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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 96/21

10:00 a.m., March 11, 1996

Contents

Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors	Alternate Executive Directors
	M. F. Melhem, Temporary
M.-A. Autheman	
L. E. Berrizbeitia	
	S. O'Connor, Temporary
B. S. Dlamini	
	J. Shields
	H. B. Disanayaka
	N. Coumbis
J. E. Ismael	L. M. Cheong
	D. Gotz-Kozierkiewicz
	H. Mori, Temporary
W. Kiekens	
	H. A. Barro Chambrier
K. Lissakers	
	T. Fukuyama
A. Mirakhor	M. Daïri
	A. G. Zoccali
	B. Esdar
	Y. Y. Mohammed
E. Srejber	
D. V. Tulin	A. V. Mozhin
E. L. Waterman	J.-H. Kang
	F. A. Schilthuis, Temporary
	Han M.

L. Van Houtven, Secretary and Counsellor
A. M. Rotenberg, Assistant

Also Present
IBRD: D. G. McNaughton, Financial Sector Development Department. African Department: C. Brachet, Deputy Director; J. A. Clément, A. Tahari, N. Toé. Fiscal Affairs Department: B. S. Weder. Legal Department: T. M. C. Asser, A. O. Liuksila, H. N. Schiffman. Middle Eastern Department: B. K. Short. Monetary and Exchange Affairs Department: M. Guitián, Director; V. Sundararajan, Deputy Director; R. K. Abrams, W. Coats, P. T. Downes, J. M. Jiménez, O. E. G. Johnson, A. Y. Kyei, C.-J. Lindgren, H. Mehran, E. A. Milne, C. Pazarbasioglu, M. Saal, P. C. Ugolini, M. R. Vaez-Zadeh, J.-W. van der Vossen. Policy Development and Review Department: V. Galbis. Research Department: N. U. Haque, P. Honohan. Secretary's Department: W. S. Tseng, Deputy Director; A. Mountford. Treasurer's Department: L. Aylward. Western Hemisphere Department: E. S. Kreis, R. J. Renhack. Office of the Managing Director: D. Burton. Advisors to Executive Directors: J. M. Abbott, M. Alemán, P. Cailleteau, J. Guzmán-Calafell, K. M. Heinonen, G. Iradian, J. John, R. Kannan, M. H. Mahdavian, M. Petrie, K. Sundara, A. V. Vernikov. Assistants to Executive Directors: L. Fontaine, A. Galicia-Escotto, R. Glennerster, A. Guennewich, D. S. Hakura, J. Hamilius, M. A. Hammoudi, O. A. Himani, Huang X., P. J. Jilek, T.-M. Kudiwu, N. L. Laframboise, J. Mafararikwa, I. Moon, Ng C. S., G. P. Ramdas, A. Ruocco, M. W. Ryan, K. Sakr, T. Sitorus, E. Zamalloa.

1. BANK SOUNDNESS AND MACROECONOMIC POLICY

The Executive Directors considered a staff paper on bank soundness and macroeconomic policy (SM/96/40, 2/12/96; Sup. 1, 2/23/96; and Sup. 2, 2/23/96).

Mr. Clark and Mr. O'Connor submitted the following statement:

Until very recently, the relevance of financial structure for economic growth and development, and the interactions between financial structure and macroeconomic stabilization policy, have not been closely examined. This is surprising considering that monetary exchange and supporting financial markets are at the very core of modern market-based economies. The valuable set of documents under discussion today, along with a number of excellent working papers produced over the past year or so, are substantial contributions to redressing this situation. With some editing to stitch the background papers and the policy paper together more smoothly and to clarify some vague sections, publication of this study would be clearly warranted.

One element of the study that may require some additional clarification is the concept of market efficiency underlying the discussion of banking regulation and market incentives. For example, the background paper on maintaining a sound banking system (SM/96/40, Sup. 2) asserts that efficiency may be usefully traded at times for stability through prudential and consumer protection regulations. But, no valid concept of market efficiency would endorse an unstable financial system since the resulting financial market (and hence general) equilibrium would be unsustainable. The same criticism holds for market outcomes where deposit investors relative to equity investors in banks would bear a disproportionate share of market risk. The point is that such regulations exist because, in their absence, the market outcome would not likely satisfy generally accepted efficiency criteria given the information problems and incomplete market problems identified elsewhere in the documents. With such regulations, the constrained market outcome would satisfy at least some efficiency criteria.

In the same vein, the staff notes quite validly that bank regulations may have more quasi-fiscal objectives than prudential objectives but then add that these quasi-fiscal regulations may have the intent of achieving some social objective. The implication seems to be that social goals automatically raise the prospect of greater market inefficiency. As suggested above, an outcome in unregulated banking markets would likely be inefficient and, for the same reasons, banking markets would not yield desirable social outcomes in the absence of regulation. Nevertheless, banks, as the key institutions in the financial system because of their roles in the payment system, financial asset allocation and monetary policy implementation, can have important positive participation externalities in financial markets. Consequently, regulations, such as liquidity requirements on bank portfolios, can encourage the development of secondary markets for short-term securities that are necessary for the introduction of indirect monetary controls. Since indirect monetary control is generally accepted as a more efficient mechanism than direct controls for policy implementation, these liquidity requirements can yield a net social benefit defined by the efficiency gain.

In the study, the staff has noted that macroeconomic variables and macroeconomic stability have an impact on the fragility of the banking system and has observed that a fragile banking system could constitute a constraint on the macroeconomic stabilization policy. Although this is certainly true, one must carefully distinguish between strategic objectives and operational constraints regarding macroeconomic policy formulation and implementation.

Macroeconomic stability is a necessary condition for the achievement and maintenance of a sound banking system. As the staff suggests rising inflation can, for example, encourage banks to expand credit and restrict liquidity, resulting in an overall reduction in credit quality and an increase in vulnerability to failure. Nevertheless, in addressing the inflation problem, the tactical selection of monetary policy operations can be constrained by the market structure and soundness of the banking system. While this would affect, in the short-term, the operational mix between direct and indirect monetary controls, it should not delay the strategic decision to take immediate action to lower the rate of inflation. If tighter monetary policies aimed at inflation reduction threaten the solvency of individual financial institutions, the authorities must ensure that effective exit policies are in place, rehabilitation strategies and last-resort loan facilities for remaining institutions are well formulated, and the costs of banking sector rehabilitation are adequately reflected in the fiscal position of the government. These initiatives, combined with other actions such as enhanced public reporting of conditions on financial institutions and markets, could help minimize the prospect of perverse systemic responses to necessary stabilization policy actions.

In terms of policy mix, there is an interesting proposition in the paper that the soundness of banks should affect the relative reliance on fiscal, monetary and exchange rate policies for stabilization purposes. Despite some degree of short-term substitutability with regard to macroeconomic stabilization (limited substantially by the different channels of adjustment), fiscal and monetary policies are, however, poor substitutes in the long run. The latter primarily influences nominal variables only while the former is particularly relevant to real variables, including both macroeconomic and structural variables. More intriguing is the issue of the mix between interest rate and exchange rate adjustment and its effect on bank soundness. An unanticipated increase in interest rates, which tightens monetary conditions, lowers the value of domestic financial assets and the corresponding value of credit collateral and that this can threaten the solvency of banks. However, an unexpected decrease in the domestic price of foreign currency, which also tightens monetary conditions, reduces the value of foreign currency assets and can similarly threaten the solvency of banks, particularly if they have a net uncovered foreign asset position. Consequently, the singular importance of the interest rate–exchange rate mix is not entirely evident and a more detailed discussion of this proposition in a revised version of the study would be useful.

The objectives of banking reform and financial liberalization—including the phase-out of controls on foreign currency transactions and investments—are to improve the allocative efficiency of the financial system and the effectiveness of monetary control through the use of indirect instruments. The soundness of the existing banking system would affect both the pace and sequence of specific reforms but should not delay the initiation of these reforms. In fact, the more fragile the banking system, the more imperative it is that the reform process begin immediately, given the evidence that a robust financial system is a necessary condition for sustainable and strong economic growth and development.

As the staff suggests, the first issue on the reform agenda must be the establishment of effective prudential regulations, strong and equitable supervision, and an adequate banking sector rehabilitation plan, which includes a "free-to-fail" exit strategy for individual institutions. This implies that the institutional and legal framework for contracting, collateral conversion, private property rights, and bankruptcy must be as much a part of the rehabilitation plan as is recapitalization for recoverable banks. Moreover, the rehabilitation program must have clear and transparent eligibility requirements for individual banks and must not be perceived by managers, owners and depositors as a "free bail-out". Consequently, rehabilitation must involve conditions for reform including the adoption of internal risk management systems, new capital and loan reserve policies, and new reporting requirements so that owners, managers and depositors become more clearly accountable for the soundness of banking firms. The regulators must enforce the rules, publish relevant data, and advise the banks so that they become more clearly accountable for the soundness of the banking system and the capacity of the market to effectively discipline market operations. An independent regulatory authority may be best suited to achieve these objectives.

Once these institutional foundations are firmly under construction, steps to develop trading markets in domestic money, foreign exchange and securities are feasible. These steps, some of which can be concurrent with institutional reform, may involve liberalization of entry requirements to encourage domestic and foreign competition and the liberalization of interest rate and exchange controls to encourage the development of primary and secondary markets for bank liquidity and for securities. Part of this market development would be related to the phasing-in of indirect methods of monetary control and the institutional arrangements necessary for such operations. Of course, the speed of this reform process varies from case-to-case and may be influenced by fiscal financing constraints, but it is clear that delays in beginning the process can ultimately complicate the adjustment and increase its costs.

Finally, considering the innovative and dynamic nature of financial institutions and markets, financial reform—including banking reform—should be viewed as an ongoing process in order to prevent financial regulation from becoming another source of inefficiency and potential failure for the banking system.

As to the role of the Fund, the soundness of the banking system is clearly a legitimate policy issue for the Fund. Furthermore, it is an important issue for all members of the Fund because of the potential systemic nature of serious problems, especially with global financial markets becoming increasingly integrated. Any policy proposals to improve the soundness of an individual member's banking and financial system are, therefore, relevant topics for discussion in regular consultations. The Fund surveillance and technical assistance missions already focus on many of these issues, but a more formal mandate could indicate that:

(1) the Fund's technical assistance with regard to banking sector fragility should continue to focus on banking supervision and the rehabilitation of the banking system and must be well integrated not only with surveillance activities by the Fund but also with technical assistance related to financial infrastructure and the development of securitized financial markets and to central banking operations and the development of indirect monetary controls;

(2) program negotiations should continue to consider banking sector reforms as part of the necessary structural reform package embedded in program conditionality and its fiscal costs in the determination of fiscal policy targets;

(3) advice on macroeconomic policy tactics should continue to reflect the current state of banking soundness as well as the projected state consistent with the negotiated schedule for financial reform in the Fund program; and

(4) the Fund, in collaboration with other international bodies such as the Band for International Settlements, should continue to encourage members to meet international standards for financial sector reporting, regulation and supervision, while recognizing that policy harmonization does not necessarily imply homogeneity of policies.

Mr. Shields made the following statement:

The fundamental role of banks in the payments system and macroeconomy means that they cannot be treated with the same detachment as other parts of the private sector. The staff papers set out in graphic detail the market imperfections which have justified regulation and supervision. In the absence of such intervention, a weak banking sector can prevent the effective transmission of monetary policy signals, undermine fiscal policy and threaten exchange rate policy. As a result, banking soundness is a legitimate objective of Fund surveillance and feature of Fund programs.

Although increasing emphasis has recently been put on financial sector surveillance and reform, the Fund has not always paid sufficient attention to this issue. The current problems in Latin America suggest that either there was a failure to detect problems at an early stage, or concerns of banking experts were not effectively transmitted to area department, or area departments did not take the warnings sufficiently seriously.

I shall focus my attention on how the Fund might best approach the issue of bank soundness in the future. On the substance of the issues affecting structure and regulation, I am generally in agreement with the excellent staff papers, which were clear, comprehensive and timely.

The first step is to ensure high quality surveillance of banking structures so that potential problems can be spotted before they develop into a crisis. The Fund is the only institution conducting regular surveillance over a wide membership. This provides it with a clear role to be exercised in Article IV consultations. The problem of course is to know for which countries and at which point efforts should be concentrated. This may well require more extensive training of area staff on bank surveillance. Where there are prior reasons for concern, the expertise of the Monetary and Exchange Affairs Department staff on missions will be necessary. Background papers for the Board should result.

While banking crises are caused by underlying problems in internal management of banks, weak accounting, political interference, lack of competition and poor supervision, the cracks appear when the system is subject to shocks. A stable economic environment clearly helps to avoid a crisis. This is already a primary function of the Fund.

Once problems have been identified, the Fund can encourage a bank reform package within a programme, provide technical assistance or promote recourse to other institutions such as the World Bank. Fund programs, especially Extended Fund Facilities (EFFs) and the Enhanced Structural Adjustment Facility (ESAFs) have increasingly incorporated significant elements of financial market reform. We support this development.

A harder question is how macroeconomic elements of programs and advice in Article IV consultations should be adapted to recognize the limitations placed on policy by unsound banks. On some issues this is already done. For example, the need to adapt the pace of introduction of market based monetary policy to the sophistication of the banking sector is well understood and frequently debated in this Board. The links between bank soundness and capital account liberalization are also regularly discussed—although there are differences about the balance between the need to avoid provoking a banking collapse by pushing ahead with liberalization and the need to encourage domestic banking reforms by introducing some competition. I have not, however, seen banking weakness specifically cited as a reason to moderate the pace of stabilization or acknowledged as a factor in the choice of exchange rate regime or type of stabilization. One reason may be that advice to moderate the pace of stabilization runs counter to the very strong culture of this institution. Of course there is a risk that governments may use "problems in the banking sector" as a frequent excuse for slowing stabilization inappropriately. However, at least in theory, there may be cases where slower, but more sustainable, stabilization is optimal.

On fiscal policy, I am concerned that the staff may sometimes be tempted to concede to delays in bank restructuring or avoid recommending the placing of contingent liabilities on to the budget because of the implications for the fiscal deficit. These are not answers. Addressing the problem may make the deficit look worse but it is really a recognition of underlying weakness.

The Fund should clearly encourage its members to adopt appropriate standards. But that does not mean that it should go further and work for international harmonization of banking regimes. Although I am conscious of the fact that much of the work done by the BIS recently has had little immediate relevance to the issues faced by developing countries, I do not think it would be appropriate for the Fund (or anyone else) to attempt to develop uniform standards for all non-BIS members—a kind of "super Basle". Where there may be useful work to be done is in developing guidelines which can then be adapted to different country situations. World Bank staff have, I believe, looked into this.

The Fund's role might be to give support to groups of countries addressing these issues in a regional context. There are elements of the BIS framework which could usefully adopted by regional groups—for example, agreements on cooperation and information-sharing between regulators. Countries may, for example, want to agree to nominate a lead regulator responsible for coordinating the worldwide supervision of internationally active banks.

The staff paper mentions the need for data standards to support bank soundness. I would be interested to know if there are specific areas where data should be improved which are not already covered in the Fund"s data initiative.

Banking soundness is clearly a current priority for the Fund. This means that we must be prepared to consider some aggregate use of resources rather than just a shift between surveillance and technical assistance. This may mean less time is devoted to other structural issues, such as labor markets. The staff also need to ensure that they maximize the benefit of their work by cooperating closely with the other institutions.

Up to now, division of tasks between the various institutions has been rather ad hoc. By all accounts this has worked reasonably well with each institution playing to its strengths in different countries. But with the Fund and the Bank re-evaluating their roles in promoting banking reform, it is important that these reviews go hand in hand.

The papers provided excellent summaries of the issues. Stripped of some of the sensitive material they contain, they would be good candidates for publication. My only concern is that their tone is rather one-sidedly interventionist. The problems of overregulation, such as the diminished incentive for internal and external private monitoring, could be put more forcibly.

Mrs. Gotz-Kozierkiewicz made the following statement:

According to common wisdom, the easiest way to judge the quality of an economy is to refer to its money, which, in turn, depends a lot on the standards of the banking sector. Its role in the linkage of monetary to real processes puts this sector in the center of developments, both in macro- and microeconomic terms.

Unfortunately, developing and transition economies, which strongly need efficient and sound banks to successfully implement the stabilization and structural transformation strategy, have been, as a rule, the countries relatively poorly envisaged in properly designed banking institutions. Fragility of the banking sector itself at the introductory stage of the changes, the scale of which needs the adaptive capacity, much higher than that required for a business cycle reversals, generates processes difficult to be tackled, nevertheless the fundamental ones for cumulative results in the medium to longer term. The fact that also well developed, industrialized countries have not been free from sometimes substantial bank illiquidities and bankruptcies bringing nonnegligible costs to their governments, does contribute to a recognition of particular complexity of the issue discussed in the staff papers.

This concerns first of all a relationship between the soundness of the banking sector and macroeconomic policy formulations. It has become clear that their relationship is essential for the design of stabilization programs and for their performance. On the other hand, one can hardly deny that the measures programmed and implemented in the framework of the stabilization programs contributed in many countries to a dramatic worsening of the situation in the banking sector. This has, in particular, been evident in a number of developing and transition economies. As a matter of fact, elaboration on an optimal trade-off between macroeconomic stabilization and microeconomic banking destabilization seems to be required, however doubtful in terms of its potential results.

Concomitant structural reforms fostering the soundness of the banking system should be included in the design of stabilization policies. The pace of stabilization does need to be adjusted to take into account the effectiveness of policies to restore banking soundness. However, the question of what it really means for the pace of stabilization should be raised. A lack of banking soundness means that monetary policy is much less efficient than would otherwise be the case and that a part of economic adjustment is absorbed at the level of financial intermediation, resulting in much higher costs for the real sector of the economy. A realistic approach to stabilization should therefore take into account a rate of economic growth lower than otherwise. This must have implications i.a. for the budget and for balance of payments projections. A more specific case may constitute the restructuring of the banking sector in countries with a currency board and the difficult dilemma of sources for financing the additional public sector borrowing requirement (PSBR).

In a nutshell, because reality offers little choice in terms of sequencing urgently needed stabilization measures and restoring the soundness of the baking sector (which is taking its time), I would understand the question, as posed, rather as a search for a realistic policy approach to feasible policy results than suggesting a delay in taking these stabilizing measures as necessary.

Financial sector liberalization, the adoption of market-based monetary instruments and capital account liberalization constitute a completely different problem. These are structural policies which do not have the urgency stabilization policies normally have. In these cases, policy design can take into account the effects these reforms will have on the banking sector. The pace of liberalization must be adjusted and be sequenced in such a manner that it can restore and maintain a sound banking system (see SM/96/40, Sup. 2). It would be expected that regulatory and supervisory measures would be taken before liberalization occurs. Proper sequencing of prudential and stabilization policies greatly increases the chances that liberalization will be successful. Failure, however, cannot be excluded. Bank soundness here should be a long-term objective complement of structural policy design.

The policy framework for monitoring bank soundness is reasonable. Both market discipline and official surveillance are needed for maintaining bank soundness. Market discipline is based on transparent data, official surveillance on many pillars. One of them is the adoption of regulations regarding capital standards in order to reinforce internal governance. Many non G-10 countries have adopted the Basle capital standard. However, it is well known that higher levels must be adopted in uncertain or volatile conditions (SM/96/40, Sup. 2, page 25). Therefore, in case of the Fund's eventual involvement in policy advice in this respect, it would be necessary to have a view on the appropriate capital standards to be used by non G-10 countries. This constitutes perhaps an area for further systematic work. Strong implementation of exit policies for insolvent institutions should be encouraged so as to minimize the costs. A well-founded Fund advice on deposit insurance stresses the necessity of an incentive-compatible system and rightly does not advocate the introduction of a deposit insurance scheme in cases where banks are in crisis or where supervision is inadequate.

The system of official regulation and supervision should keep pace with market developments. However, constantly changing the regulatory and supervisory environment may not be desirable, since every change in regulatory and supervisory practice affects the transmission of monetary policy and has, therefore, macroeconomic implications. Thus, in the case of less developed countries, the main objective is to establish a minimum standard of regulation and supervision. Their adjustment should be rather limited only to fundamental changes in the markets.

On the role of the Fund, the health of the banking sector should clearly be taken into account as a constraint when designing a stabilization program. However, restoring banking soundness, while being a legitimate objective of a country's authorities, would be ill-suited as a target for the Fund-supported programs. Of course, it does not mean that the subject of maintaining banking soundness should not be covered in surveillance discussions with the Fund playing the role mainly of policy advisor and, where national supervisory capacities are lacking, providing technical assistance to strengthen it.

The Fund's technical assistance has come to play a critical role in recent years in supporting member countries' efforts to reform their central banking and financial markets. Demand for technical assistance for basic institution and capacity building may, however, be expected to diminish in the future. Therefore, while agreeing with the proposal to shift resources from technical assistance toward surveillance activities for banking and financial sector issues, caution should be taken not to implement it too hastily. Such a reallocation should not threaten the essential contribution technical assistance is currently providing to structural reform efforts and has still to provide in the near future.

As for considerations about government contingency costs linked to banking sector problems and their transparent inclusion in the formulation of macroeconomic policies, they should be covered in the regular discussions between members and the Fund. However, the quantification of these costs is difficult and further work on the appropriate treatment of this uncertainty in a financial program will be required. The Fund should rely as much as possible in the evaluation of these costs on national supervisory authorities and the Would Bank, for instance. The Fund should avoid entering into more microeconomic considerations, such as assessing the costs of different bank restructuring strategies.

As to the role of the Fund in banking supervision in regions outside the G-10, international cooperation in banking supervision has been a long-standing responsibility of the Basle Committee, a body working under the auspices of the BIS and reporting to the central bank governors of the G-10 countries. The Basle Committee has acquired a lot of experience in banking supervision. In addition, it has established cooperative mechanisms with other international supervisory organizations, such as several regional groups of bank supervisors (Offshore Group of Bank Supervisors, Caribbean Banking Supervisors Group, Central Asia and Transcaucasia Group of Banking Supervisors, Group of Banking Supervisors for Central and Eastern European Countries) as well as with the International Organization of Securities Commissioners (IOSCO). The biannual International Conference of Bank Supervisors has for two decades been a forum for the development of cross-border supervision and for the coordination of supervisory policies among these organizations and the countries represented.

The task of international cooperation in banking supervision should not be duplicated by the Fund. First, the Basle Committee and the BIS are closer to financial markets. Second, they are less subject to conflicts of interest between supervisory tasks and general economic considerations. And third, they have established international information and coordination channels for banking crises. The functioning of those channels would rather be impaired by the existence of parallel mechanisms.

Ms. Srejber and Mrs. Heinonen submitted the following statement:

The staff has prepared an interesting set of papers, which form a useful review of a topic which we agree deserves our full attention at a time when the integration of capital markets, as well as the transformation process of transition economies into market economies, increases the importance of paying due regard to the soundness of financial sectors.

I will structure my remarks along the issues presented for discussion, but begin with a general comment on what this chair felt was a main conclusion to be drawn from the report.

It is important to preserve a clear division of labor in this area between the Fund and other relevant institutions, such as the World Bank and the Bank for International Settlements. The analysis in the paper spells out very clearly the Fund"s responsibilities and field of expertise on these issues, i.e., the focus of

Fund surveillance is, and has to remain, macroeconomic stabilization. Hence, the Fund should not assume a larger role than necessary in, for instance , harmonization of financial sector legislation. In cases where financial sector reforms are essential parts of stabilization programs, Fund advice—in cooperation with other institutions—is appropriate. In such cases performance criteria might be required to provide for the undertaking of financial sector reforms. But Fund involvement must never escalate to a point where Fund financing is designed to cover the costs of financial sector restructuring. Technical assistance will, of course, continue to play an important role and should be provided on a timely and sufficient basis.

Should banking soundness be added to the legitimate policy objectives the Fund is concerned with? Yes, the Fund should put increased emphasis on the relationship between banking system soundness and macroeconomic policies in surveillance, program design and in technical assistance. This is especially important for economies either undergoing important structural changes or otherwise subject to particularly large macroeconomic shocks, as banking soundness in those cases easily becomes a policy constraint. Focus should be on identifying and trying to correct problems at an early stage.

The banking industry in three of the Nordic countries in my constituency ran into severe difficulties which led to severe distress in the late 1980s and early 1990s. While the main factors behind the crises were more or less the same in the three countries, they differed in how they reacted. The Baltic countries have not been spared either, as they more recently have experienced serious banking problems. It is therefore easy for us to recognize the linkages between macroeconomic policies and the state of the banking system, as well as the two-way nature of that relationship.

Specifically, design of strong stabilization policies may require structural financial sector reform. Once the timetable for stabilization policies has been set, however, it should be observed, unless unforeseen developments in the financial system make adherence to the schedule counterproductive.

There are also cases where it can be envisaged that timely structural reforms in the financial sector are a precondition for the implementation of appropriate stabilization policies. Improper sequencing of measures and inadequate supervision during the adjustment to structural economic shocks can lead to systemic problems in the financial sector. There is little evidence that banking supervision can be strengthened fast enough to avoid banking problems once they become apparent. Intervening too late might, however, even aggravate problems.

The Fund needs to take into account all linkages and the reciprocal nature of financial system problems in its activities, as well as pay due regard to the cooperation between responsible authorities in the member country.

We find the proposed policy framework for maintaining soundness, as presented by the staff, acceptable, provided that the framework in each individual case is always carefully designed to minimize moral hazard. It is also important to keep the supervision process resistant to political interference. Thus, an unambiguous mandate for supervisory and restructuring authorities, central bank provision of finance only for liquidity support, and transparency, in particular of the bank reporting of credit losses, are all essential elements.

Supervisory regulation aims at ensuring legality and preventing insolvency. As financial systems tend to change relatively fast, there is now an absolute need for supervision systems to update the rules and adapt the resources in response to market developments in a timely manner. This is primarily an issue for more developed markets, where the framework of rules and regulations was adopted a relatively long time ago, but, also, for less mature markets, is it essential to adapt rules and supervision resources as the financial system develops. In countries where the financial system is developing and/or restructured, for example in the countries in transition, priority should be given to ensuring high solvency for viable banks, in addition to simple and transparent exit criteria for other banks.

As regards financial sector liberalization and the proper operational sequencing of policies, I think many useful lessons can be drawn from transition economy experiences, where financial sector reform has been a key component of each step of the transition process and has had both macro- and microeconomic dimensions.

Free capital movements improve the allocation of resources and impose some discipline in the conduct of economic policy. The first step for transition economies would be to complete the liberalization of their current payments (and to liberalize their medium- and long-term capital movements. Short-term capital movements could be freed in a second step.) A bolder movement towards capital liberalization can even reinforce macroeconomic policies and accelerate the development of the domestic financial markets.

The process has started with liberalization and the establishment of a two-tier banking system, providing a monetary policy framework for the stabilization efforts. All countries have by now laid a basis for the implementation of a stability-oriented monetary policy, and are progressively relying on indirect, market-based instruments in the exercise of their policies. The results in reducing inflation have been substantial, especially considering that the central banks have had no track record in conducting independent stabilization policies, and have had to build up their anti-inflationary credibility from scratch.

Banking reform and the development of capital markets, however, have been longer term processes. Therefore, the implementation of monetary policy continues to face a number of difficulties, stemming from persistent structural weakness in the financial system. Capital markets remain at a early stage of development; they lack liquidity and deepness and are still suffering from a number of regulatory deficiencies. Underdeveloped financial systems can thwart the conduct of monetary policy in various ways.

Moreover, while transition economies, on the whole, have initiated some form of cleaning up of bank's portfolios, these programs have not managed to fully create sound conditions in the banking sector. Bad loans are an obstacle for increasing competition and speeding up banks' privatization, which are both progressing very slowly everywhere. But the main threat is a risk of banking crisis. This risk, with chain effects between bad loans, banks' bankruptcies and collapse of depositors' confidence, must still be considered as significant, as recent events in the Baltic States bear witness to. Transition economies therefore continue to be confronted with a delicate problem: they have all made progress in imposing prudential rules necessary to build confidence in the banking sector, but they need to proceed gradually along these lines to avoid that the large state-owned banks be declared insolvent.

We agree that government contingency liabilities should be determined without delay and included in program design to the extent possible. Bank restructuring programs must be based on a realistic assessment of any public means that may be available.

Should part of Fund resources be shifted from technical assistance toward surveillance activities in the banking and financial sector field? While we agree on the need to focus more on financial soundness issues henceforth, my chair is, nevertheless, on balance reluctant to see a major shift in priorities. We would stress the positive effects that may arise from improved coordination of technical assistance with the BIS, the World Bank and other relevant institutions, for instance, the EU. The Fund's macroeconomic and structural advice can in itself enhance stability of the financial sector.

To the extent that enlarged surveillance of financial systems in the period ahead would require, not just refocussing of existing resources, but maybe additional staff, this issue should be brought to the budgetary discussions, and given proper priority after comparison with other activities.

Finally, on the Fund's involvement in international cooperation outside of the G-10 framework, I wish to make the following point:

International cooperation and harmonization in banking supervision - including regions outside the G-10 framework—is already supported by the Basle Committee for Banking Supervision. Therefore, the Fund should, in the first place, encourage its members to participate in such existing cooperation. The Fund's special competence lies in comparative macroeconomic analysis. It is with that in mind that the Fund's contribution must be seen; as providing useful input and background for cooperation and harmonization efforts by other appropriate supervisory organizations.

Mr. Autheman made the following statement:

I welcome this report, which in my view concludes a positive evolution in our doctrine. To a certain extent, I see it as a complement to two previous transversal reports from the Monetary and Exchange Affairs Department on indirect monetary controls and capital account convertibility.

When we discussed, less than two years ago, the review of conditionality, I was among those who emphasized that financial sector reform was at the core of the Fund's mandate and who expressed the concern that by pressing for faster liberalization we might have overlooked the need to pay proper attention to the strengthening of the banking sector's soundness. My sense is that the evolution of our doctrine shows that we are now in the process of finding the right balance between the need to enhance efficiency through financial liberalization, both domestically and internationally, and the necessity to take the appropriate measures to avoid major collateral damage. I remain of the view that we need to be vigilant in order to ensure that liberalization goes along with both increased competition and improved supervision.

Turning now to some more specific issues, I would like to make a few comments on the question of the design of our programs. I agree with the paper that it is extremely useful, and in some cases absolutely necessary, to take into consideration situations of bank unsoundness in the assessment of the financial need and in the financial programming. Indeed, it seems to me that this is maybe done more often in ESAF-eligible countries than in other Fund programs. One of the reasons may be that in ESAF we can benefit from the existence of policy framework papers, which help us assess the medium-term issues better than we sometimes do in other cases.

Fund programs are increasingly using structural benchmarks. Some of them are, indeed, very difficult to monitor, and some of them are sometimes closer to wishful thinking than to conditionality, but I think that, at least in two areas, we need to continue to use structural benchmarks: first, tax reform, which is an essential component both of an effective liberalization of the external trade and of an improvement of revenue performance of countries, and, second, financial sector reform, which indeed has to go along with decisions which are often critical to conditionality, such as interest rate liberalization.

I think that what is important for the Fund is to have a clear understanding of what needs to be done, but I would tend to believe that we should rely mainly on the World Bank or, in other cases, regional development banks to develop this strategy and to design specific adjustment lending operations along with Fund programs. I notice that this is very frequently done for ESAF-eligible countries, and with reason, because the failure to address the difficulties of the banking sector is one of the main reasons for the slippages we often encounter. This has been less systematically done for countries drawing on the general resources account.

I wonder whether in some cases we should work on joint understandings between Fund staff and World Bank staff which, for countries drawing on Fund resources, could, at least in the banking sector, have a similar impact as the one which we achieve through policy framework papers.

Another issue is the one relating to surveillance. I welcome the readiness shown by the Monetary and Exchange Affairs Department to play a more active role in surveillance. I think we must be aware of the limits of our capacities and of our responsibilities. Our surveillance must continue to focus on the hard core of our responsibilities, which are made up of monetary and fiscal policy and exchange rate and balance of payment issues, which imply that we must be ready, when we expect that issues related to either tax reform or financial sector soundness are important for a country, to address them in our surveillance process, but I do not think that we should systematically try to enlarge the coverage of our surveillance.

Another difficult issue is the role which the Fund should play in the dissemination of prudential good practices. There is now one international standard. Interestingly, a recent working paper from the staff shows that this Basle standard is not very relevant for developing and emerging countries; and we should be cautious not to recommend to these countries that they follow this standard, because, far from strengthening bank soundness, it would in many countries imply weakening. Therefore, at this stage it seems to me that it may be premature for the Fund to put too much emphasis on the need for countries to adhere to international standards. I think that the right emphasis is still on the strengthening of the domestic capacity to supervise the banking industry. Maybe we should be ready to provide support to any regional initiative which could arise; for instance, in the Asia-Pacific Economic Cooperation framework or if requests come from Inter-American Development Bank, which has also shown great interest in the issue of macroeconomic dimensions of banking crises. The Fund should not promote prudential regionalism; however, it should be ready to provide support to initiatives. Nothing can replace the efforts of domestic supervisory authorities. There is no doubt that we must be able to integrate situations of financial vulnerability in our work, but I would see a danger of confusion if we were to develop a database of microeconomic information. It is unrealistic to expect that work which is not done properly by national authorities could be done by ourselves.

I have two final comments. I reiterate my suggestion that we need to improve in some areas our joint understanding with the World Bank. I am no longer calling for policy framework papers in countries entering extended financial arrangements with the Fund, and I do not think that we need to negotiate a general agreement. But, since the World Bank is very active in this area, I think that on a case-by-case basis it could be useful to agree on joint approach.

Finally, I have some views on the issue of whether we should reduce technical assistance and increase surveillance, but I would prefer to present them when we discuss the report on the evaluation of technical assistance.

Ms. Lissakers made the following statement:

As regards the Fund's role, these are timely papers touching on important issues that are central to the Fund's surveillance and lending activities. Paul Volcker once asked Gerald Corrigan, who was then at the Federal Reserve Bank of Minneapolis, to write a short paper on why banks matter. Corrigan wrote that banks are the fulcrum upon which the rest of the economy turns. It follows from this premise that the banking system warrants special attention. Clearly, the Fund has an important role to play in monitoring the banking sector and in encouraging policies and conditions conducive to a sound banking system. At the same time, the specifics of the Fund's role need to be approached with an eye to what other bilateral and multilateral institutions are doing in order to ensure the comparative advantages of different parties are well utilized and coordinated. Thus, it would be premature for the Board to reach definitive conclusions on the Fund's role in certain areas such as bank supervision and the institutional infrastructure of the financial sector.

That being said, it does appear sensible for the Fund to pay more attention to banking system issues in surveillance activities and program design—bearing in mind the aforementioned caveats. Toward this end, the Monetary and Exchange Affairs Department might appropriately refocus staff resources from technical assistance to support for surveillance and program activities. Again, though, we do not want to prejudge at this stage the outcome of future discussions on how the Fund might most effectively respond to banking system issues, particularly in the emerging markets. Clearly, the Fund has and will maintain a key role; the specifics will require a bit more work in some areas. An issue that highlights both the scope and possible limitations of the Fund"s role involves the establishment of standards for the publication of financial sector data and the promotion of timely disclosure.

A common, unifying thread that binds much of what is discussed in the paper is the need for adequate financial data and timely disclosure. In highly-regulated banking markets, there was a bargain, if you will, between the regulators and the banks in which intense regulation and supervision by the authorities was accompanied by secrecy and the protection of the sector. As more indirect forms of banking regulation have emerged along with greater reliance on market discipline, however, so has the need for comprehensive and timely disclosure of banks' financial condition. The Fund can certainly play a role in promoting sound, internationally accepted accounting standards and liberal disclosure rules, though it is probably not best placed to develop and promulgate these rules in member countries. It can identify problems and work to facilitate their correction, but more thought will need to be given to how these standards are put in place. The Fund should be part of the process; the challenge is optimizing the division of labor among the different institutions and committees particularly active in the field.

Related to transparency and more clearly in the Fund's bailiwick is the need to better identify and account for governments' and monetary authorities' realized and/or contingent liabilities vis-à-vis the banking system. Failure to do so risks perpetuating unsound banking practices as well as producing unexpected fiscal shocks. In the context of Fund programs, failure to account for a program country"s accumulation of contingent liabilities creates a potential loophole in the fiscal performance criteria. A government may reduce budgeted spending items in order to fulfill a deficit target, for example, but still seek to achieve spending objectives through loan guarantees or on-lending activities that are not accounted for in the budget. Quasi-fiscal deficits may emerge at the central bank for similar reasons.

Such practices have implications for demand management, resource allocation, banking sector soundness, central bank profitability and management, and long-term fiscal health. I recognize that programs do sometimes include specific criteria that address these issues by limiting loan guarantees, net lending, etc. But the application of conditionality is somewhat uneven (as is the recognition of these issues in Article IV consultations). This is due in part, I imagine, to inadequate information in some cases and associated uncertainties over the magnitude of potential problems. Such factors, of course, highlight the need for improved transparency and accounting treatments. Such practices would help prevent banking crises from developing in the first place. We need to establish a more comprehensive and consistent Fund approach to these issues, however, in the context of surveillance as well as program design.

In regard to capital flows, foreign exchange exposure, and dollarization, recent developments in Mexico and elsewhere have highlighted the importance of prudential regulations addressing banks' net foreign exposure. For the market or supervisory authorities to ensure sound practices, however, adequate accounting and disclosure standards need to be in place. Moreover, these standards must permeate the economy. While prudential requirements may limit banks' net foreign exchange positions, for example, unless the borrower has a similarly matched position (or at least access to foreign exchange through operating earnings), the exchange rate risk is transferred but not really eliminated for the bank. I recognize that prudential regulations can be tailored to address this issue, but such regulations are only as good as the accuracy and timeliness of financial disclosures by creditors and borrowers.

Similar issues arise in cases of dollarization, though dollarization presents some unique challenges for monetary and supervisory authorities. As alluded to above, commercial banks whose balance sheets are heavily weighted toward dollar liabilities and assets may present well-matched positions but still be subject to substantial country risk. In these circumstances, the central bank's lender-of-last-resort role would seem to require a foreign reserve position that is adequate to meet prospective demands. I wonder if the staff could comment on this issue, specifically the sorts of benchmarks/rules-of-thumb that might guide policy advice.

In addition, while it is true that shocks resulting in capital flight will adversely affect banks in both non-dollarized and dollarized economies, the scope of the potential threat to a dollarized economy's banking system would appear to be more pronounced. Whereas a nondollarized economy's banking system may confront liquidity problems in such circumstances, the dollarized economy's banks confront potential solvency problems as well given the risks to loan portfolios. In other words, both sides of the bank's balance sheet are at risk in the event of a shock in a dollarized economy. I would be interested in the staff's views on this topic, including what sort of policy framework might best address these risks.

As to bank regulation/supervision and surveillance, we need to be aware of the conflicts of interest that confront local regulatory authorities at times and which can compromise sound supervision. Governments eager to ensure that balance of payments needs are financed or that a given exchange rate regime is sustained, for example, may not show a strong inclination to limit the risks of their banks' international exposure. On the contrary, governments may be a primary force pushing the banks to increase such risks. We need to be conscious of such dynamics in our surveillance efforts and be prepared to weigh-in heavily against imprudent policies and practices.

Again, information is essential. This may be an area where cooperation with the supervisory authorities on the credit-side of the transaction would be necessary and useful. Perhaps the staff can comment on the extent to which we might "back check" any concerns we might have about foreign exposure in a country with the creditor countries' regulatory authorities and whether he feels there is systemic cooperation in this area.

Finally, I think we should be aware, as we try to refine our focus in the banking area to encourage countries to strengthen banking supervision, that the banking industry itself is probably in decline, in terms of its relative importance in financial intermediation. To the extent that the United States is a precursor of what is likely to happen in other economies, the banking system's total share of financial intermediation could be expected to decline. In the United States the share was on the order of 50 percent in the immediate postwar period and today stands at about 25 percent. The assets of GE Capital alone, for example, are equivalent to those of the top money center banks, but it is not a bank and is not subject to any of the regulatory issues that we are discussing today. I think that we need to bear that in mind, and that the Fund's adaptability will no doubt be challenged in the future as other non-banks take on a greater role in other economies as well.

Mr. Berrizbeitia made the following statement:

The importance of the issues addressed in the staff paper is highlighted by its very first sentence, which states that at least two-thirds of Fund member countries have experienced significant banking sector problems since 1980. This first sentence also emphasizes the attention which these issues deserve, in the context of the Fund's relations with its members, and I welcome today's discussion because of this importance.

The staff deserves to be commended for presenting a highly readable and succinct overview of the multi-faceted issues related to bank soundness and macroeconomic policies. This review is at the same time broad and dense, and is complemented by the appendices in the two supplements to the main document. I join Mr. Clark and Mr. O'Connor and others in recommending that these documents be published after appropriate editing.

I fully share the proposal that bank soundness is a legitimate objective of policies, as well as an important policy constraint in surveillance, program design, and technical assistance. Although the Fund has been involved in providing technical assistance in banking regulation and supervision over the past 30 years, the emphasis on banking sector issues in surveillance and program design is a more recent development. This simple fact probably goes a long way toward explaining why such a high proportion of members have had significant banking problems in the last 15 years or so. This is also why I feel that, beyond the complexity and multiplicity of the technical issues raised by the document, this Board discussion should have as a primary objective defining and focusing the Fund's activities in the banking area.

I would first like to address the suggestion, in the issues for discussion, that resources be shifted from technical assistance to surveillance activities in the banking area. I believe this should not be framed as an either/or issue, as it involves complementary efforts. In certain member countries, it is likely that technical assistance in banking supervision will continue to be required for a certain period of time. In others, it is likely that surveillance will be the more appropriate course of action for the Fund to follow. In some cases, technical assistance could evolve into a surveillance activity. In others, it could be the other way around. Thus, while I fully agree with the need to put more emphasis on surveillance of the banking system in the course of the Fund's regular surveillance activities, such emphasis should not come at the expense of technical assistance activities, which are also crucially needed. If this implies, as is likely to be the case, that it will be necessary to assign additional resources to banking-related activities by the Fund, so be it. Although the Board has correctly emphasized the need for efficiency and cost reduction, there is a practical limit to the feasibility of carrying out new responsibilities on the part of the Fund and its staff without increasing the resource base concomitantly. I feel we are now reaching that limit, as was commented by the Managing Director during our recent retreat.

I believe the document that we are discussing, and the recent experience of many member countries with banking sector problems, highlight the need for the Fund to intensify surveillance of banking soundness in the course of its regular surveillance activities, and that adequate resources will need to be devoted to this purpose. As in other situations in which an ounce of prevention is worth a pound of cure, the intensification of preventive surveillance in the banking sector, as well as the continued provision of technical assistance where appropriate, could help avoid substantial use of Fund resources in future program financing.

As to how banking-related surveillance should be strengthened, the document identifies several areas which would result in substantial benefits. These include focusing policy discussions with the authorities on the adequacy of the banking regulatory framework, on the need for strict exit policies for insolvent banks, and on adherence to appropriate banking standards. Further work needs to be carried out in developing a set of indicators and an operational framework for the staff to evaluate the condition of the banking sector and its policy implications, and for improving the quality and disclosure of financial sector-related data to encourage market discipline, as was just emphasized by Ms. Lissakers. I feel strongly that these proposals to improve surveillance of the banking sector deserve the support of the Board.

As regards cooperation and coordination with other international bodies, I agree with other Directors that the Fund and other organizations should each concentrate on their particular field of expertise. However, the Fund does have an especially broad view of banking sector issues across a wide spectrum of its membership, and it provides the Fund with a particularly useful focus on banking sector policies. This particular expertise should be employed judiciously and intelligently in contributing to the development of internationally accepted prudential policies, in collaboration and coordination with other organizations.

As suggested by Mrs. Gotz-Kozierkiewicz, one area that probably deserves further work is the establishment of appropriate capitalization standards for financial institutions in non-G-10 countries. In this regard, for example, the Basle Committee may not necessarily be the best qualified organization to achieve this purpose, whereas regional cooperative councils could provide more appropriate fora with Fund support and advice.

Perhaps the most crucial and difficult of the technical issues raised by the staff is the adjustment of the pace of stabilization in order to secure bank soundness. From recent experience in program countries, it is clear that the choice of the policy mix needs to be carefully taken into account in designing stabilization programs. While the relative importance of banking issues is not as great as the necessary mix of fiscal, monetary, and exchange rate policies, these could be self-defeating if the weakness of the banking sector is not adequately taken into account. I therefore agree with the need to emphasize the realistic assessment of the situation of the banking sector and to recommend an orderly restructuring program, where needed, as an integral element in designing macroeconomic stabilization programs. Such an assessment could and should lead to an adjustment of the objectives and the phasing of a macroeconomic program in order to facilitate the strengthening of the banking system and ensure the flexibility required for policy making. Although banking sector weakness cannot be an excuse for postponing adjustment and stabilization, it needs to be taken carefully into account to ensure the sustainability of the adjustment process. There is, of course, a very delicate and difficult balance that will need to be achieved on a case-by-case basis to determine the proper phasing and the policy mix.

Recent experiences with program countries in which Fund-supported programs have been combined with financial support for restructuring the banking system from the World Bank and other regional development banks are indicative of the type of approach that needs to be applied in the case of weak banking systems, on a case-by-case basis, as suggested by Mr. Autheman. In addition to underpinning the banking sector itself, such support from other multilaterals can help strengthen the fiscal policy stance and thereby allow greater flexibility, at least in the short run, for the application of monetary policy, which often becomes a constraint in cases of weak banking systems.

Similarly, a precondition for financial sector liberalization is the prior strengthening of the banking sector, particularly of prudential policies and regulatory supervision, and all the more so in the context of global and integrated capital markets. Thus, the sequencing issue becomes particularly important in cases in which financial sector liberalization constitutes an important structural element of a Fund-supported program. Again, as in the case of a stabilization program, an appropriate bank restructuring process may be necessary as part of any liberalization package in order to minimize the risk of significant banking problems.

I would like to conclude by reiterating the importance of this topic in the context of the evolving role of the Fund and the need for continuous adaptation to changing circumstances. Banking issues were perhaps previously taken somewhat for granted in the design of Fund-supported programs, but the realities of globalized capital markets have highlighted the critical issues related to this sector, which can become the Achilles' heel of any stabilization program.

I consider, therefore, that high priority should be assigned to these issues in all three principal areas of the Fund's activities—surveillance, program design, and technical assistance—and that appropriate additional resources should be devoted for this purpose in our budgets.

Finally, I look forward to the papers that have been announced on policy responses to banking crises and resolution and restructuring strategies, including in particular the design of appropriate exit strategies and related moral hazard issues, the contents of which can certainly be enriched by including in them the relatively recent developments in several member countries, including Venezuela.

Mr. Tulin made the following statement:

Let me, first, congratulate the staff for the excellent paper, which is now under discussion by the Board. It appears to be so informative, elaborative and instructive that I would regard it as part of the Fund's technical assistance to member countries, and I will definitely hand it over to my authorities as useful guidance on the issues of bank crises avoidance and crises management. I shall try to resist temptation and shall not speak on the substantive problems of banking supervision, exit procedures and so forth, since due to my previous professional involvement in this area I would risk burdening my colleagues with some personal anecdotal experience. The staff is obviously interested in the Board's judgment on their elaborations in the area under discussion and, probably, in the Board's blessing of their future endeavors. Therefore, I would rather be pragmatic and present my brief comments on the issues proposed for discussion.

I am deeply satisfied to note that the Fund is paying more and more attention to structural adjustment policies as a necessary addendum to, if not part of, a classical stabilization policy mix. It has been recognized that success or shortfalls in general governance, the ability or inability of authorities to establish or to adjust appropriate institutional settings may become critical factors affecting the efficacy of stabilization policies aimed at the elimination of major macroeconomic imbalances. For evident reasons, I fully endorse the staff's conclusions that the Fund should treat banking soundness as a legitimate objective of policies, as well as an important policy constraint in surveillance decisions, program design and technical assistance. Likewise, I have no doubts about the legitimacy of the other assumption by the staff that the design of stabilization policies should be complemented by concomitant structural reforms to foster soundness of the banking system. The staff's analysis of the implications of bank soundness or unsoundness for macroeconomic policy was thorough and precise, and I have nothing to add on this issue.

I have some difficulties in interpreting the proposed statement that the pace of stabilization might need to be adjusted to take into account the effectiveness of policies to restore soundness. Indeed, one has to face reality and acknowledge actual slippages and shortfalls in program implementation arising from banking failures and subsequent involvement of authorities in banking crises management. In this regard the design of country programs needs to be adjusted, most commonly towards less ambitious ultimate, and intermediate, targets. However, the slowdowns and setbacks must be acknowledged only if and when all preventive and concurrent measures to avoid major difficulties in the banking system, or to restore its soundness without adverse implications for the program objectives, have already failed. It would be highly undesirable to design a program with deliberately downgraded policy objectives in anticipation of banking difficulties. The better alternative would be to strengthen the program design, firstly, by drafting measures to improve banking supervision as well as the necessary judicial and procedural settings to be employed in case of rehabilitation or closure of banking institutions, and, secondly, by envisaging adequate contingency reserves both in fiscal and monetary areas of a program.

I would support any strengthening of the Fund's involvement in formulation of a systemic bank restructuring strategy for program countries covering the issues of banking supervision, bank resolution and loan recovery strategies. In my opinion, there is much logic and sense in establishing a closer linkage between the Fund's technical assistance, on the one hand, and program design and program implementation, on the other hand. My authorities very much appreciate the efforts being made by the Fund in this area, mostly through the Monetary and Exchange Affairs Department, and they are generally satisfied with the scope and quality of external advice and expertise they receive. However, technical assistance is often regarded by its recipients as some pleasant, very attractive, but unobtrusive and non binding sort of intellectual and cultural exchange with the Fund. Very differently, work on program design or implementation is accepted by authorities as a very unpleasant, sometimes torturous, but absolutely unavoidable and highly binding procedure.

Mission people from area departments are accepted as providers of resources and as ruthless supervisors, while people from the Monetary and Exchange Affairs Department are recognized as friends and colleagues. Technical assistance people can win more sympathy and popularity in program countries because authorities are less politically dependent on them in contrast to area department people. The adverse side of such recognition and popularity is that policy advice by the Fund on banking and financial sector issues coming in the form of technical assistance is treated with less awe than similar policy recommendations under a program. At the same time, program policy guidelines on banking issues address the question "what is to be done," but give almost no hints on "how it can be done."

Probably, participation of traditional providers of technical assistance from Monetary and Exchange Affairs Department in regular missions in connection with the use of the Fund resources, or sending joint or mixed missions to program countries, would tend to increase the efficiency of the Fund's policies in all domains. In the case of my country, this problem has one more aspect. Under the monthly monitoring scheme selected for the programs under the stand-by arrangement and the Extended Fund Facility my authorities simply can not find the intellectual and physical resources to deal with separate Fund missions with the same degree of enthusiasm and devotion.

Authorities must become convinced that technical assistance on banking and financial issues is tailor-made for their program with the Fund, and that they can hardly achieve the program targets and sustain access to Fund resources if they do not reinforce their political will and do not make banking soundness their priority political objective, meticulously following the Fund's technical guidance in this area. Provided that such understanding between authorities and the Fund has been achieved the eternal contradiction between "what is to be done" and "how it can be done" will be, at least partially, resolved.

Mr. Disanayaka made the following statement:

I agree with the previous speakers that the set of papers is quite comprehensive and excellent, particularly the appendices, which give a broad picture of the behavior of the banking systems over the last two decades. Many lessons are to be learnt from these developments in the global banking sector, and we commend the staff for its work and excellent efforts.

As the staff has mentioned, these papers constitute part of an ongoing study of the implications of the banking and financial sector on the macroeconomic environment. The relevance of such an exercise, in our view, has been amply demonstrated by the present set of papers. We would like to encourage the staff to continue further its studies into this vital area.

We would in particular wish to see the extension of these studies into the nonbanking financial sector, which plays a significant role in complementing the development banks in the provision of financial services. I agree with Ms. Lissakers that the nonbanking sector is increasingly becoming important in intermediation. I think our efforts, in the course of time, should be devoted to this area, because it will play a very vital role in the years to come, particularly in the developing countries.

The papers before us analyze clearly the role of banks in the macroeconomy, their intricate relationships with the other parts of the economy, and the implications of developments within that sector for a country's stabilization efforts, and its monetary and fiscal policies. The paper argues quite convincingly that bank soundness should be factored into the formulation of Fund–supported programs for countries, as the sustainability of any achievements in the macro area would depend to a large extent on the health of the banking sector. This has been proven true in many Fund program countries, where banking soundness had lent much support to stabilization programs.

We are in full agreement with the thrust of the paper. We have, however, some concerns about the pace and the sequencing of banking reforms. In many developing countries, the banking sector is highly controlled, and is often made to serve the broad objectives of government. Thus, banks may be required to contribute on concessional terms to the financing of government fiscal deficits. In some countries, banks are directed to make funds available, at concessional rates, to certain sectors, as determined by government on the grounds of equity. At one level, these measures affect the financial viability of the banking sector. At another, they also result in the crowding out of the credit requirements of the private sector, thus retarding the general growth prospects. More importantly, they also shackle the initiative and enterprise of the banking sector. These shackles need to be removed as early as possible. At the same time, we must ensure that the reform process does not lead to any major unintended sharp cutbacks in the area of crucial government expenditure or to large-scale social resistance to the reform process itself, which a sudden denial of funds might trigger. This is the crux of the problem.

We would, however, wish to emphasize that we are not arguing for any postponement or dilution of the banking reforms. Rather, we are emphasizing that the proper timing and pace of such reforms would contribute to better results with less cost. Proper sequencing of policies can help assure results with the least possible dislocation and disruption to the fiscal consolidation process itself, and can thereby enhance credibility. Therefore, in our view banking reforms should go hand in hand with other mutually reinforcing reforms.

The same could be said of the liberalization of the external sector and the restructuring of the banking sector. As Ms. Lissakers and Mr. Berrizbeitia have noted, the banking sector needs to be strengthened prior to financial sector liberalization, because in countries where the financial sector reforms have preceded the strengthening of the banking sector, there have been very mixed results. Similarly, experience has shown that for any meaningful results to be derived from external sector liberalization the banking sector would also have to be revamped and strengthened. In sum, banking sector reform should proceed in tandem with other structural reforms, particularly those in the financial sector.

As the paper clearly brings out, bank unsoundness derives from a variety of factors: political, institutional, structural, and macroeconomic. Banking sector problems could be sourced to domestic or external factors, or both. However complex and sensitive these causal factors are, they have to be recognized and effectively addressed for any meaningful resolution of bank unsoundness. Otherwise, as the history of the banking industry has amply demonstrated, banking crises could unfold, with devastating consequences for the economy, not to mention the serious social and political consequences. We would, therefore, encourage the Fund to vigorously continue its efforts in assisting countries to address the real cause of bank weaknesses in their structural adjustment programs.

In this exercise, as the paper has pointed out, it could be profitable for the Fund to coordinate its efforts as far as feasible with other multilateral financial institutions, such as the World Bank, which have very deep and sustained involvement in structural adjustment programs in these countries. A joint effort by the Fund and the World Bank, as mentioned by earlier speakers, would be much more productive in addressing these structural or sectoral problems.

In this respect, we agree with the staff that supervisory authorities have a major role to play, not only in ensuring an orderly functioning of the banking sector, but also in the early detection of signs of an oncoming crisis and taking preventative measures toward averting the same. As in the case of many diseases, prevention is better than cure, so it is in the case of potential banking crises.

The consequences of bank failures are very well documented in this paper. Every effort should therefore be made to avoid them through effective supervision, early detection, and corrective action where there is a reasonable chance of a turnaround. However, we are not saying that the banks that suffer from chronic unsoundness should be propped up at any cost. They should be allowed to fail as early as possible. We would therefore like to see the Fund lend its support to the strengthening of bank supervision in countries with troubled banks, and assist the authorities to operate an effective and well-designed system of onsite and offsite supervision. We wish to emphasize the Bank's expertise in assisting countries to strengthen their supervision. The Bank's efforts have greatly accelerated the pace of reform in most of these countries. We would like the Bank to continue this commendable effort.

With regard to prudential standards, I agree that the Basle standards are not well suited for banks in developed countries. But, as experience has shown in our part of the world, these standards do provide a good foundation on which countries can model their systems or base their standards. We would encourage the Fund to assist countries to move forward in adopting prudential standards best suited for their situation.

We are in broad agreement with the main thrust of the arguments of the paper. The banking sector deserves a greater focus in our dealings with countries, particularly in those countries with weak banking systems. Bank soundness should be an important objective in all our future macroeconomic policy formulations. For this reason, we would support an enhanced focus by the Fund on bank soundness in general, and on the strengthening of the supervisory capacity of countries in particular. Such intensification of Fund efforts would no doubt entail further technical assistance, as well as more resource support to area departments. Like Mr. Berrizbeitia, we believe that support should go to both technical assistance and surveillance activities; we would not wish to see any reduction in the present levels of technical assistance to secure funds for in-house surveillance in the area departments. On the contrary, we would urge that adequate resources be given to each, as they are equally important.

Mr. Esdar made the following statement:

The topic we discuss today is certainly a very important one. A sound banking system or, to put it in a more general way, a sound financial system is a crucial element of any market-based economy. The process of economic globalization and the liberalization of international markets have increased its importance even more.

These linkages between the banking system and monetary, fiscal and also exchange rate policies and its repercussions have been discussed in detail in the paper and by previous speakers and I can endorse the general findings. However, there is an inverse relationship from macroeconomic policies onto the soundness of the banking system, which is not discussed in the paper and which in my view is of a similar crucial importance.

In recent times, we were confronted with a significant number of cases where unsustainable exchange rate policies and/or unsound financial policies undermined the stability of the banking system. For example, in the case of Mexico, an unsustainable exchange rate anchor created wrong expectations and policy orientations, whose unavoidable later correction caused significant problems for the banking sector. Many observers have stressed the crucial role of a too expansionary monetary policy in creating the asset price bubble which eventually led to the still ongoing banking problems in Japan. Currently the Fund is being asked to find policy responses on the banking problems in Venezuela, which also were caused by unbalanced monetary and exchange rate policies.

This listing could easily be continued; I just wanted to emphasize that the interlinkages between macroeconomic policies and the banking system work in both directions and both effects have to be taken into consideration when advising member countries. This brings me to the question of the appropriate role of the Fund.

First of all, I fully support those speakers who stressed that the state or soundness of the financial system has to be a crucial part of the surveillance process. To identify and address imbalances and weaknesses in the banking sector at an early stage would be an important contribution for the prevention of financial crises.

Within such a surveillance exercise, the overall soundness of the banks involved, the competitive situation in the banking system, the degree of governmental interference , the adequacy and the independence of banking supervision, in other words, the balance between market discipline and official supervision as well as the interaction between the players involved would be important elements. However, the Fund has to refer to and pay due regard to the responsibilities of other institutions in this field. These certainly include the BIS or other regional corporations of central banks in the area of supervision, the World Bank and other regional development banks who have a crucial role in supporting and advising the development of the banking system, and the OECD. Thus, for example, I agree that data on gross credit flows as well as prudential and microeconomic information is needed for the analysis of the soundness of the banking system. However, especially the collection and evaluation of the microeconomic data should remain the responsibility of specialized institutions . This does not preclude that the Fund in its surveillance role should urge member countries to provide the relevant data.

The Fund itself should concentrate on assessing the efficiency, sustainability and adequacy of the overall system, with the main objective of identifying systemic weaknesses at an early stage. The main responsibility for addressing those weaknesses, for example by introducing capital adequacy ratios or improving supervisory bodies or by a general reorganization of the banking system, should remain with the specialized organizations. I fully agree that the Fund's surveillance role cannot be as a banking supervisor and—I would add—also not as a banking reorganizer, but as an advisor on general policy or an improved policy orientation.

As already indicated, in my view it is crucial to include the working of the financial markets and the banking sector in the surveillance exercise at least because of the close linkages between bank soundness and the prevention of financial crises. Therefore, I would like to suggest that the results of such a stronger bilateral surveillance of the financial sector should be one of the elements of the general surveillance review which will be discussed biannually as a follow up to the so-called Madrid Declaration.

This brings me to the question of how to integrate systemic banking reform into Fund-supported programs. Undoubtedly, the effectiveness of macroeconomic policy depends very much on an efficient monetary transmission mechanism, which must be provided by the financial sector.

Therefore, the Fund should continue to encourage and urge member countries whose banking systems are unsound, to immediately embark on appropriate reform measures. The progress of such reform efforts should be measured by benchmarks, which should, as in the past, constitute important elements of Fund-supported programs. The fiscal costs, including possible contingency measures and their financing, should be adequately reflected in the budgetary targets. However, while we agree that the recommended set of policies, especially of monetary policies, should reflect the implementation and adjustment capacity of the financial system, we would on the other hand object to the finding that a weak financial system would require prolonged adjustment periods and a prolonged financial involvement of the Fund. While there is certainly no blueprint for the optimal sequencing of macroeconomic adjustment and structural reform in the banking sector, I support the staff's view that concerns about the soundness of the banking systems should not provide an excuse for postponing adjustment. Finally, the financing of structural reforms of the banking system should remain the full responsibility of the World Bank and the regional development banks. They have the appropriate institutional knowledge and the appropriate instruments.

Further, on the role of the Fund, I was puzzled by the misleading formulation on page 21, that "the Fund provides a financial safety net for member countries." This formulation—in my view—provides ample room for misinterpretation as it creates the expectation that the Fund might have the final responsibility as lender of last resort in a given member country. This chair has repeatedly rejected such a role for the Fund especially because of its severe moral hazard effects on the countries concerned as well as on creditors. This issue was addressed when we discussed proposals on international debt adjustments. I would like to repeat our view that it cannot and should not be the role of the Fund to bail out other creditors or to give the impression to debtor countries that if crises should arise, the Fund might provide an easy way out.

Extending his comments, Mr. Esdar noted that, if the surveillance role of the Fund was to be limited to the general task of promoting soundness in banking, significant additional resources would not be needed. Mr. Shields had developed some ideas for reducing Fund involvement in some other structural areas, and they should be pursued.

Mr. Berrizbeitia observed that, while unsustainable policies could undermine the banking systems of countries, weak banking regulation and moral hazard had had more to do with the Mexican banking crisis than had weak macroeconomic policies, although the latter had certainly contributed to it.

The Acting Chairman, responding to Mr. Esdar's concern that the Fund not be perceived as a lender of last resort, noted that one of the purposes of the Fund, as laid out in the

Articles of Agreement, was to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards. Such a financial safety net might be seen as providing such confidence.

Mr. Esdar replied that the reference in the staff paper to the Fund performing a safety net function could be misinterpreted as a suggestion that the Fund would provide the necessary resources to bail out creditors under any circumstance. Greater importance needed to be attached to the qualification "adequate safeguards".

Mr. Fukuyama made the following statement:

> As the staff points out, the banking sector plays an important and unique role in the economy, and its vulnerability could constrain macroeconomic policies. Thus, the Fund should pay special attention to the soundness of the banking system. That said, considering that the Fund has already been increasingly concerned with this issue, it is not easy to assess in what direction and to what extent the Fund should move further. In this respect, I notice that Mr. Clark and Mr. O'Connor used the word "continue" many times. In addition, as long as the industrial countries are concerned, there is a forum, the BIS, where they have actively discussed the improvement of bank supervision, and, therefore, it is not easy to assess what additional contribution the Fund can and should make to these efforts.
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> As mentioned before, the interaction between macroeconomic policies and banking system soundness warrants close attention; nonetheless, how to have it reflected in the Fund's operations is not immediately apparent. Let us take monetary policy. We can argue, quite realistically, that the conduct of monetary policy cannot be unrelated to the degree of soundness of the banking system. Thus, the Fund may recommend, for example, not to tighten monetary policy even in the face of inflationary pressures, if the banking system is unsound. This may be called a balanced approach, and one might wonder as to its relationship with the Fund's frequent support for a single target, such as an inflation target or an exchange rate target. Appropriate logic seems needed.
>
> As to fiscal policy, I am not fully convinced by the staff's argument for identifying government contingency costs as related to the banking system problem in the budget or in the Fund program. It is rather unrealistic to expect the authorities to publish, or even reveal to the Fund staff, the "projected" government costs before the failure of banks is evident and the restructuring plans are set. Thus, at least the argument that making contingency costs transparent would press for timely action to deal with the banking problem seems invalid.
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> On the other hand, I think it more straightforward that the Fund has made a considerable contribution to developing the institutional framework for improving banking system soundness through technical assistance and consultation, and that it should continue to do so, or even strengthen its assistance where necessary. Regarding points to pursue, the staff mentions official surveillance, data disclosure, exit policies, lender-of-last-resort function, limited deposit guarantee facilities, and so on. I have no difficulty with this, although I doubt whether the supervisory agency can and should be fully

independent. I also agree that the system of official regulation and supervision should constantly evolve in response to market developments and to innovations in banking. As for financial sector liberalization and the adoption of market-based monetary instruments, I recall that we have already agreed on previous occasions that these contribute to efficient resource allocation and therefore should be pursued aggressively, but that these must go hand in hand with the improvement of risk management within banks and of the official supervision system.

Turning to some specific aspects of the possible role of the Fund, the staff suggests shifting part of the Monetary and Exchange Affairs Department's resources from provision of technical assistance toward surveillance activities. In this respect, the experiences of the Fiscal Affairs Department may be worth referring to, since the fiscal system seems as important as the banking system for surveillance. In any case, we will perhaps see an appropriate balance with technical assistance in due course, without serious discussion on this issue. As to the Fund's role in supporting international cooperation and harmonization in banking supervision, like some other directors, I wonder actually what the Fund can and should do.

Finally, a comment on the publication of the staff papers. I think that the main paper, especially, is not a pure analytical paper but rather a strategic paper on the Fund's surveillance which, therefore, naturally includes sensitive issues. My understanding is that the Fund normally does not publish such papers, however excellent they may be.

Ms. Srejber asked whether Mr. Fukuyama was implying that governments should not be encouraged to think ahead about contingency measures to deal with problems in the banking sector, or that the authorities may be reluctant to disclose such matters to the Fund. Experience had shown that countries with financial sector problems tended to wait in hope that the problems would disappear, and that when action was taken, it was often too late. Experience had also shown that inaction, however human, could be costly as banks tended to spiral deeper into insolvency. The staff paper was not advocating that governments should publicize the costs of resolving banking sector problems, but rather that the Fund had a role to play through its consultations in helping governments to focus on the problems, and to consider the impact on the fiscal program of alternative corrective actions, and thereby encouraging early resolution.

Mr. Fukuyama reiterated that it was not realistic to expect governments to disclose in the budget contingency costs arising from the banking sector, unless the banking problems were already known to the public.

Mr. Coumbis made the following statement:

This is a set of very good papers. They are comprehensive and contain many interesting ideas. Like previous speakers, I recommend their publication and believe that supervisors, not only in developing countries, would find many useful and valuable suggestions in these papers.

The staff papers provide us with a very clear picture of the importance and magnitude of the problem of securing a sound banking system and the detrimental effects, substantial costs, and negative externalities related to bank failures or to an unsound banking system. In fact, in Appendix 1 of Supplement 1 we see that 131 of the 181 member countries have experienced banking problems during the past 15 years. I agree with the staff's view that there is no benchmark measure of insolvency which determines when a banking system may be considered unsound. Moreover, banking problems can emerge with little warning even in the most industrialized countries. It is quite clear that banking problems are not limited to developing economies or economies in transition. Past and recent experience indicate that countries belonging to the G-7 and the EU or other industrialized countries have faced some serious problems in the banking sector.

We have seen in Article IV reports and reports from program countries the conflicts that have been created from the effect of macroeconomic policies on the soundness and solvency of the banking system. The Fund has started only relatively recently to take into account the two-way linkages of cyclical and stabilization policies on the one hand and the soundness of the banking sector on the other. In this study, the advice given to the authorities in formulating their stabilization and cyclical policies is quite clear. Authorities must take into account the banking system's degree of soundness. The extent to which consolidation affects the stabilization and cyclical policies is a rather practical problem which should be solved on a case-by-case basis. Its solution depends on the extent of the vulnerability of the banking sector. If it is close to a crises, then I also believe that short-term stabilization objectives have to give way in order to prevent a banking crisis. The same consideration, I think, has to be given when the authorities and the staff are formulating macroeconomic program targets. The extent of price deflation, currency devaluation, or restriction of domestic credit expansion have to be considered in view of the banking sector problems. It should be made clear, however, that in order to consider a change in basic stabilization targets, the dangers in the banking system have to be systemic and should have affected the whole banking system. I also agree with Mrs. Gotz-Kozierkiewicz that the liberalization of the financial sector and the introduction of indirect instruments of monetary control is a different story. Regulatory and supervisory measures in this case should be taken before liberalization measures in order to protect the soundness of the banking system.

With respect to structural policies aiming at the maintenance of a sound banking system, I found very interesting the following ideas and suggestions:

"The efficiency and integrity of the oversight process is hampered when the supervisory agency is not independent." Although I also prefer the supervisory authority to be located in the central bank, I should like to stress that this fact by itself does not guarantee independence. I also agree with the staff that prudential regulations should be independent of monetary management. Regulatory standards should be established in order to keep banks solvent regardless of the phase of the business cycle.

"The exit of weak individual banks is critical for the maintenance of a strong banking system." I am in agreement with this suggestion, but this, of course, does not mean that we should overlook a systematic effort to restructure an ailing bank. The supervisory authorities, however, should take care that the restructuring takes places in a predetermined period of time and in the framework suggested and/or approved by the supervisory authorities. If it is clear that there is no other solution beside bank exit, then I agree with the staff that supervisory action should be taken to initiate or at least control the closure.

With respect to issues for discussion suggested by the staff, I have already answered questions 1, 2, and 5. For questions 3 and 4, I agree with the staff's proposed policy framework for maintaining banking system soundness. There is the problem of financial conglomerates, however, which include banks, insurance companies, and other financial institutions, which usually are supervised by different competent authorities. In these cases, there are difficult problems connected with the coordination of the supervisory authorities, questions about the necessity of a lead supervisor, problems with capital adequacy, consolidated financial statements, and so forth.

There is also the problem of banks with international branches and subsidiaries and the question of the coordination of supervisory authorities of the home and host countries. The EU's advisory committee and the Basle Committee of the G-10 have made substantial efforts in regulatory harmonization and supervisory cooperation. Much more remains to be done especially in areas outside the EU and G-10. In fact, numerous problem cases, including BCCI, Meridian Bank, Barings, and Daiwa, indicate the still-existent gaps in international oversight of banking operations. They also indicate that supervisory rules and regulations are still country-specific and may be enforced by different authorities both within and between countries. I agree with the staff that this makes regulatory arbitrage possible which will probably result in unequal competition between banks.

Another area of concern is the rapid development of financial innovations in banking and other financial institutions which actually render obsolete certain regulations and supervisory procedures. What should be the reaction of supervisory authorities in such cases? I agree with the staff that "supervisors will almost always be a few steps behind, trying to adopt rules and supervisory procedures to the latest financial products and developments in financial markets." The only way out of this difficult problem is for regulators to be able to operate efficiently with internal auditors who are in a better position than supervisors to anticipate the consequences of the introduction of new products for the liquidity or the profitability and/or the solvency of a bank and to engineer the proper mechanisms that will protect banks from extreme risk taking positions.

With respect to the last two questions (7 and 8), I would like to stress the following points. We have already seen that extensive cooperation among regulators in the same country and among countries is a very important element for the efficient supervision of big international banks and financial conglomerates. From the staff report, it is clear that so far there is not an efficient mechanism to initiate cooperation among supervisory authorities on an international level. There is no doubt that the Fund, in cooperation with the World Bank, could facilitate coordination, in certain circumstances, in cases of international banking problems outside G-10 countries, and this according to the staff would be consistent with our Articles. I have some doubts, however, if such assistance from the Fund would be accepted from supervisors which usually find it very difficult to communicate their problems to outsiders that is to people that are not banking supervisors.

As for the staff's proposal to shift part of Fund resources from technical assistance toward surveillance activities, I would like to state that Fund consultations can help authorities to examine very carefully the adequacy of the regulatory framework and its enforcement and to realize the need for a strict exit policy for insolvent banks and the desirability of adherence to international standards on supervisory issues.

I would not like, however, to recommend a shift of resources from technical assistance toward surveillance of banking and financial sector issues, as I consider technical assistance in this area an equally important function of this department. One solution to this problem may be, assuming that budget constraints do not permit an increase in the staff level, to prioritize the cases where the participation of staff from the Monetary and Exchange Affairs Department is necessary. I would suggest, as priorities, cases where macroeconomic imbalances are serious and the problems in the banking sector are worrisome. The latter can be identified, as Mr. Shields points out, by the regular staff of the area departments in the Article IV consultations after some extensive training of the regular staff. In these cases, one or two specialists from the Monetary and Exchange Affairs Department would participated in the next regular Article IV consultations or, in the case of an urgent need, a small mixed mission would visit the country in the interim to examine the structural problems in the banking system.

But there is another valuable function that Monetary and Exchange Affairs Department's staff can perform in cases where there is no evidence of serious problems in the economy or in the banking system. In such cases, an expert from the Monetary and Exchange Affairs Department could visit such countries from time to time to review procedures and regulations with the supervisory authorities. It would be valuable for both the staff and the authorities since the staff will be brought up to date with the supervisory conditions, strengths, and weaknesses in each country and the authorities will be briefed on new methods and procedures to help them in their role as supervisors.

Ms. Srejber asked whether Mr. Coumbis was recommending that the Monetary and Exchange Affairs Department's participation be limited to dealing with financial crises that posed a risk to stability, and that with appropriate training, area departments provide advice in all other contexts.

Mr. Coumbis reiterated that, where banking sector problems needed to be addressed urgently, special missions of technical and area department staff could be sent; otherwise, in less urgent cases, technical specialists could participate in the regular Article IV consultation discussions.

Mr. Waterman made the following statement:

As others have noted, a sound banking system is important because of the key role it plays in an economy and the significant costs associated with chronic weaknesses and crises in banking. I agree with the paper that we need to focus on the banking system as a whole. If anything, our focus may need to be still broader since many of the issues apply to the financial system as a whole. As Ms. Lissakers noted, in many countries we have seen a blurring of the distinction between the banks and the non-banks—on both the deposit and lending sides. That is one reason why there is a debate in some countries about whether regulation should be by institution or instrument. There are no clear answers to the issue of regulatory overlap. In Australia, we have tried to overcome the problem by having a council of regulators meet periodically to hold ongoing discussions on common regulatory concerns. But there are no simple solutions.

In terms of today's discussion, it would be useful to keep a separation in our thinking—as far as possible for analytical purposes—between appropriate macro policy measures and effective prudential policies, although clearly if the banking system is weak prudentially that can have implications on the macro side. We have seen the significant budgetary costs of bailing out troubled financial institutions, and the constraints on the implementation of monetary policy when banks' balance sheets are weak. But, in principle, we can separate what we see as the role of monetary policy—to control inflation—and the preferred type of prudential structure for a banking sector, and maybe for the financial sector more generally.

Both issues are important during periods of financial liberalization. In Australia, in the 1980s, significant deregulation had taken place and the importance of prudential regulation had to some extent been overlooked, particularly with respect to state-owned banks not closely regulated by the Central Bank. Those institutions had rapidly expanded into new lines of business and had got into a lot of strife. A number of those institutions had suffered very large losses that were ultimately born by the government.

So I accept that, during a period of financial deregulation, prudential and broader macro issues can become intertwined, but in a longer-term sense they are separate issues, as brought out very well in Mr. Clark's and Mr. O'Connor's statement. A weak financial system may well limit the scope for macro policies without the risk of destabilizing the system itself. But allowing high inflation to run or generate its own problems. In the Australian context, if we had been more successful in reducing inflation and avoiding asset price inflation in the 1980s, we could have prevented, or certainly greatly moderated, the problems that the state banks ran into owing to prudential weakness. Conversely, had prudential controls on banks been stronger but inflation broadly unchanged, I suspect inappropriate lending would still have occurred but on the balance sheets of the non-banks. That outcome may have been a little better in sense of less pressure on the government to sort out the issues with funding but we are really talking about a matter of degree rather than kind.

It is clear that prudential supervision certainly needs to evolve as markets change. Globalization, rapid technology change, and new market pressures are promoting widespread structural shifts in the financial sector. You have to be close to the coal face to understand the nature of many of the new instruments, the risks involved and how they should be handled. It is difficult for regulators to keep up, but there is an increasing amount of cooperation and harmonization where sensible at the international level on prudential policies. Central banks will need to remain involved in the supervision of their banking and financial systems through what will remain rapidly-changing circumstances.

In terms of the banks themselves, it is the business of private banks to handle the risks of intermediation and they are often in the best position to make judgements about the best way of handling them. Information and transparency are very important as well as an incentive structure to ensure that management is taking decisions based on the longer-term interests of both borrower and lender and the institution itself and not driven primarily by the immediate benefits of increased business on remuneration and profits.

We want banks to be prudent, but we also want them to be efficient, innovative and even entrepreneurial. Striking the right balance between safety and soundness on the one hand and on the other hand giving banks the freedom to develop, innovate and compete is one issue that is at the heart of any bank supervision debate.

The Fund needs to keep abreast of thinking and developments in this field. Much is published, there are regular international meetings and my own authorities are prepared to discuss their thinking in the context of Article IV visits. But there is a difference between doing that and being able to direct countries that need assistance in the right direction on the one hand, and on the other getting involved in the more detailed formulation of prudential standards. This is an already crowded field and we would not want to see the Fund involved in duplicating work undertaken by the BIS, the OECD, the World Bank, several regional development banks, and a number of regional groups of bank supervisors.

Mr. Mirakhor stated that he had not interpreted the staff paper as suggesting that the Fund would duplicate the efforts of the Bank for International Settlements, as some speakers cautioned. Rather, the idea promoted by the staff was to hold more regular discussions with authorities on banking sector soundness issues, such as the adequacy of prudential practices and supervision, without implying that the Fund would have to set new performance criteria for the banking area. At the same time, he wondered how far the staff thought the Fund's mandate in the surveillance of the banking sector should go, or how intrusive or duplicative it might be.

Mr. Mori made the following statement:

These excellent papers show the complex relationship between the financial sector and the macroeconomic situation of a country. The fact that at least two thirds of Fund member countries have experienced significant banking sector problems underscores the importance of improving our understanding of such relationship.

One of the relevant cases analyzed is characterized by a weak financial system and a need to lower inflation. If monetary policy is too restrictive, high interest rates could trigger systemic problems which could hinder the stabilization process. A similar scenario would be one in which a targeted accumulation of international reserves is sought through a tight domestic credit policy, but is unattainable because of an unsound banking system.

It is true, as the staff points out, that such concerns cannot be an excuse to postpone adjustment. But it is also true that when the staff talks about a "sustainable pace of adjustment," it is implying that in many cases such situations should lead to a slower pace in the reform process.

On the relationship between fiscal policy and the banking system, it is true that the problems should not be swept under the rug. Costs to government, including contingency costs, should be taken into consideration. Nevertheless, estimating such contingency liabilities is a difficult task and highly uncertain.

With respect to capital flows and the financial sector, the Board has emphasized that adequate supervisory institutions and a regulatory framework should be in place before the capital account is liberalized. The present document stresses these points, and reinforces the need for a careful sequencing of such reforms.

On the issue of supervision, the document points out that there is no substitute for adequate internal governance of financial institutions, although discipline in the form of supervisory oversight is critical. I would add that although Fund surveillance on this matter is very important, there is also no substitute for strong local supervisory institutions. In this regard, technical assistance continues to be extremely important.

On exit policies, one point which is somewhat questionable is that when market discipline is working, banks are forced to correct their deficiencies or exit the market before they become insolvent. In most cases, banks which have to exit are already insolvent and even the strongest supervision can preempt such cases. A related issue is that it is still not very clear how to strike the right balance between a limited deposit insurance, avoiding moral hazards, and deterring bank runs.

Finally, on the issues for discussion:

Bank soundness is clearly a legitimate objective of Fund policies.

The pace of stabilization, in most cases, must be slowed down to take into account the constraints implied by a weak, inefficient, or unsupervised financial sector. Hence, the proper sequencing of stabilization policies can lead to successful liberalization.

Although government contingency costs may be included in policy discussion, it is also important to take into consideration that these costs are generally uncertain and difficult to estimate.

As I mentioned earlier, although Fund surveillance of the activities of the banking and financial sector is very important, there is also no substitute for strong local supervisory institutions. Hence, it would be preferable to see a strengthening of the provision of technical assistance to member countries, than a shift of resources toward surveillance activities.

Mr. Zoccali made the following statement:

As other speakers, I wish to commend the staff for the valuable papers prepared for this discussion and would support their publication with pertinent editing. To save time, I will make available to the staff some specific suggestions offered by my authorities pertaining to references on countries of this constituency.

Given the central role of the financial structure and of the banking system in particular, in economic growth and development and the linkage between a well functioning banking system and the effectiveness of stabilization policies, I fully share the greater attention being given to issues of bank soundness. The high degree of integration of financial markets has heightened the risks that a particular banking crisis could produce contagion or domino effects. Moreover, the fact that since 1980 at least two thirds of Fund member countries have experienced significant banking sector problems should serve to elevate the priority of preventing stress in the banking system across the membership.

Banking soundness constitutes, in my view, a legitimate objective of policies to be discussed between member countries and the Fund. The Fund is not only mandated to foster orderly and stable financial market conditions, but also uniquely placed to contribute to sustainable macroeconomic policy mixes, and to well-balanced institutional and regulatory structures in member countries. I share, therefore, the thrust of the more formal mandate for the Fund suggested in Mr. Clark's and Mr. O'Connor's statement. However, since banking crises or even episodes of banking fragility have occurred in members of systemic consequence, it is important that the Fund's surveillance activities reflecting the current and projected state of banking soundness not be limited to program countries. In this connection, I tend to share the sentiment expressed by Mr. Shields, that more extensive training of area staff on bank surveillance may be required and, where there are prior reasons for concern, even the direct involvement of the Monetary and Exchange Affairs Department staff in surveillance missions. The size of potential fiscal and efficiency losses associated with unsound banking systems would suggest the desirability of beefing up staff resources in this area instead of just rejuggling priorities through redeployment between technical assistance and surveillance activities. This does not signify that there is no need to coordinate these activities in the case of program countries with the World Bank and regional banks, as they have a primary responsibility for developing and financing comprehensive sectorial reforms.

Regarding the short-run trade-off between efficiency and stability through prudential regulations, I could conceive of situations where there is indeed such a short-run trade-off, particularly when there is no official lender of last resort arrangement. In any case, the actual scope for monetary policy to accommodate lender-of-last-resort requests or settlements of officially guaranteed bank liabilities without abandoning the objective of price stability would seem limited even if central banks were not legally constrained in providing liquidity or facilitating payments settlement for banks in distress. Some additional elaboration of this aspect in the papers would have been useful. Similarly, as the particular risk of dollarization was raised, perhaps the focus should be on the costs of the alternative, namely having no institutionalized financial intermediation, and perhaps the staff could also comment on the prospects, of increasing the demand for local currency bank liabilities and assets through regulations, prudential or otherwise.

With respect to the combination of stabilization policies with structural reforms, program design should aim at improving allocative efficiency in all markets. This requires often a large dose of institution-building, including the appropriate legal framework for markets to develop in a manner that satisfies both efficiency and social considerations. The existing banking system will have a bearing on the effectiveness of the macro policy mix and, more particularly, of monetary policy. At the same time, where banking soundness is dependent on institutional reforms, a minimum degree of initial stabilization will be required to sustain the process. Generally speaking, I consider that waiting for an ideal critical mass before initiating the reform of the banking system will result in a costlier and more prolonged process of adjustment.

The past growth and capacity of the financial system for innovation suggest that avoiding the failure of prudential regulation and supervision should remain a priority of policy-makers. In that regard, while it is difficult as noted by the staff for supervisors to "out-engineer the financial engineers," we would see sufficient positive externalities from the Fund's work with market participants and G-10 regulators in helping individual country authorities to adapt risk guidelines and incentives in a manner that ensures both market discipline and strong internal governance.

On the issue of contingency costs from guaranteed assets and liabilities in the banking system, I agree that their inclusion in regular policy discussion could serve both to improve awareness of the potential fiscal and moral hazard implications of certain strategies and to facilitate the adoption of corrective measures. The inclusion of contingent liabilities in program design, however, is not a clear-cut exercise. Such liabilities should only be factored in when they are unambiguously quantifiable. In any event, the preferable resolution strategies would be those that preserve constructive ambiguity regarding future bailouts and do not give rise to perverse incentives, touched on by Mr. Waterman.

In closing, the Fund has an important role to play in collaborating with other international bodies in the coordination and harmonization in banking supervision, particularly in regions outside the G-10 framework, keeping in mind that the priorities of the Basle Committee have tended to reflect the concerns and priorities of the most developed financial centers. Even so, a large number of internationally active banks escaped consolidated oversight until they failed, and situations of regulatory arbitrage abound. For these reasons, I would neither understate the lack of international coordination in the area of banking supervision nor the systemic benefits of a greater role for the Fund in working with regional and individual regulators to speed up the harmonization of banking laws, accounting standards, supervisory rules, and exit procedures. I fully associate myself with the comments of Mr. Mirakhor in this regard.

Mr. Han made the following statement:

I join other speakers in expressing my appreciation to the staff for providing us with a set of informative papers. At the same time, I share other speakers' concerns on this subject.

The worldwide experience of significant banking sector problems in recent decades has demonstrated that increasing interlinkages between macroeconomic policies and the soundness of banking systems warrant special attention. Given the crucial role of the banking system in the economy, there is no doubt that the promotion of a sound banking system should be considered as an important objective as well as constraint for macroeconomic stabilization and structural reforms. The current challenge facing many countries is how to adapt macroeconomic policies so as to address the existing banking problems and facilitate a strengthening of banking sectors in a timely manner.

The effectiveness of macroeconomic policies, in particular monetary policy, depends to a large extent on the soundness of the banking system. Therefore, the design and implementation of macroeconomic stabilization and structural reforms have to consider the constraint of unsound banking systems or potential systematic implications of individual banking problems. As the staff emphasizes, concern with bank soundness should not be seen as an excuse for postponing adjustment, but rather as a constraint on the pace of sustainable adjustment. With the globalization of capital markets, the vulnerabilities of the banking sector to external shocks should be taken into account in the design of macroeconomic policies.

Maintaining a sound banking system requires improved internal governance, efficient market discipline, and strengthened official oversight. Internal governance plays a major role in ensuring the soundness of banks, and there is no substitute for it. Many recent cases have shown that bank problems resulted mainly from internal mismanagement and lack of self control. It is of vital importance for individual banks to establish an efficient framework of internal controls under rapidly changing financial market conditions.

Complementing internal governance, market forces can exert pressures and discipline on banks' activities, forcing poorly managed or unsound banks out of business. Appropriate official supervisory oversight is crucial to compensate for failures in internal governance and market discipline, but a supervisory agency must have sufficient authority and independence.

While financial deregulation will undoubtedly promote the soundness of the banking sector over the medium and long term, it will also inevitably bring to the banking sector new risks and problems, at least in the short term. In this regard, the deregulation process should fully take account of the state of market development and the institutional environment, accompanied by prior or concurrent measures to strengthen the oversight framework.

Appropriate sequencing of prudential and bank restructuring policies would also help facilitate the deregulation process. I concur with the staff that reform of bank accounting standards and loan valuation systems should begin early in the reform process so as to increase the efficiency of internal control, provide a basis for market discipline, and strengthen supervisors' ability to monitor banks.

Regarding the role of the Fund in the banking system, I share Ms. Srejber's view that it is important to preserve the clear division of labor in this area between the Fund and other relevant institutions. The focus of Fund surveillance has been, and continues to be, macroeconomic stabilization. The Fund's surveillance role cannot be as a bank supervisor, but rather as an advisor on banking reform and policy, including the adequacy of the regulatory framework and its enforcement. Technical assistance should continue to play an important role in providing Fund advice to member countries.

Mr. Schilthuis made the following statement:

This chair welcomes the growing recognition by the Fund of the importance of banking system soundness. The extensive discussion by the staff on the various linkages between bank soundness and macroeconomic developments is very useful and clarifying. We endorse much of what it said. It is rightly argued that the soundness of banking systems is of relevance not only to developing and transition countries, and the regular inclusion of this issue in the Article IV consultations will be useful.

The quality of Fund programs would benefit if the constraints that a weak banking system puts on macroeconomic policy are clearly taken into account. This will not always be easy, as the staff recognizes. For instance, as mentioned by others, a policy of rapid disinflation may be harmful to the quality of the assets and, therefore, to the soundness of banks. Yet, subordinating the disinflation targets to banking system soundness could imply unduly slowing down the process of disinflation, making it difficult for the authorities to gain credibility and to reduce the public's inflationary expectations.

With respect to the role of the Fund, the staff paper seems to imply a role in the supervision process itself when it notes the gaps being left by the Basle Committee and the World Bank. In this respect, I agree with the remarks by Mr. Esdar; from a practical point of view, one should not underestimate the complications. It is doubtful that the staff would have sufficient human resources, expertise, and instruments at its disposal to assess the micro prudential legal framework in individual countries, its regulatory implementation, and the supervisory process. The staff would likely have an information disadvantage which could impair its recommendations on supervisory policy matters.

With respect to the coordination with other institutions on issues related to the soundness of banking systems, we would encourage institutions to supplement each other's work. However, my authorities feel that the staff paper does not fully recognize the scope of the work of the Basle Committee. The Basle Committee sets international standards which supervisors in every country can seek to attain. Its main achievements are very relevant for supervisory authorities in developing and transition countries. Also, it may be noted that, under the auspices of the Committee, regional groups of supervisors themselves are working to implement such rules and to advance the international coordination of banking supervision.

As a last point, a related issue that deserves some attention is the relationship between micro prudential supervision and the integrity of the banking sector, including the issue of money laundering. On this subject, a paper is being prepared by the staff that was requested by the Financial Action Task Force on Money Laundering. We would like to be informed about the progress of that paper.

Mr. Mohammed made the following statement:

This Board has frequently pointed out that banking difficulties pose significant threats to stabilization efforts in many countries. We, therefore, very much welcome today's discussion of bank soundness and macroeconomic stabilization.

The banking difficulties in a large number of countries arise from a variety of risks that include potential fiscal costs, high interest rates, ineffectiveness of monetary instruments, and possible confidence crises. The state of the banking sector, therefore, has important implications for the design of reform programs, including their pace and sequencing. Also, it is crucial for the Fund to highlight potential bank crises in its surveillance and in policy advice in the context of Article IV consultations.

The state of the banking sector has, indeed, important implications for the design and success of a stabilization program. For example, the effectiveness and desirability of indirect monetary control instruments is significantly reduced when the financial sector is shallow and segmented. In many Fund-supported programs, we tend to introduce indirect monetary control instruments prematurely; before the institutional and financial infrastructure is in place. More generally, stabilization and structural adjustment efforts, including in the financial sector, should be appropriately sequenced so as not to aggravate the problems of the banking sector. There is much merit in the view that the policy framework for maintaining bank soundness should, in addition to macroeconomic stability, include a balance between official surveillance and market discipline. The importance of adequate supervision by the authorities cannot be overemphasized. Here, I would underscore the requirement that official regulations and supervision should constantly evolve to take account of developments and innovations in the financial market and products which are mushrooming and increasing in complexity.

The issue of government contingent liabilities is important and should be taken into account in the regular policy discussions between member countries and the Fund. However, information on such liabilities are not readily available in most cases, and their quantification would require further technical assistance.

On the proposal to shift part of the resources from technical assistance to surveillance as it relates to the banking sector, I feel that this question is motivated by budgetary constraints. The questions that we should be asking ourselves are the following. First: does the surveillance activity warrant high priority in our agenda? My answer would be yes. Second: if we do shift resources from technical assistance to surveillance, will our technical assistance significantly suffer? Or does the staff expect a reduction in demand for technical assistance in the next few years, thereby freeing resources for increased surveillance? Third: if demand for technical assistance remains high, will it be feasible to rely on the area departments' staff to carry out the required increased surveillance of the banking sector if they are provided with adequate training? Or will we need additional resources? Staff comments on these questions are welcome.

These questions can be addressed fully only if we define the role the Fund is to assume in the area of banking sector soundness. Here, we need to coordinate with other agencies who carry out work in this area to avoid overlapping and duplication. I have in mind here coordination with, of course, the BIS and the World Bank. Following this exercise, an assessment of the role of the Fund and the necessary resources required to fund this role should be addressed in a subsequent paper.

Mr. Dlamini made the following statement:

The papers give important insights into the relationship between the soundness of the banking sector and macroeconomic policy formulation. The evidence leaves no room for debating the critical role of this sector in the economy, and the fact that there are still bank failures even in industrial countries suggest that the soundness of the banking system is a legitimate area of interest for the Fund.

The key issue to be addressed is, where banking sector reforms are necessary, at what stage and pace should they be implemented. These issues fall under the rubric of structural reform which is crucial for the successful functioning of the overall economy. Structural reforms, however, can take time to be implemented and yield results, especially in developing and transition economies, and proper sequencing is important. The question is particularly relevant for such issues as liberalization of interest rates, the introduction of indirect instruments of monetary policy, and the relaxation of capital controls. In this connection, I would appreciate staff comments on what has been their experience on sequencing reform in the framework of Fund-supported programs, where the banking system has not been functioning efficiently. One could contemplate cases in which the adjustment effort might have to be less rapid than otherwise to take account of problems in the banking sector, which in some cases might have serious implications for growth and the fiscal situation. However, this does not mean that the adjustment process should be postponed.

On technical assistance, the Fund should complement the role of the World Bank, regional development, and other relevant institutions. In this regard, I welcome the importance that the Fund is attaching to providing technical assistance in this area, particularly the intention to strengthen country missions with banking expertise. I want to emphasize, however, that this should not be done at the expense of technical assistance in other critical areas. Also, the process of managing banking crises and restoring the soundness of banks has important implications for fiscal performance. In this regard, the strategy being contemplated of joint work and missions between the Monetary Affairs and Exchange Department and Fiscal Affairs Department is welcome.

Regarding the Fund's role in supporting international cooperation in banking supervision, I feel that the Fund should focus on encouraging members to adopt appropriate practices and support the efforts of regional groupings in this area.

Mr. Ismael made the following statement:

A nation's banking system, being situated at the center of the savings-investment nexus, is intricately intertwined with the development of the "real" economy. If it is not functioning well, it holds the possibility of inflicting great damage to the economy. Therefore, if it is to work for the good of the economy, its workings must be consistent with the macroeconomic needs of the country. It is this consistency between overall economic development and the development of the banking system that needs to have our attention.

To this end, it is important that the BIS international capital adequacy standards be adopted; loan to deposit ratio requirements, net foreign currency open position limits, and legal lending limits be introduced. In addition, regional cooperation on prudential regulation should be enhanced and encouraged. On the other hand, the improvement of a sound banking regulatory environment should not stifle the growth of the banking system. The banking system has to adapt itself continuously to increase its resilience and competitiveness, domestically as well as internationally.

Having said this, I therefore do not see the need to intensify Fund surveillance on the banking system beyond what is practiced to date. Likewise, on technical assistance, I would not recommend that it is replaced by intensified surveillance. What is important is that data on banking developments and performance are adequately made available at the time of the Article IV consultation discussions.

Mr. Barro Chambrier made the following statement:

I commend the staff for the excellent and well-focused set of papers centered on bank soundness issues, with emphasis on the role of the Fund in the areas of surveillance, program design and technical assistance. As set out in the staff paper, the banking system has to play a crucial role in the adjustment process of the membership. Indeed, banking system soundness, as considered in the present study, can contribute to the establishment of a stable macroeconomic environment, necessary to promote savings and investment. In addition, the study clearly shows the serious problems on macroeconomic policies, namely on fiscal and exchange rate policies, that could result from a weak banking sector. In light of the several lessons that we can draw from this study for members of the Fund, I welcome today's discussion and in particular, the crucial role the Fund is called to play through its surveillance and technical assistance, in order to address the macroeconomic imbalances prevailing in the member countries.

Let me now address some of the main issues for discussions proposed in the staff report.

On the issue to promote banking system soundness as a legitimate objective, I can agree with previous speakers that in light of the implications that the banking sector can have on macroeconomic measures, the Fund should continue to pay more attention to the relationship between the banking system soundness and macroeconomic policies in surveillance, program design and technical assistance. In addition, it will be crucial to identify rapidly the problems, so as to help correct them at an early stage.

While I can agree that particular attention should be focused on structural policies, such as financial liberalization, however, it is worth noting that more time will be needed for structural policies to succeed. As indicated in the report, if the banking system presents many weaknesses, it will be imperative to start reform without delay and to persevere in its implementation. However, a pragmatic approach appears necessary because in some cases, it will be useful to put in place an effective prudential regulations; an adequate supervision or to rehabilitate the banking system before proceeding to the liberalization of the financial sector.

On the Fund's technical assistance to support member countries' banking sector, I share the view that this assistance should continue to play a critical role in the areas where Fund members continue to experience difficulties, namely on banking supervision and rehabilitation of the banking system. I have no problem with the staff proposal to consider in some cases the need to shift resources from technical assistance toward surveillance activities. In this connection, I would like, however, to emphasis that in the case of developing and transition countries, it will be crucial to give them sufficient time, to further strengthen the efforts in the area of structural reform. Moreover, effective surveillance by the Fund and constructive response by members are called to play a crucial role, in order to help correct the specific problems in individual countries. Still on surveillance, it will be crucial to rapidly identify systemic risks and keep attention on countries facing these risks. This is important, because of the scarcity of resources and the possible consequences on the Fund's financial situation.

On the Fund's involvement in the international cooperation outside the G-10 framework, I think that the Fund should continue to play an important role in providing its contribution in the macroeconomic context. Regarding the role of the Fund, while collaboration with other institutions will be critical, it will also be essential to focus where systemic risks exist. The Fund's mission and World Bank collaboration on this issue should be well delineated.

Before closing my statement, I would appreciate staff comments on the following issue: In case of independence of the central bank in the member country, how can the relationship between the Fund and the central bank be strengthened, so as to facilitate Fund's surveillance? We have some specific cases where data communication to the Fund present considerable delays, besides weaknesses in the data provided.

Finally, I would like to associate myself with previous speakers on the need to have the staff papers published. However, it will be desirable to consider a clear segmentation between the Fund member countries, according to the magnitude of the problems confronting them, because some countries have sufficient financial resources, and easy access to external financial markets, while other continue to remain in poor conditions. In sum, I would prefer a better differentiation, because problems occur at different levels depending on the stage of their banking systems. Moreover, I look forward to have fruitful discussions on the forthcoming papers related to policy responses to banking crises, as well as on resolution or restructuring strategies.

Mr. Mirakhor made the following statement:

The papers are very good and long overdue. I agree with colleagues who have suggested they be published. However, I wonder if the staff would perhaps consider two areas where additional information, or perhaps some elaboration of existing material, might be included.

The first area is that of the separation of monetary policy and bank supervisory functions. The main paper dealt with this matter briefly on page 15, but I wonder whether the topic does not deserve greater attention. The separation issue will become important in the context of EMU, when the European Central Bank is charged with the monetary policy responsibility, while banking supervision is left to national authorities. Moreover, as Ms. Lissakers noted earlier in reference to trends in some industrial countries, the commercial banking sector is shrinking relative to the mushrooming of financial activity outside the regulated sphere, and outside the direct policy reach of the monetary authority. There is the risk that the central banks may not be able to conduct a strong enough supervision on the whole financial system to prevent the problems of banks and other financial institutions from snowballing into problems of systemic proportions.

The question of how rescue operations are funded in the banking sector is also conditioned by the separation issue—by whether bank supervision is conducted by the monetary authority or by a separate agency of the government. Recent trends in the use of taxpayers' money to rescue troubled banks is important in that regard, as is the question of a possible conflict between the macro goal of monetary policy and the micro objective of maintaining a stable banking system. The paper's emphasis on the need to manage governments' contingent liabilities suggests at least an implicit recognition that the separation issue has some bearing. It would be instructive to consider which system would be better in preventing bank failures or which system would generate a more efficient resolution of bank failures, while avoiding possible systemic consequences.

The second question that deserves some additional attention is the impact of privatization programs on the soundness of the banking system: how is the quality of bank portfolios affected by the privatization of non-bank enterprises; how does the privatization of banks affect the implementation of prudential reforms, and their exposure to related borrowers.

On the role of the Fund, I now wonder how intrusive passing judgement on the soundness of a country's banking system might be, and, considering how quickly reports can leak, how serious the ramification could be. I would welcome the staff's views on that matter and on how duplicative the Fund's work might be vis-à-vis the work of the Bank for International Settlements.

I am very much in sympathy with what Mr. Barro Chambrier had to say. We do not agree with the shifting of resources from technical assistance to surveillance. If bank soundness should become a regular feature of Fund surveillance and additional resources are needed, then, as Mr. Berrizbeitia said, so be it; we should go ahead and find the resources, as needed.

Mr. Kiekens made the following statement:

Industrial countries, developing countries, and transition countries alike have a bad record with respect to the soundness of their banking systems. Since 1980, two-thirds of the member countries have experienced serious problems in their banking sectors. One can therefore wonder whether today's staff paper is not overdue, and whether these problems could not have been mitigated if the Fund had sooner sharpened its focus on the problems we discuss today. Indeed, the problems of the banking sector in the transition countries, for instance, are to a great extent due to the lack of adequate prudential regulation and supervision. In any case, today's paper could not have been produced five years ago, as it owes much to the lessons of the recent past. They give an accurate and detailed picture of the relationship between bank soundness and macroeconomic policy.

This is not to say that the Fund has been passive in the recent past, as we see that programs increasingly contain structural benchmarks aimed at improving bank regulation, supervision, and restructuring. The Monetary and Exchange Affairs Department has also provided extensive technical assistance. The Board decided, last year, that in the framework of the Fund's strengthened surveillance, more attention should be given to the structural weaknesses of the banking sector in the face of free capital movements and the vastly globalizing financial markets.

Given the changes in financial intermediation, and the growth of disintermediation, the pursuit of financial soundness cannot be limited to banks, but must extend to the broader goals of "sound financial institutions" and "sound financial markets."

The Fund's primary role is macroeconomic stabilization. As problems in the financial sectors can endanger macroeconomic stabilization and limit the effectiveness and sustainability of stabilization policies, financial sector soundness is indeed a legitimate policy objective of the Fund. However, the Fund's involvement should be limited to what is justified by its mandate of promoting macroeconomic stabilization. The Fund should therefore continue to coordinate its efforts closely with the World Bank and the BIS. I believe that the proposals contained in the papers we discuss today do in fact remain within these limits.

Consequently, I agree that stabilization policies, in order to be effective and sustainable, often need to be supported by structural reforms aimed at increasing the soundness of the banking sector. Obviously, such reforms have to be tailored to the situation of the individual member country. The Fund can make a real contribution by sharing its experience in advising national governments and supervisory authorities. Experience should also enable the Fund to identify any obstacles to structural reforms in the banking sector.

The staff document identifies the necessary components of a sound banking system and a comprehensive supervisory framework. International coordination of banking supervision is still too limited to avoid the occurrence of gaps in supervision, as for example the gaps between regulated banks and centers, and off-shore centers. Greater transparency and better data reporting would certainly enhance market discipline. There appears, however, to be a danger that efforts in this direction, especially for off-balance sheet operations, will fall victim to shortsighted cost cutting. I also fear that different data reporting requirements may become an undesirable object of supervisory competition.

The staff rightly advocates an active policy with respect to bank closures, and that banking supervision in general should be within the competence of an independent supervisory body.

The possibility of designing a standard lender of last resort policy is very limited. The central bank should therefore adopt a case-by-case approach, which will limit the problem of moral hazard.

The continual change and evolution of the banking sector requires continual change and evolution of regulation and supervision, applies to the whole range of financial agents and services, and includes close scrutiny of technological innovations.

Contingent budget expenditures in the area of banking should be taken into account when designing Fund supported programs. Mr. Fukuyama was clearly reluctant to go in that direction, as making these liabilities public could trigger a banking crisis one would prefer to avoid. I believe that the staff does not propose making these contingent liabilities public. They should, however, be discussed between the staff and the authorities, and the government should give assurances that it stands ready to take additional action, if these liabilities materialize, by indicating in advance which kinds of revenue raising and spending reduction measures the government is willing and able to take. These understandings between the staff and the government need not necessarily be spelled out in detail in the letter of intent.

Concerning the possibility of the Fund's involvement in banking supervision in regions outside the G-10, I believe we limit the proliferation of institutions engaged in the various aspects of international supervision. The Basle Committee has gathered valuable experience over the years. The Fund should continue its present cooperation with the Basle Committee by addressing the interrelation between bank stability and macro financial stability. In addition, I presume that the Basle Committee's recommendations should in principle be supported by the policy advice and technical assistance the Fund gives its members, in the absence of clear contradictions.

Mr. Fukuyama commented that he doubted that governments would incorporate the contingency costs of troubled banks in their budgets before the banking problems had become public knowledge. Moreover, he wondered whether reflecting contingency costs in budgets would necessarily result in prompter action to resolve banking problems.

The Director of the Monetary and Exchange Affairs Department said that he welcomed the Board's recognition of banking sector soundness as a legitimate objective of, as well as constraint on, macroeconomic policy implementation. Understanding the interrelationship between the macroeconomy and the banking system was of growing importance to the work of the Fund, as more economies became market based, as capital accounts were opened, and as domestic financial systems become more closely integrated.

The role of the Fund envisioned in the paper was consistent with its mandate in other areas involving structural adjustment, namely, to address the causes and consequences of bank soundness from a macroeconomic standpoint, the Director continued. Since the effectiveness of macroeconomic policies, in turn, depended on the health of the banking sector, the paper focused on that two-way relationship and on the balance required between prudential regulation and market discipline in promoting sound financial practices in the banking industry. In that context, the Fund had a clear role to play in offering macroeconomic policy advice that was mindful of conditions in the banking sector. The Fund was also in a position to share its knowledge about the macroeconomic aspects of bank soundness with supervisory institutions. To that end, it was useful for the Fund to have a clear view of what constituted appropriate prudential standards, without that implying Fund involvement in the setting of standards or in the supervision of banks.

Regarding the effectiveness of the Basle Committee's standards—and in particular the minimum risk-weighted capital adequacy requirements set by the G-10 group of banking supervisors for international banks—certain prerequisites were worth noting. In particular, such effectiveness presupposed adherence to basic prudential practices, such as proper valuation and adequate loan provisioning. As for the capital adequacy standard, it would be important to avert the risk noted by Mr. Autheman and others that an insufficient norm could weaken bank soundness. As the paper had noted, in many instances, the standard was not high enough, even in industrial countries, and particularly so in developing and transition economies, where vulnerabilities and uncertainties in the banking sector were often acute, the Director commented. The proper prudential capital adequacy standard would clearly have to reflect risks and conditions particular to the banking sector of each country and, while no single standard applied to all banks, the Basle Committee did provide a useful minimum norm, with the emphasis on "minimum."

A duplication of efforts was not envisioned in suggesting a role for the Fund in the harmonization of prudential banking standards, the Director continued. The Monetary and Exchange Affairs Department had had a close working relationship with the Basle Committee from its inception. It participated in regional and international meetings of bank supervisors, and offered support to their efforts to improve supervision through its technical assistance. Where appropriate, the department disseminated through member countries the work of the Basle Committee and explained the reasons for minimum prudential standards. More recently, that information was also being conveyed in the context of Article IV consultations. An idea proposed in the staff paper was that the Fund would support international supervisory efforts advocating the need for prudential banking standards through surveillance, and contribute advice on the macroeconomic aspects of banking sector problems.

A clear division of labor also prevailed in the longstanding understanding between the Fund and the Bank, with the World Bank traditionally focusing on the micro aspects of sectoral reforms, and the Fund minding the macro and prudential considerations, the Director added. With demand for technical assistance in the areas of financial sector reform and bank restructuring having increased sharply in recent years, the Monetary and Exchange Affairs Department had increasingly sought to coordinate its efforts with those of the Bank. Such cooperation was essential to the Fund, as the institution could not cover the rising demands singlehandedly.

Linkages had progressively emerged among various Fund activities when dealing with bank-related issues, the Director remarked. Historically, banking sector weakness had been addressed exclusively through technical assistance provided by the Monetary and Exchange Affairs Department. In recent years, bank soundness had increasingly become a topic of discussion in Article IV consultations and, more recently, it had become an important aspect in the design of Fund-supported programs. One reason for a measure of interaction in the work of the technical assistance and area departments was that determining what needed to be done to resolve banking sector problems was greatly facilitated by expert knowledge about banking systems. To the extent that the Board considered bank soundness a legitimate concern of the Fund, then the subject warranted even greater attention in regular Article IV consultations by area departments, as well as in the design of countries' adjustment programs.

While demands for technical assistance to build banking sector institutional infrastructure in transition economies was expected to taper off, looking ahead new demands could be seen emerging with trends in financial sector deregulation, external financial liberalization and greater integration of the global financial system, the Director said. Hence, in asking whether the Board supported a shift in resources from technical assistance surveillance, the purpose was not so much expecting resource relief as it was determining whether more should be done to address the macroeconomic causes and consequences of bank soundness through Fund surveillance and in the design of Fund-supported adjustment programs. Mr. Coumbis and others had suggested alternative ways of allocating the Fund's resources, and the staff was open to those possibilities.

Mr. Mirakhor said that, if banking soundness were to become a part of regular surveillance, perhaps it would be beneficial to consider Mr. Shields's suggestion that there be training for the regular staff, and possibly related courses through the Institute and the Economist Program. That way the staff would better understand the issue of banking sector problems, the membership would be alerted to the importance of bank soundness, and Fund surveillance would be strengthened. That was a subject that would have to be seen together with other training needs in the institution.

The Acting Chairman confirmed that the issue of training in the area of bank soundness would be addressed in the context of management's overall review of internal staff training programs.

The Director of the Monetary and Exchange Affairs Department said that although estimating the costs to the government of resolving banking sector weaknesses was admittedly difficult, it was nevertheless crucial that those costs—including loan and deposit guarantees, and any negative net worth of the central bank or state-owned banks—be recognized and factored into the fiscal program at an early stage. Governments that assumed significant contingent liabilities were clearly constraining, at least in probability terms, the scope for fiscal policy freedom. Moreover, by addressing banking sector problems only very late in the process—often only once the guarantees had been called—governments imposed considerable costs on tax payers. The Fund had an important role to play in encouraging timely resolution of banking weaknesses and greater transparency of the related costs, and in explaining the need for prudential regulation and sectoral reforms. That way, banking crises, and the sort of self-fulfilling prophecy to which Mr. Fukuyama had referred, could be avoided.

Regarding Mr. Fukuyama's point, if events had gone so far that the banking authorities feared the consequences of a public disclosure of fiscal consequences, then in all likelihood problems had already gotten out of hand. The question then was unlikely to be whether markets knew about troubled bank institutions, but to what extent that information was already known and had been discounted., the Director remarked. Keeping banking difficulties close to the chest was not as easy as one might imagine in today's financial market environment. That was why the paper emphasized the importance of forward-looking discussions on ways to strengthen domestic banking systems, these being of course issues to be treated with the same measure of confidence given to discussions of sensitive budget and exchange rate policy matters between the authorities and the Fund. Banking sector difficulties did not have to become either/or propositions; there was a continuum and one stood to get ahead by tackling the problems early in the process.

Acknowledging the importance of a sound financial sector for the efficient functioning of the macroeconomy did have implications for the design, pace, and sequencing of stabilization and liberalization policies, to ensure that those policies would be sustainable, the Director said. However, there were no categorical answers for what the best sequencing of policies might be. Some speakers had suggested that a sound banking sector was a precondition for liberalization; one might equally argue that progress toward liberalization was a precondition for bank soundness; both statements could be defended. Of course, most policy choices fell somewhere between those extremes, and the critical issue was deciding where to draw the line. One had to think in terms of how much responsibility for bank soundness the banking sector itself would take on through internal governance, how much would be left for market discipline to handle, and what would be the appropriate role of official oversight and prudential standards in that context. Therefore, while one had to be mindful of conditions in the banking sector in designing the pace and the sequence of macroeconomic policies and sectoral reforms, that did not imply that the pace of adjustment would have to slow down. Rather, it meant a distribution over time of policy actions that differed from those that would have prevailed in the absence of banking sectors weaknesses.

While there was limited scope for any trade-off between fiscal and monetary policies in all but the short run, more thought was required on the interactions between bank soundness and macro adjustment under different exchange rate and regimes and in the context of interest rate liberalization, including the associated bank portfolio implications, the Director continued. With respect to the potential conflict between monetary control and concern with banking soundness, again it was important not to view those objectives as either/or propositions. While one could certainly control inflation at the expense of the banking sector, the policy challenge was how to achieve both successfully over time. This required viewing the maintenance of a sound banking sector as an objective of, as well as constraint on, macro policy implementation; the two complemented one another in the long run, even if there was some potential for conflict in the short run, as, for example, the temptation to tamper with banks' minimum prudential standards in the implementation of monetary policy, which should be avoided.

The paper avoided taking a categorical position on whether authority for bank supervision ought to be situated in the central bank or elsewhere, the Director observed. The data in the paper indicated that over 60 percent of countries gave responsibility for bank supervision to the central bank, rather than to a separate agency. Preference for that institutional arrangement was partly due to human resource constraints, and the economies of scope in employing qualified central bank staff to perform both functions. Also, many countries may have preferred that arrangement because it ensured that the central bank had immediate access to information on banks in performing its lender of last resort function. However, regardless of the institutional framework, it was still necessary to maintain a measure of functional separation in the supervision of banks and monetary management to minimize the scope for potential conflict.

Regarding banking sector data, the paper was not arguing for new requirements, the Director continued. Rather, over time it would become evident whether bank soundness could be assessed on the basis of existing information or whether complementary data might be needed in the context of certain countries. Finally, on the question of money laundering, a staff paper was under preparation which would shortly be presented to the Financial Action Task Force on Money Laundering.

The Deputy Director of the Monetary and Exchange Affairs Department said that he wished to focus on the sequencing of banking supervision and prudential regulations in support of interest rate liberalization. Where banking systems were financially weak and lacked prudential safeguards, experience suggested that a critical mass of prior measures to strengthen supervision and restructure banks could be implemented as interest rates began to be liberalized, as a way of supporting the adjustment process. The flexibility of interest rates would initially be constrained by the cash flow problems for banks and for the enterprises to which they lent, and those problems would be eased by the prior measures undertaken. The choice of prior measures depended on the initial health of the banking sector, the state of official oversight, the development of financial markets, and the strength of internal governance. As those factors changed over time, the scope of supervisory and restructuring actions would progressively evolve. In undertaking prior actions, close cooperation with the authorities and with organizations and agencies that participated in financing any recapitalization restructuring was crucial, as was early recognition of the bank restructuring costs. In particular, an early introduction of concrete bank accounting standards, capital adequacy norms and loan loss provisioning requirements, helped to foster liberalization objectives over the medium term, and stabilization objectives in the short term. Those were some of the staff's findings, as summarized on page 20 of the staff paper.

The staff representative from the Monetary and Exchange Affairs Department said that concern about banks' currency exposures in dollarized economies pointed to the need for prudential limits regardless of whether those exposures were in domestic or foreign currency. It was important to look beyond the banks' balance sheets at the underlying exposures in the real economy, and the impact of macroeconomic policies on those underlying sectors. With respect to the suggestion that prudential regulations be used to encourage the use of the local currency, one would not typically use prudential rules toward such ends. The means of increasing the demand for domestic currency was to foster stable and sustainable macroeconomic conditions.

As to the merits of universal banking, no one ownership structure was necessarily better than another; each country had its own institutional background, the staff representative continued. However, it was important to monitor the different risk concentrations, including those arising among financial and nonfinancial conglomerates, to manage those risks adequately, and to ensure that proper internal controls were in place. However, highly specialized banks—such as housing banks—were generally not recommended, as they tended to take on excessive amounts of undiversified risk.

Ms. Lissakers said that she disagreed with the staff's view that dollarization did not give rise to a particular sets of issues in the study of macroeconomics and bank soundness. Where the deposit base of a country was largely held in foreign currency, there was a direct link between the availability of foreign exchange reserves and bank soundness in the event of a run on deposits. Moreover, there was a growing body of technical advice offered by the Fund on ways to deal with problems of monetary control under conditions of dollarization. For example, the appendix of the staff report for the 1995 Article IV consultations with Bolivia (EBS/96/32, 3/1/96) indicated that, while a currency board arrangement could be used to restore confidence in the domestic currency, the ability of the central bank to provide liquidity as a lender of last resort would be circumscribed under a currency board arrangement. That suggested a conflict between the policy objectives of monetary management and bank soundness because of the dollarization issue, and those were the kinds of issues on which the Fund's surveillance teams needed to be knowledgeable and focus greater attention.

To the extent that a trade-off had to be made between technical assistance and surveillance, the priority would have to be given to surveillance, as that was the Fund's principal area of responsibility, Ms. Lissakers added. The Fund should also encourage bank supervisory groups, whether the Basle Committee or other cooperative initiatives, to assume a greater share of the technical assistance burden, to the extent that resources had to be shifted to strengthen the role of the Monetary and Exchange Affairs Department in the surveillance function.

The Director of the Monetary and Exchange Affairs Department agreed with Ms. Lissakers that more focus on bank soundness was required through surveillance. To some extent, the staff paper had suggested the possibility of moving resources from technical assistance into surveillance in order to focus attention on the possibility of integrating some of the more policy-oriented aspects of technical assistance into surveillance. However, he doubted that that would require a significant shift in resources away from technical assistance.

Ms. Lissakers indicated that she was addressing the question of where to put the weight of the resources, assuming the institution faced a resource constraint. She was not arguing that the Fund should stop providing technical assistance, but if a trade-off had to be made, in her view the priority would have to be given to strengthening the surveillance function, leaving the more specialized aspects of banking sector soundness to other institutions to carry out, whether the World Bank or the regional development banks or groups of central banks. Her position had always been that the Fund paid too little attention to weaknesses in the banking system in its surveillance activities and, indeed, in the design of programs. Very significant improvements had been made since she had first made that point in the Board, and the emphasis should remain on the catalytic role of the Fund in making authorities aware of potential banking sector problems and the associated costs, encouraging them to seek technical assistance when needed, and encouraging other institutions to provide the technical assistance in a way that complemented the Fund's macroeconomic surveillance and program design.

Ms. Srejber said that, while greater attention to financial soundness was clearly required in surveillance, the technical assistance offered by the Fund was important to countries, and the Fund had a legitimate role in coordinating with other institutions and organizations on matters of technical assistance. In addition to Fund staff from the technical departments, there was a long list of distinguished experts from member central banks and ministries of finance who provided invaluable technical assistance, and for whose services the Fund paid the bills. Hence, she wondered whether Ms. Lissakers was suggesting that those resources should be released and shifted into surveillance.

Ms. Lissakers reiterated that she was responding to the staff paper, which asked whether the Board agreed with shifting part of Fund resources from the provision of technical assistance toward surveillance activities. In her view the answer was yes, up to a point. She was not advocating that technical missions be canceled, but rather that the weight of resources be given to surveillance, and that the Monetary and Exchange Affairs Department should become more directly involved in area department surveillance than it had historically.

The Director of the Monetary and Exchange Affairs Department noted that part of the department's function over the past three or four years had been to bring into the general discussion of policies some aspects of the advice given to countries in the context of technical assistance missions. For example, the introduction of indirect instruments of monetary policy was a topic that typically had been handled through technical assistance, until the Board considered that it should become part of general policy advice. Viewed in that context, some technical assistance was already going to support surveillance activities, without that reducing the Monetary and Exchange Affairs Department's input in other areas, or lessening the role of central bank experts in dealing with the nuts and bolts of technical advice. There had been a growing linkage of technical assistance and surveillance activities in policy areas of importance to the Fund in recent years, and technical assistance could provide essential support to the surveillance activities of the institution.

The Acting Chairman called on the staff representative from the World Bank to comment on the division of responsibilities between the Bank and the Fund as seen from the Bank's perspective.

The staff representative from the World Bank said that informal collaboration between the Bank and the Fund on banking sector issues dated back many years. The Fund and the Bank exchanged information and views on banking sector reforms on a regular basis, in the context of seminars, and by reviewing each others papers. More recently, with greater focus by both institutions on the banking sector, there had been a significant increase in the frequency of communication and coordination, with the Fund approaching the banking sector problems primarily from the perspective of macroeconomic stabilization, and the Bank handling the long-term growth and resource allocation issues.

The Bank was currently developing a plan to strengthen its capacity to support banking sector reform, the staff representative continued. As part of that initiative, full account was being taken of Bank and Fund involvement in the financial sector, with a view toward delineating the responsibilities of each institution. Also, the staff from the Bank and the Fund were meeting regularly, along with various central bankers, to exchange information, as a first step, and ultimately to collaborate in a more structured mode in the future. The Bank and the Fund also participated in joint staff training programs, and more comprehensive training in the banking domain was anticipated. Finally, the Fund and the Bank communicated about banking sector-related reforms in almost every country in which the Bank had a presence. There was an important role for both institutions to perform, and efforts to give more structure to that cooperation were underway. Given the magnitude and pervasive nature of banking sector problems, far more coordination between the two institutions was envisaged in the future.

Mr. Esdar asked how the responsibilities of the two institutions were divided in the specific context of a country that faced a banking crisis. Which institutions took the lead, and how were their efforts coordinated?

The staff representative from the World Bank indicated that the Bank tended to focus on the restructuring of institutions and on ensuring appropriate financial sector infrastructure was in place, including banking laws, prudential banking regulations, and adequate banking supervision. In that context, the role of the Fund was often to carry out the technical assistance—to bring in technical advisors that supported the banking supervisory agency in developing the laws, the regulations, and the supervisory capacity. Such technical assistance took place in conjunction with financial sector adjustment lending from the World Bank. That was the sort of division of labor that had prevailed in Poland and in Kenya, and which was envisioned in the future.

The Director of the Monetary and Exchange Affairs Department added that the department would respond to requests for technical assistance through a mission. In the context of a banking crisis, the mission would ascertain the extent of the problem, its macroeconomic implications, and the type of expert advice that might be required. If the technical issues needed ongoing advice, the Fund would send resident experts to the country, as appropriate. The role of the Bank was to deal more directly with the financial end of bank restructuring and rehabilitation.

The Acting Chairman made the following summing up:

> Executive Directors welcomed the opportunity to consider the relationship between banking system soundness and macroeconomic policy. Directors noted with concern the large proportion of Fund member countries that had experienced banking sector problems in recent years and the increasingly international nature of many bank failures. Given the fundamental role of banks in the economy, Directors stressed that awareness of the factors leading to banking sector problems, understanding of the impact of banking sector fragility on the macroeconomy, and the ability to design and implement measures to foster sound banking, deserved increased attention by the Fund.
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> Directors agreed that, in view of the linkages that exist between banking systems and macroeconomic policies, it was necessary to take into account the condition of the banking system in the formulation of economic policies, both as a key objective and as a constraint on policy. Directors generally accepted that stabilization program targets and instruments might need to be adjusted in the face of an unsound or potentially unsound banking system. However, several Directors stressed that this did not imply delayed adjustment, but rather showed the need for a realistic approach to design ambitious, yet achievable, policies. They urged that the design of stabilization policies should be complemented by structural reforms to foster banking system soundness, including strengthened supervision, and the advancement of financial sector development and liberalization. They stressed, in that context, the importance of a sound macroeconomic framework in underpinning an efficient banking system.
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> Directors agreed that the Fund should continue to encourage its members to adopt appropriate prudential standards. They also agreed that emphasis needed to be placed not only on external oversight of banks, but also on market

discipline and internal bank governance, while the nature of oversight should evolve in line with the development of financial markets. Most Directors agreed that in developing, emerging markets, and transition economies there was still a strong need for an independent and effective supervisory authority, which often might best be vested in the central bank. Directors observed that, in the industrial countries, market discipline must be supplemented by effective official oversight, and they noted that banking problems had occurred even in countries in which market discipline was reasonably strong.

Directors noted that a comprehensive mix of supervisory and regulatory policies could provide, in principle, for a sound banking environment, provided the macroeconomic framework was also sound; an inadequate mix of these policies had weakened market discipline in many countries and had increased the fiscal cost of banking problems.

Directors emphasized the importance of contingent government liabilities that arise with respect to the banking sector. They agreed that more attention should be paid to the issue of contingent liabilities, and that national authorities should be encouraged to make such liabilities more transparent and to include them, with an appropriate degree of specificity, in fiscal projections.

Several speakers drew attention to the declining role of banking systems, particularly in industrial countries, vis-à-vis the rest of the financial sector. The implications of that development would need to be considered further at some point.

In addressing the Fund's role, Directors emphasized the need to coordinate closely with the World Bank and other international agencies so that each agency would concentrate on areas of core competence and complement each other. In the case of the Fund, that would include surveillance and advice regarding the linkages between macroeconomic policy and banking systems, as well as guidance in the areas of monetary and prudential policies in support of bank soundness. Most Directors agreed that the Fund should play a role in encouraging the strengthening of banking supervision and financial systems through the surveillance process, Fund-supported program design, and the supporting technical assistance. Although some Directors noted that member countries might be reluctant to discuss sensitive banking data with the Fund, most felt that Fund surveillance of financial sectors was critically important, and that the necessary data should be made available to Fund missions. It was observed that that would be consistent with the newly developed standards for dissemination of economic and financial statistics to the public.

A number of Directors suggested that international cooperation in banking systems was best left to the Basle Committee. Some noted, however, that the Basle standards were not necessarily applicable or useful for all member countries of the Fund, which faced widely differing situations. While somewhat downplaying the need for international cooperation and harmonization in banking supervision, they considered that the Fund should focus its own contribution on encouraging national authorities to strengthen their domestic systems and practices, and on supporting regional initiatives. The Fund should also encourage members to meet international standards for financial sector reporting, regulation, and supervision, while recognizing that harmonization would not necessarily lead to homogeneity of policies.

Directors encouraged the staff to devote greater attention to banking and financial sector issues in the context of the Fund's surveillance and program activities. Differing views were expressed on whether that could be achieved without a major redeployment of or increase in resources. Many Directors stressed the importance of continued technical assistance in the areas of bank supervision and financial sector development, and underlined that such technical assistance needed to be properly integrated into Fund-supported adjustment programs and the content of structural benchmarks.

Directors supported publication of the staff papers after revision to take into account the Board discussion. In that regard, comments on the paper should be communicated to the staff within two weeks; that is, by March 25.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/96/20 (3/8/96) and EBM/96/21 (3/11/96).

2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/96/19, Supplement 1 (3/7/96) and EBAM/96/35 (3/5/96) and.Correction 1 (3/5/96) and by an Assistant to Executive Director as set forth in EBAM/96/36 (3/5/96), and Correction 1 (3/5/96) is approved.

APPROVAL: February 12, 1997

REINHARD H. MUNZBERG
Secretary