the caveat already mentioned, namely that diligent use will need to be made of metadata, in order to avoid misinterpretations.

I thank the staff for the preliminary summary of the outside comments received on the draft *Compilation Guide*. It would be helpful if, after the end of the outreach period later this month, Staff could prepare a more comprehensive summary, also indicating how the staff intend to incorporate the outside suggestions in their work going forward.

Lastly, I would note that my authorities have a number of more technical comments to make which they will convey shortly to Staff in the context of their response to the draft *Compilation Guide*.

Mr. Miyoshi made the following statement:

Like other Directors, we welcome the progress made by the staff in line with the work program endorsed by the Executive Board in June 2001. We thank them for their informative papers on the progress made in drafting the *Compilation Guide*, and the progress in the analytic work. This chair continues to hope that the compilation of FSIs by members will contribute to the authorities' assessment of financial sector soundness and its implications for macroeconomic developments. We also think that FSIs could prevent a sudden financial crisis or outflow of capital, and that the presence of FSIs could provide the authorities with the incentive to make efforts to strengthen the financial sector, if the FSIs effectiveness as publicly available data is verified and if they are shared among market participants.

For the Fund, FSIs are part of its strengthened activities in the financial sector, which include FSAPs, the standards and codes initiative, and strengthened financial sector surveillance. They could prove valuable for the staff's analysis of the linkage between the financial sector and the economy as a whole. It is therefore important for the Fund to make efforts to prove the FSIs' usefulness, and to utilize them to provide comprehensive policy advice. That said, the Fund needs to recognize that great care and realism are warranted in promoting FSIs. Making FSIs fully applicable across the membership, and in particular making them comparable among countries, is difficult at this stage, at least, in view of different legal and accounting systems, different regulatory and supervisory frameworks, and different safety nets. The Fund should also be mindful of the implications of making a compilation of FSIs a condition for something else, because this could mean a new requirement for most members, thereby forcing not only the authorities, but also financial institutions, to assume the additional burden.

Furthermore, in order to encourage the use of FSIs, it is crucial that the appropriateness of FSIs as indicators for soundness of the financial and corporate sectors is verified, both theoretically and empirically, and that compilation of FSIs is seen as beneficial for financial regulation and supervision. Disseminating FSIs without sufficient examination of their relevance and usefulness could cause unexpected repercussions in the markets. The Fund should therefore be cautious in making a judgment on this issue, and should resist the temptation to rush to an outcome. It should put in place a realistic plan that takes into account the situation of adaptation and compilation of FSIs in members.

Let me turn to our comments on the issues for discussion. First, we broadly support the proposed work program aimed at completing the *Compilation Guide*. Like Ms. Indrawati and Mr. Alowi, however, we urge the staff to ensure that all comments and views are considered thoroughly before finalizing the *Compilation Guide,* and to be flexible about the timetable as necessary. I welcome the Acting Chair's comments in this regard. In particular, we believe that the utilization of FSIs as an analytic tool, and the need for interagency cooperation, will present significant challenges ahead.

Second, we welcome the proposal for a coordinated compilation exercise, since we believe that accumulating experience in compilation, as well as in other outreach activities to promote use of FSIs, is beneficial. That said, we believe that Mr. Kanaan's and Mr. Sakr's concern about the resource implications of this exercise is valid in view of the Fund's experience so far in the FSAP. As for the participants in the exercise, I tend to agree with Mr. Callaghan and Mr. Reddell that it is important to include those responsible for financial supervision and financial system stability.

Like Mr. Portugal, we do not support the staff's proposal to set target dates for including some of the FSIs into the SDDS, because this could lead to hasty adoption and dissemination of FSIs. The staff cites the creation of the *Compilation Guide* and the increase in experience of using FSIs in FSAPs as the reason for this proposal. However, as Mr. Kanaan mentioned in his statement, we understand that the Board expressed concern about such proposals during the previous meeting on this issue, in light of insufficient data collection, even for core FSIs among members; the lack of cross-country comparability due to different legal and accounting systems and supervisory frameworks; the need to carefully examine the impact of dissemination of FSIs on the markets; as well as further efforts necessary with regard to theoretical and empirical analysis of the effectiveness of FSIs. Although the progress in the staff's analytic work is welcome, this chair does not believe that the quantitative and empirical analyses are sufficient.

Moreover, including core FSIs in the required categories in the SDDS could possibly mean additional data collection requirements for many countries subscribing to the SDDS. The staff should not consider the issue of data availability lightly. They should establish the date for inclusion of FSIs in the SDDS, if at all, realistically based on the progress in compilation by members and in their own analytic work.

Fourth, the financial stability analysis indicated in Figure 1 of the Board paper is broadly appropriate in the qualitative sense, although I tend to agree with Mr. Kremers and Mr. Litman that the framework may not cover all possible shocks and macro-financial linkages, and that corporate sector shocks may disrupt the functioning of the financial system without destabilizing the banking sector. As mentioned above, we look forward to further analysis by the staff, even though we greatly appreciate the analytic work on the linkages among FSIs and between FSIs and macro-financial indicators.

We agree with the staff that they should modify the list of core and encouraged FSIs through international consultation with national supervisory authorities, national statistical agencies, and standards-setters. We continue to have reservations about making corporate-sector indicators as core FSIs. While we understand that such indicators could be used as forward indicators for the soundness of the banking sector, the impact of the corporate sector differs, depending on the form of financing and collateral, and on the degree of dependence of the corporate sector on the banking sector.

We can support in principle the staff's proposal for developing the role of FSIs as a surveillance tool in Fund surveillance in light of the increased importance of the financial sector in the Fund's activities. However, the staff should be careful in interpreting the results of analysis using FSIs, just as they should with regard to stress testing, because the relevance and usefulness of FSIs has not been established fully yet, either theoretically or empirically. The staff should also bear in mind the quality and reliability of FSIs, which are still at the development stage.

Finally, we agree with the staff's proposal to assess the capacity of countries to compile FSIs, and encourage them to develop their capacity through such channels as the FSAP review missions, Article IV consultation discussions, and technical assistance missions.

Mr. Rouai made the following statement:

Like other speakers, I thank the staff for their commendable efforts in preparing today's review on Financial Soundness Indicators (FSIs), and particularly the *Compilation Guide*, which will help countries better assess strength and vulnerabilities of their financial sector and enhance Fund surveillance. The participation in the FSAP review exercise of most of the countries in our constituency confirms the importance of FSIs in helping the authorities monitor and assess financial sector risks. In particular, the compilation of FSIs has been helpful in pointing out very important issues, some of which follow below.

Market regulation and supervision in most of our countries are segmented with minimal cooperation and exchange of information between supervisors of deposit-taking institutions, insurance companies, and capital markets. The growing interaction between these three markets and the banks' reliance on subsidiaries to diversify their activities into insurance and security dealing render it very difficult for market supervisors, for example, the central bank, to timely identify and properly assess risks associated with bank activities in other segments of the financial system. Out of this perspective, while we do not recommend any institutional change, for example, to move to a single regulatory and supervisory authority, we note a clear benefit in centralizing FSIs' compilation and dissemination within the central bank. In addition, we believe that the encouraged set of soundness indicators should include those economic and financial sectors most relevant for assessing financial stability, including the insurance sector. However, the actual compilation of FSIs should remain flexible and should reflect each country's institutional setting, technical capacity, and expertise.

For the FSIs initiative to be successful and widely supported, member countries should realize that it is in their own interest to invest in this area. The voluntary participation in FSIs' compilation within the FSAP review exercise has been a first step in this direction. We should build on this collaborative approach to move forward. Also, presenting FSIs as a requirement for Fund surveillance or as an addition to the SDDS should be avoided, and countries are encouraged to compile FSIs with the objective of preparing regular financial stability reports using, among other things, the analytic framework for financial stability, detailed in Figure 1 of the staff report. Box 1 of the background paper highlights the importance of these reports in strengthening financial stability, enhancing transparency, and developing in-house expertise. These reports could also help enhance cooperation and exchange of information among regulatory authorities and in developing coordinated policy actions.

We caution against the temptation of using FSIs to compare countries. This objective should be a medium- to long-term one until most countries adopt internationally agreed upon accounting, supervisory, and statistical standards. In this context, the preparation of metadata for each FSI is as important as the compilation of the associated FSI, and this is where the *Compilation Guide* could be most useful. We note the lack of agreement on best practices regarding nonperforming loans and provisioning policies. These indicators are routinely included in Article IV staff reports as well as in the *WEO* and the *GFSR* to assess assets quality and capital adequacy, without indication on how they are compiled by countries. The staff should pay due attention to this aspect, document the rules applied in this task, and highlight deviations from best practices. In this regard, a guidance note on the use of FSIs in Fund surveillance would be very helpful.

Turning to the issues for discussion, we have the following comments:

We agree with the proposed work program for the completion of the *Compilation Guide* and encourage the staff to continue collaboration with standard setters and outreach exercises.

We strongly support the staff proposal of conducting a coordinated compilation exercise to help countries compile FSIs and to promote their international comparability in the medium term. Countries who participated in the FSAP review exercise as well as SDDS subscribers could form good candidates for such an exercise, and we encourage the staff to include some of the countries in our constituency.

The proposal to include FSIs in the SDDS merits careful consideration. How will this decision impact, for example, potential SDDS candidates? How to reconcile between strict SDDS requirements and the flexibility in accommodating country practices in compiling FSIs? In any event, we need to show flexibility with regard the target date. In the meantime, the establishment of an internet gateway to provide a single entry point for accessing FSIs for all countries could play a useful role in furthering and disseminating work in this area and in nurturing public awareness. As the only subscriber to SDDS in our constituency, Tunisia supports, in principle, the inclusion of FSIs in the SDDS.

Finally, we support the following proposals presented by the staff:

- Integrating FSIs into the framework for financial stability while paying due consideration to the cautious comments made by Directors;

- Updating the core and encouraged sets of FSIs, as proposed in paragraph 97 of the staff report. We support, in particular, moving market-risk FSIs and adding insurance FSIs to the encouraged set.

Mr. Alazzaz made the following statement:

I thank the staff for the set of papers on Financial Soundness Indicators (FSIs), and welcome the completion of the draft *Guide*. I also commend the staff for the consultations with a large number of countries and multilateral and regional institutions as detailed in Box 1 of the staff report. In this connection, I can endorse the proposed work program, which aims at continuing the consultative process and the revision of the draft *Guide* to incorporate relevant additional information and feedback. Taking those various views into account should help facilitate the ownership and implementation of the *Guide* by the membership. Here, I will add four brief comments.

First, the proposal to hold a coordinated exercise after finalization of the *Guide* should help countries in compiling FSIs. However, limiting the number of participants in the exercise to 60 countries, most of which are SDDS subscribers, could be an issue, especially if the use of the FSIs is going to be fully integrated in future surveillance work.

Second, on the proposed target date for including FSIs in the SDDS, I am of the view that it is premature at this stage to set a specific date. Indeed, the *Guide* has not been finalized, and it is not yet clear if some FSIs should be added to the core or encouraged lists. Moreover, before setting a date for inclusion of FSIs into the SDDS, additional experience is needed regarding the benefits of various FSIs to vulnerability assessments, as well as the costs of collecting such data.

The focus at this stage should be on finalizing the *Guide* and then moving cautiously to encourage and assist countries to develop FSIs. Here, the importance of providing technical assistance needs to be emphasized. In this regard, I would appreciate if staff could provide a rough estimate of the likely costs of the additional technical assistance needed in this area. It is also important to take into account the countries' costs for compiling the additional data as well as the other competing priorities, especially given the large number of standards and initiatives they have to deal with. Here, I welcome the recognition in the draft *Guide* that the authorities must make a judgment whether the contribution to surveillance of an additional data series is worth the increased resource cost.

Third, FSIs should be interpreted with great caution due to lack of international comparability. Indeed, statistical systems, accounting practices, and supervision implementation vary across countries. Therefore, moving to meet the requirements of the *Guide* will be a medium-term endeavor as noted by the staff. However, it is important in the drive to enhance international comparability, to retain some flexibility to take into account the differing banking practices and administrative capacities in the various countries. Therefore, the use of FSIs in Article IV consultations should be eased in slowly, as experience is gained on their relevance as a predictor of the vulnerability of the financial system, and additional data are collected.

Finally, the analytical framework for financial stability as depicted in Figure 1 of the staff report is comprehensive. However, it is important not to go overboard in trying to collect data and create databases on too many issues. Here, I share Mr. Kanaan's and Mr. Sakr's stress on the need for selective emphasis on different FSIs depending on each country's specific circumstances. In this connection, it is premature at this stage to form a firm opinion on whether life insurance FSIs or corporate FSIs should be included in the core or encouraged sets. The *Guide* will need to evolve as experience is gained.

Mr. Wei made the following statement:

At the outset, we thank staff for the well-written papers. We welcome today's discussion on the development of FSIs and the next steps forward further clarifying the financial stability analysis methodology and the role of FSIs and providing a useful instrument to analyze systemic financial sector vulnerabilities. Nevertheless, I fully share the views of Mr. Martí and Mr. Moreno as expressed in their preliminary statement that we should not be too ambitious in trying to push the FSI agenda. We also believe that the introduction of FSIs should be made gradually to allow a smooth implementation that takes into account country-specific circumstances.

I will comment on the following three areas for emphasis: the FSI *Compilation Guide*, the financial stability analysis framework, and the use of FSIs in Fund's surveillance.

FSI *Compilation Guide*

The staff should be commended for the hard work in drafting the comprehensive *Compilation Guide* on FSIs. We support finalization of the *Guide* by the end of this year after feedback from all the relevant parties and incorporating developments in International Accounting Standards, the Basel Capital Adequacy Accord, and other concerned international standards.

We agree with staff's proposal that upon finalization of the *Guide*, the Fund should sponsor a coordinated compilation exercise involving both supervisors and statisticians to test how well the *Guide* can be followed and highlighting problems and difficulties member countries may encounter during FSI compilation. Member countries should take part in this exercise on a voluntary basis.

On the matter of adding FSIs into the SDDS, as more work needs to be done in reclassifying the core set and the encouraged set of FSIs and as lessons will be learned from the forthcoming compilation exercise, it seems more appropriate to discuss this matter after both exercises have been concluded. In addition, we note Mr. Callaghan's and Mr. Reddell's concern that many countries may not be able to provide FSIs in line with the frequency and timeliness requirements prescribed by SDDS. We would like to get staff's estimation on how many countries which has already subscribed in SDDS are able to provide FSIs in line with the SDDS requirements.

Financial Stability Analysis Framework

Figure 1 of the staff report provides a self-explanatory outline of the financial stability analysis framework, establishing internal linkages among various Fund analytical instruments and clarifying the financial stability analysis methodology. Macro-prudential surveillance using FSIs has been appropriately integrated into this framework. Nevertheless, in consideration of the nature of the indicators on non-financial sector conditions, it seems more appropriate to combine these with the early warning indicators. Indicators on corporate sector conditions should be part of the early warning indicators, rather than a component of FSIs.

In addition, we would like to point out that FSIs are not the only instruments used for the second part—"financial sector surveillance." Well-tailored econometric models with variables reflecting member countries' economic features may be instrumental in testing the weaknesses and strengths of a country's financial sector.

With regard to the further development of FSIs, we encourage staff to continue their analytic and data development work, including assessing the reclassification of the core set and encouraged set of FSIs. However, we share Mr. Callaghan's and Mr. Reddell's concern that the extension of FSIs to the insurance sector needs to be weighed carefully. In most circumstances, it is difficult to prove that the failure of an insurance company will generate the systemic consequences associated with the failure of a deposit-taking institution. The staff's proposal to hold a conference on financial stability analysis is also well taken.

Use of FSIs in Fund Surveillance

There is no doubt that the financial stability analysis framework and use of FSIs have important implications not only for a country's financial soundness but worldwide. However, this methodology and the set of indicators should be tailored to real circumstances since the management of financial institutions, financial market deepening and the degree of opening-up, as well as financial supervision skills, vary across member countries. Simply transplanting this methodology to every member country and making peer comparisons may draw the wrong conclusions. FSAP review experience also vindicates that flexibility should be built into interpreting FSI definitions in different cases.

Meanwhile, the financial markets in advanced economies as well as their market players have a dominant role to play in the global financial arena with implications for global financial soundness. Therefore, it is of the utmost importance to apply the financial analysis methodology and FSIs in assessing potential risks in the financial sectors of the major advanced economies.

Turning to developing and emerging market economies, while weaknesses in the financial sector are identified during the financial stability analysis, the development potential of the financial sector in these economies should never be overlooked and should have equal weight in the assessment. At the same time, as FSAP review experience shows, financial sector development is of greater consequence for developing and emerging market economies and viewed as more than an assessment of their financial sector vulnerabilities.

We also encourage the Fund to educate member countries on the financial stability analysis framework and FSIs through a series of seminars, training courses and direct technical assistance. However, what we would like to stress is that member countries should be encouraged to compile FSIs on a voluntary basis and when conditions mature. The Fund should assess a country's capacity to compile FSIs only at the member country's request.

On the issue of collecting comments from the authorities on the *Guide*, I join others in supporting Ms. Indrawati's and Mr. Alowi's call for postponing the deadline for responses in order for more countries to make their views available.

Last but not least, I share the concerns of Mr. Kanaan and Mr. Sakr that additional staff resources are probably needed for implementing this task.

The Acting Chair (Mr. Aninat) clarified that the proposal in the Board document was to have 2006 and 2008 as indicative target dates, and not cutoff dates, for including FSIs in the SDDS. Moreover, there would be two further reviews of progress in compiling and using FSIs in 2005 and in 2007, during which the Board would have the opportunity to decide on the final dates for including FSIs in the SDDS.

Mr. Brooke made the following statement:

Like other Directors, we welcome the good progress that the staff has made on the FSI *Compilation Guide* and on the analytic work to clarify the role of FSIs in Fund surveillance. The recent study by the Independent Evaluation Office on capital account crises once again reminds us that the lack of data frequently impairs and hampers the initial assessment of crises, and therefore makes consideration of the appropriate policy response more difficult. We therefore attach high priority to the staff's work in this area.

We agree with Mr. Callaghan and Mr. Bossone that much needs to be done to increase the collection, compilation, and dissemination of FSI data. We also fully share Mr. Callaghan's view that countries will only compile FSIs if they consider that this information will be useful to them. Consequently, I agree with Directors who have emphasized the need for the staff to increase the outreach efforts, and that this should include greater emphasis in demonstrating to member countries the usefulness and benefits of using FSIs.

Since we broadly agree with the main elements in the Board paper, I will restrict the rest of my comments to briefly answering the questions that were posed.

On Questions 1 and 2, relating to the *Compilation Guide* and the coordinated compilation exercise, we are content with the proposed work program.

On Question 3, with regard to the potential inclusion of FSIs into the SDDS, we have the following general remarks. First, we agree that the ultimate aim of including a subset or even the full list of core FSIs as required elements of the SDDS is desirable. We also see merit in setting a target date for the inclusion of FSIs in the SDDS to give countries that currently meet the SDDS standard a deadline to work toward. We are mindful, however, of the concerns that have been raised by other speakers, in particular, that adding more elements to the SDDS may inhibit some countries from participating in this important initiative. Balancing these considerations and the comments of other Directors, we believe that the way forward at this stage should be to include the core FSIs as encouraged items in the SDDS, as the staff proposes. I hope that most Directors could support at least this suggestion.

Beyond this, however, it certainly seems that there is not enough support to set a definitive deadline at this stage for compulsory inclusion of FSIs in the SDDS. Further discussions with member countries should be part of the coordinated compilation exercise, and other outreach efforts will be needed before we can finalize the timetable. Here, I very much agree with the Chairman's comments that this issue would be reviewed in coming years up to the deadline that he proposed.

We strongly support the objective in Question 4 of further integrating FSIs into the Fund's ongoing Article IV and FSAP surveillance work. The framework for financial stability analysis as outlined in Figure 1 of the Board paper appears to be a reasonable starting point. We hope that the staff will take account of the various helpful suggestions that have been made by Directors on the framework, and revise it accordingly in light of any ongoing experience as well.

On Question 5, we agree with Mr. Martí that ongoing innovations in financial markets, together with changes in international accounting rules, will necessitate periodic reviews of the lists of core and encouraged FSIs. Therefore, we agree with the staff that it will be appropriate to review the composition of these lists approximately once every two years to ensure that the choice of FSIs is aligned with surveillance priorities and that resources are not channeled into compiling FSIs that are no longer useful.

In terms of the process, we agree with those who have called for a consultation exercise directly with all of the appropriate authorities, including central banks, national supervisory agencies, national statistic agencies, and other institutions that are important in these areas.

We support the staff's proposals for changes to the FSI coverage of the insurance and corporate sectors. As I noted earlier, however, there are clearly costs involved in moving toward this goal in terms of potential implications for SDDS subscriptions. That being said, where there are particular concerns in these areas, we hope that in conducting Article IV consultations, the staff would look at the indicators in these areas, and if they are not available, to actively discuss them with the relevant authorities as part of their outreach efforts to encourage the use of FSIs.

On Question 6, we support the preparation of a guidance note on the use of FSIs in surveillance and the development of an FSI database. We hope that consideration could be given to making this database available to Fund members, which a number of Directors have suggested. I am not quite clear if that is what the staff intends to do. At a minimum, if data could not be made available on the web, the main elements of the database could perhaps be included in the IFS publication.

On Question 7, we strongly agree with the intention to assess the capacity of countries to compile FSIs. Here, staff should be sensitive to the costs and benefits of compiling these indicators. As other Directors have noted, in some cases it may make more sense to concentrate on compilation and dissemination first before considering the first-best option of generating all of the proposed FSIs. In particular, for small countries, it may be sensible to limit the initial scope of the exercise in the way I have outlined.

Finally, we would very much welcome being kept informed—perhaps through lapse-of-time documents—on the progress being made in this initiative, perhaps through 2004.

The Deputy Director of the Statistics Department (Mr. Enoch), responding to Directors' comments on including FSIs in the SDDS, recalled that the SDDS emerged as part of the Fund's standards initiative in response to the financial crises in the 1990s. Even though the SDDS had initially focused on macroeconomic data, very few countries at the start could meet the SDDS standards; the staff had to work with almost all of the subscribing countries to help them meet the new standards. There had been several hundred transition plans in the late 1990s before countries came fully in observance of the SDDS Currently, there were almost no outstanding transition plans for the macroeconomic data in the SDDS.

There had also been plenty of misgivings among subscribing countries when the reserves template, which involved 55 categories of data, had been added to the SDDS, as very few countries had disseminated those data at that time, the staff representative continued. The staff had also worked with members to help them compile the data, and all SDDS subscribers currently disseminate the reserves template. Those had all been major achievements of intensive collaboration between the staff and the member countries. The staff was aware that very few, if any, countries currently would be able to comply fully with SDDS standards on an FSI core data set. However, given the experience in working with member countries in the past decade to put together the macroeconomic data set for the SDDS, the envisioned exercise should also produce positive results. The staff had had some informal feedback from compilers in some countries indicating that, from the point of view of national authorities, an indicative target for 2008 would enable countries to prioritize their work program.

Concerning the work program, there would be an experts' meeting convened in October to put together all the comments on the *Compilation Guide*, the staff representative remarked. The staff would discuss the comments with the experts, and use them as inputs in finalizing the *Guide*. The planned coordinated exercise would also be discussed. The staff aimed to finish the *Compilation Guide* by the end of the year, and in early 2004, invitations to participate in the coordinated compilation exercise would be sent out. The staff had suggested inviting about 60 participants, and while participation would be on a purely voluntary basis, the staff had also suggested that the initial invitation should be extended to the SDDS subscribers and to about 10 GDDS subscribers. If more member countries were to volunteer to participate in the exercise, the staff would try to accommodate those countries subject to the resource constraints.

The staff had had recent experience in conducting a coordinated exercise, the staff representative stated. The coordinated portfolio investment survey had been a major achievement, which had enabled member countries to produce good-quality portfolio investment data. The exercise had involved around 70 countries, and the experience of working together to make a framework operational was an excellent precedent. The staff aimed to specify in greater detail by mid-2004 what the coordinated compilation exercise would involve.

Participating countries would be invited to send inventories of their metadata, describing how they compiled data and how their approach differed from the recommendations in the *Compilation Guide*, the staff representative explained. A major meeting with all participating countries would be held in September 2004. The following year would be spent in dialogue with the participating countries, through regional workshops, to help them move toward being able to participate in the compilation exercise.

The staff had considered including the encouraged indicators in the compilation exercise, the staff representative continued. However, the staff would consider the Directors' and the experts' suggestions on whether the exercise should be limited to the narrow group of core indicators. The choice would also be part of the consultative process involving the participating countries, the experts in the supervisory agencies, statisticians, and international institutions such as the BIS and OECD.

The staff expected to return to the Board around mid-2005, the staff representative stated. If the Board approved the conduct of the compilation exercise at the next review, the exercise would take place thereafter, with the latter part of 2005 as the reference date for the exercise. The results would be reported in early 2006, followed by another major meeting with participating countries during that year. The next review by the Board could take place in 2007, by which time the staff would be expected to have a firm idea as to which indicators were most useful analytically, as well as which data sets worked best empirically. During the Board's review in 2007, it would be able to determine the set of indicators to be included in the SDDS.

With regard to the resource requirements of the compilation exercise, the work program was consistent with maintaining the existing team that was currently working on FSIs, the staff representative remarked. There would be no net new resources relative to the budgets of the previous, current, and next fiscal years. Additional resource requirements, if any, would be met by extending the timetable, instead of increasing the resource input. The only element that was not factored into the budget was possible unanticipated demand for technical assistance in addition to the programmed regional workshops.

The Deputy Director of the Monetary and Financial Systems Department (Mr. Sundararajan) acknowledged the useful suggestions made by Directors regarding the framework for financial stability analysis. Those suggestions included: examining the robustness of the relationship between the debt-to-equity ratios of corporations and banks' nonperforming loans, and examining alternative indicators of capacity to pay; incorporating more explicitly the impact on financial stability of the operations of financial markets, instead of focusing mainly on bank credit channels; making more explicit the effects of shifts in collateral values and accounting rules; providing more guidance on stress-testing and specifying more explicitly the role of stress-testing in the financial stability analysis framework; delineating more clearly how the financial soundness of institutions in home countries affect financial stability in host countries; and supplementing macroprudential surveillance with qualitative analysis of the effectiveness of supervision and the strength of financial infrastructure. Work on all those areas was ongoing—Figure 1 of the staff report represented an outline of the actual work done in FSAP reviews and Article IV surveillance. The staff planned to continue the same process while further developing it in the course of normal operational work such as FSAP review missions, Article IV consultations, and other ongoing engagements, including the forthcoming international banking seminar.

Mr. von Kleist agreed that setting firm target dates was useful in helping establish a path toward a goal. However, if the target date had to be changed close to its occurrence, there was a risk of losing credibility. The same was true about setting a target date for incorporating the FSIs into the SDDS. The consideration of a target date should await the results of the coordinated compilation exercise two years hence when the staff would have a firmer idea of the plan's feasibility.

Mr. Portugal agreed with the point that had been made by Mr. von Kleist. There was a long time to go before 2008, the year that FSIs were proposed to be included in the SDDS. Moreover, the *Compilation Guide* had not been completed, and the coordinated compilation exercise had not been started. A better approach would be to start with the coordinated compilation exercise. In addition to losing credibility if the target date was not observed, setting a target date now could discourage countries that were considering subscribing to the SDDS.

The staff's confirmation that no new additional resources would be needed for the coordinated compilation exercise was welcome, Mr. Portugal continued. He expressed the hope that the staff would not request additional resources during the discussion of the Fund's budget.

Mr. Sakr agreed with Messrs. von Kleist and Portugal. The careful approach that Mr. von Kleist had cautioned should apply to the various aspects of the staff's proposal. With regard to the compilation exercise on portfolio investment data that had been referred to by the staff, it would be useful to explain whether the amount of work required to compile FSIs would be comparable to the amount of work required in that previous exercise. In addition, while it was difficult to estimate the number of technical assistance requests that might arise in connection with the compilation exercise, the staff should have some idea from experience regarding the likelihood of such requests for technical assistance. It was important to be realistic about the work program that the Fund set for itself, as the Managing Director himself had noted. It was preferable to start with more modest targets, which could be raised if the resources were available.

Mr. Baukol agreed that there was a need for realism. However, the eight indicators from the core FSIs that his chair had proposed were fairly unlikely to be excluded from the core set a few years hence. No Director had suggested that any of those eight indicators should be moved to the encouraged list. Moreover, Figure 3 of the background paper seemed to indicate that most countries surveyed had a good chance of fulfilling the data requirements for the eight indicators. Hence, including those eight indicators in the SDDS would not entail a high cost, or have a negative effect on prospective SDDS subscribers.

Mr. Rouai requested the staff to elaborate on the timetable for the preparation of the *Compilation Guidance* and the development of the FSI database.

Mr. Alowi supported the view that had been expressed by Messrs. von Kleist, Portugal, and Sakr.

After recessing at 1:00 p.m., the Executive Board reconvened at 2:30 p.m.

Mr. Boitreaud made the following statement:

> Let me commend the staff for this excellent and comprehensive set of papers and the progress achieved so far in implementing the work program on the compilation and the use of FSI. We support the staff's proposals and their work program and would like to stress a few points for emphasis.

First, we agree with the staff that it would be useful to assess the capacity of countries to compile FSIs and to encourage them to develop their capacity through the channels described in paragraph 99 of the staff report. We also strongly support the collaboration with other international organizations to develop and promote FSIs and are in favor of conducting a coordinated compilation exercise involving both supervisors and statisticians to assist countries in compiling FSIs. This exercise could however prove difficult and it seems reasonable to focus, at least at an early stage, on the core set of indicators.

Second, regarding the periodicity of the release of data, I share the remark made by Mr. Andersen and Mr. Gulbrandsen in their statement. We should adopt a pragmatic and flexible approach on this issue and avoid causing a too heavy compilation burden, especially for indicators that are expected to remain largely unchanged between quarters.

Third, we support the framework for the financial stability analysis illustrated in Figure 1 of the staff report, as it will allow a better insight into likely transmission processes. However, like Mr. Kremers and Mr. Litman, we wonder whether this framework might not cover all possible shocks and macro-financial linkages. More generally, we believe that the framework should be further detailed, for example with regard to the use of stress testing, in order to facilitate making a judgment on its relevance for surveillance.

Fourth, we agree with the staff that the analytical work should continue to focus on developing FSIs as a surveillance tool and the Fund's capacity to use them with other tools. We support the proposal to incorporate the essential insurance FSIs identified by the staff but would like to insist on a pragmatic and realistic timetable to achieve this goal since international standardized data on life insurance have not yet been extensively developed. We are in favor of a more in-depth treatment of the role of the corporate sector's FSIs in our surveillance while noting that the compilation of FSIs for the corporate sector remains a challenge for many member countries.

As mentioned by previous speakers, it is crucial for the Fund to continue to consult with international experts in the field to ensure that the core and the encouraged sets of indicators reflect surveillance priorities and needs. More precisely, like others, we are in favor of moving the indicators on duration of assets and duration of liabilities from the core to the encouraged set as these data are compiled by a small number of countries and are still difficult to harmonize.

Finally, like Mr. Padoan and Mr. Bossone, we recommend that the completion of the *Guide* take on board all relevant elements that might emerge from the process of the New Basel Capital Accord. Although we support this proposal, we wonder whether the proposed date for including FSIs in the

SDDS might be slightly too ambitious, and we recommend flexibility in this issue. I have, however, taken note of the Chairman's remark on the fact that this date is a target date and that further reviews will be held before any definitive decision.

Mr. Abel made the following statement:

The staff's work on Financial Stability Indicators (FSIs) has made an important contribution to the Fund's surveillance. Financial stability has become not only a major responsibility for the Fund, but one of its most successful as well. The occasional changes in the focus of the Fund's surveillance, and its constant adaptation to current needs, enhance the Fund's performance in other areas. The staff's work on the compilation, dissemination, and analysis of FSIs takes place in an area where the Fund's assistance is most needed and where its advice can be most useful.

The staff has consulted extensively with supervisory authorities, other international agencies, standard-setting bodies, and member countries. The progress reflected in this report, and the enthusiastic comments our office has received from some of our countries' authorities, show that the initiative has been most worthwhile.

The ambitious work program suggested by the report is not without difficulties. Several of the core indicators are readily available in most countries, but the more complex and perhaps most interesting indicators are not easy to compile and present in terms that permit meaningful comparisons across countries. For example, at a recent outreach seminar on FSIs hosted by the ECB, several participants expressed skepticism about the possibility of producing meaningful duration measurements at the sectoral level.

Some FSIs are difficult to define in simple, broadly understood terms, and there are other issues related to compilation and dissemination of the data. For example, the current guidelines for institutional coverage suggest that data on deposit takers should be collected on a domestically-controlled cross-border basis, but this method is problematic in countries whose banking sectors have large numbers of foreign participants. Again, the *Compilation Guide* suggests that assessment of the degree of consolidation should be based on activities, rather than on legal corporate boundaries. But in countries whose financial systems are dominated by conglomerates which are simultaneously involved in insurance, banking, and investment activities, dividing the entities' capital, costs, revenues, and other factors among their various activities is by no means a straightforward task. More flexibility is needed in the *Compilation Guide* to take account of the special nature of financial conglomerates.

Such difficulties create the risk that an overambitious program could force unnecessary compromises of content for the sake of generality. Until standardized FSIs are readily available across countries, and until we have more experience in analyzing these indicators, their use should be limited to single-country surveillance, where they can be discussed with the authorities and relevant supervisory bodies, as in FSAPs and Article IV consultations.

At this stage, country specifics may require special modification of concepts and coverage of some indicators to maximize the usefulness of the information for analyzing the most urgent problems.

We support the goal of incorporating FSIs in SDDS once experience has shown that they are of high quality and sufficiently comparable across countries. But at this stage the timetable suggested in paragraph 94 of the staff report for including them in the SDDS looks overly ambitious. Such a timetable should reflect the results of the compilation exercise described in paragraph 88, which we fully support.

Also, although incorporating FSIs into the SDDS is an attractive idea, we should wait until we have more experience showing that these methods are reliable and produce answers that are comparable across countries. Making the most important FSIs available and comparable across countries would entail significant losses in terms of the sensitivity—and importance—of the information.

The plan described in paragraph 40 of the staff report for finalizing the *Compilation Guide* is feasible. We also support suggestion that the Fund should lead a coordinated exercise with the participation of central banks, supervisors, and statisticians, as described in paragraph 88.

All countries subscribing to the SDDS should take part in this compilation exercise. Even though some countries cannot produce FSIs as quickly as others, all countries that have subscribed to the SDDS should be expected to deliver a wider range of FSIs more rapidly than those that have not yet subscribed to the GDDS. Each country should advance as fast as possible, both for its own benefit and to secure the benefits of financial stability to the entire international community.

The list of core FSIs and encouraged FSIs should be continually updated in light of experience. We support the changes proposed in Table 6 of the staff report. Given the difficulty of compiling meaningful duration indicators, it might be best to shift them to the encouraged set at this stage. FSIs should also be prepared for life insurance companies and the stock market as well as the banking sector. And at some stage, non-life insurers (property and casualty companies) should also be included too, because major catastrophes (such as September 11) can destroy their financial soundness, with dire repercussions for the rest of the financial system.

Finally, these two papers clearly show that designing and monitoring meaningful and comprehensive FSIs will remain a very challenging task for prudential supervisors, statistical agencies, international organizations like the BIS, and the Fund. The staff's assistance, described in paragraph 99 of the staff report, will be most welcome to help national authorities play their essential part in reinforcing the stability of the international monetary and financial system.

Mr. Szczuka made the following statement:

At the outset I would like to join other colleagues in commending the staff for the impressive results of its efforts to develop, through an open and collaborative process, the *Compilation Guide* on Financial Sector Indicators. The staff has also made progress in their analytical work on the use of FSI in assessing the stability of financial sector, and the broader macro-financial linkages. This analytical work, however, has to advance further, because only by proving the very clear benefits of FSI compilation for enhancing our surveillance and crisis prevention activities we can be successful in encouraging a broadest possible group of countries to join this resource-intensive initiative. We should also be fully aware of the very large amount of work that still needs to be done in order to ensure the availability of the statistical data and the cross-country comparability of FSIs. Various technical limitations, as well as resource constraints, clearly suggest that we should avoid unduly expanding the FSI-related agenda and setting too ambitious deadlines. We should also try to ensure that the FSI framework is flexible enough to adjust to the circumstances of different countries, and to swiftly absorb the ongoing modifications of international standards. Like several other chairs, I would also like to sound the word of caution that we should continue setting realistic expectations regarding the benefits of FSIs, because most likely they will not be sufficient to identify all risks and vulnerabilities, and they cannot substitute for adequate regulation and strong supervision. I have the following comments on the questions asked by the staff.

I agree with the proposed roadmap for the completion of the Compilation *Guide* as described in paragraph 40 of the staff report. I appreciate the difficulty with formulating the *Guide* in parallel to the ongoing development of new international standards, but the *Guide* can only be relevant if it incorporates the most recent versions of such standards. When finalizing the *Guide*, the staff should also consider the possible modifications to the lists of core and encouraged indicators and address some of the issues already raised in the consultation process. The question of the treatment of banking systems with dominant foreign ownership and the proposed broader use of stress tests are just two examples of such issues.

A coordinated compilation exercise is certainly warranted and could take place in the envisaged timeframe. Like some other colleagues, I would like to stress that care should be taken when selecting participants for this exercise. While the SDDS subscribers should be one of the target groups, it would also be important to include a number other emerging and developing countries in order to both encourage them to compile the FSIs and to identify the main challenges and difficulties in advancing the FSI agenda.

Merging the FSIs with the SDDS implies a quantum jump. However, I generally agree with the goal of including a carefully selected set of FSIs into the SDDS as this would certainly contribute to making a fuller use of the informational content of the FSIs. I also agree that it may be very helpful to set a specific deadline, but I have some concerns that the date proposed by the staff may prove too ambitious because of burden it would impose on data providers and compilers. In view of the relatively slow increase in the number of new countries joining the SDDS we should also try to avoid overburdening this scheme and thus possibly discouraging further countries from subscribing to the SDDS. To alleviate such concerns I am inclined to support the pragmatic approach suggested by Messrs. Martí and Moreno that envisages delaying the decision on setting the deadline for a possible SDDS inclusion until after the completion of the coordinated compilation exercise.

The proposed framework for financial stability analysis appears reasonable and quite comprehensive. It confirms that the FSIs can play a helpful role in the surveillance process. However, there is no one-to-one mapping between FSIs, vulnerabilities, and macro-linkages. There are still important problems resulting from varying definitions and implementation practices. Such difficulties can ultimately be partially resolved by pursuing a coordinated approach but, as reminded by the U.S. chair, there are limits as to what the Fund could and should try to achieve in this area. There are also limitations due to the fact that some statistical relationships between FSIs and the macro variables still appear to be quite weak. Only after having a sufficiently large number of observations will it be possible to prove their relevance. All this suggests that a fully effective use of FSIs for surveillance purposes is a long-term task.

I broadly support the proposals to add some FSIs for the insurance sector to the encouraged set and to evaluate the feasibility of moving some corporate sector FSIs to the core set. However, when considering the implementation of these proposals we should be guided by the principles of parsimony, practicability and flexibility. As indicated by the staff, two-thirds of countries outside the advanced economies group do not collect data on a single encouraged FSI for the corporate sector. There is also no common standard for assessing capital adequacy of insurance companies and the importance of this sector varies quite substantially. All this suggests that we should not rush with introducing the new FSIs and perhaps start with calculating them for countries where their relevance would be more obvious.

I fully support the measures proposed in paragraphs 98 and 100 of the staff report. As regards the database, its further development has obvious advantages but also brings an important risk that needs to be minimized. The existence of such a database will create a strong temptation to compare the collected data even though, at this stage, more often than not they cannot be directly compared. Ways will have to be found to avoid the pitfall of comparing what is dissimilar.

I fully agree on the need to assess the capacity of all countries to compile FSIs. However, I have some reservations with two of the many proposed channels. I wonder whether Article IV and UFR missions will be able to accomplish this task without additional resources and/or without negatively affecting their basic objectives. The staff's comments would be appreciated. I have no problems with the other proposed channels, in particular FSAPs and FSAP review updates.

Before concluding I would like to comment on the apparent significant problems with using durations of assets and liabilities as measures of sensitivity to market risk. The staff is pointing to several shortcomings of this "crude" indicator, but nevertheless still tries to defend its inclusion in the core set. Such shortcoming include not only the lack of relevant data in a vast majority of countries, but also the usefulness of duration for measuring only small shocks and its inability to capture any indirect effects. In my view, such weaknesses would justify at least relegating duration to the encouraged set and putting more emphasis on stress tests which appear to be better suited to assessing the interest rate risks. The staff's position on using such tests as a substitute for duration does not appear entirely consistent and I would welcome staff's further comments on this issue. Pending such clarification I can only agree with staff's assertion that further analytic work on this issue is needed. In this regard, it is important to note that the third consultative paper of the new Basel accord specifies a measure of interest rate risk that takes the form of a stress test: according to paragraph 72, "supervisors should be particularly attentive to the sufficiency of capital of 'outlier banks' where economic value declines by more than 20 percent of the sum of Tier 1 and Tier 2 capital as a result of a standardized interest rate shock (200 basis points)." This kind of stress test should in our view be explicitly recognized as an alternative to duration in the list of FSIs. My authorities would be very reluctant trading a meaningful indicator (stress tests) for a less adequate one (duration FSIs).

Finally, I would like to ask an important question on the resource requirements. The staff indicated that the preparation of the Guide could be completed using available resources but not other activities like the creation of a database, development of new FSIs for non-bank institutions and provision of technical assistance. Would the staff be able to provide an estimate of the additional resources that would be needed to implement the whole FSI-related program?

Mr. Faircloth made the following statement:

At this late stage in the discussion, I only have a few additional remarks to add. First, we agree on the need to periodically review the set FSIs, and believe it is useful to expand the coverage of the SDDS to include data relevant to assessing the stability of countries' financial sectors. With this in mind, we support the proposed target dates for incorporating encouraged and core financial FSI soundness indicators in the SDDS. The planned compilation exercise and the ample lead time provided by the schedule should help provide a smooth transition. At the same time, it is imperative to avoid over-burdening countries with new data compilation requirements, which might dissuade members from participating in the SDDS initiative. In this respect, we agree with those Directors who favor selectivity and are willing to consider further Ms. Jacklin's and Mr. Epstein's proposal of introducing a streamlined set of core indicators in the SDDS.

Second, we commend staff on the tremendous amount of work that went into the preparation of the FSI *Compilation Guide*. We support its completion once feedback from members has been received, and endorse the proposed compilation exercise to strengthen cross-country consistency and improve public dissemination. To enhance the rigor of FSIs from the perspective of crisis prevention, best practices will need to be established, particularly on issues of valuation and provisioning, in line with evolving international standards.

Third, on revising the set of FSIs, we believe that the close link between changes in corporate leverage and bank asset quality underscores the importance of corporate FSIs and the potential need to move these indicators into the core set. While, in principle, we support the proposed revision to the core and encouraged sets as reflected in Table 6 of the staff report, we believe that further analytical work on clarifying macro-prudential linkages of corporate and insurance indicators, as well as additional experience with their integration in Fund surveillance is needed. Also, we agree with Mr. Callaghan and Ms. Jacklin, that we should remain mindful of the cost implications of any changes in the FSI set. While there is no question that more data would be desirable, there needs to be a fuller discussion of the tradeoffs or cost/benefits associated with new data requirements, as well as consideration given to how these data "measure up" within the context of national priorities. With this in mind, the issue of reconfiguring the set of FSIs is, in our view best taken up at a later date—perhaps in 2005 when the staff presents its work program on FSIs to the Board.

> Before moving on to other issues for discussion, I would like to join those Directors who questioned the proposal that insurance indicators be incorporated in the core set for some countries. The principle of applying standards uniformly across Fund members should, in our view, not be compromised.
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> Fourth, on the work program going forward, it will be important to clearly articulate the conceptual limitations of interpreting FSI data. For example, few would disagree that certain types of financial derivatives can pose difficulties when held or traded by institutions with inadequate risk management processes and internal controls. Conversely, derivatives, if used effectively for hedging purposes, could reduce risk exposure. Given this ambiguity, an indicator as broad as the proposed gross asset/liability position in financial derivatives to capital is likely to be a relatively blunt instrument for assessing the soundness of a country's financial sector. It may be the case that the most that can be gleaned from such an indicator is basic factual information about the magnitude of exposures.
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> The average bid-ask spread in the securities market indicator is also ambiguous. A lower bid-ask spread could easily be interpreted as being indicative of more efficient and liquid markets. It is less clear, however, whether there are critical values for the bid-ask spread that should be interpreted as cause for concern. Moreover, it may be necessary to take into account tradeoffs between efficiency and stability. One could envision a financial system in which spreads were relatively high on average, but stable. It is not clear that such a financial system would be less sound than one where spreads were on average narrower, but much more volatile under certain stress conditions. Indeed, in this case, a measure of spread volatility might be more useful. These examples point to the need for conceptual clarity and discussion concerning the interpretation of the indicators, or at least greater understanding of their limitations.
>
> Finally, I, like Mr. Portugal, was somewhat uncertain of the budgetary implications implied by paragraph 101 of the staff report, and I appreciate Mr. Enoch's clarification on this matter.

Mr. Reddy agreed in principle that corporate and insurance sector indicators should be included in FSIs, but recognized that there were challenges to member countries in providing data on the sector. Such difficulties should be carefully considered in determining the pace for including corporate and insurance sector indicators into the FSIs.

Mr. Reddy expressed his appreciation for the contributions that had been made by Mr. Sundararajan on FSI and on related work in strengthening bilateral and multilateral surveillance.

The Acting Chair (Mr. Aninat) remarked that it was important, from the point of view of Management, to set indicative dates, as it would allow the Board to convey a sense of movement toward a goal. Not having a goal to aim for might weaken the momentum of the initiative. It could also give the wrong signal to some member countries about the importance that the Board attached to the initiative. The Board would have a chance in 2005 to review the indicative date based on the results of the compilation exercise.

The Deputy Director of the Statistics Department (Mr. Enoch), in response to Mr. Sakr's question, said that the compilation exercise for FSIs should be easier in comparison to the compilation exercise on portfolio investment data. First, there would be a *Guide* to refer to, which would make the process clearer for participating countries. Second, during the previous compilation exercise, much time had been spent on establishing the process. The staff now had experience with regional seminars and workshops, and monitoring from Washington was well established. Third, the reporting units within countries for FSIs were well identified, which had not been the case for the exercise on portfolio investment data.

It was difficult to tell whether a subset of FSIs could be produced quickly, the Deputy Director continued. The occasional paper on financial soundness indicators that had been issued the previous year, which was Appendix 4 of the staff report, listed the number of countries that were already compiling selected FSIs, and those that were compiling the required components and adjustments. For instance, the Basle capital adequacy ratio was already being compiled by 78 percent of SDDS subscribers; data on distribution of loans by sector were being compiled by 72 percent of SDDS subscribers; 80 percent of SDDS subscribers compiled ratios of nonperforming loans to total assets; and so on. Hence, the majority of SDDS subscribers were already compiling a number of the core indicators, which could be the indicators that would be included in the shortened list.

The Deputy Director of the Monetary and Financial Systems Department (Mr. Sundararajan), noted that a guidance note on monitoring financial systems in Article IV surveillance had been issued in June 1998, before the FSAP review had been developed and the work on FSIs had begun. The staff intended to rewrite the guidance note in light of the experience gained in FSAP review missions. The revised note would be issued in September or October 2003.

The work on the operational database for FSIs was ongoing, the Deputy Director continued. The staff put together data collected from FSAP review missions, data from national websites, and data that were publicly available through various commercial channels, to perform a more enhanced day-to-day monitoring, in particular for the quarterly vulnerability assessment of emerging markets. The quality and comparability of the data still needed to be improved, and the database was currently only being used internally, including for mission work. The information was also made available in summary form for the *Global Financial Stability Report.* As the staff followed up on those indicators through Article IV consultations, metadata would be collected which could be made available for additional uses in due course.

The staff planned to draw on comments and suggestions during the current Board discussion to elaborate the financial stability analysis framework, develop additional guidance on stress-testing, and develop additional analysis on the role of international linkages and transmission through financial markets, the Deputy Director remarked. The activities would be done in the context of ongoing work in FSAPs and Article IV surveillance. A financial stability analysis conference would also be convened in the fall of 2004.

Mr. von Kleist said that his chair could support the staff's and Management's position if the FSI exercise were to be defined as a process where the Board would agree on a date when it would make a decision in the future.

Mr. Portugal stated that there were still a number of issues to be settled. First, the *Compilation Guide* still had to be completed, and the international comparability of the indicators still had to be improved. Second, the list of indicators to be included, including the indicators' periodicity, had yet to be decided on. The Board did not need to set a date to give a sense of progress, as work was in fact progressing, for example with the preparation of the *Guide*. Moreover, the Board was agreeing on a process with a timetable, which was that of the coordinated compilation exercise. The Board should await the completion of that exercise.

Mr. Martí said that the difficulties of the process should be sufficiently recognized. Many member countries were still struggling to set up sufficiently strong supervisory structures. Until those countries were able to establish a powerful supervisory authority, the quality of the primary data would continue to be poor. For the purpose of the whole initiative, it was the quality of data that mattered.

Mr. Reddy considered that the decision with regard to the date for including FSIs in the SDDS should be taken by the Board at a later date, perhaps during the time of the next review.

Mr. Epstein said that his chair was able to support Management's position; however, in order to preserve the continuity of the process, there should be an indication of when a decision would be taken. Any decision to include FSIs into the SDDS should apply at least to the subset of the core indicators that his chair had indicated.

Mr. Szczuka supported Mr. von Kleist's position. There was still plenty of analytical work to be done, and the composition of the core and encouraged sets had to be agreed on. Hence, it was premature to commit to a certain date for including FSIs in the SDDS. Moreover, as many Directors had pointed out, prospective subscribers in the SDDS could be discouraged by the additional requirement.

Mr. Litman said that it might be useful to concentrate initially on four or five indicators.

Mr. Andersen agreed with Mr. von Kleist that the FSI initiative should be viewed as a process. The Board's last discussion of FSIs in June 2001 was the first step in the process, and the Board should be able to make a further step. His chair could agree to a 2008 indicative target if there was consensus on it.

Mr. Rouai agreed with other speakers that what was important was to start the process, particularly the coordinated compilation exercise. That would allow the staff to demonstrate to countries that it was in their interest to participate in the work. Setting a date was also important, however. That approach had been taken in connection with the inclusion of external debt figures and reserves in the SDDS. The indicative date was helpful in encouraging the authorities to give priority to the work.

Mr. Miyoshi agreed with Mr. von Kleist that significant progress had been made, including the preparation of the draft *Compilation Guide*, and the planned coordinated compilation exercise in 2005. Hence, it was not clear why the setting of a target date was critical at the current juncture. While doing so was beneficial in some cases, the difficulties in compiling the data and in establishing a supervisory authority, as well as the insufficient analytical work on the indicators, made the setting of a target date not feasible and exerted undue pressure on member countries.

The Deputy Director of the Statistics Department (Mr. Enoch) said that, with regard to the number of countries that currently compiled indicators from the core set, it was only the duration of assets and duration of liabilities indicators that were compiled by less than half of the SDDS subscribers, based on a survey in 2000. Eleven of the indicators were already being compiled by at least 70 percent of the subscribers. Hence, if the Board aimed for a streamlined set of indicators, those indicators would be the ones that the majority of SDDS subscribers were already compiling. It was only for a minority of the members and for a subset of the indicators that substantial work still had to be done over the next years. The core indicators had been selected based on the responses of members—including almost all of the SDDS subscribers—as to which indicators were readily available and useful for them.

The Acting Chair (Mr. Aninat) made the following summing up:

> Executive Directors welcomed the Fund's on-going work on the development, compilation, and use of Financial Soundness Indicators (FSIs) and the broad support provided by member countries, international organizations, and other standard-setting bodies in this exercise. They considered FSIs a key tool for assessing financial sector soundness by national authorities, enhancing the overall effectiveness of Fund surveillance, increasing the transparency and stability of the international financial system, and strengthening market discipline. They commended the results achieved in three areas following the Executive Board's endorsement of a core and encouraged set of FSIs in June 2001: the draft *Compilation Guide* on FSIs (*Guide*), aimed at encouraging national authorities to compile and disseminate FSIs, has been completed; substantial progress has been made in analytic work to enhance the role of FSIs in macro-prudential analysis, and further

work is planned; and the use of FSIs in Fund surveillance has been further developed. Notwithstanding this progress, Directors noted that use of FSIs needs to complement strong financial sector supervision.

Directors considered that the draft *Guide* represents a milestone in establishing a standard reference on the concepts and definitions, data sources, and techniques with respect to the compilation and dissemination of FSIs, and on the nature and type of information on a country's financial infrastructure that is relevant for analysis of FSIs. They broadly endorsed the conceptual framework for the *Guide*. They supported the dissemination of metadata that describe the attributes of the underlying data and facilitate interpretation of FSIs.

Directors noted that FSIs inevitably differ from country to country due to differences in accounting and bank supervision rules and varying levels of financial sector development. The development of FSIs consistent with established statistical conventions and evolving accounting and supervisory guidelines will be essential to limit reporting burdens. Meaningful comparability of FSIs over time and across countries, while desirable, remains a challenge. Many Directors suggested that fostering greater comparability remains an important medium term objective. Directors felt that convergence toward internationally accepted accounting standards should result in greater data comparability. In addition, Directors stressed the need for supplementing quantitative indicators with qualitative assessments.

Directors generally endorsed the ambitious work program for finalizing the *Guide*, welcoming in particular the planned regional outreach seminars on FSIs. They encouraged continued proactive consultations and outreach with experts from other international organizations, standard-setting bodies, and IMF members. For this purpose, a one-month extension of the period for public comment before finalization of the *Guide* was proposed, and will be announced shortly.

Directors observed that the experience to date in using FSIs in FSAPs has confirmed the relevance of the core and encouraged sets of FSIs, despite data limitations and difficulties in their compilation in many countries. They suggested that the two sets of FSIs be kept under review, to ensure that they reflect the evolving priorities of Fund surveillance, the rapidly changing financial environment, and the relative capacity of countries to compile FSIs. Many Directors encouraged members to increase public dissemination of data collected on the FSIs. Some Directors suggested that the FSIs on duration of assets and liabilities be moved from the core to the encouraged set.

Directors noted that FSIs for the corporate sector could serve as useful indicators of banking sector asset quality, and that FSIs for the insurance sector would be desirable given the growing linkages between the insurance and banking sectors. Several Directors therefore supported the development of these FSIs in order to strengthen financial sector surveillance. However, many Directors urged caution in expanding the number of FSIs, in view of the cost of compiling FSIs and the risk of compromising their quality. Directors welcomed the analytical work that continues to inform the selection of FSIs—with the core FSIs consisting of those that are sufficiently informative to merit widespread compilation, and the list of encouraged indicators being as focused and streamlined as possible and consistent with the overarching objective of strengthening surveillance modalities.

Directors encouraged work on combining the use of FSIs and stress testing in macro-prudential surveillance. They noted that stress tests may be particularly valuable in assessing market risk, but noted that they should serve as a complement to, and not as a substitute for, FSIs. They emphasized the importance of drawing on standards assessments and other sources of information on supervision and the financial infrastructure to strengthen the capacity to interpret FSIs and assess financial stability. They looked forward to the proposed conference on financial stability analysis in the second half of 2004.

Directors considered the proposed Framework for Financial Stability Analysis as a useful tool for integrating macro-prudential surveillance, analysis of macro-financial linkages, and surveillance of macroeconomic conditions. They observed that macro-financial linkages may vary across countries, and endorsed further analytic work to clarify these linkages, including the role of financial market functioning and cross-border linkages, and identify the data needed to assess them.

While recognizing resource constraints, Directors encouraged countries to compile at least a core set of FSIs on a continuing basis and called for more vigorous outreach and communication efforts to persuade countries of their usefulness. They endorsed proposals for assessing countries' capacity to compile FSIs and helping to develop this capacity, including through the FSAP, Article IV consultations, and UFR missions, as well as a coordinated compilation exercise, and other workshops and technical assistance. They generally endorsed the preparation of a guidance note on financial sector monitoring, including the use of FSIs, and the continued development of an operational database on FSIs, as steps that would enhance Fund surveillance, help integrate FSIs into the broader framework of vulnerability assessments in the Fund, and facilitate the tailoring of indicators to country specific circumstances.

Directors considered the proposal that, to support country compilation efforts, the Fund should conduct, with the assistance of other international agencies, a coordinated compilation exercise for supervisors and statisticians after finalization of the *Guide*. Nearly all Directors supported the proposal.

The exercise would involve the participation of around 60 countries representing a balance in country representation selected on transparent criteria. A variety of possible priorities for participation was suggested, including: countries with relatively good databases and the capacity to compile FSIs; systemically-important countries; developing countries with significant vulnerabilities; and SDDS subscribers. Nevertheless, a few Directors expressed concern about the potential resource costs of the exercise.

Views differed on the merits of including FSIs in the SDDS. The progress that has been made in clarifying and documenting the conceptual and compilation issues relating to FSIs, the early experience gained from using FSIs in FSAPs, and the availability of data in many countries on at least some core group FSIs, were seen by a number of Directors as arguments supporting the inclusion of FSIs in the SDDS. However, because of the high reporting burden and the ongoing development of FSIs, some of these Directors recommended that initially only a selective subset of the core FSIs—those likely to be most informative about financial system soundness—be included. Some of the other Directors were of the view that inclusion of FSIs in the SDDS should be voluntary. They felt that the first priority should be to address the significant gaps that still remain across countries in the compilation and dissemination of FSIs.

Directors discussed the merits and feasibility of establishing an indicative timeline for the inclusion of FSIs in the SDDS, including the proposal to include the core, or a subset of the core, FSIs as encouraged indicators by end-2006, and the core, or a subset of the core, FSIs as prescribed indicators in the SDDS by end-2008; and an alternative proposal involving more accelerated inclusion of—possibly selected—core indicators as early as end-2005. Most Directors were concerned about fixing target dates prematurely.

Most Directors endorsed expanded reporting and analysis of FSIs in Article IV staff reports, the Global Financial Stability Report, and in the quarterly vulnerability assessment report. Most Directors also supported the dissemination of FSIs on national websites, and consideration of the establishment of a Fund internet gateway in the medium term to provide a single entry point for accessing FSIs for all countries.

Directors welcomed the effort to continue to absorb the cost of work on FSIs within the existing budget for the current year. Some Directors noted their expectations that the Board will not need to return to consider the question of additional resources in the near future. A few Directors reiterated that technical assistance for this purpose should not come at the expense of other existing technical assistance. Directors looked forward to reviewing progress on the FSI work program in about two years.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/03/50 (5/30/03) and EBM/03/51 (6/2/03).

3. SDR DEPARTMENT—DESIGNATION PLAN FOR JUNE–AUGUST 2003

The Executive Board approves the SDR designation plan for the quarterly period June–August 2003 as set out in EBS/03/60 (5/15/03).

Decision No. 13016-(03/51) S, adopted
May 30, 2003

4. FINANCIAL TRANSACTIONS PLAN FOR JUNE–AUGUST 2003

The Executive Board approves the list of members considered sufficiently strong and the financial transactions plan for the period June–August 2003 as set out in EBS/03/59 (5/15/03).

Decision No. 13017-(03/51), adopted
May 30, 2003

5. TRAVEL BY MANAGING DIRECTOR

Travel by Managing Director as set forth in EBAP/03/71 (5/30/03) is approved.

APPROVAL: September 8, 2003

SHAILENDRA J. ANJARIA
Secretary