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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/12

10:00 a.m., February 10, 1997

Contents

Executive Board Attendance

S. Fischer, Acting Chairman
S. Sugisaki, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	J.P. Borpujari, Temporary
	A. Fayolle
	P.A. Fremann, Temporary
T.A. Bernes	C.X. O'Loghlin
	T. Turner-Huggins, Temporary
	J.A. Chelsky, Temporary
	W.-D. Donecker
	R.J. Heinbuecher, Temporary
H. Evans	J. Shields
	N. Coumbis
	A. Giustiniani, Temporary
	J.P. de Morais
D. Kaeser	
A. Kafka	A. Calderón
	H. Mori, Temporary
W. Kiekens	A. Cserés, Temporary
	M. Nemli, Temporary
K. Lissakers	B.S. Newman
	M. Sobel, Temporary
H. Mesaki	H. Ono
A. Mirakhor	M.-H. Mahdavian, Temporary
A.V. Mozhin	A. Vernikov
A.S. Shaalan	T.K. Gaspard, Temporary
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	
J.J. Toribio	J. Guzmán-Calafell
E.L. Waterman	A.G. Yakub, Temporary
J. de Beaufort Wijnholds	P.I. Botoucharov, Temporary
	A. Barro Chambrier
Zamani A.G.	S. Joyosumarto
Zhang Z.	Han M.
	Zheng H., Temporary
A.G. Zoccali	D. Merino, Temporary

R.H. Munzberg, Secretary
W.S. Tseng, Acting Secretary
S. Bhatia, Assistant

Also Present
IBRD: C. Petersen, Middle East and North Africa Regional Office and D. McNaughton, Financial Sector Development. M. Saal. African Department: G.G. Johnson. Asia and Pacific Department: I. Otani. European I Department: M.C. Deppler, Deputy Director; G. Belanger, M.J. Fetherston, T.D. Lane, A. Magnier, L.K.-G. Meuller, S.H. Samiel. External Relations Department: A. Caminis. Fiscal Affairs Department: V. Tanzi, Director; J.A. Daniel, J.M. Davis, L.P. Ebrill, J. Escolano, S.A. Symansky, Y.H.T. Young. IMF Institute: G.C. Dahl. Legal Department: A.O. Liuksila, L.E. Nordgaard, H.N. Schiffman. Middle Eastern Department: P. Chabrier, Director; M. A. El-Erian, Deputy Director; V. Sundararajan, Deputy Director; P. Alonso-Gamo, S. Eken, A. Fedelino, T.F. Hebling, O.T. Kanaan, A. Mazarei, K. Nashashibi, M. Zavadjil. Monetary and Exchange Affairs Department: M. Guitián, Director; M.D. Knight, Deputy Director; P.T.Downes, C.A. Enoch, C.-J. Lindgren, H. Mehran. Policy Development and Review Department: J.T. Boorman, Director; R.J. Bhatia, J. Ferrán, N.L. Happe, A. Ibrahim, T. Nakao, S.M. Nsouli, S.K.Wajid. Secretary's Department: P. Gotur. Treasurer's Department: M.G. Papaioannou. Western Hemisphere Department: E.S. Kreis. Office of the Managing Director: D. Burton, H.L. Mendis, J. Prust; Office of Internal Audit and Inspection: E. Brau, Director. Advisors to Executive Directors: P.A. Akatu, M.B. Alemán, S.S. Farid, A. Guennewich, K.M. Heinonen, A.R. Ismael, J. Jonáš, A. Levy, M.F. Melhem, O. Sein, L.B.J. van Geest, V.Y. Verjbitski. Assistants to Executive Directors: M.A. Brooke, M.A. Cilento, A.L. Coronel, C.K. Duenwald, J.C. Estrella, S. Fukushima, B. Grikinyté, W.K. Gruber, J.K. Honeyfield, O. Issaev, H. Javaheri, K. Kpetigo, J.P. Leijdekker, D.G. Loevinger, A. Lucenti, B.M. Lvin, M.Z. Maatan, D. Merino, I. Moon, J.A.K. Munthali, L. Palei, A.R. Palmason, H. Paris, J.L. Pascual, L. Pinzani, E.T. Rădulescu, S. Rouai, M.W. Ryan, O. Schmalzriedt, M. Yiu, E.L. Zamalloa, Zubir bin Abdullah.

1. ICELAND—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Iceland (SM/97/20, 1/24/97; and Cor. 1, 2/7/97). They also had before them a background paper on recent economic developments in Iceland (SM/97/22, 1/27/97; and Cor. 1, 2/7/97).

Ms. Srejber made the following statement:

My Icelandic authorities would like to express their appreciation for the constructive discussions which they have had with the Fund mission. Let me say at the outset that they are in agreement with many points stated in the staff report.

In order to create the necessary conditions for sustainable growth, the priority of economic policy in recent years has been macroeconomic stabilization and structural reform. The policy has aimed at improving the operational environment of business and eliminating the persistent fiscal deficit, while keeping inflation in check. The social consensus and stability have been preserved in the labor market through cooperation between authorities and social partners.

The rewards of this policy have materialized: healthy economic growth, low inflation and gradually declining unemployment (down to approximately 4 percent). Exports of manufacturing and services have flourished, while the diversification in Iceland's base industries has increased. Recently, domestic demand has increased considerably as business investment has rebounded, and a rise in disposable income has led to a surge in private consumption. The authorities have responded by reducing public sector investment and have focused on preserving the intermediate exchange rate target through monetary policy.

According to preliminary figures, the Treasury budget deficit amounted to 0.4 percent of GDP in 1996. This is but half the deficit envisaged in the 1996 Fiscal Budget and less than a quarter of the 1995 outcome.

The 1997 Fiscal Budget proposes a surplus for the first time since 1984. This is in line with the government's goal as reflected in the medium-term projections for Treasury finances. According to these projections, a fiscal surplus will be run in the next few years, which will lead to a decline in the Treasury debt down to 38 percent of GDP at the turn of the century.

The tax reforms implemented in recent years have made the tax system more responsive to economic developments through built-in stabilizers. The importance of indirect taxation has been reduced and the corporate tax system changed in order to improve the competitive position of Icelandic companies. A committee of government officials, representatives of the political parties in the government and the social partners, is currently working on proposals to lastingly improve the income tax system. The aim of this work is to reduce the marginal effects of both the income tax itself and related benefit payments, to broaden the tax base, to lower the tax rates, and to reduce the means-testing of the system, without significantly affecting the Treasury's revenues.

On the expenditure side, the policy of the government is to restrain fiscal expenditures further through structural reforms. However, it is important not to undermine the competitive position of industries, the social consensus, and the balance in the labor market.

Although—as noted by the staff —Iceland's public debt to GDP ratio may not be large by international standards, its size is somewhat of concern due to the country's vulnerability to external shocks, and as the foreign currency component of the Treasury debt is relatively high because the young and still narrow domestic financial market can only absorb limited amounts of public debt issues at any given time. However, according to the 1997 Fiscal Budget, the Treasury debt is expected to fall in 1997 for the first time in two decades, with the net borrowing requirement being negative.

The central bank has in recent years developed its instruments in the money and foreign exchange markets to better fulfill the goals of the monetary policy. Simultaneously, the Bank has assumed a leading role in facilitating a speedy and orderly development of the domestic financial market. This work has already started to bear fruit, as the central bank already has been able to relinquish its role as market maker in the secondary market for long-term government debt. The liquidity in the market for interest-bearing securities will be further enhanced by the Treasury's decision to reduce outstanding issues from 46 to 9. The response in the bond market to this announcement was very favorable.

The pegged adjustable exchange rate has served Iceland well as an intermediate target for monetary policy and—as correctly pointed out by the staff—the framework played a key role in facilitating responsible and transparent disinflationary policies. With its actions last September, the central bank underscored its commitment to the framework by raising interest rates to reflect a 300 basis point differential vis-à-vis the trading partners.

The staff suggests in its analysis that the overall stance of monetary policy might be too loose at present, referring to a negative output gap, an unemployment rate close to NAIRU, strong growth in some monetary and credit aggregates, and a slight increase in inflation in 1996 compared to the year before. My authorities are of the opinion that it is very likely that the degree of slack that existed in the economy in recent years has more or less disappeared. This assessment was part of the reason for the tightening of monetary conditions last September. But there are mixed indications as of yet concerning whether the economy has entered an overheating phase.

Firstly, as is well-known, and as pointed out by staff, there is great uncertainty concerning the measurement of output gaps and NAIRU in general, and specifically in Iceland. The seasonally adjusted unemployment rate is now close to the upper limit of the estimates for NAIRU. There are some localized bottlenecks but, on the other hand, wage drift has been decreasing. Secondly, M3 grew by 5.8 percent in the course of 1996, which is consistent with continued low inflation. And, even if bank lending increased by nearly 12 percent, in the context of the upswing in the real economy, house prices fell in the fourth quarter, and were only 0.3 percent higher in nominal terms than the year before. Finally, even if consumer prices increased by 2 percent in the course of 1996, which is slightly more than 1995, the annualized increase in the consumer price index between the third and fourth quarter was only 0.6 percent. The slight increase in inflation in 1996 compared to 1995 can be fully explained by higher increases in import prices and domestic agricultural prices and other prices subject to public price controls. Overall, it is therefore not completely accurate to state that there have been inflationary pressures in the Icelandic economy. Rather, it is a question of an inflationary danger associated with the strong growth in the real economy and the upcoming wage settlements.

The authorities have already started the much needed process of reducing the presence of public entities in the private sector in order to enhance efficiency and increase competition. A number of government enterprises have been privatized, several large state enterprises are in the process of being turned into limited liability companies, and the Post and Telegraph Administration became a corporation as of the beginning of 1997. Furthermore, a proposal to turn the two state owned commercial banks into limited liability companies will most likely be presented to parliament in the coming weeks. In addition, plans to rationalize and incorporate the investment credit funds are currently under preparation.

Important reforms have been instigated on labor market laws and relations between companies in order to make the labor market more flexible and to improve business relations and decision making within the labor unions. Likewise, the enactment of new legislation concerning the pension fund for state employees will make Treasury pension expenditure more transparent and more in line with those prevailing in the private market. At the same time, the ongoing reform of the unemployment benefit system will tighten eligibility and make supervision more effective.

One of the main characteristics of the financial system in Iceland has been the extensive practice of indexation on financial obligations. As price stability has become more entrenched, the government has formed a policy of gradually reducing the practice of indexation, starting with reducing it in the short end of the market by issuing only nonindexed government securities for maturities up to five years. Nevertheless, indexation will continue to play a role at the long end of the market.

The economic outlook for 1997 is somewhat uncertain, as general wage negotiations are in process and agreements on large construction projects have not been finalized. However, in many respects the overall economic environment is favorable: the extensive conservation measures in the fisheries sector have started to pay back in growing fish stocks; the competitive environment has improved; the unemployment rate (approximately 4 percent) is low by international standards; substantial improvements have already taken place in public finances; and the government's medium-term plan of fiscal surpluses will lead to a substantial reduction in public debt in coming years.

Mr. Chelsky made the following statement:

To all outward appearances, 1996 was a good year for Iceland—growth was vigorous, exceeding last year's projections by more than 2 percentage points, and as noted in Ms. Srejber's statement, inflation is low, the fiscal deficit is down significantly from 1995, and the unemployment rate has declined to levels that are the envy of many other countries within the OECD.

However, as staff have rightly pointed out, there are number of emerging developments that draw into question the sustainability of the current period of good fortune and may warrant early action to stabilize the economy.

I share staff's concern with building inflationary pressure. Real wage growth is high and looks likely to maintain its brisk pace in 1997. This, combined with a surge in consumer credit, helped fuel strong growth in consumer expenditure and imports. While some of this may reflect the dissipation of pent-up demand from the earlier period of slow growth, a significant portion is due to factors which are likely to persist into 1997. Add to this the general acknowledgment that the degree of slack that existed in the economy in recent years has more or less disappeared, and we have an economy for which growth needs to moderate.

The authorities have responded to these developments to a degree—interest rates were raised last fall and a balanced Treasury budget was introduced for 1997. But I share staff's assessment that stronger fiscal and monetary action is needed. Failure to do so at an early stage, when inflation is still low, will undoubtedly raise the economic and human costs of restoring internal balance to the economy.

In this regard, I would like to raise a few questions for staff on their recommended policy mix. In calling for a tightening of monetary policy, staff favor allowing only a modest exchange rate appreciation since, in their opinion, the current account deficit limits the size of the appreciation that would be desirable. They therefore conclude that the "lion's share" of the adjustment to achieve internal balance should come from expenditure-reducing measures.

On the one hand, further fiscal tightening is clearly needed, particularly given the vulnerability of the Icelandic economy. I share staff's disappointment that the stronger-than-expected growth in 1996 did not result in a greater improvement in the deficit and this was instead used to cover expenditure slippages and delay consolidation. On the expenditure side, in addition to proposed actions and those recommended by staff, the authorities might also consider, if this has not already been done, moderating growth in public-sector wages, which can have beneficial demonstration effects for the private-sector process.

Returning to monetary policy, I am not convinced that monetary tightening should be contained so as to prevent the currency from appreciating to the upper end of the expanded range instead of, as staff recommend, keeping it within the old narrow band. Apart from the obviously desirable impact higher interest rates and a currency appreciation would have on inflation and growth, it would also lead to an much-needed increase in private savings.

But, as noted, the staff has cautioned against anything but a modest appreciation given perceived scope for a further deterioration in the current account and its impact on the already high level of foreign indebtedness. To the extent that a portion of the current account deterioration is the result of a surge of investment, particularly in export-oriented industries, I believe staff's concerns may be overstated. Also, as staff have noted, an accompanying fiscal tightening would lessen the impact on the current account. Further, higher interest rates will help contain the growth in credit-financed consumption and its accompanying impact on imports.

I am somewhat puzzled by concerns with the impact of appreciation on the current account in the staff report. According to staff's own analysis in the background paper on "Internal Balance, the Current Account and Competitiveness," the current account in Iceland is relatively insensitive to changes in the exchange rate. While the analysis in this section focuses on past experiences with devaluation and its past failure to generate an improvement in the current account, staff conclude that "revaluations may not have drastic negative impacts on the current account either."

In light of this, I have a sense that the desire to limit the scope for monetary tightening is, to a large degree, motivated by a desire to maintain the present exchange rate regime. In this regard, I recall that both staff and the authorities are of the opinion that "the stable but adjustable exchange rate had served Iceland well, providing the nominal anchor that had played a critical role in disinflation." I do not question this assessment. Instead, I would suggest that the circumstances which made this regime appropriate for Iceland's needs back in 1989 have changed markedly—due in no small part to the exchange rate policy itself—and that this warrants a rethinking of the value of the regime to the Icelandic economy if the continuing focus of monetary policy over the medium term is to be price stability. This is all the more important given that, as staff themselves have noted, "the frequency of supply shocks and lack of diversity in the composition of exports would appear to strengthen the case for a flexible exchange rate or fixed exchange rate with frequent realignments."

However, in arguing for more flexibility for the krona—albeit perhaps still within the wider band—I acknowledge staff's observation that "such a policy does not seem to have been successful in the stabilizing the Icelandic economy in the past." I would respond to this in two ways, first by noting that, in the past, monetary policy does not seem to have had the benefit of complementary fiscal policy and second, that the inflationary bias in the pre-1989 monetary policy and exchange rate regime was not due to the fact that the exchange rate was flexible, but that it was flexible only downward. The policy was, in effect, "to keep the nominal exchange rate fixed during upturns and devalue on the downturn." Allowing their currency to appreciate more freely at this time would therefore not represent a return to past failed policies.

Looking forward, we should encourage the monetary policy dialogue in Iceland to remain open to new approaches given that what has worked in the recent past might not be as effective under changed circumstances. I raise these issues here only to ensure that this debate continues.

Finally, I would like join staff in urging the Icelandic authorities to raise the ratio of ODA to GDP beyond its current level of 0.09 percent to a level more in keeping with a country possessing its relatively high standard of living. I wish the authorities well in the coming year.

Mr. Botoucharov made the following statement:

I agree with Ms. Srejber and staff's view that the overall economic environment in Iceland remains generally favorable. The benefits gained from developing the country's natural and human resources, and from the authorities' efforts to follow responsible stabilization policies have materialized in strong growth, low inflation and exchange rate stability. In line with the ongoing stabilization and structural reform efforts, Iceland's international financial position improved, as signaled by the upgrading of its credit rating in early 1996. The authorities are to be commended for these achievements.

Nevertheless, staff points to some sources of uncertainties to the economic development of Iceland in the period ahead. More precisely, the expected positive supply shocks and the uncertain outcome of the wage negotiations could endanger inflation and fiscal position prospects. In addition, the low savings rates and the resulting saving-investment imbalance, remain serious problems to Iceland's sustainable development.

The progress achieved in the past several years of keeping inflation under control and restoring fiscal balances is very welcome, particularly viewed against the earlier periods of macroeconomic instability. Consumer price inflation has been moderate since 1994, and fiscal consolidation has brought about substantial improvement in public finances. In order to sustain these developments and assure risk free growth prospects, staff believes that renewed pressure on inflation and fiscal position should be avoided. To this end, I agree with staff's recommendations, and support the view that contingency fiscal measures would be needed, if for instance, wage negotiations yield a larger-than-envisaged increase. In addition, having in mind the expected weakening of economic activity in 1997, and the opportunity missed in 1996, namely the effect of the automatic stabilizer was partially lost due to expenditure slippages, the authorities should avoid a new fiscal slip.

While these concerns are probably a bit overstated, the continued decline in savings rates over the past two decades remains an issue of serious concern. The longstanding domestic saving-investment imbalance had resulted from a substantial drop in households savings, but more importantly from a steady decline in government savings due to deterioration of Iceland's public finances since mid-1980s. The data show that the share of government savings in GDP has fallen by 6 percentage points over the past decade, fully offsetting the rise in private savings during the same period. As a consequence, national savings dropped to an average of 15 percent of GDP over the past decade, compared with 25 percent in the 1970s. It is even more worrisome that staff envisages further, albeit smaller, decline in savings rates due mainly to positive supply shocks. According to staff, the consumption smoothing behavior implies that the shocks will cause an even larger increase in consumption and lower savings rates. I would be interested to know staff's opinion on whether one could expect to see some recovery in the government savings after the improvement that has already taken place in public finances.

Mr. Yakub made the following statement:

I must say I find Ms. Srejber's statement to be quite balanced, and I tend to share a number of her observations. I think it would be fair to say, on the whole, that Iceland is moving in the right direction, given its early experiences of macroeconomic instability, made worse by the accommodative policies resulting from pressure to achieve a "social consensus," which seems to be a permanent and determining feature in the Icelandic macroeconomic framework.

The main issues at stake here are essentially one of degree or depth of reforms and one of mix of appropriate policies to be pursued. This is often the situation, or perhaps I should say the challenge, that the Fund usually endures with nonprogram countries, where it can do nothing other than advise or use moral suasion in the discharge of its obligations under the Article IV consultation.

Iceland has a GDP per capita which is as high as one of the more developed island states in our constituency; that is, New Zealand. Furthermore, Iceland's exports are not so diversified, which in fact could dampen its ability to sustain current account deficits. However, when one looks more closely at these two economies, there are some fundamental differences. In the case of Iceland, for instance, consumption is the largest contributor to GDP growth and this has been fueled by the growth in real disposable income, resulting partly from the last general wage agreement in February 1995.

I would like to focus my comments or suggestions on four main areas. Firstly, I would like to comment on the fiscal program. Given the significant role that the public sector continues to play in Iceland, it seems to me that the authorities have displayed a somewhat timid commitment to fiscal consolidation in 1997. When I view it on a year-to-year basis, the 1997 total treasury expenditure cut is only 2 percent, compared to 1996 actual expenditure, excluding the one-off budget item of treasury bonds redemption in 1996. In fact, the bulk of the adjustment is attributable to the planned transfer of the primary school system from central to local governments. Other than that, there does not appear to be any downward adjustments to other ministries' individual budget allocations, nor any spending cuts on transfers. As noted by Ms. Srejber in her statement, this situation gives rise to more uncertainty, in the light of the general wage negotiations still going on after the passing of the 1997 budget last December. I feel it is important to impress upon the authorities that, as much as is practicably possible, wage agreements ought to be determined or settled prior to the finalization of the national budget. In fact, the staff have clearly pointed out in the budget papers that one of the factors contributing to the cost overruns in the 1996 budget was the high wage cost resulting from such agreements being made after the passing of the budget bill.

In terms of the medium-term fiscal outlook, I am of the view that, unless the authorities are prepared to address the broader issues of public sector employment, the wage bill, and transfers—in other words, unless they are prepared to tackle what I would term the politically more delicate components of the budget—rather than the nonwage expenditure, then fiscal surpluses being targeted in 1997 and beyond may not have a lasting positive impact on the macroeconomy.

There is one point of clarification I would like to seek from the staff. It is not clear to me from my reading of the report and background papers as to whether any or enough provision has been made for general contingency measures in the budget, taking into account the potentially adverse outcome of the current round of wage negotiations. I would also like to ask the staff how confident they are that it will be politically palatable for the authorities to cut tax credits for housing interest, given the reservations already expressed by the authorities in the staff report.

Secondly, on the issue of the central bank independence, I note that no bill has been passed by the parliament to legalize the bank's independence, although it does enjoy a de facto independence, at least in the management of interest rates. I feel it is imperative that this legislated or statutory independence is implemented and observed in practice, or at least be seen to be respected in practice. However, based on my own experiences, and taking into account the size of the Icelandic economy, I think it would be important that monetary policy plays a supportive role to the government's fiscal policy provided the latter is prudent.

My third point is on the fishing sector. Given the prominence of fishing as a natural resource in Iceland, I read with interest the staff's presentation in the background papers of the pros and cons of the current method of allocating fishing quotas. From experience drawn from other island states, I would not support the idea of giving away quotas to a limited number of Icelandic fishermen based on their 1981 to 1983 catch. I think a more equitable system is required that will give an equal opportunity to newcomers and also encourage some competition, which can only improve overall efficiency in that industry in the long run. A fishing licence fee concept could be considered, in my view. Furthermore, I support the staff in their recommendation that such items should be incorporated in the budget and not be regarded as off-budget items.

> Finally, I would like to refer to a dilemma that the authorities must be facing currently, being an island state and being involved in promoting tourism, on the one hand, and the construction of an extra aluminum smelter, on the other hand. Iceland, with its 250,000 inhabitants, receives a similar amount of tourists every year. Most of those visitors tend to go to the south-west corner of the country. From my understanding, the additional aluminum smelter, with all its expected pollution, is going to be located in that same part of the country. I say this because this is a conflict that a lot of island states often face, in terms of having to decide and make long-term choices. I can give you one actual example where a balance between these two objectives is useful. In the Seychelles islands, we have an 18th century law whereby no building or hotel complex can be higher than a coconut tree along the coastal zones. This statutory legislation is still in practice and it works extremely well, because the environment is actually conserved, in the sense that people and businesses, wherever they build, can still enjoy a scenic view of the ocean and at the same time have a view of the granitic mountains. So it was an initiative that our forefathers had to take consciously, in the interests of sustaining the environment and at the same time complement our eco- tourism policy. The question I would like to ask, which is also a very difficult issue, is: can the two conflicting objectives really co-exist?

The staff representative from the European I Department noted that the staff favored maintaining the current exchange rate policy for two reasons. First, past experience with high and variable inflation, with frequent exchange rate realignments to accommodate shocks to the economy, had damaged the credibility of monetary policy and had had a destabilizing effect on the economy. The staff believed that, given Iceland's history of monetary instability, public confidence in the authorities' commitment to monetary stability was best preserved with the current stable but adjustable exchange rate system. An alternative system with a floating exchange rate would entail considerable variability in the exchange rate and could call into question the authorities' commitment to monetary stability. Second, an alternative to the nominal anchor provided by the current exchange rate system—such as a monetary or inflation targeting regime—would require a market-determined exchange rate. In the case of Iceland, it would be difficult to move to a market-determined exchange rate system, because the foreign exchange market was relatively undeveloped; in fact the central bank was a counterparty in about 85 percent of foreign exchange transactions involving the Icelandic króna. However, as financial and foreign exchange markets developed, there might be scope to consider an alternative framework involving a market-determined exchange rate.

The staff's reservation regarding a larger appreciation within the current framework was due to the adverse effects that that could have on the current account deficit, the staff representative explained. The deterioration of the current account in the past had been partly due to the rapid growth in consumption. Consequently, over the medium term, the worsening of the current account deficit would not be reversed by an expansion of productive capacity. Moreover, as the ratios of external debt to GDP and external debt service to GDP were high, even a temporary deterioration in the current account could not be regarded with equanimity. The staff believed that there was an asymmetry in the response of the current account to exchange rate adjustments; thus while the empirical analysis showed that a depreciation of the exchange rate had not had the expected positive impact on the current account, this was likely due at least in part to the rapid upward adjustment of wages in response to depreciation; in the converse case, large appreciation of the exchange rate of about 6–7 percent could nonetheless result in a deterioration of the current account deficit because wages would not decline to the same extent. At the same time, given the margin of error in the empirical analysis, the possibility that the effect might be stronger than the empirical work suggested should not be ruled out, which would call for greater caution with regard to exchange rate appreciation.

The improvement in government savings was insufficient, particularly in view of the cyclical position of the economy, the staff representative considered. The staff believed that there would be a further improvement in the general government financial balance associated with the current stance of fiscal policy. With respect to other fiscal issues, the staff recognized that it would be politically difficult to reduce tax credits for interest on housing loans; nevertheless, such a measure would be appropriate given that the credits were, in effect, a housing subsidy and created a strong incentive to invest in housing. Furthermore, marginal tax rates were excessively high owing to the need to generate revenues to finance the housing tax credits. While the authorities had not yet introduced contingency measures to offset the effects of a higher than expected wage increase, they had indicated that some measures—such as reducing or postponing other public investment projects—were being prepared in the event that a second aluminum smelter was built.

Finally, the staff had not had extensive discussions with the authorities on the dilemma arising from the authorities' desire to promote tourism, on the one hand, and to construct a second aluminum smelter with its consequent negative effects on the environment and therefore on tourism, on the other hand, the staff representative from the European I Department noted. However, it was the staff's understanding that the authorities had undertaken extensive studies to ascertain the environmental impact of building a second aluminum smelter. The staff believed that, as the smelter would not be in the same area that was most heavily frequented by tourists, it should not have a direct impact on the tourism industry.

Mr. Ono made the following statement:

Since I agree with the general thrust of the staff appraisal and since our agenda for today is, once again, rather heavy, I will keep my comments brief.

As previous speakers have mentioned, Iceland's good recent economic performance is impressive and encouraging. I would first like to commend the authorities for achieving relatively high growth without the resurgence of inflationary pressure.

Various economic indicators, however—rapid credit expansion, deterioration of the external balance, and wage-increase pressure—suggest potential risk on the price-stability front: in other words, there's a risk of overheating. In this regard, although last September's monetary tightening was appropriate, a more cautious policy stance should be required from now on. As for the exchange rate, further monetary tightening might lead to exchange rate appreciation. However, in my opinion this is likely to be short-lived, given the recent widening current account deficit.

As for fiscal policy, I agree with the staff's recommendation that the authorities be pushed toward further front-loaded fiscal adjustment in order to improve the fiscal structure. Unlike in other industrial countries, where fiscal contraction can have a negative effect on economic activity, Iceland's further fiscal adjustment can kill two birds with one stone. The authorities should therefore take full advantage of the current favorable economic situation.

Finally, with regard to structural policy, I think that reform of the financial markets should be given a high priority. I would thus like to urge the authorities to step up their efforts at pursuing more efficient and competitive financial markets. To this end, the most important steps are—as staff mentioned—the privatization of major banks and the further liberalization of the markets. I look forward to hearing of positive developments on this front.

Mr. Nemli made the following statement:

I commend the Icelandic authorities for an economic performance that is impressive by any standard: high growth, low inflation, a stable exchange rate, low fiscal and current account deficits, and steady progress with structural reform. Now the task is to consolidate this success and strengthen the economy against supply shocks, which have proved very costly to Iceland in the past.

Although the fiscal situation is in no way alarming, there is room for improvement. In particular, the authorities should be prepared to counter possible expenditure slippages. The most likely causes of a possible spending overrun would be wage increases much larger than are now expected or a decision to go ahead and build a second aluminum smelter. Should either possibility materialize, additional measures will be needed to offset their effects on the fiscal deficit. The staff is right to urge that the fiscal adjustment not rely entirely on spending cuts. Action on the revenue side is also desirable. Some changes should be considered in the taxation of marine resources. As fishing quotas have a market value and are traded over the counter, the traditional manner of allocating them free of charge actually amounts to an off-budget transfer. Auctioning the quota rights would improve fiscal transparency and aid the fiscal adjustment. As to the income tax changes being demanded by the labor unions, I urge the authorities to resist these pressures. It would be far preferable to increase wages directly. Tax concessions, which are indirect and nontransparent, do the same damage to the fiscal position as a wage increase, and have the additional disadvantage of undermining the tax base and the fiscal discipline in the long run.

Economic diversification is important for preventing severe supply shocks. Despite some progress toward diversification, fisheries account for the largest share of Iceland's GDP and the largest share of exports. Construction of a second aluminum smelter will contribute to the diversification of Iceland's output and export base. In addition, it is expected that over the medium term it will strengthen the external position by increasing export earnings and add 1 percent to potential GDP. Provided the authorities take the expenditure and revenue measures needed to offset any deterioration in the fiscal deficit, I believe Iceland's present macroeconomic fundamentals are sound enough to support this large project, though I noted with interest Mr. Yakub's concern about its detrimental impact on the environment and the tourism sectors.

Nonetheless, given the present condition of the current account balance and the relatively low level of international reserves, it will be all the more vital to maintain tight demand management in order to ensure that the external position remains sustainable.

In the structural area, reforming the financial sector is the most important priority. The domination of Iceland's financial sector by state-owned banks and credit funds blocks effective competition and hobbles efficiency. I join the staff in urging the authorities to proceed without delay with the planned conversion of the large state-owned banks and credit funds into corporations as a first step toward their eventual privatization.

Mr. Heinbuecher made the following statement:

We can support the thrust of the staff appraisal. At this stage of the discussion I only would like to make a few additional remarks, especially on monetary policy:

We agree with staff and Mr. Yakub that steps should be taken from the de facto independence to a de jure independence of the Central Bank of Iceland. With only de facto independence there remains a kind of Damocles-sword—or should we better say: a Viking's sword in the case of Iceland—over the management of the central bank which may implicitly limit somewhat its room for maneuver in pursuing anti-inflationary policies.

However, we do not agree with Mr. Yakub that monetary policy should take a supportive stance. It's not clear to us that an accommodative monetary policy would have a more beneficial effect on the Icelandic economy in the future than it has had in the past. In our view, monetary policy should focus on keeping inflation down and only support general economic policy if it does not entail inflationary risks.

Let me conclude with three questions to staff concerning the quite strong increase in household debt to the credit system, which according to staff has increased from 20 percent of GDP in 1980 to 125 percent of GDP in the last year:

First, to what extent has this strong increase been caused by the deliberate low interest rate policy in recent years ?

Second, does this development pose a potential risk to the quality of the banks' portfolio and to the budget in the case of a real shock to the economy ?

Third, to what extent was the recent strong increase in the stock market related to the rise in the credit demand of households ?

Mr. Yakub remarked that, in stating that monetary policy should be supportive of the government's fiscal policy stance, he had not meant that monetary policy should be accommodative. He considered that monetary policy should not be conducted in isolation, but should complement the government's fiscal policy stance, provided of course that the government's policies were geared to achieving fiscal consolidation to correct the macroeconomic imbalances. Furthermore, with respect to Mr. Nemli's point on diversification, he wished to note that, in the case of small economies, there were limited opportunities for diversification. For instance, New Zealand had not diversified its production base, but its economy performed well because the country exported goods in which it had a comparative advantage, such as meat and dairy products.

Ms. Zheng made the following statement:

It is encouraging to see that the economic performance in 1996 has reversed the unlucky picture of the previous year which was due to the decline in the fish industry. With the subsequent boom of this industry and the high profitability of the power industry, partly driven by high domestic demand where consumption played a dominant role, growth in 1996 registered a historical high since 1990, while inflation remained comfortable, and the fiscal deficit declined to 1.7 percent of GDP. As a result, unemployment declined slightly and the government debt ratio started to fall. However, the overall favorable picture does not remove Iceland's vulnerability to supply shocks. Therefore, the medium-term challenges will be considerable. I broadly agree with staff appraisal and will make a few comments on the external situation, monetary and fiscal policy, and the diversification issue.

The deterioration of the external position appears inevitable when the net trade balance declined close to zero given the historical service deficits, equivalent to more than 2 percent of GDP. Therefore, it is crucial to set a long-term path for the durable decline of external debt in order to increase the external viability in case of external shocks which is very likely in Iceland.

The monetary policy framework of a "fixed but adjustable exchange rate regime" has broadly been working well. However, the rapid credit expansion and wage increases are likely to build up inflation pressures in 1997. We welcome the rise in interest rates in September 1996 which has to some extent eased the situation. Although the present inflation level is by no means alarming, the past strong negative relationship between growth rates and inflation at least cautions the authorities to be vigilant for signs of inflation. Therefore, the authorities should be prepared for monetary tightening within the limit allowed by the exchange rate band should inflation pressure appear. We welcome the increasing central bank independence and encourage the authorities to accelerate this endeavor, given the importance of enhancing Iceland's overall credibility.

On the fiscal side, the authorities are commended for bringing the general government deficit to 1.7 percent of GDP in 1996, of which local government deficit showed a significant decline. And I am pleased to learn that the 1997 Treasury Budget is expected to turn into a slight surplus. These favorable results reflect progress in recent fiscal reform which has made the fiscal system more responsive to economic developments. The authorities are encouraged to go along with their fiscal reform strategy and further reform the income tax system to a more broad based one. However, it is worth noting that the improvement in the fiscal situation in 1996 has to a large extent reflected cyclical factors. Therefore, more attention should be paid to improving the structural balance to enable the authorities prepare for any adverse impact of economic slowdown on the budget. In this connection, I note that the structural deficit only declined from 2.1 percent to 2 percent of GDP, which is far from setting the fiscal situation on a sustainable base. Therefore, the authorities should make every effort to address the expenditure slippage area, such as the health and social security, wages and investment and leave more continency room for the possible overrun. On revenue side, given the "puzzle" of revenue short-fall, a more conservative revenue projection is desirable.

Structural reform still remains the main area for Iceland as a narrow-based open economy. Though the economy cannot avoid some degree of concentration on the fishery industry, the recent development in the power industry is encouraging on the diversification side. On financial market reform, I welcome the withdrawal of the central bank from being a market maker. However, much remains to be done to reduce the government's role in underwriting risks of private decisions. The high agriculture tariff is another area calling for continuous structural effort.

Finally, I encourage the authorities to raise their development assistance to the UN target.

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

The staff representative from the European I Department observed that the expansion of consumer credit was mainly the result of the liberalization of the financial system, which had enabled financial institutions to become more involved in consumer lending, and was due, to a lesser extent, to the stance of monetary policy. About 60 percent of credit was housing credit, which was underwritten by government-guaranteed housing bonds. The stock of government-guaranteed housing bonds was a matter of some concern: by way of comparison, it exceeded the direct domestic government debt. At the same time, the impact on the housing market was not unduly worrisome because, unlike other countries, there had not been a run-up in housing prices. A large portion of the credit also went toward financing automobiles and other purchases. Finally, the increase in consumer credit did not appear to be related to the buoyancy of the stock market.

The banks' balance sheets had not yet shown any deterioration as a result of the rapid expansion of consumer credit, the staff representative from the European I Department noted. Banks' loan loss provisions were lower in 1996 owing to cyclical developments, which would suggest that the quality of banks' portfolios appeared to be improving. Nevertheless, the authorities were monitoring the situation closely.

Ms. Srejber made the following concluding statement:

Let me first thank my colleagues for their useful remarks. Of course, I will convey to my Icelandic authorities the views raised in this Board today. I have a few additional remarks on this issues raised today.

First, as concerns the exchange rate regime, I think the experience from small export-oriented economies points to the fact that it is more conducive for stability to have a fixed exchange rate regime. In the case of Iceland, the system has served the economic development well, as shown by last year's stable macroeconomic and high growth.

Many speakers have commented on the monetary policy. As I tried to explain in my buff, the signals, when it comes to the inflationary pressures, are not very clear cut at this stage. My Icelandic authorities believe that there is a risk of inflationary pressures emerging but, depending on how wage negotiations will turn out, and depending on future investment development.

But, as mentioned, the fiscal policy contains contingency measures, would these investment decisions be taken and as concerns wage developments, I think two points should be remembered. First, even if real wages have increased recently, they are still only slightly above the level they were before the recent recession. Second, the wage bargaining system is being reformed. The new system's main goal is to establish a time schedule for the negotiations between unions and employers, and they restrict procedures for calling a strike, to the effect that unions need an approval by a secret ballot before calling a strike. My authorities think that the overall effect of these measures I just mentioned and other measures to reform the wage bargaining system will be an orderly and less time-consuming wage negotiation procedure resulting in more market-responsive wages. Needless to say, of course, the central bank is cautiously studying the situation. Should the situation in the money or exchange markets deteriorate, of course it will respond properly.

Looking at fiscal policy, I agree that fiscal policy needs to play a central role in restoring the savings-investment balance consistent with the exchange rate sustainability in the medium term. I believe that the medium-term fiscal outlook presented is testimony to the authorities' efforts in that regard. Moreover, it would be desirable in the medium-term context to free monetary policy somewhat of its burden in order to facilitate a more favorable environment for lower long-term interest rates.

I think the record of the Icelandic authorities shows that they have been gradually working toward a balanced budget, as evidenced from a steadily declining budget deficit in the 1990s. The structural deficit for the general government has dropped from 3.8 percent in 1994 to 2 percent in 1996, although it is true, as mentioned, that it did not change much in 1996. But according to projections, it will decrease further in the years ahead. In the year 2000, Treasury gross debt will be reduced to 38 percent of GDP.

I think one also should keep in mind while looking at the health of the fiscal situation in Iceland that Iceland's pension system is healthy. It is relatively sustainable compared to the situation in many other industrial countries, which I think makes a big difference in judging the situation. It poses a relatively limited burden on fiscal finances. Nevertheless, the authorities have already taken precautionary steps to secure sustainable long-term funding of this public pillar, which I think is worth keeping in mind.

As concerns the tax credits mentioned by many speakers, the government is committed to tax reform. As I mentioned, a committee is working on trying to put together proposals. But I think the problem should not be blown out of proportion. Actually, tax revenue in Iceland is at a healthy 25.4 percent of GDP in 1996. My Icelandic authorities believe that a higher level of taxation might have adverse effects on the economy and, hence, also put the emphasis on fiscal consolidation on the expenditure side. In addition, I think it is worth mentioning that to my mind there is a valid argument for providing interest rate credit for housing; namely, that private ownership of housing produces good, responsible citizens and nurtures the basic needs of families, which I think is important for a good society.

Concerning ODA, I will convey the views from the Board to my authorities.

Diversification has been mentioned several times. I did not dwell very much on diversification in my statement, but a lot has actually happened in this area in the last years. Vertical diversification in the fishing industry has decreased seasonal fluctuation in income, because more products are fully processed. There is also more diversification between different markets. There is an increase in the variety of marketable products, and more ocean fishing is taking place to complement the catches in domestic waters. Simultaneously, horizontal diversification is taking place, with noticeable growth in high-tech companies for example originally served processing plant technology that has spun off into other areas of hardware and software production. Private companies including in the fishing area are also exporting technical solutions and providing advice to other countries that need to advance in food processing, thermal power production, and medical technology. So, I think more is ongoing than may be shown by the figures.

The fish quotas have been raised. I think one has to remember the historic context. They were introduced relatively recently, as mentioned, in 1984 in response to overfishing. Now, 12 years later, it is apparent that the system has achieved that goal to protect the fish. Fish catch has increased considerably to record high levels. Considerable consolidation ha also taken place. However, the questions of transparency and equity have actually risen at a later stage, and much of the same discussion mentioned here in the Board is ongoing and has attracted considerable political attention in Iceland.

I think I will stop my concluding remarks by these last words, and again thank my colleagues.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the recent improvement in Iceland's economic performance, which had been marked by strong growth and low inflation. That performance was underpinned by policies of exchange rate stability and fiscal consolidation in a medium-term framework, and there had been significant progress in structural reforms.

While Directors saw these broad developments as moving Iceland in the right direction toward sustainable growth, they also highlighted several areas of concern. Rapid credit expansion, together with large wage increases, had fueled a consumption boom and contributed to the emergence of an external current account deficit. In view of the prospect of strong growth continuing and the danger that inflation would accelerate, Directors considered that stronger monetary and fiscal policies and more vigorous structural reforms would be necessary to ensure price stability and restore a sustainable savings-investment balance.

On fiscal policy, Directors called for further adjustment, front-loaded in 1997, to achieve a small general government structural surplus over the medium term. They considered that there should be more emphasis on expenditure adjustment. In that light, they regretted the slippages in 1996 and the upward revision of expenditure projections in the 1997 budget, both due in part to the abandonment of some intended savings measures. They called for greater attention to curtailing the public sector wage bill and transfers.

Directors urged the authorities to move forward with reforming Iceland's system of taxes and means-tested benefits by lowering basic marginal rates and broadening the base, pursuing economic efficiency and enhanced revenues while preserving the commendable simplicity of the existing system.

Directors stressed the need to keep the focus of monetary policy on medium-term price stability. They noted that the exchange rate had served Iceland well as an intermediate target, with its simplicity and transparency contributing to credibility. However, they saw the need for further monetary tightening within the scope afforded by the exchange rate arrangements. Some Directors considered that, in pursuing further monetary restraint, greater exchange rate flexibility may need to be considered. Looking further ahead, monetary policy credibility would be enhanced by formal central bank independence, which would entrench in law the central bank's increasing *de facto* autonomy and its orientation toward price stability.

Directors also noted the importance of wage bargaining arrangements in restraining inflation. They observed that the new arrangements were untried and would require a cooperative spirit to avoid gridlock or excessive wage increases. Directors also stressed the role of public sector wage moderation not only in achieving fiscal targets but also in the demonstration effect on wage setting in the economy as a whole.

Directors urged the authorities to implement plans to incorporate public banks and investment funds, a step that should be followed as soon as possible by privatization. Directors also noted that developing more efficient and open financial markets would help to reduce the government's borrowing costs.

Directors encouraged Iceland to raise its official development assistance.

It is expected that the next Article IV consultation with Iceland will be held on the standard 12-month cycle.

2. JORDAN—1996 ARTICLE IV CONSULTATION; AND EXTENDED ARRANGEMENT—REVIEW, AUGMENTATION, AND WAIVER AND MODIFICATION OF PERFORMANCE CRITERIA

The Executive Directors considered the staff report for the 1996 Article IV consultation with Jordan and the second review under the Extended Arrangement (EBS/97/7, 1/24/97; Cor. 1, 1/29/97 and Cor. 2, 2/7/97), as well as a request for augmentation of the arrangement, and waiver and modification of performance criteria (EBS/97/7, Sup. 1, 2/6/97). They also had before them a statistical appendix (SM/97/17, 1/24/97).

Mr. Shaalan made the following statement:

Supported by financial and technical assistance from the Fund, the Jordanian economy continues to gain strength, maintaining a path of steady economic growth, low inflation, and improving external balances. It is particularly noteworthy that the impressive macroeconomic performance has been achieved in the context of a fluid and at times highly uncertain regional environment. The Jordanian authorities would like to express their deep appreciation to the Fund's Executive Board, management, and staff for the institution's very positive contribution to the development of their economy. As the staff Supplement indicates, there has been a marginal excess (0.1 percent of GDP) in the net claims on the public sector for December 1996. As this excess in no way affects Jordan's performance or its exemplary record, I have every hope that the Board will endorse the request for a waiver.

As the well-written staff report provides a thorough account of recent economic developments and prospects for the Jordanian economy, my statement will be limited to highlighting six points which colleagues may find pertinent to our discussion today.

First, it is important to remind oneself how far Jordan has come with the help of the Fund and the international community. At the end of the 1980s the country was facing a foreign exchange crisis, inflation was running at an annual average of 20 percent, and GDP had contracted by 7 percent per year. With an external debt-to-GDP ratio of some 180 percent, a current account deficit of over 15 percent of GDP, and a budget deficit of 20 percent of GDP, there were major questions as to the ability of the economy to restore sustained high medium-term growth. Jordan's situation was not helped by the regional crisis of 1990/91 and the associated drying up of remittances and official flows from within the region. Thanks to a sustained adjustment and reform effort, the country has maintained an average growth rate of some 6 percent since 1993, inflation has fallen to an underlying rate of about 4 percent, and the current account deficit has been reduced to 3 percent of GDP. At the same time, the country's external indebtedness, while still very high—at about 100 percent of GDP—has fallen sharply. These developments attest to Jordan's determined efforts to address its economic problems.

Second, the considerable gains achieved by the Jordanian authorities were essentially due to homegrown policy actions. This was particularly the case in 1996 when an already difficult external environment deteriorated and tended to complicate economic management, further illustrating the importance of the responsive policy stance of the Jordanian authorities. To offset continued pressures on foreign exchange reserves due to the process of unofficial redemption in the West Bank and Gaza (WBG), the Jordanian authorities tightened monetary policies beyond what was envisaged in the program and maintained a tight fiscal policy. While the budget deficit target for 1996 was slightly exceeded (reflecting in part the short delay in the implementation of the difficult reform of the subsidy system necessitated by the need to disseminate sufficient information), Jordan experienced a further decline in the deficit to 4.6 percent of GDP, a significant improvement from the outcome of the previous year.

Third, Jordan's structural reforms that were envisaged in the EFF program were strengthened. Conscious of the need to press forward with growth-enhancing measures whenever possible, the Jordanian authorities implemented a number of additional measures going beyond the EFF program, as well as accelerated the adoption of others. Box 1 in the staff report (pages 12–13) illustrates well this point. I would simply note the additional actions taken in the areas of monetary reforms, privatization, trade liberalization, and domestic deregulation.

Fourth, the challenges facing Jordan, while certainly much more manageable now, are far from over. Unemployment and poverty are still too high and the country's industries will face challenges as it integrates more fully with the world economy, including in the context of the Association Agreement with the European Union currently under negotiation. The authorities recognize these challenges and will continue their steadfast implementation of adjustment and reform measures. They will continue to look to the international community—especially the Fund and the World Bank—for assistance in formulating the needed policy response. It is especially important that quick progress be made in reducing poverty which, as detailed in Box 3 of the Staff Report (pages 24-25), remains a problem that could undermine the sustainability of the reform program. For many, the fruits of the peace process and of the courageous reform effort have yet to materialize. Accordingly, in addition to strengthening safety net provisions, the authorities are working with the Bank on enhancing their poverty alleviation strategy.

Fifth, and especially given Jordan's excellent policy implementation track record and the exceptional circumstances it is facing on account of its currency circulating in the fluid West Bank and Gaza environment, the response of the official donor community has been rather disappointing. As noted in the staff report, notwithstanding significant disbursements from Japan and the European Union, for which the authorities are most grateful, financial assistance to Jordan in 1996 was less than hoped for. Indeed, the authorities believe that the inability to decisively increase foreign exchange reserves, and thereby minimize concerns about the impact of unofficial redemption in the West Bank and Gaza on the Jordanian economy, has been a factor inhibiting full realization of the benefits from Jordan's adjustment and reform efforts. For 1997, the authorities have worked with the staff on a comprehensive financing plan which includes, inter alia, some commercial borrowing by Jordan, in spite of the heavy debt burden, as proposed by some Executive Directors during the last Board meeting, new official financing, and a follow-up rescheduling by Paris Club creditors.

Finally, the Bretton Woods institutions have provided important financial assistance to Jordan. The Jordanian authorities are grateful for management's support of their request to augment the current EFF by SDR 37.24 million. If the augmentation is approved by the Board and assuming that all purchases are made as scheduled, Jordan's outstanding credit to the Fund would reach the cumulative limit of 300 percent of quota upon the expiration of the arrangement. The authorities would have preferred, and felt that there was a case for, triggering the exceptional circumstances clause. From my own point of view, this case illustrates the need to follow up on the discussions that the Board had last November in the context of its review of access limits.

In concluding, allow me to reiterate the Jordanian authorities' appreciation for the important role that the Fund has played in the country's successful adjustment and reform effort. The authorities look forward to continued close collaboration with the Fund as they make further progress in addressing the economic challenges facing their country.

Mr. Al-Tuwaijri made the following statement:

I commend the Jordanian authorities for their perseverance with adjustment and reform. The strong and comprehensive measures that have been implemented led to a remarkable turnaround in the economy as detailed in Mr. Shaalan's helpful buff.

This success notwithstanding, the adjustment process is not yet complete. Unemployment remains high, and the external sector is still vulnerable. Therefore, I welcome the authorities' commitment to press ahead with their adjustment and reform agenda.

Perseverance with consolidation efforts has resulted in an impressive improvement in the fiscal accounts. Equally important is the progress made in strengthening the structure of the budget. In this regard, implementation of the reform of food and animal feed subsidies is especially welcome. I also welcome the 1997 budget and the medium-term fiscal program which will cement the progress made so far. In that regard, continued emphasis on expenditure reduction, especially current spending, is appropriate. Such a stance will allow for the financing of the infrastructural investments needed to attain the growth objectives without undermining the fiscal position.

A tight monetary policy is also important for strengthening overall confidence. Under a policy of maintaining a stable nominal exchange rate vis-à-vis the U.S. dollar, further reduction in the underlying inflation is important for competitiveness. Increasing foreign reserves is also essential to enhance confidence in the exchange rate, especially in light of the ongoing dinar redemption in the West Bank and Gaza Strip. Therefore, I welcome and fully support the authorities' request for augmentation.

On the structural reform front, I am most encouraged by the progress made last year. The authorities have gone beyond program requirements in many areas as Box 1 indicates. To achieve the full potential of the macroeconomic adjustment, however, the authorities need to continue pressing ahead with structural reform.

Efforts to broaden and deepen financial markets and improve the efficiency of the banking system are critical ingredients in this regard. Timely passage of the securities law is a priority. Acceleration of the privatization program and the reform of the regulatory framework would also increase private sector investments and encourage capital flows. Here, I am reassured by the authorities' ambitious agenda and by their commitment to undertake the needed reforms.

With these remarks, I support the revised proposed decisions and the request for waiver and wish the authorities further success.

Mr. Kiekens made the following statement:

Jordan's determined implementation of stabilization and structural reform measures has produced very satisfactory macroeconomic results. Inflation is low, the exchange rate stable, and the budget deficit, the current account deficit, and external debt are in decline. The authorities have shown great ability and determination by their unswerving implementation of prudent policies over a period of years, and their impressive track record admits no doubt about their policy stance.

Nevertheless, Jordan continues to suffer from a shortfall of international reserves. Neither the satisfactory macroeconomic situation nor the authorities' good track record can account for the apparent weakness of confidence in the currency. Under these conditions, the stubbornly low level of reserves may well be a sign of ongoing unofficial redemption of dinars due to external factors such as regional uncertainties and events in the West Bank and Gaza Strip.

It has become clearer with each review that prudent domestic policies alone cannot overcome problems stemming from external factors. Nonetheless, Jordan's tight fiscal and monetary policies have succeeded in preventing these external problems from causing domestic macroeconomic instability. Two major conclusions can be drawn from this picture: (i) there is no room for relaxing demand management policies nor for weakening the ongoing structural reforms; and (ii) the continued support of the international financial community is essential. To this end, Jordan should continue its efforts to integrate itself into the world economy. I therefore hope that Jordan's request for access to the WTO will be accepted this year, and that its negotiations with the EU aiming toward an association agreement will likewise succeed.

On the fiscal side, I will comment on the relative importance of expenditure and revenue measures in the fiscal adjustment, and the availability of sufficient resources to support poverty alleviation.

In the future, as in the past, the authorities intend to continue their fiscal adjustment primarily by means of spending cuts. Tax revenues are expected to decline from 17 percent of GDP last year to 16.1 percent this year. Part of this decline comes from cutting customs duties, which is acceptable. But instead of taking steps to offset the unavoidable fiscal effects of trade liberalization, the authorities added reductions in both the personal and corporate income tax rates, and expressed their reluctance to introduce new tax measures. I urge the authorities to seek ways of increasing tax revenues. Further reductions in tax exemptions and deductions would be an important step in the right direction.

The success of any stabilization and structural adjustment program hinges on popular support. I have much praise for the staff's attention to this aspect of the program and for their provision of useful and detailed information on poverty and income distribution in its report. It is worrisome that poverty and income distribution have worsened considerably in recent years. It is critically important to reverse this trend. The living conditions of the poorest, most vulnerable segments of society should be improved.

It is encouraging to see the authorities intensifying their efforts to address these issues. Although the problems are structural and can therefore be solved only in the medium term, promises alone will not fuel popular support for very long. The government must demonstrate to the people that attention is being paid to the hardships of the poor. It is therefore important to make sure that the targeted cash payments that replace the food subsidies are made correctly and on time. I would appreciate it if the staff could provide some information about the 1997 budget's allocation for these cash payments and the effectiveness of the new system so far.

In the monetary area, I agree with the authorities and the staff that Jordan's exchange and interest rate policies have served the country well in the past. Maintaining the dinar's nominal stability vis-à-vis the US dollar and keeping the interest rate differential biased in favor of the dinar should help increase the attractiveness of dinar-denominated assets. But I join the staff in urging the authorities to closely monitor the behavior of money demand in 1997. The authorities must act immediately to adjust their monetary program in case the expected pick up in money demand does not materialize. Alertness is necessary to protect price and exchange rate stability.

In conclusion, Jordan's economic policies are impressive. However, they cannot be fully effective in addressing the effects of regional uncertainties and an unfavorable external environment on the level of external reserves. Therefore Jordan needs and deserves the continued strong support of the international community. Increasing Jordan's access to the Fund's general resources to almost 300 percent of its quota is a balanced and therefore justifiable decision. I think that generous Fund support should encourage other donors to expand their own balance of payments support for Jordan. Let me add in order to give even more confidence, that I would even be willing to favorably consider access under the "exceptional circumstance" clause if Jordan should be confronted by an unmanageable wave of dinar redemptions. Such access requires Jordan to continue and perhaps even strengthen its present policies, and should be supplemented by broad support from Jordan's bilateral creditors. I support the proposed decisions, including the requested waiver.

Mr. Mesaki made the following statement:

It is encouraging to see Jordan's strong macroeconomic performance, representing real GDP growth of more than 5 percent, improvement of fiscal and external balances, low inflation, and wide-ranging structural reform. The achievement of end-September as well as end-December performance criteria, with the exception of one item, is commendable.

As direct support for Jordan's balance of payments, my authorities have provided early financial assistance amounting to $230 million in the past two years. As is described in Supplement 1, my authorities will now provide nonproject grant assistance for structural adjustment support amounting 2.5 billion yen, which is my authorities' maximum possible support. This decision was made in response to the Jordanian authorities' request, taking into account their significant efforts toward economic reform and the encouragement of the peace process in the region. It is expected that this support will, when coupled with the Jordanian authorities' continued efforts, enhance structural adjustment as well as contribute to a further buildup of foreign exchange reserves.

In light of my authorities' tight fiscal constraints, continued support of this nature would seem to be extremely difficult.

To further stabilize and develop the Jordanian economy, my authorities' support, in the years ahead, will focus on economic and social infrastructures, especially the development of the private sector and the export industry.

This said, I support the proposed decision to approve the request for the waiver of the performance criteria. In light of the difficult situation in which the authorities find themselves, I also support their request for the augmentation.

Let me make a few remarks on policies.

On fiscal policy, I commend the authorities' addressing subsidy reform. Although the fiscal balance deficit at end-1996 was larger than the program target, I hope the good results of the reforms, implemented last year, will shortly begin to show. I welcome the authorities' intention to repay the outstanding loan from the banking system with revenue realized from privatization. However, I also note the risks inherent in this without strict repayment and would urge the authorities to not get in the habit of such borrowing as an ongoing solution.

On monetary policy, inflation, which picked up last year due to the increase of administered prices, is expected to decline to 4 percent this year. It is reported that the tight monetary policy, which contributes further buildup of foreign exchange reserves, constrains the real economy. Maintaining the balance between external and internal policies is a subject that the central bank must tackle.

On structural reform, as Box 3 in the report mentions, developments by the private sector will be inevitable to attract foreign direct investment. For this purpose, an increase in the numbers of competent skilled workers is needed. In this regard, my authorities are considering providing an education sector loan, amounting to 6.5 billion yen.

The staff report mentions that the proportion of people under the poverty line has increased to 20 percent of the total population. As these people are most vulnerable to economic reforms, the authorities must expand the social safety net to be successful in its implementation.

Finally as Mr. Shaalan mentions in his buff, I also mentioned at the November Board meeting that we need to explore the possibility of flexible use of the access limit. I concur with Mr. Shaalan's suggestion that we follow up on this discussion.

Ms. Turner-Huggins made the following statement:

First, let me thank the staff for their useful papers, and Mr. Shaalan for reminding us how far Jordan has come. Indeed, Jordan is now reaping the benefits of considerable adjustment under the Extended Arrangement, and through their own home-grown policy actions. We are also encouraged by the difference in the tone and outlook of recent press reports concerning a prosperous Jordan, in contrast to publicity around the time of the last Board review. We take note of a recent remark that fiscal and monetary stability are preconditions for development; this was reported in Friday's *Wall Street Journal*. We could not agree more and, on this basis, this chair agrees fully with the staff appraisal and supports the proposed decision, along with the request for waiver and augmented access under the Extended Arrangement.

My comments relate to items in the reform agenda, which remain only partly finished. Despite all the progress in reducing its macroeconomic imbalances, Jordan still remains highly dependent on external financing. And while prospects for growth are promising, complete freedom from grants and exceptional assistance is still a way off—by staff estimates around the year 2000 or 2002, assuming another round of Paris Club rescheduling and current policies are sustained.

Moreover, confidence remains tentative, as reflected in Jordan's inability to build up an adequate external reserve cushion and the slow growth in JD deposits. Meanwhile, social conditions remain dire, the poverty gap is widening, and the details described in Box 3 of the staff report are disturbing. For these reasons, there is no room for complacency. In general, the authorities need to bolster their quantitative achievements by intensifying, as the staff puts it, any outstanding social reforms and implement with urgency its program with the World Bank on poverty alleviation, as noted by Mr. Shaalan.

On some specific issues, I have a few remarks. Regarding fiscal policy, we welcome the tax reform efforts under way, in particular the administrative practices relating to the General Sales Tax and the recent changes related to income tax rates. However, there remains scope for additional reform, and we support the staff's view that revenue buoyancy is being hampered by a number of factors, including exemptions and deductions to income taxes, which need to be eliminated in order to broaden the personal income tax base.

On the expenditure side, we are concerned that public sector employment—estimated by the staff to be in the range of 40 percent of total employment—is very large and that expenditure on wages and other employment-related items, including pensions, amounts to about 30 percent of total government spending, excluding the military staff. The staff's views on the government's efforts to reduce the size of public sector employment and the medium-term plans for reform would be appreciated.

On privatization, Jordan's record here has not been too impressive, and we understand that a privatization strategy is being formulated and that a law has been passed giving 100 percent of the sale proceeds to the government. The staff has explained that with respect to Royal Jordanian Airlines, a candidate slated for divestment last year, its heavy indebtedness and weak financial position prohibit any prospective buyers. In this case, the government might be advised to consider absorbing the debt to the airline in order to improve its salability. This has proven to be an effective strategy in other countries.

On monetary policy, we agree with the staff's view that the objective of monetary policy is to build up reserves and support exchange rate policy. If achieved, demand for local currency should increase and confidence restored. Looking at the data, however, Jordan is some distance from attaining these goals. We are concerned that banks are opting to hold more liquid assets in the form of central bank certificates of deposit at fairly attractive interest rates rather than lend to the private sector, where credit growth is estimated below nominal GDP in 1996.

Meanwhile, quasi-fiscal costs associated with the central bank's open-market operations—central bank CDs grew to 10 percent of GDP in the first nine months of 1996—led to a reduction in central bank profits of 0.9 percent of GDP. The implication suggests that the mix of monetary and fiscal policy may need to be adjusted somewhat, and I would be interested in the staff's views on this.

Finally, one quick comment on trade issues. A recent press report suggested that Jordan's progress is being hampered by protectionist policies of some of its trading partners in the region and the rest of the world. We encourage the early dismantling of any such barriers by trading partners to open markets to Jordan's exports in support of their adjustment and reform efforts.

Mr. Shields made the following statement:

I join others in congratulating the Jordanian authorities on recent performance of good growth rates and low inflation, which is largely due to the fact that they have persevered over a number of years with a strong program or a succession of programs that have been based on increasingly tightening fiscal policy and also steady structural reform. Last year was quite a testing time really, because of the strains that the old subsidy system revealed under the rise in wheat and barley prices. The authorities grasped the nettle well by taking the opportunity to radically reform the subsidy system. They took strong action. It is a pity that there was some delay in the middle of the year before it was carried out, and that was one of the contributing factors to the overshoot in the fiscal deficit. But the important thing is they got there in the end, and that is giving a sounder basis for future policy both in terms of resource allocation and also overall implications for the budget.

Jordan now has had several years of structural reform, good fiscal policy, but there is still obviously a long way to go. 1997 is going to be another difficult year on the fiscal side, particularly in terms of current spending. Here, I was glad to see the further strong action on public service, employment and wages, although I must note that the defense budget takes about a quarter of total budget spending. This does need to be kept under very careful scrutiny.

On the other side of the budget, it is essential, as Mr. Kiekens was saying, that revenue is held up, particularly as there will be some loss in revenue because of the early cuts in customs tariffs. I believe a broadening of the tax base is really very important, as well as more efficient overall tax administration.

I was pleased to see the fact that structural reforms are continuing over and above the terms of the existing Extended Arrangement, and I believe that that indicates the extent of ownership of the program by the authorities. Quite a lot of the structural targets for the program are formulated in fairly general terms, and I wonder whether some of these might perhaps be made a little bit more specific. But the overall direction seems fine; it is just a question of speed and priorities within the program itself.

On monetary and exchange rate policy, the framework is right at the moment. We have had some worries in the past about whether the link of the JD to the U.S. dollar was going to be sustainable, but the authorities have managed to preserve that well. I think the premium on interest rates is not unreasonable at all. It does show reasonable confidence in the policies.

I noticed some indications in the staff's statement, and Ms. Turner-Huggins also referred to, on monetary issues. Obviously, the authorities are concerned about the tightness of policy as it affects the private sector. It seems to me to be appropriate at the moment, and I hope they will not act too rashly in this field. It is crucial, I think, for confidence in the dinar that policy both be tight and be seen to be tight.

Of course, there is not total control over policies. Confidence can be maintained by appropriate domestic policies, but there is also a certain exogenous element as far as redemption from the West Bank is concerned, although I note that, despite all the worries, in fact a fair amount of redemption does seem to have taken place so far without major instability. I was pleased to see the additional information from the staff on indicators of redemption.

The authorities have obviously been concerned—now it is nearly three years—about preparing themselves against future shocks. They so far seem to have handled that well. It is right that they should be getting external support for this process. The fact that this Fund program is the third augmentation that we have had in a Jordanian program in less than three years, and the fact that we have gone up to the cumulative access limits as well, does show how much we have been prepared to do this, with assistance also from the World Bank. Over the last probably six or seven years there has been a succession of Paris Club reschedulings and another Paris Club rescheduling is to come some time in the middle of this year. We certainly hope that that would be on terms at least as generous as the last one. There is also continuing bilateral aid for Jordan from Japan, as Mr. Mesaki says. So, it seems to me the international community is giving strong support to Jordan in recognition both of the difficulties it faces and the strength of their adjustment program. The fact that this is happening is supporting the credibility of the overall program. The problem about redemptions in the West Bank, I believe it is right that the reserve targets be re-amalgamated, and I think a fairly realistic target schedule has been set for that over the next year or two.

To conclude, I support this augmentation of the program and the waiver, and I wish the Jordanian authorities every success.

Mr. Wijnholds made the following statement:

It is encouraging indeed to see that the Jordanian authorities have been able to stabilize the economy in spite of the regional and other uncertainties that they have faced in the past year. In addition, growth continues to be strong and broad based with inflation under control, as the increase in prices in 1996 reflects the increases in the GST rate and in administered prices. Strict adherence to the Fund program and especially restrained fiscal and monetary policies have planted the seeds for a rebuilding of confidence in the Jordanian dinar. The authorities deserve to be commended especially for the implementation of reforms in the food subsidy system which enabled the achievement of the fiscal deficit target for 1996.

Tight monetary policy, with monetary growth amounting to only 0.3 percent in 1996, has enabled the authorities to surpass the reserve target, in spite of pressures on the dinar in the foreign exchange markets. The recent decrease in the share of foreign currency deposits to total deposits, may be taken as an indication of renewed confidence in the dinar: a direct result of tight monetary policy, continued fiscal restraint and the improvement in the external position. The decrease in the reserve requirement on foreign currency deposits from 35 percent to 14 percent and its equalization to those prevailing on dinar deposits, is a step in the right direction. However, the reserve requirements are still relatively high and as they are nonremunerated, they may still have some adverse effects on the competitiveness of the banking system, and perhaps even more important at this stage, on the ability of the banking system to attract deposits denominated in dinars. I wonder therefore whether it would not be more efficient to reduce further the reserve requirement, both on dinar and foreign currency deposits, while absorbing the increase in the banks' liquidity through open market operations. I would appreciate staff's view on this topic.

The real appreciation of the dinar since 1995 has merely brought it back to its level in mid 1994 and seems not to have affected the competitiveness of the exporting sector, as exports have continued to grow in 1996. The rise in exports, together with the pick up in workers' remittances, have offset the large increase in imports, resulting in an improvement in the current account deficit.

The main problems that need to be addressed at this point are the high unemployment rate, the low income level and poverty issues as Mr. Shaalan points out in his statement. Speeding-up the privatization process should help to attract much needed foreign direct investment and thereby alleviate these problems. The authorities' commitment to continuing the adjustments and reforms and their excellent track record are a clear indication of the prospects of success of the program.

With these remarks I support the program and the authorities' request for a waiver and for an augmentation of Jordan's access under the EFF. I have two main considerations for this: strong adjustment efforts allow for a more generous access. We should also be alert to the possibility of underfinancing of the program.

Mr. Donecker made the following statement:

The Jordanian authorities are to be commended for the progress achieved so far in macroeconomic stabilization and in structural reforms. Against this backdrop, I can support the request for a waiver. In our view, the augmentation of Jordan's access under the EFF is justified, in particular, if it encourages and supports a further strengthening of the authorities' praiseworthy adjustment efforts. In this context, I concur with staff and my colleagues that the agreed program objectives can only be achieved if Jordan's fiscal and monetary policies—despite domestic political problems—continue to be geared rigorously to maintaining stability, and structural reforms are intensified, in particular with regard to the privatization of the telecommunication company.

Since I generally agree with staff's analysis and recommendations, I shall only comment briefly on two issues that deserve special attention.

On exchange rate policy, the maintaining of the nominal value of the Jordan dinar vis-à-vis the U.S.-dollar has so far served well as stability anchor and has facilitated economy policy geared to stability. However, the question now is whether the present exchange rate policy can, respectively should be pursued over the medium term. Against the backdrop of the still unsolved problems caused by dollarization in the West Bank and the Gaza Strip, and in view of Jordan's high external indebtedness, speculative attacks against the dinar, connected with increased downward pressures and further losses in reserves, cannot be excluded. In our view, the (macroeconomic) fundamentals, in particular the high external current account deficit, the real appreciation and the low level of international reserves, tend to suggest an appropriate realignment of the dinar exchange rate. In contrast, staff does not see any indications that the Jordanian Dinar is overvalued (page 10, paragraph 11). Therefore, I would appreciate it if staff could comment further on whether the fixed nominal value of the dinar vis-à-vis the U.S. dollar still reflects correctly the developments in the real economy vis-à-vis Jordan's main trading partners and why they think that the appreciation of the Jordan dinar in real effective terms does not indicate a need for adjustment of the nominal exchange rate. In other words, does staff still consider the present exchange rate arrangement to be appropriate in the foreseeable future?

We agree that a floating exchange rate regime does not appear to be feasible at present, given Jordan's special circumstances. Incidentally, the build-up of foreign exchange reserves through additional foreign assistance and additional Fund-support which is proposed by staff, in our view, should become less necessary to the extent that continued stability-oriented fiscal and monetary policies induce per se a strengthening of the currency.

The fact that Jordan will have reached the cumulative access limit of 300 percent of quota after completion of all proposed disbursements implies that the authorities will have to intensify their external adjustment efforts in particular increase their efforts to strengthen Jordan's export sector during the remaining program period in order to become independent of Fund support after completion of the present EFF arrangement.

Having said this, I wish Jordan much success in their valiant stabilization efforts.

Mr. Disanayaka made the following statement:

We commend the Jordanian authorities for their excellent performance under the first two years of EFF. Their firm commitment to the program is amply demonstrated by their strict adherence to the performance criteria and benchmarks despite increasing complications arising out of recent regional developments as well as strong protests from within against some of the more stringent measures taken. Attachment V of Appendix I of the Staff Report shows how well they have performed in 1996. In fact, in many areas they have gone beyond the program targets, as illustrated in Box I, pages 12 and 13.

Adoption of a tight fiscal stance, particularly restraining expenditure, prudent monetary and exchange rate policies in support of fiscal efforts as well as to stabilize the Jordanian dinar vis-à-vis the dollar and above all a dynamic and far-sighted approach to reform have underpinned this remarkable achievement. High rates of growth, low inflation, improvements in external imbalances and debt dynamics are the rewards for these steadfast and courageous efforts.

Despite these very positive factors, Jordanian economy suffers some inherent fragilities as the staff report points out. These are mainly exogenous factors over which Jordanians have little control. Sensitivity analysis in Appendix IV shows how vulnerable the economy is to these exogenous factors such as possible adverse regional developments and increase in oil and food prices in the international market. Jordanian authorities are proceeding to meet these challenges by building up an open, robust and a more competitive economy that would have the resilience to withstand such shocks. We concur in this approach and would encourage them to progress rapidly on this prudent path. In this respect, we would urge the authorities to accelerate their privatization program, which has lagged somewhat behind, compared to progress in other areas. We would support the staff recommendation to encourage the authorities to pass a law to mandate that all proceeds from privatization revert to government. We would wish to see these proceeds used to reduce government debt, which is still very high. Authorities are also encouraged to further strengthen the tax system, by reducing income tax exemptions and expanding GST coverage. The process of civil service and pension reforms too has to be expedited as there is yet substantial ground to be covered. Through deeper structural measures and further opening up of the economy, Jordan would be able to create the necessary climate for attracting a greater flow of foreign investment. The ongoing trade liberalization and tariff reforms, coupled with streamlining of customs procedures would strengthen export growth. These measures would greatly complement the strategy of the authorities to build up a reasonable cushion of international reserves. The existing fragile NIR is the Achilles heel of Jordanian economy in the face of potential redemption threats and other external shocks which I referred to earlier. In view of this and also in the context of the well-prepared 1997 program, we would support the authorities' request for an augmentation of their access limits under the EFF.

We would however urge the authorities to continue to maintain strong social safety nets to protect the most vulnerable, even as they accelerate the process of adjustment.

With these comments, we support the proposed decision and wish the authorities well.

Mr. Fayolle made the following statement:

Let me first join other speakers in commending the Jordanian authorities for the very good results achieved under the EFF program. The determination of the authorities in implementing the program has provided a very good macroeconomic performance. I am referring, for example, in the fiscal area, to the adoption of the courageous reform of the subsidy system. In the structural area, I was very impressed by the implementation of financial reforms which went beyond those specified in the program, as clearly reflected in Box 1.

I am in broad agreement with the staff analysis and recommendations, and will make only a few points.

On fiscal policy, like Mr. Kiekens, I have to confess that I am a bit concerned by the composition of the fiscal adjustment for 1997. As it appears in the table on page 46, implementation of measures agreed in the framework of the EFF has been less satisfactory in the fiscal area than in other areas. Consequently, the fiscal adjustment is essentially relying on the expenditure side, and the authorities seem to be reluctant to implement new revenue measures.

However, there has already been an important decrease in expenditure during the period 1995–97, which amounts to 4.8 points of GDP. Therefore, the fiscal adjustment process will only be sustainable over the medium term if balanced between expenditure cuts and revenue increase. This implies an ambitious program of revenue measures, especially in the GST and personal income taxes. Finally, a tight fiscal policy will also help the authorities in keeping inflation under control, which is specially important in order to maintain the competitiveness of the economy.

Like Mr. Shields, I think the premium in interest rates is at the present time reasonable. The level of interest rates and the consequences of this level on banks' portfolio has to be monitored very carefully, and requires continued effort in implementing banking regulation and supervision.

There was a short reference in the report to the EU negotiation. I wonder whether the staff could provide an update of this negotiation and the possible timetable attached.

Finally, let me wish the Jordanian authorities every success in their adjustment process. I support the proposed decision, including the augmented access.

Mr. Mirakhor made the following statement:

The excellent staff report and Mr. Shaalan's lucid and comprehensive statement give us an example of a country that has achieved outstanding success with macroeconomic stabilization and structural reform. Growth and inflation performance has been impressive; fiscal and monetary policies have been kept tight; and the external current account and external indebtedness have been reduced. Complementing this sound macroeconomic framework, Jordan has implemented an impressive array of wide-ranging structural reforms, some of which, as directors have noted, go beyond the understanding contained in the extended financial facility.

The credit for Jordan's excellent performance must go to the authorities. They are to be commended for their steadfast implementation, their ability to take prompt corrective actions when circumstances warrant, and, most importantly, for their strong ownership of the program. Jordan's economic performance also reflects the Fund's best—in terms of the high quality of policy advice and well-focused technical assistance, and the effective use of its financial resources.

Since I broadly agree with the staff report as well as much of what has been said by other directors, I shall refer only to a few aspects of the program.

My first comment relates to the fiscal situation. I am grateful to the staff for the analysis of fiscal sustainability, contained in the report. If my understanding of the staff's analysis is correct, it would mean that, provided the fiscal deficit continues to decline in line with the authorities' medium-term fiscal program, Jordan will not have to face a problem of fiscal sustainability. The more interesting question is whether Jordan's present fiscal deficit is sufficiently small to set in motion positive debt dynamics, in which case the first-order condition of fiscal sustainability is being met. If this is the case, then there seems little merit in further cuts in the fiscal deficit, unless it is warranted by the dictates of generating a particular savings-investment balance—staff may wish to comment.

My second point relates to the adjustment in the value-added tax rate. While I do not think that a value-added tax rate of 10 percent is unduly high, I wonder if the focus should not be placed on improving tax administration and compliance, and reducing exemptions and concessions instead of raising taxes. Staff may wish to comment.

Third, on the issue of wages. While wage moderation, or in this case no wage increase, is always considered to be good, Jordan's case is different since the country is implementing civil service reform. It is thus important that the real value of the pay and emoluments of government servants are protected and, indeed, enhanced, so as to attract and retain high quality officials and staff. We hope that, in the context of the development of a more comprehensive data on wages and salaries, this issue will be monitored closely.

Finally, I support the authorities' request for an augmentation of Jordan's access under the extended financial facility. The case for augmentation derives its merit not only from the points made in the staff report and Mr. Shaalan's statement, but from Jordan's excellent track record of policy implementation, the unswerving commitment of its authorities to adjustment and reform, and the fact that macroeconomic policies are already sufficiently tight. Any further policy tightening is bound to have an adverse impact on growth and unemployment as well as on poverty alleviation. On this last point, I look forward to the World Bank assistance to Jordan in enhancing its poverty alleviation strategy.

All in all, Jordan provides an illustration of a country that is highly deserving of the support of the international community, including enhanced Fund support through augmentation. In this regard, I am pleased by Mr. Mesaki's announcement of Japan's financial support to Jordan. One hopes that other donors could be persuaded to follow suit as Jordan continues to forge ahead and achieve further success with its adjustment program.

With these remarks, I support the proposed decision, along with the request for waiver, and wish the Jordanian authorities all the best.

Mr. Han made the following statement:

The Jordanian authorities are commendable for their impressive progress in restoring macroeconomic stability and advancing structural adjustment measures—as reflected in the decline of inflation and external current account deficit as a share of the GDP. I am particularly pleased with the Jordanian authorities' strong efforts to continue its stance on strengthening macroeconomic policies in the year to come. The authorities' prudent macroeconomic policy will be the key to sustained improvement in its economic setting. I am in broad agreement with the staff appraisal and would like to offer a few comments for emphasis.

On fiscal policy, the programmed reduction in the budget deficit is conducive to the attainment of the macroeconomic objectives under the EFF program. The containment of government expenditures and the extension of GST to the currently exempt services in the near future, including reduction of personal income tax exemptions, will introduce important steps in strengthening the central government budget. The measures to contain the public sector wage bill and cost of the public pension system, together with improving the efficiency of government operations will consolidate progress in the fiscal balances.

I appreciate that the authorities are intensifying their efforts to improve the living standards of the poor segments of the population, reform the income distribution, and strengthen the social safety net.

Regarding monetary and exchange rate policies, I welcome the Jordanian authorities' policy of aiming to restore confidence in the dinar through strengthening the stability of its exchange rate vis-à-vis the U.S. dollar. In this connection, I believe the recently announced measures by the Central Bank of Jordan concerning the reserve requirement, will be helpful to the expansion of dinar assets and the interbank market. I would like to stress the importance of an overall tight fiscal policy—which should be conducted hand in hand with the monetary policy—in the face of the very high external debt stock and service burden. We appreciate the authorities' determination to continue the strong reform program. Past experience has shown that adjustment programs will tend to meet the economic objectives more efficiently when social and political stability is better maintained.

In view of the Jordanian authorities' excellent record in discharging their obligations to multilateral organizations, I would like to support the requested augmentation under the current EFF arrangement. We welcome the supportive assessment and financial assistance extended to Jordan as a result of the recent Consultative Group meeting. I would like to join my colleagues in calling on the authorities to further their efforts in building up the official reserves and gradually reducing the high debt-service ratio in the medium term.

In conclusion, I would like to support the revised proposed decisions and wish the Jordanian authorities further success in their economic adjustment efforts.

Mr. Giustiniani made the following statement:

Let me first join the previous speakers in commending the authorities for having endured the reform process despite the difficult political situation, even though I share the concerns expressed by some Directors.

At this point of the discussion, I will limit my comments to a few issues related to fiscal and monetary policy.

On fiscal policy, as far as the revenue side is concerned, looking at Table 12 of the Statistical Appendix, I would appreciate some additional information by the staff on what type of government revenue are included in the miscellaneous item which accounts for about 4 percentage points of GDP. Furthermore, as far as fiscal sustainability is concerned, if I understand correctly, the expected reduction in debt-to-GDP ratio of more than 13 percentage points over the next six years stems more from the expected results of privatization and an expected new Paris Club rescheduling than from an underlying well-rooted improvement in government finances. In fact, surpluses in primary balances are sufficient to meet interest payments. There are, therefore, uncertainties surrounding this exercise, uncertainties which are increased by the expected declining trend in the revenue-to-GDP ratio. There is not, therefore, much room left to the Jordanian authorities. The need for broadening the tax base, for improving tax collection becomes more compelling, and cuts in expenditure may also support the process of fiscal consolidation. However, the burden of military expenditure is expected to remain heavy in the coming years, equal to about 8 percent of GDP. Therefore, as Mr. Shields said, probably some monitoring on this expenditure is needed.

On monetary policy, one of the main problems of the conducting of monetary policy in Jordan is to restore public confidence in the dinar. However, I wonder whether the elimination of the different reserve requirement regime of foreign currency deposits and the abolishment of the distinction between residents' and nonresidents' accounts for several types of banking operations run in the right direction. These measures seem to me to be adopted in order to simplify the system. However, the increasing dollarization of the economy, as stressed by the increasing trend in foreign currency deposits, as a percent of total deposits may pose more lasting obstacles to the conduct of monetary policy. And therefore, I wonder whether the authorities and the staff have considered other possible measures in order to make foreign currency deposits less attractive.

Ms. Lissakers made the following statement:

I am pleased to support the increase in access to Fund resources for Jordan. We have long argued that the Fund should not hesitate to increase access when there is a need and a strong program. Indeed, I said at the last meeting on Jordan that I thought the Fund should be ready to step forward with additional assistance. I am pleased to see that this is now happening in response to strong policies.

The authorities have maintained a tight monetary policy, which has helped build reserves beyond programmed levels despite shortfall in programmed aid and continued redemption of dinars in the West Bank and Gaza. They have implemented a number of structural reforms beyond those set out in the EFF, particularly in trade liberalization. And they stuck to the withdrawal of bread subsidies, despite intense political pressure. We should keep Jordan's track record in mind when we debate how hard to press some European governments to undertake politically sensitive reforms.

Nevertheless, despite the reforms and the resulting gains in growth, Box 3 on poverty and income distribution was a useful reality check. It reminds us how far the Jordanian authorities still have to go. Staff should consider including such assessments more frequently in their reports.

On macroeconomic issues, building reserves remains a priority. Further redemptions in the West Bank and Gaza are likely to continue to drain reserves. However, I still do not see a risk of a sudden and massive redemption of dinars as an immediate threat. In fact, it is probably less of a threat now given the improved political environment. Furthermore, with the economy improving in the West Bank and Gaza, there should be less need for households to draw down their savings. Does staff have any recent information on the decline in the stock of dinars in the West Bank and Gaza?

Right now, I do not see an "exceptional circumstances" invocation in the offing. Therefore, for the near term, Jordan will have to rely primarily on strong domestic policies to boost reserves. Monetary policy will have to remain focused on assuring that dinar assets are attractive. Given all the uncertainties and the low level of reserves, a 4 percentage point spread over dollar-denominated assets does not seem to be exceptionally high.

Tight monetary policy has, and will continue to have a restrictive effect on the economy. Growth of credit to the private sector has slowed, although I wonder whether this is not partly because the private sector borrowed significantly in recent years and companies may be trying to limit the growth of their indebtedness. I would appreciate staff's views on this latter point.

The central bank has adopted a number of interesting reforms. What are staff's views on the bank's decision to lower the reserve requirement but no longer paying interest on reserves? The Fund generally recommends that bank reserves be remunerated. Does the staff have an update on what is happening to interest rates and flows into dollar deposits? What is the likelihood that overseas workers will now keep more of their money overseas rather than in dollar accounts in Jordan? Also, I would appreciate staff's views on the ability of Jordanian banks to manage dollar lending as we are spending a lot of time thinking about banking system reform and the regulatory oversight of banks.

On the fiscal side, I share many of my colleagues' concerns about the composition of adjustment. There has not yet been a significant cut in primary spending and there were slippages last year. It is important that whatever cuts are undertaken not fall on social spending. I am also disappointed the authorities are backing away from their commitment to reduce income tax exemptions next year. This seems counterproductive. I wonder whether staff is being sufficiently forceful in their discussions with the Jordanian authorities on this.

We are pleased the authorities are finally considering tapping the capital markets. I think it will be useful to establish a sovereign benchmark. This will help attract other forms of capital flows, and could boost reserves. This seems like a good time to be doing this given the turnaround in the political developments.

On structural reforms, Jordan could do a lot more to attract foreign direct investment. Protection of intellectual property could be improved significantly. Privatizations should be speeded up. On the latter, while there has been a lot of preparation, not a lot of actual privatizations have taken place.

I still think it would be useful to incorporate some of the most critical structural reforms formally into the program as performance criteria, or at least as benchmarks. Both the law requiring privatization revenues be transferred to the treasury and the commercialization of Jordanian Airlines seem to be stuck. If these have not been completed by the next review, staff should consider making these performance criteria or structural benchmarks.

Lastly—and I put this lastly because this is the last place the authorities should be looking—I urge other governments to support Jordan's efforts. I cannot agree completely with Mr. Shaalan that the response from the official donor community has been disappointing. But what was disappointing was that, in his statement, the United States was omitted from the list of countries who have provided significant assistance. The United States has provided more debt forgiveness to Jordan than any other country, forgiving more than $700 million. Our total assistance in the past two fiscal years is more than $450 million.

We would urge other creditors to be as forthcoming as us in providing debt relief. In particular, it is time nonParis Club creditors provide relief. We also urge other countries in the region to remove obstacles to trade in a manner consistent with their national security needs.

The staff representative from the Middle Eastern Department noted that, in setting the fiscal deficit targets under the program, the staff had considered the impact of fiscal consolidation on the debt/GDP ratio. The dramatic improvement in the debt ratio over the medium term depended critically on growth and interest rate assumptions. If the growth rate were 2 percentage points lower than projected and interest rates were 2 percentage points higher than expected, then a slippage in the primary deficit of 1 percent of GDP would sustain debt at its current level as a percent of GDP. It was also important to assess fiscal sustainability in the context of the medium-term macroeconomic framework. In order to achieve the investment targets in the program and to reduce the current account deficit as programmed so as to eliminate the need for exceptional financing by 2000, savings, particularly public sector savings, would have to increase. Otherwise, there would be either lower investment and lower growth, or a larger external current account deficit over the medium term.

According to the staff's initial calculations, the reforms of the general sales tax would generate sufficient revenues to compensate for the decline in revenues from the planned tariff cuts, the staff representative noted. However, the staff envisaged that additional revenues would be generated from reform of the personal income tax and the corporate tax systems, and from the elimination of various tax exemptions and deductions. On cash payments to the poor, under the reformed subsidy system, each Jordanian resident received JD 15 per annum, the staff representative stated. In addition, Jordanians covered under the National Aid Fund (NAF) would be eligible for an additional cash payment of JD 10 per annum. Thus, the additional transfers under the NAF would amount to about JD 1.6 million in 1997. The additional funds would be covered under transfers to decentralized agencies in the budget, which were slated to increase from JD 41.5 million to JD 43 million. The transfers to decentralized agencies also included transfers to universities. In that context, it should be noted that university fees had been raised in 1996. Thus, there was sufficient room in the budget to compensate for the additional cash payments to NAF recipients.

The reform of the civil service had started, and the authorities were receiving technical assistance from the World Bank, the staff representative continued. The reforms included measures to reduce the size of the civil service, as well as to promote the effectiveness of the civil service by rewarding superior performance, streamlining procedures, and improving managerial skills and the conditions of employment. The authorities did not wish to address the reform of the civil service in a piecemeal fashion and thus were formulating a comprehensive package. In the short term the civil service reform would have a negligible impact on the budget. However, studies had shown that the positive impact in the medium term would be substantial.

A key objective of the program in 1996 was the buildup of official foreign exchange reserves and confidence in the Jordanian dinar, the staff representative stated. In light of the external financing that was flowing in and the declining demand for Jordanian dinars, the authorities felt that monetary policy needed to be tightened, particularly as the fiscal policy had little room for maneuver in the short run. Thus, although monetary policy had borne most of the burden of adjustment, it could be expected that, over the medium term, the authorities would change the macroeconomic policy mix by shifting more of the burden to fiscal policy. In addition, the authorities were assessing their instruments of monetary policy. A mission from the Monetary and Exchange Affairs Department was scheduled to go to Jordan to provide technical assistance in the area of monetary management, including the appropriateness of the current monetary policy instruments. As to whether the reserve requirements should be lowered further, it should be noted that the authorities would need to mop up the resulting increase in liquidity through the issuance of additional certificates of deposit, which would be difficult and costly in the current circumstances. However, over the medium term, the authorities believed that reserve requirements could be lowered.

The most effective way to discourage the dollarization of the Jordanian economy would be to build up confidence in the Jordanian dinar through the pursuit of strong macroeconomic policies and the strengthening of the official foreign exchange reserves position, the staff representative considered. It was too early to assess the impact of the new regulations regarding reserve requirements for foreign currency deposits. The reduction in the reserve requirements on foreign currency deposits— from 35 percent to 14 percent—was being phased in over a three-month period.

The nonremuneration of the reserve requirements on foreign currency deposits should increase the cost of those deposits to banks but was expected to have little impact on interest rates on those deposits as more liberal portfolio management opportunities abroad would raise profits from foreign currency deposits. There was no reason to believe that the Jordanian banks were not managing their dollar assets well. Finally, it should be noted that reserves held against foreign currency deposits were not part of the usable reserves of the central bank.

The staff did not have very up-to-date information on the holdings of JD deposits in the West Bank and Gaza Strip, the staff representative continued. The information on those deposits from the Palestinian Monetary Authority was also somewhat different from that obtained from the Central Bank of Jordan. Nevertheless, it would appear that the holding of JD deposits in the West Bank and Gaza Strip was about $560–$600 million at end-October 1996. The staff did not have any information on the JD cash holding in the West Bank and Gaza Strip. Given the positive macroeconomic environment in Jordan, the decline in JD cash in circulation which served both Jordan and the West Bank and Gaza Strip and in the overall ratio of JD cash to JD deposits in Jordan could be attributable to the decline in JD cash in circulation in the West Bank and Gaza Strip.

As to whether the currency was overvalued, it should be borne in mind that the calculations of the real appreciation of the dinar were based on the cost of living index, the staff representative stated. Thus, some of the recorded appreciation reflected the increases in administered prices that were made in the course of the previous year. However, there were no clear-cut indications that the Jordanian dinar was overvalued; indeed, the performance of exports, imports—excluding cereal imports and transport equipment—tourism receipts, and the external current account were in line with program projections. At the same time, as the U.S. dollar was appreciating, it was likely that the Jordanian dinar would also appreciate. Thus, it was important to keep the competitiveness of the economy under review. The sustainability of the current exchange rate policy depended on how supportive monetary and fiscal polices were over the medium term.

Based on information from officials of the European Commission, negotiations on the Association Agreement with the EU were proceeding as envisaged, the staff representative stated. However, agreements on intellectual property rights, agriculture, and labor movements had not yet been finalized. The officials were optimistic that an agreement would be reached by end-1997. The agreement would then have to be signed by the Council of the EU and ratified by member states, and the whole process was envisaged to be completed by end-1998. According to the terms that were being negotiated, there would be a 12-month transition period and a four-year grace period. Thus, the impact of the measures under the Association Agreement would not be felt until after 2000.

As the paper noted, the Jordanian authorities had already undertaken substantial structural reforms—in some areas going beyond what was programmed—the staff representative from the Middle Eastern Department observed. The remaining reforms—civil service, pension system, and privatization—were complex, and it would be difficult to formulate them in terms of structural benchmarks or performance criteria. Moreover, the usefulness of doing so was questionable, given the authorities' good track record of implementing far reaching structural reforms and their commitment to move ahead with the remaining reforms.

The staff representative from the Policy Development and Review Department noted that, if the reforms were going to be set as performance criteria or structural benchmarks, they would have to be formulated in precise terms and be verifiable in certain instances, which was impracticable. Moreover, Jordan had a good track record of implementing structural reforms, making such a step unnecessary.

Ms. Lissakers remarked that it would not be unprecedented to include fairly precise structural benchmarks in Fund-supported programs. There might be scope for greater use of those.

Mr. Shaalan noted that, although Jordan had adopted the correct policies, it continued to experience balance of payments problems. The country faced a unique situation, arising from the unofficial redemption of Jordanian dinars in the West Bank and Gaza Strip, which was adversely affecting the official foreign exchange reserves position. Indeed, the official reserves currently covered about two months of imports. The vulnerability of the balance of payments position was evident in 1996 when the balance of payments deficit had widened, capital outflows had increased, and Jordan had not received the hoped-for $300 million. While Jordan had received project assistance at the consultative group meeting held in mid-1996, it had received only limited balance of payments support. The debt service ratio was about 25 percent, and the debt was about 100 percent of GDP. His Jordanian authorities were grateful to the United States for granting a debt write-off of $700 million. Indeed, the generous support of the United States had brought down Jordan's debt from 190 percent of GDP to the current level of 100 percent of GDP. In his statement he had referred to disbursements rather than total aid, and hence had not mentioned the United States' support. He wished to reiterate that his Jordanian authorities were very appreciative of U.S. support.

The real issue facing the authorities was how to minimize the external vulnerability and restore growth, Mr. Shaalan stated. The issue had been discussed extensively by the authorities with the Managing Director during his recent visit to Jordan. The Fund and the international financial community should assist Jordan in building up its official reserves and addressing the problems, which were associated partly with the uncertainties in the region. He was grateful for Directors' support for the authorities' request for higher access to Fund resources; however, he would hope that, if the need arose, the exceptional circumstances clause could be invoked for Jordan.

Jordan had pursued tight monetary polices in 1996, and the high interest rates adversely affected the country's ability to attain its growth potential, Mr. Shaalan observed. Net domestic assets of the banking system had increased by less than 3 percent, the increase in liquidity had been negligible, and private sector credit growth had been only about 5 percent. On structural reforms, as the paper noted the authorities had taken measures that went beyond the requirements of the Fund-supported program. The were committed to taking the remaining structural measures, in civil service reform, pension reform, and privatization.

On the sustainability of the current policy mix, it should be noted that the 1997 budget provided for an expenditure cut of about 2.2 percent, most of which entailed a reduction in current, and not capital, expenditures. Furthermore, there would be no wage increases, and only half the vacancies in government employment would be filled. The fact that there would be no wage increases was particularly important. After all, it should be borne in mind that average Jordanian had yet to reap the benefits of the peace and reform dividend. That constrained the government's ability to take measures beyond those programmed. While it was true that there would be no additional revenue increases in 1997, it should not be forgotten that revenues were already about 30 percent of GDP, which was quite high compared to other developing countries. One should also not forget that the authorities had taken courageous measures in the past by raising the prices of basic commodities, such as bread, water and electricity prices. While the authorities realized that they needed to reduce income tax exemptions, given that the income tax, the corporate tax and the general sales tax had been reformed only recently, it would be difficult to make further changes to the tax system in 1997.

As the staff had noted, the 9 percent appreciation of the real effective exchange rate was calculated on the basis of the consumer price index, and therefore reflected changes in administered prices, Mr. Shaalan noted. However, such calculations were fraught with error; indeed the margin of error according to a recent staff paper could be about plus or minus 30 percent. There were no indications that the dinar was overvalued. He believed that it would be a mistake for the authorities, at the present time, to take measures that would have the effect of depreciating the dinar.

Ms. Lissakers said that her authorities wished to commend Japan for its recent support to Jordan.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities' steadfast implementation of adjustment and reform policies, which had led, despite a difficult external environment, to an impressive record of sustained high rates of economic growth, low inflation, an improving external current account position, and a reduction in the external debt burden. Notwithstanding those achievements, Directors noted that Jordan had faced difficulties in building up official foreign exchange reserves, due in part to uncertainties related to developments in the West Bank and Gaza Strip and the region.

Directors stressed that Jordan needed to build on its recent progress through continued strong macroeconomic policies and an intensification of structural reforms, thereby consolidating the economic gains for its population and further reducing its vulnerability to adverse external developments. In that regard, while Directors generally welcomed the authorities' policy package for 1997, a number of Directors noted that the programmed reduction in the budget deficit in 1997 relied mainly on containment of expenditures. They expressed concern about the composition and sustainability of fiscal adjustment over the medium term, stressing that sustaining fiscal consolidation would require continued progress on fiscal reforms on the revenue side—thereby strengthening revenue buoyancy—including moving forward quickly with extending the general sales tax to currently exempt services, reducing personal income tax exemptions, and improving tax administration. Directors called for a careful monitoring of expenditures, including pensions and wages. Directors were concerned about the worsening poverty situation, and called for attention to social spending to provide an appropriate safety net to protect the most vulnerable segments of the population. They considered that the intensified efforts by the government to address poverty issues, especially through the social productivity package that was being formulated with assistance from the World Bank, were essential for the sustainability of adjustment and reform efforts.

Directors noted that Jordan had maintained an appropriately tight monetary policy, accompanied by substantial reforms in the financial sector, and that the current exchange rate policy had contributed to financial stability. Monetary policy should continue to be geared to building up official foreign exchange reserves and supporting the current exchange rate policy. Directors indicated that, given the fluid regional conditions, the authorities would need to continue monitoring monetary developments carefully and to adjust their policies in the event of an unanticipated decline in money demand. In that regard, they stressed the importance of a flexible interest rate policy and of monitoring external competitiveness.

Directors observed that the authorities' far-reaching structural reforms were resulting in significant transformations in the Jordanian economy, including in the regulatory framework, the financial sector, and the subsidy system. They stressed the importance of accelerating the pace of privatization in order to encourage further private sector activity and to help attract much needed foreign direct investment. Directors also encouraged the authorities to move forward expeditiously with reforms of the public pension system and the civil service, with a view to improving the efficiency of government operations and contributing to fiscal consolidation.

Directors observed that Jordan's medium-term balance of payments position continued to remain vulnerable to adverse external shocks. Thus, they stressed the continued importance of building up official foreign exchange reserves to provide a cushion against such developments. While underscoring that strong policies were the key to meeting the challenges that Jordan faced, Directors also noted the significant role of external assistance in supporting Jordan's stabilization and adjustment efforts. Directors hoped that the signal provided by the further augmentation of Jordan's access to Fund resources would help to catalyze additional external support for the authorities' economic program, and thereby help to secure the decisive increase in foreign exchange reserves needed to underpin confidence and reduce Jordan's vulnerability to external developments.

It is expected that the next Article IV consultation with Jordan will be held on the standard 12-month cycle.

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Jordan's exchange measures subject to approval under Article VIII, Section 2(a), in the light of the 1996 Article IV consultation with Jordan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Jordan retains, as described in EBS/97/7, an exchange restriction on payments and transfers for current international transactions evidenced by arrears on certain external debt service payments that is subject to Fund approval under Article VIII, Section 2(a). The Fund urges Jordan to eliminate this restriction as soon as possible. In the meantime, in view of the authorities' continued best efforts to eliminate these external payment arrears, the Fund grants approval for the retention of this restriction until September 30, 1997, or the completion of the third review under the Extended Arrangement, whichever is earlier.

Decision No. 11439-(97/12), adopted
February 10, 1997

Extended Arrangement—Review, Augmentation, and Modification and Waiver of Performance Criteria

1. Jordan has consulted with the Fund in accordance with paragraph 3(c) of the Extended Arrangement for Jordan (EBS/96/3, Sup. 2, 2/13/96), as amended, and paragraph 42 of the Memorandum on Economic Policy of the government of Jordan ("Memorandum") attached to the letter from the Minister of Finance and Customs and the Governor of the Central Bank of Jordan dated December 30, 1995, in order to review progress made in the implementation of the program's policies, measures, and structural reforms, reassess the adequacy of the macroeconomic and financial targets for 1997, and establish performance criteria for March 31, 1997 and June 30, 1997.

2. The letter from the Minister of Finance and Customs and the Governor of the Central Bank of Jordan dated January 11, 1997 and its attachments shall be attached to the Extended Arrangement for Jordan, as amended, and the letters from the Minister of Finance and Customs and the Governor of the Central Bank of Jordan dated December 30, 1995, with its attached memorandum, and June 16, 1996, with its attachments, shall be read as supplemented and modified by the letter of January 11, 1997 and its attachments.

3. Jordan has also requested that the amount of its Extended Arrangement, as amended, be augmented by an amount equivalent to SDR 37.24 million. The Fund approves this request.

4. Accordingly:

(i) The Extended Arrangement for Jordan, as amended, is further amended in Paragraph 1 by deleting the amount of "SDR 200.8 million" and substituting it with "SDR 238.04 million."

(ii) Paragraph 2(a), (b), and (c) of the Extended Arrangement for Jordan, as amended, shall be modified to read:

"2(a) Until November 15, 1997, purchases under this Extended Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 161.79 million, provided that purchases shall not exceed the equivalent of SDR 82.2 million until February 15, 1997, the equivalent of SDR 110.3 million until May 15, 1997, the equivalent of SDR 139.96 million until August 15, 1997.

(b) Until May 15, 1998, purchases under this Extended Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 190.69 million,

(c) The right of Jordan to make purchases after May 15, 1998 shall be subject to such phasing as shall be determined."

(iii) For purposes of the purchase of the augmented amount, the Fund waives the limitation in Article V, Section 3(b)(iii);

(iv) The performance criteria referred to in paragraphs 3(a)(I), (ii), (iii), and (iv) of the Extended Arrangement, as amended, for March 31 and June 30, 1997, shall be as specified in paragraphs 10 and 19 of the letter dated January 11, 1997 and in Attachments III, IV, and VI attached thereto.

(v) The intention with respect to external payment arrears specified in paragraph 3(b) of the Extended Arrangement shall be as described in paragraph 19 of the letter dated January 11, 1997.

5. The Fund decides that the second review contemplated in paragraph 3(c) of the Extended Arrangement for Jordan, as amended, has been completed, and that, notwithstanding the nonobservance as of December 31, 1996 of the performance criterion set forth in paragraph 3(a)(ii) of the arrangement, Jordan may proceed to make purchases under the Extended Arrangement.

Decision No.11440-(97/12), adopted
February 10, 1997

3. SYSTEMIC BANK RESTRUCTURING AND MACROECONOMIC POLICY

The Executive Directors considered a staff paper on systemic bank restructuring and macroeconomic policy (SM/97/1, 1/3/97; Sup. 1, 1/3/97; Sup. 2, 1/3/97; and Sup. 3, 1/3/97.

Mr. Bernes made the following statement:

I would like to thank staff for an insightful set of documents, the content of which I can broadly endorse. I consider these papers valuable complements to the "Bank Soundness and Macroeconomic Policy" discussion of last March. A key message arising out of that discussion was that countries' experiences with banking problems underscored both the importance of a sound banking sector for macroeconomic stability and the influence of macroeconomic (and structural) policies on the soundness of the banking system. The present set of papers is somewhat more focused in that it considers strategies for systemic bank restructuring and their macroeconomic aspects and implications. Indeed, much of the Fund paper is devoted to technical details of bank restructuring, such as how to measure and allocate the costs of bank restructuring and instruments to restructure banks.

The relatively frequent incidence of banking sector problems among Fund member countries, and the increasingly international nature of those problems together with the important role played by banks in virtually all types of economies, suggest that the Fund has an important role to play in this respect. At the same time, there are limits to this role, and one would hope that discussion of these issues would help delineate the Fund's role in identifying, managing, and resolving banking sector crises in member countries.

Among international financial institutions, the Fund is uniquely placed, through its Article IV consultations, to regularly assess the soundness of member countries' banking sectors, and to identify at an early stage systemic banking problems. In this latter connection, the availability of timely and accurate data cannot be overemphasized. Recommendations that arise out of Article IV or program review missions can be elaborated upon and implemented in the context of technical assistance, which should be well integrated with the Fund's surveillance activities. In addition, as this Chair has noted before, 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.

While the Fund clearly has an important contribution to make in the area of banking sector issues, care obviously needs to be taken to avoid duplication with the work of other international financial institutions. Thus, the microeconomic and institutional details of bank restructuring would normally fall within the expertise and experience of the World Bank and the regional development banks. Broadly speaking, one could envisage a setup where adherence to internationally-set prudential regulations is monitored by the Fund, perhaps in consultation with regional development banks, and the World Bank assumes a leading role in helping to restructure those banking sectors identified as weak. Clearly, this does not obviate the need for prudential regulations and bank supervision in individual countries, yet it gives a broad indication of where, in my view, the relative competencies of these international bodies should lie. I would therefore agree that the staff should actively explore mechanisms for enhanced cooperation, particularly with the World Bank. Indeed, it is very important that information regarding countries' financial systems be shared among the IFIs.

While it is likely that, in practice, the sources of financial fragility are difficult to disentangle, attempting to identify the cause of a particular country's banking problems is an important first step in managing and resolving those problems. In that context, one can characterize different sources of financial fragility, which helps define the areas in which the Fund can most productively provide input: (i) low monitoring capacity, for instance in countries where the legal and jurisdictional basis for monitoring loans, including bankruptcy legislation and procedures, is weak; (ii) distorted bank incentive structures (or poor governance), i.e., those distortions that reduce the return to banks of loan monitoring or cause banks to prefer to lend to poor quality projects. Such distortions can arise from inadequate bank regulation and supervision, as well as from a poor bank restructuring strategy which fosters expectations of future unconditional bank bailouts; and (iii) macroeconomic shocks, domestically or externally generated, such as the collapse of a domestic real estate bubble or an unexpected devaluation or rapid depreciation of the exchange rate. As I noted above, the World Bank or regional development banks would likely assume the lead role in addressing the microeconomic and structural sources of financial fragility alluded to in (i) and (ii). However, in the case of (ii), as underlined by the staff, the Fund has a role to play to the extent that bank restructuring implicates macroeconomic policy.

When the source of banking system fragility is a macroeconomic shock, as opposed to originating in the banking sector itself, there is a strong case for the Fund to play a leading role in its resolution through the design of appropriate macroeconomic policies. This would involve managing not only the shock itself, but also the macroeconomic impact of any ensuing bank restructuring program.

In recapitalizing an insolvent bank, private capital injection is the preferred route since it has no direct or indirect fiscal costs, unless accompanied by forbearance or tax preferences, and provides for appropriate incentives. However, to the extent that private capital is not available in sufficient amounts, and this has tended to be the rule rather than the exception, government contributions to capital will be necessary. As a result, the staff paper focuses on the macroeconomic implications of government-assisted bank restructuring involving the issuance of government debt, either in exchange, or to compensate, for nonperforming loans. The staff notes that, *ceteris paribus*, such an operation increases aggregate demand in the economy, outlining five channels through which such an impact could operate. Aggregate supply would also be expected to rise following bank restructuring due to the resultant increase in intermediation, although one might expect this effect to be small.

Given these expected effects, what should the macroeconomic policy response to bank restructuring be? In my view, the staff is correct in suggesting that fiscal policy is a primary instrument for managing financial restructuring, and that the fiscal policy response and restructuring strategy should ideally be interactively determined. The staff notes that for a country with a high initial debt stock and a weak primary balance, debt sustainability will be an issue. However, if the government is supporting a potentially viable and profitable banking system, then the debt can be repaid at some point in the future so that medium-term scenarios need not look unduly worrisome. On the other hand, it is worth emphasizing that ultimately the full cost of public involvement in bank rehabilitation programs is borne by the private sector, as public expenditure and fiscal deficits must eventually be financed. Moreover, if governments are fiscally constrained in their restructuring efforts, or if an the Fund-supported adjustment program is overly exacting in its fiscal targets, the authorities in question may well resort to monetary financing. The resulting unexpected inflation is likely to weaken the government's credibility, and undermine the economy's performance.

The staff suggests that monetary policy targets may need to be compromised during a financial crisis or bank restructuring program, arguing that too tight a monetary stance and accompanying high interest rates could exacerbate banking sector problems. However, I believe that bank restructuring is best undertaken in the context of a monetary policy geared to the achievement of price stability. Using loose monetary policy risks having the cost of bank restructuring opaquely funded by inflation, and could involve a weakening in central bank credibility. In addition, unless liquidity is scarce or fiscal capacity is limited, there may not be an inherent trade-off between monetary policy goals and bank restructuring. If liquidity is scarce, the central bank, as lender of last resort, can make loans to the troubled bank(s). As this form of support tends to involve a change in the composition of central bank assets (rather than an increase in assets), such LOLR lending should not be inflationary. I would add that once bank incentive structures have been corrected, a tight monetary stance is consistent with the fiscal obligations of the restructuring program.

In sum, I am of the view that an appropriate macroeconomic stance in the context of systemic bank restructuring would be to maintain monetary discipline while transferring the full cost of restructuring to the public budget in a transparent way.

Mr. Toribio made the following statement:

The set of papers presented by the staff on "Systemic Bank Restructuring and Macroeconomic Policy" constitute an illuminating insight into the problems associated with poor banking performance and its consequences for the economy at large. I want to congratulate the staff for a throughly professional job in this subject. I especially appreciate their efforts to present a comprehensive view of the accumulated experiences from different countries and the lessons to be derived from them. My agreement with their conclusions is almost complete.

The main paper raises a number of discussion issues to which I would like to refer, in the same order as they are posed by the staff.

In answering the first question, let me state my conviction that an early identification of problems is fundamental to minimize their consequences and the social costs implied by their solutions. The question is what problems are to be identified, who should identify them and what the role of the Fund should be in this matter.

In theory, there may be several causes for bank insolvency, but historical experience shows that few financial intermediaries have reached the point of an unsurmountable crisis due to operating costs, excess of personnel, high remuneration to depositors and even interest rate risk exposure. Most of these problems are serious, but they can usually be solved by a competent and professional management.

The most important cause of both single bank and systemic crises has usually been the existence of bad loans and, in general, nonperforming assets. These are the problems that no bank manager or bank supervisor can ever solve once they reach a certain point and those are also the problems whose early identification become most urgent.

The bank supervising agency must publish and enforce all the necessary norms to facilitate an early identification of problems to bank managers themselves. Accounting regulations, norms for an early provision of dubious loans, the compulsory adoption of internal control systems, etc., fall in this category and are an indispensable—although not sufficient—part of the actions to be taken.

Authorities may also impose the need of an external private auditing of bank accounts, making sure that the auditing companies have the necessary qualifications for the job and that they are recognized as such by the market. In many cases, rating agencies can also be called by the banks, in connection with the authorities, to publish an independent opinion, knowing that the high costs often involved in rating are more than compensated by the security it provides.

But external auditors do not always go beyond certifying the proper use of generally accepted accounting criteria. Therefore, they are not a substitute for a deep and direct knowledge of the bank's true situation on the part of the supervising authorities. They should develop all the necessary systems for an in-depth inspection of banks, drawing, if necessary, on the ample experience of other countries. Supervising authorities have the responsibility to know the banks under their jurisdiction and they can hardly claim they were taken by surprise when a crisis develops, except in cases of fraud or criminal conduct.

Can the Fund play a role in advising authorities on this matter? Of course it can. And it should. The staff of the Fund is in a favorable position to give this advice on the occasion of the Article IV consultations and, if necessary, to provide technical assistance for the elaboration and enforcement of norms and the development of effective inspection systems. Such support could be shared with other international institutions or, perhaps, with experienced national banking authorities, ready to participate with the Fund in technical assistance.

I concur with the staff in pointing out the need to act promptly once a problem is identified in a simple bank or in the system as a whole. Nothing is gained by postponing action. Costs will be increased and finally a stronger and more difficult decision must be made. In my opinion, two observations are relevant in this point. First, problems should be faced and solved once and for all. I do not believe the recapitalization of banks (or any other solution to their solvency problems) should be made gradually and on a recurrent basis. Such a strategy would probably generate perverse expectations which may aggravate instead of solve the problems at hand. The second observation refers to the need to introduce operational and management restructuring. When problems become serious, a contribution of fresh capital or a simple swap of assets are usually not enough. In fact, most of the experiences of bank restructuring that the staff paper consider as successful incorporated rather radical changes at the operational level, together with new financial resources.

Again the Fund is in a very favorable position to urge the supervising authorities to take prompt action, advice them in the measures to be taken, and support their efforts to implement those policies. Supplement 2 to the document we are discussing proves that the Fund treasures a deposit of knowledge on comparative banking crises that very few institutions have.

As for other questions raised for discussion at the end of the paper, I would point out my agreement with the staff's views that solvency support for problem banks—when needed—should be provided by the budget and that central banks are not the appropriate institutions to bear the burden of providing new financial resources to banks. The role of central banks should be restricted to providing liquidity to the system at large, under the ordinary instruments of monetary policy, where a run on bank deposits due to some bank's problems may affect the quantity of money.

I would entirely agree with the staff about the need to add complete transparency to the process of bank restructuring. That is a crucial factor to avoid doubts and generate confidence in the designed policies. In this connection, I would entirely support the proposal to go beyond the conventional GFS-based practices and introduce the concept of "augmented balance," although I am not sure about the specific recommendation made on Table 5 to include public sector deposit transfers as part of that new concept.

Finally, let me declare my inability to draw a clear line between the responsibilities of the Fund and those of the World Bank in matters of bank restructuring. I am not sure to be in agreement with the scheme envisaged in Mr. Bernes' statement to limit the Fund's field of play to monitoring the adherence of banks to prudential regulations and let the World Bank the leading role in helping to restructure the banking system. It seems to me the Fund is fully equipped to contribute more than a simple monitoring of regulations, although I am convinced the World Bank has also wide expertise on these matters. I would be ready, however, to fully support Mr. Bernes' proposal that the staff actively explores mechanisms for enhanced cooperation with the World Bank. I am sure the staff will keep this Board informed about any progress reached in that direction.

Mr. Shaalan made the following statement:

The timely and informative documents before us today provide useful insights on the design of macroeconomic policy in the context of bank restructuring. The lessons derived from the sample case studies on financial and operational restructuring are particularly enlightening, given the spreading incidence of financial liberalization and globalization on the intermediation ability of banks and the risk of occurrence of bank crises.

An outstanding feature of the staff study is the fairly unequivocal conclusions that can be used as basic guiding principles in a bank restructuring strategy. Two lessons are particularly noteworthy in this regard.

To succeed, a process of bank restructuring has to cover both financial and operational restructuring. The benefits of an integrated approach to systemic bank restructuring are clearly demonstrated by the favorable experiences of Côte d'Ivoire, the Philippines, and Poland (where operational restructuring was extended to public enterprises). On the other hand, whereas financial restructuring usually attracts the immediate attention of authorities, the neglect of operational restructuring can thwart the successful completion of the restructuring process. A noteworthy finding of the staff study in this regard is that all sample countries suffered from management deficiencies that led to banking problems, and that progress in bank restructuring depended on addressing these deficiencies. Unfortunately, competent management is a scarce commodity and can become a major bottleneck in the restructuring process, especially in developing countries. Management considerations could well determine the viability of the institution in question, notwithstanding the presence of all other necessary elements for the success of the operation. In developing countries in particular, more attention needs to be accorded to this area.

Bank restructuring is a lengthy and costly affair. If anything, this underscores the priority to be attached to the establishment of an early warning or preventive mechanism, in the form of an efficient financial regulatory and prudential framework, in order to limit potential future costs of distress or crisis in the banking sector. Thus, regarding the first two issues posed for discussion by staff, the Fund should indeed assist member countries in identifying problems early on, and in addressing these problems by proposing solutions based on the experience of other countries. This assistance should be part of the Fund's regular surveillance activity. I believe, however, that we need to look into the feasibility and desirability of developing a mechanism for an operational procedure with the World Bank for early identification of incipient problems. I would appreciate staff views on this issue.

The central bank is frequently the lead, if not the sole, agency in charge of restructuring, usually providing liquidity as a main form of support. Interestingly, a major finding of the staff study is that the countries achieving substantial progress had little recourse to liquidity support, and that less progress was registered in countries that had extensive recourse to central banks. Obviously, if feasible, limiting recourse to central bank assistance has the advantage of minimizing cost and moral hazard. One should note, however, that a central bank is often the only qualified institution available to oversee restructuring. More important, particularly in crisis situations, the potential adverse consequences of inaction may far outweigh the cost of intervention. With little time to ponder alternatives, a central bank would therefore tend to err on the side of caution, acting promptly and in whatever necessary amount of liquidity in order to forestall erosion in confidence and a major adverse shock to the exchange rate and foreign reserves.

The opening sentence of the staff report evokes a fundamental rule of market discipline, namely that individual banks should be allowed to fail. A related issue that is discussed elsewhere in the report concerns the need for the central bank to provide liquidity support to viable banks only. It is not an easy task to ascertain bank financial viability at the onset of, or even during, restructuring, especially in view of the difficulty of securing adequate management—an essential viability element—for several institutions undergoing restructuring. Objective criteria for assessing bank viability are few and can be unreliable in a situation of systemic crisis or distress, thus constraining the ability to enforce market discipline and reduce moral hazard.

As indicated above, systemic bank restructuring tends to be very costly, and the public sector tends in turn, and is often expected, to bear a relatively large share of the burden of this cost. The general rule is that the authorities should attempt to distribute restructuring costs on the shareholders, creditors, and, to a lesser extent, for reasons of macroeconomic externalities, depositors. In considering ways in which the central bank can contain the cost of its financial assistance, I would refer in particular to obtaining collateral from the shareholders in exchange for financial support, and putting a time limit, as in the United States, or some ceiling on the amount of official assistance. Particular country circumstances usually determine, however, the best combination of actions. I would have been interested to learn about the French experience, to which there is no reference in the report, whereby the central bank may attempt to spread the costs of bank restructuring by inducing commercial banks to support failing or distressed banks. Staff comments will be appreciated.

Regarding the impact of bank restructuring on the design of macroeconomic policy, clearly both monetary and fiscal policies, and the goal of price stability, will be constrained by the monetary impact of the banking problems and the fiscal needs of restructuring. In particular, the design of monetary policy may be complicated by distortions in the monetary data series and the transmission channels, especially in the early stages of the restructuring process. While the monetary authorities may face the added complication of having to choose between tightening to relieve pressure on the exchange rate and foreign reserves, and monetary easing to alleviate banking sector problems, the advantages of tightening are more straightforward for fiscal policy. A sustained strengthening of the fiscal stance would support the domestic and external objectives by enhancing stability and confidence, thus relieving pressure on monetary policy. These considerations underline the primary role that fiscal policy would have to assume, particularly in the early years of restructuring.

Finally, in the case of Egypt, the central bank was not requested by the Fund to provide the necessary data on which, similar to other countries in the study, the assessment was based. Accordingly, I request that the conclusions or observations made on Egypt be deleted. If requested, the central bank will readily respond to the questionnaire on the subject.

Regarding Kuwait, its macroeconomic performance following restructuring is characterized in the report as belonging to the category of countries exhibiting a pattern of "slow but steady deterioration of certain macroeconomic indicators." This is an inaccurate description. It must be pointed out that Kuwait's case, the only oil-producing country covered in the documents, is atypical and not comparable with other countries in the sample since the year of restructuring (1992) is the year which, coming just after liberation following the Gulf war, has produced an unusually strong performance in terms of growth and inflation. Thus, the data for that year cannot meaningfully serve for comparative purposes with subsequent years. Moreover, Kuwait's macroeconomic performance has in fact significantly improved after 1992. This is best indicated by simply comparing average performance during the four years following restructuring to the average performance during the four years preceding restructuring. I am happy to add, however, that the staff agree with these comments and have undertaken to make all the necessary amendments in this regard.

Mr. Borpujari, speaking on behalf of Mr. Al-Turki, made the following statement:

I commend the staff for an excellent set of papers on this very important and complex issue. As the case studies show, banking sector reform has all along been a priority for the Fund. However, the urgency of the challenge has increased with the recent rapid globalization and expansion of financial markets. Indeed, the adverse effects of delayed banking reforms on efficiency and the growth potential has greatly increased. Timely attention to systemic bank restructuring issues can thus contribute to effectiveness of the Fund's surveillance process.

That being said, I see the Fund's future role in bank restructuring as primarily a continuation and reassertion of the present country-by-country approach. I will offer a few remarks in that regard in the context of the issues that the staff has singled out for discussion.

I see the identification of problem situations as a continuing integral part of the consultation and surveillance process. While I recognize the added urgency, the staff's responsibility on this matter is essentially unchanged. Also, I am convinced that the Fund should not engage in bank-specific financial and operational issues. The Fund's direct involvement should thus remain focused on the banking sector as a whole.

The staff has also asked for guidance on presentation of the bank restructuring issues. Given that the restructuring of banks and the use of debt-based instruments are multi-year processes, the use of a medium-term framework appears essential. The case for augmentation of the standard fiscal balance concept is, however, less obvious. Let me also emphasize that these questions, as a rule, have no general answer. One must therefore look to the staff for making timely innovations with due attention to the importance of keeping the analysis simple as well as reasonably comparable across countries. The proposed augmented fiscal balance concept, for instance, has to be approached with particular caution since bank restructuring is not the only contingency for which such an augmentation may be justified.

I also see no need for any general rule to decide whether a program's time-table or policy-mix should be altered to accommodate a bank restructuring effort. Indeed, this is a two way process as one also has to consider whether the program itself might trigger a banking crisis. This clearly is to be decided on a country-by-country basis. Thus, as normal practice, any adverse impact, including exacerbation of bank solvency problems, has to be factored into the adjustment pace proposed for a program. Also, I fully agree that there will be occasions when the authorities should be encouraged to make additional fiscal adjustments to expedite the bank restructuring process.

Bank restructuring evidently requires extensive technical, microeconomic, regulatory and institutional improvements. Selectivity is thus crucial to avoid getting into areas peripheral to the Fund's usual responsibilities and comparative advantage. I have two remarks in that regard.

First, it is essential to have conceptual clarity about the key links between the individual banks, the banking system and the macroeconomy. I therefore commend the staff for a very helpful paper on that subject. I welcome especially the focus on highlighting the main channels through which bank restructuring impacts on the macroeconomy. I also welcome the staff's work on critical constraints and best practices for bank reform across countries. Such well-focused research to help restoration of bank solvency and profitability has to be continued. For actual implementation, however, the emphasis should remain on cooperation with other international organizations, especially the World Bank.

Second, given that bank restructuring is an extensive and multi-year process, I see need for further reflection on the sequencing of related policies within the overall adjustment and reform effort. Once again, the issue is best addressed on a country-by- country basis supported by an improved knowledge of the conceptual links and best practices across countries. In this connection, I recall the helpful suggestions in the Working Paper that Mr. Sundararajan prepared last November on bank restructuring and enterprise reforms. Indeed, a properly sequenced and coordinated critical mass of policies in all the three areas of bank restructuring, bank supervision and enterprise reforms can help expedite the financial liberalization process without endangering financial stability.

Ms. Lissakers and Mr. Sobel submitted the following statement:

The United States strongly endorses the Board's discussion of systemic banking restructuring and macroeconomic policy. In recent years, structural flaws in banking systems have spawned macroeconomic problems or full-blown crises with major repercussions for the concerned countries and the Fund. Staff's fine papers further our understanding of the issues surrounding such cases, and they will help us to adapt our operations to better respond. These papers will also complement the work under way in the G-10 and other fora on strengthening financial supervision in emerging markets.

Systemic bank restructuring is an area where an ounce of prevention is worth a pound of cure. But unfortunately, history is riddled with countless instances in which countries took the pound of cure rather than the ounce of prevention. Perhaps this is because prevention and restructuring is a multi-year, complex and nitty-gritty process and because crises tend to focus one's mind.

Certainly we agree that addressing systemic banking restructuring requires a comprehensive approach, combining: 1) sound macroeconomic policies, 2) market-oriented financial sector policies, and 3) active government involvement in the supervisory, institution-building and regulatory areas.

First, the relationship between the banking environment and macroeconomic policy is well-trodden terrain, covered excellently in staff's papers. But a few points seem critical. Delaying restructuring can be very costly in imposing fiscal burdens, dragging down a country's growth potential, fostering demonetization, perpetuating high deposit-lending spreads which hamper household savings and private sector borrowing, and impeding the functioning of indirect instruments of monetary policy control. Banking system vulnerabilities will raise the risk premium embedded in domestic interest rate spreads, and this is a further argument for better balance in the fiscal-monetary mix, if not a tighter fiscal/looser monetary policy mix.

Also, when crises emerge due to delays in restructuring, central banks obviously have a lender of last resort responsibility. But it is important to exercise this responsibility without undermining stabilization by pouring liquidity into insolvent banks. If there is a tradeoff between achieving macroeconomic goals and systemic bank restructuring, this should be highlighted in the Fund policy advice to member countries.

Second, in terms of market incentives for the financial sector, this is also well trodden terrain. But it is nonetheless useful to highlight, as Gerald Corrigan did in his recent seminar on building effective banking systems in Latin America, that often at the root of banking problems are inter-locking relationships between lenders and borrowers and the absence of a credit culture and arm's length transactions. And this is by no means limited to emerging markets. It will take a long time to address all of these accumulated problems. But in doing so, one aim should be to achieve robust and profitable banking systems. Accordingly, financial sector policies must be formulated as a package to mobilize domestic savings and investment in a safe and efficient manner, channel savings to their most efficient uses, and provide low-cost and safe means of making and receiving payments.

For these reasons, interest rate controls should be avoided as they will distort financial flows and increase disintermediation. Financial innovation should be permitted and encouraged. A competitive, open environment with a level playing field is crucial, and in this regard, foreign banks should be afforded liberal establishment and entry rights.

Also, banks should be privatized. The clearest reference to this topic was the last point in the paper on elements of best practices where staff notes that bank privatization, if achieved inappropriately, can create real headaches. This is an unassailable, but narrow, point. Certainly it is true that we have seen many instances in which private banks do not conduct arm's length transactions, are no sounder than inefficient state-owned banks, and in the end harm the financial system and impose large burdens on taxpayers. But, at the same time, state owned banks, in the extreme, are passive financing arms for a government, propping up insolvent state firms. Even when there are hard budget constraints, state banks may have less incentive to focus on the bottom line and make loans on the basis of market judgments of creditworthiness.

It is accepted wisdom that governments are much less efficient at restructuring than the private sector. There are often good reasons to proceed cautiously with changes in the financial sector, especially in emerging markets. But experience leads us to believe it would be wise to place more emphasis on avoiding the costs of inaction. In its policy advice, staff should be far more pro-active in urging bank privatization and in advising countries on the best practices and complementary policies needed to buttress successful and faster bank privatization.

Third, bank restructuring also requires an active governmental hand as the financial sector faces acute problems of asymmetric information, adverse selection and moral hazard. A robust supervisory and regulatory regime is critical for successful systemic bank restructuring and soundness. A few points are noteworthy in this regard.

The staff is correct in underscoring the need for firm and clear entry and exit policies. Many countries allow private banks to establish too easily, sometimes resulting in too many poorly staffed banks, too much connected lending, and too little capitalization. In other cases, banks serve government purposes or have close ties to it, and continue operations even though they are insolvent. Such cases highlight in particular why, as a general rule, licensing procedures should be rigorous, standards for minimum capitalization ought to be high, and authorities need to be in a position to promptly resolve insolvent banks.

Governments need to promote an environment for sound internal bank governance. Banks should thus be subjected to stringent public disclosure and reporting requirements on the basis of transparent and uniform accounting standards. On-site supervision and examination need to be strong to ensure that appropriate controls and procedures are implemented and to verify that information reported by banks is complete and accurate.

A lead agency should be designated as responsible for implementation of bank restructuring. But we found two parts of staff's analysis curious in this respect. One, we felt the critique of "regulatory forbearance" (para. 30) was mild. The United States had a terrible experience with this. There are reasons why the mention of "zombie S&Ls" sends shivers up the spines of financial analysts. Indeed, there are estimates that if we had tackled the S&L crisis of the 1980s sooner, our taxpayers could have been saved up to $100 billion. In essence, banks should not be allowed to bet the house.

Two, the staff notes that a high level governmental commitment is needed to ensure effective implementation. This is true. But there are also major risks associated with this involvement—namely, that those who govern and regulators may not have the right incentives to minimize taxpayer costs. These risks are captured by the principle-agent problem and staff might have usefully underscored this point.

In this spirit, deposit insurance inevitably gives rise to moral hazard as the U.S. experience in the 1980s testifies. But the lack of deposit insurance is more likely to foster runs and panic, as the 1930s show. Deposit insurance and safety net schemes should be structured to provide a proper balance of incentives for bank owners, managers and depositors to minimize moral hazard. But it was not clear if staff had a view on "best practices" for deposit insurance and for addressing the resolution of very large and insolvent banks.

Also, as the staff suggests, it is optimal to ensure that those who create losses bear them, and to minimize the cost to public finances for both moral hazard and fiscal reasons. But there are limits to the application of these principles. Bankrupts cannot be made to pay. government involvement in absorbing costs is inevitable. In many respects the costs are already there, they are just implicit rather than explicit. In this context, we support the augmented fiscal balance approach. While not a perfect measure, it would make fiscal accounts more transparent and encourage more prompt action and firmer exit policies.

The staff correctly notes that countries have succeeded more in financial restructuring than in operational restructuring. Two observations are merited in this regard.

One, numerous countries have recapitalized banks through exchanges of bonds, allowing restructuring costs to be stretched over time, unlike cash infusions. This raises the issue of how to deal with troubled assets. In principle, such assets should be written down or off. Also, troubled assets might usefully be viewed as the legacy of the past, especially when they reflect losses of state firms, and as very distinct from a bank's future operations. In terms of management of such assets, quick liquidation at fire sale prices may be preferable to hanging on the hopes of realizing a higher value. A slower liquidation process may create large uncertainties for, and weigh more heavily on, the real economy.

Two, to truly avoid moral hazard, recapitalization should occur only once. Thus, recapitalization must be firmly linked to new modes of operation, including bank privatization. This point cannot be overemphasized. Thus, it might have been useful if the staff had dealt more forcefully with operational restructuring.

Finally, the staff invites Directors to comment on the Fund's role in systemic bank restructuring vis-à-vis others, such as the World Bank and Managing Directors. I recognize the Board will continue the discussion of banking supervision and systemic restructuring in March. But this chair would like to offer some of its preliminary thinking and hear the views of staff and the World Bank representative. Indeed, our preference is that in the near future, the two institutions work out a division of labor in this area in a format that can be considered by both Boards.

The Fund surveillance can be a useful vehicle for alerting members to weaknesses in their banking systems and supervisory regimes; for encouraging countries to adopt guidelines developed by the supervisory community; and for assessing progress toward that end. Given the broad agendas facing Article IV missions and that Fund economists generally do not have expertise in the mechanics of banking and supervision, it would be useful to hear how staff plans to develop the skills to take on this task with adequate rigor. Also, the IBRD has a stronger presence in some countries than the Fund, so we must also take heed of its capability in assessing financial sector weaknesses in these economies.

Both the Fund and Bank have extended technical assistance in the banking area and we assume that this effort will continue. Could staff tell us if they have divided the responsibilities for such technical assistance with the Bank and if so, how?

Systemic bank restructuring should be the primary domain of the World Bank, and here the Bank can play an active role with its policy advice and its support for the financial sector through FESALs and projects. In so doing, the Bank should, of course, consult with the Fund, especially on matters having a macroeconomic bearing, such as fiscal costs.

The role of the institutions in the area of program design is perhaps the most sensitive issue. We believe it makes sense for the Bank to have the primary responsibility for designing and supporting programs to strengthen the financial sector and supervisory regime and to prevent crises.

In cases where the Fund program is responding to a financial crisis caused in part by weaknesses in the banking system or supervisory regime, a Fund program could appropriately include conditions to restructure banks and strengthen the supervisory regime. In such circumstances, the Fund should consult closely with the World Bank and joint missions should be considered.

The Fund is frequently summoned by the international community to put out fires. This fact, however, should not drive the Fund to enter, or to take on, long term microeconomic tasks that are beyond the scope of the Fund's role as a monetary institution.

Mr. Cserés made the following statement:

The staff papers summarize experience with restructuring banking systems in industrial, developing and transition countries. The restructuring of banking systems has gained new interest during the present period of worldwide capital market integration. With some editing they could be very well suited to general publication as guidelines for successful bank restructuring.

On such topics as strategies for restructuring, its macroeconomic effects, and policy responses to those effects, I generally agree with the staff. My comments on specific issues will follow the order of the staff paper.

An important conclusion of last March's seminar on bank soundness and macroeconomic policy was that the Fund's primary responsibility for macroeconomic stabilization gives it a clear policy interest in the soundness of banking systems. When financial sector problems threaten macroeconomic stabilization and cripple stabilization policies, the Fund has an obligation to promote financial sector soundness and even to support a restructuring of the banking sector if that is necessary. The Fund's surveillance, program design, and technical assistance should all pay more attention to the relationship between bank soundness and effective macroeconomic policy. Since financial sector weakness can quickly cripple policy, a strong banking sector is especially important for an economy undergoing major structural changes or exposed to severe macroeconomic shocks.

Obviously, the sooner problems are identified and corrected, the better. Though the Fund's interest in restructuring is limited its impact on macroeconomic stabilization, this is not much of a limitation: stabilization's success depends on banking soundness, which often can only be gained by restructuring the banking sector. Obviously such restructuring have to be tailored to specific conditions which vary from country to country. The Fund, with experience in many countries, is well positioned to offer advice to governments and banking authorities. Once the problems are identified and a restructuring plan to correct them has been designed with the aid of technical assistance from the Fund and other knowledgeable institutions, a bank reform package can be included in a Fund supported program. Increasing numbers of programs supported by EFF and ESAF arrangement contain financial sector reform elements, a trend which we support.

Until now, the division of labor among IFIs has been accomplished on a more or less ad hoc basis taking account of each institution's strengths, an arrangement which admittedly has usually worked well enough. The Fund's cooperation with the World Bank is in a special category, due to the great amount of experience the Bank has accumulated during the last decade, and it is probably time to re-evaluate their respective roles in promoting banking reform and restructuring. The Fund should also aim at closer coordination of its efforts with those of other IFIs. I would like to urge the staff to explore more formal mechanisms for further enhancing Fund-Bank cooperation.

I entirely agree with the staff about the need to increase the transparency of the process of bank restructuring. The fiscal balance, for example, supposedly provides a transparent and comprehensive measurement, reasonably comparable across countries, of the effects of fiscal policy, but reality falls far short of this ideal accounting situation. The staff paper describes a wide variation in the accounting techniques, rules, and practices used to reveal or conceal the "price" of bank restructuring programs.

Since under these conditions it is impossible to compare and evaluate the banking sector restructuring of many countries, we welcome the "augmented balance concept" that which will explicitly record all of the major quantifiable costs, whether fiscal or quasi-fiscal, cash or noncash, of bank assistance operations that are currently not reflected in GFS-based figures. The staff's discussion would have been much enhanced by providing a summary table illustrating these real costs, on the plan of the illustrative case studies given in Supplement 2. Have there been any attempts to produce such an informative table?

The staff's question about conflicts between certain macroeconomic goals suggests that monetary policy targets might have to be temporarily modified during a bank restructuring program to prevent the high interest rates connected with a tight monetary stance from aggravating the banking sector's problems. We would say that the appropriate macroeconomic stance during a systemic bank restructuring should avoid loosening monetary discipline, even if this requires transferring the necessary resources from the public budget. Relaxing monetary policy would damage the credibility of the central bank as prices rise, while the costs of the bank restructuring would be hidden and unfairly distributed by inflation. If the banking sector suffers a real liquidity problem, the central bank can bridge it in a noninflationary way as lender of last resort. The staff rightly warns against providing injections of central bank liquidity to banks that are insolvent. Responsibility for their support should be shifted to the government budget.

Finally, we come to the need to address the financial and operational problems of individual banks as well as problems affecting the sector as a whole. This duality runs in both directions: microeconomic structures affect macroeconomic performance and macroeconomic policies have microeconomic consequences.

Banking system soundness generally reflects the health of the economy. Fluctuations in real sector conditions have immediate effects on banking system soundness by affecting the quality of banks' loan portfolios. Loan losses reduce the level of banks' capital and reserves. And macroeconomic shocks combined with the general difficulty of operating in a weak economy often undermine bank soundness and create a need for bank restructuring. The soundness of banks, and their probability of failure, is determined by factors affecting individual banks as well as by macroeconomic conditions and the overall fragility of a banking system beset by systemic risk. Variables affecting individual banks are the subject of microprudential guidelines. Macroprudential safeguards protecting the health of the whole economy against external shocks work best in an environment of transparent, predictable and stable macroeconomic policies. Success will depend on distinguishing, at the outset, between potentially viable banks that merit restructuring and nonviable banks that will have to be closed. The financial restructuring of the banks that are deemed viable is essential because an unsound bank will not have the financial capacity to provide banking services, will not win public confidence, and will not provide incentives for its owners and managers to operate it properly. A restructuring program must therefore address both the financial condition and the operations of each individual bank. A program for restructuring a banking system must solve problems on three levels—the individual banks, the banking system, and the macroeconomy.

Mr. Zoccali made the following statement:

I wish to commend the staff for the interesting and comprehensive papers prepared for today's meeting on the scope of future Fund involvement in systemic bank restructuring. I can support publication of these valuable papers with appropriate editing to reflect the comments made in today's discussion.

There can be no doubt that a well functioning banking system contributes to the effectiveness of financial policies, to efficiency in the allocation of resources and to macroeconomic stability. Systemic banking difficulties, on the other hand, impair the transmission mechanism of monetary policy and very often entail substantial fiscal costs. These consequences become even more relevant in today's globalized and integrated financial markets, where abrupt changes in market sentiment can quickly lead not just to a reversal in capital flows but to contagion and perturbances of global proportions.

The close interrelation between a country's financial and structural policies and the soundness of its banking system and the increasingly international character of banking sector difficulties suggest, therefore, that the Fund has a role to play in this regard. Fund surveillance under Article IV consultations should encompass assessments of the overall soundness of members' financial systems and attempt to identify, at an early stage, potential system-wide difficulties. Enhanced coordination and cooperation with other international organizations, in particular with the World Bank and regional development banks, is nevertheless essential to ensure that the Fund does not overstretch its available resources and overextend its mandate by delving into the microeconomic and institutional aspects of bank restructuring, for which is not equipped.

I would agree with Mr. Bernes that, while in practice, the sources of financial fragility are difficult to disentangle, these can be assimilated into two broad groupings for the purpose of defining when the Fund should assume the leading role. The first, relates to institutional shortcomings, i.e., in the accounting, legal, supervisory and regulatory frameworks, including weak bankruptcy legislation and procedures; while the second, would correspond more closely to difficulties stemming from macroeconomic mismanagement or from domestic or external shocks. Fund resources should fundamentally be geared to providing timely advice on the design of appropriate macroeconomic policies to reduce the incidence of the latter and to facilitate the orderly resolution of systemic banking crisis, should they occur.

Fund technical assistance in bank restructuring should be contemplated as part of a comprehensive strategy to address the sources of banking difficulties impinging, in particular, on the effectiveness of members' macroeconomic policy mix. It can also prove valuable to facilitate the adaptation of internationally accepted accounting and prudential standards to country-specific macroeconomic circumstances. The accelerated pace of financial innovation and market integration would suggest that the Fund could also play a useful role, given its universal membership, in the early dissemination of significant developments in the supervisory and prudential areas that could have a bearing on the effectiveness of members' efforts to enhance bank soundness.

Regarding measurement and allocation of the costs of restructuring and of instruments to restructure banks, I wish to highlight two aspects. First, bank restructuring often entails debt-based government assistance, with clear consequences on aggregate demand and possibly on debt sustainability. In such circumstances, fiscal policy should be guided by the principle of minimizing public sector costs to ensure macroeconomic stability, equitable burden-sharing and the avoidance of moral hazard. The fiscal stance should be set in a medium term context which prioritizes the return of strong economic growth to help banks rapidly resume lending and return to profitability. The cost of government assistance, including that of quasi-fiscal operations, should be reflected in the fiscal accounts when it is unambiguously quantifiable. However, when the contingency costs of restructuring are not straightforward, their inclusion will not necessarily lead to the adoption of "off-setting" measures and could even undermine the fiscal stance if it is construed as a signal that more generalized assistance will follow. Second, regarding the potential trade-off between bank restructuring and achieving other macroeconomic goals, principally price stability, too tight a monetary stance could exacerbate banking sector difficulties, particularly when illiquidity or problem loans are on the rise and fiscal capacity is limited. On the other hand, significant central bank involvement as lender of last resort, other than to give access to bank reserves or to very short-term liquidity facilities, is likely to lead to a relaxation of the inflation objective or to a moderation of the timetable for achieving other macroeconomic or structural goals.

The staff has presented a very detailed and useful analysis of country experiences and policies judged to be successful and sufficiently robust for wider application. I broadly share their conclusions, with exception of the stylized characterization of high liquidity requirements based on their more traditional definition as instruments of monetary rather than prudential policy.

The limited fiscal impact of Argentina's bank restructuring in the aftermath of the Mexican financial crisis should be seen as the result of a substantial effort aimed at enhancing bank soundness long before the crisis materialized. The Convertibility Law in 1991 made evident not only the hard liquidity constraint on the banking system but also the need for revamping the regulatory and supervisory framework. The minimum capital asset requirement was raised to 11.5 percent, high legal reserves to counter volatile market conditions were maintained and special emphasis was placed on monitoring credit quality, adequate loan loss provisioning, associated or connected lending as well as loan portfolio concentration. This incentive structure fostered a market-driven process of mergers, acquisitions and self-liquidations that was fully under way long before the crisis occurred. More recently, official banking oversight was supplemented, inter alia, by the introduction of a requirement that banks obtain a periodic market rating and pass the market test of successfully placing public bond issues to cover at least a minimum portion of their funding requirements. In addition, most public provincial banks were privatized with support from a special trust fund financed with resources from the IDB, the World Bank and public debt placements. A trust fund was also established to facilitate private bank restructurings. To date, it has provided financial support for the merger of 37 financial institutions, which represented more than one fifth of the total number of private entities operating before December 1994.

Regarding the Chilean experience with bank restructuring, my authorities agree with the general assessment contained in paragraph 77 of SM/97/1, Supplement 2; in particular with the comprehensiveness and complexity of the adopted approach. While admittedly the process took a long time, was costly and not completely transparent, the strategy nevertheless succeeded in restoring bank soundness. In that context, it should only be noted that the final settlement reached in 1996 did not involve debt forgiveness. More specific comments on this section have been made available to the staff.

In conclusion, what is important is that the Fund, in discharging its core functions aimed at fostering strong macroeconomic fundamentals, be in a position to help members internalize the costs of bank restructuring and adopt resolution strategies that minimize and distribute the costs equitably, with losses first charged against shareholder capital to reinforce market incentives, and transparency regarding government assistance to avoid undermining the fiscal stance.

Ms. Srejber made the following statement:

The staff has with this sequel to the papers on Bank Soundness and Macroeconomic Policies carried on the Fund tradition of producing papers that contain comprehensive high-quality descriptions and analysis on the macroeconomic dimensions of banking sector issues. The set of papers we have for consideration today is based on broad research and contains information which may be valuable for a wider circle. Thus, we find that publishing chosen parts of the documents could be considered after some proper editing. Here we do have some factual comments relating to the mention of countries within our constituency which we will take up with the staff on a bilateral basis.

Our main remarks are structured along the issues presented for discussion, with the side remark that our views undoubtedly would have benefited from some further thoughts by the staff on the possible role of the Fund in this area, but we will begin with some remarks related to the general analysis of the paper.

We basically agree with the main findings in the papers concerning banking restructuring strategies. Based on the mix of experiences in the several countries in our constituency which have been dealing with systemic banking sector issues in recent years, we would, in particular, emphasize the importance of formulating comprehensive policies and of implementing these policies without delay. In general, strong political commitment and support, as well as transparency, is crucial in this process and will help restore public confidence. Furthermore, it is important to have an adequate institutional framework, including a separate, and to a certain degree, autonomous agency to deal with the restructuring.

While most countries presumably are able to subscribe to such lessons, there is, of course, no clear prescription that would apply for all countries and for all circumstances, and there are undoubtedly individual cases where other aspects should be given priority. Moreover, both the effects of any bank support and whether alternative solutions would have yielded different results can be gauged more closely only in retrospect. Even though there often will be similarities between the reasons for the banking crises experienced, often including factors such as "bad luck, bad policies and bad banking," every banking crisis seems to have its own peculiarities.

As can be seen from several places in the papers, countries in our constituency have far from been spared from banking sector problems. The banking sector in three of the Nordic countries came 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, but with other aspects of importance. As concluded in a readable Working Paper issued recently ("Financial Sector Reform and Banking Crises in the Baltic Countries," prepared by Marta de Castello Branco, Alfred Kammer, and L. Effie Psalida, December 1996), banking crises in those countries had their roots in the structural deficiencies specific to planned economies and were largely unavoidable, just as even the failure of large banks had limited systemic effects and a limited impact on growth. A noteworthy conclusion in this Working Paper is that "The crises slowed down the financial reform process, but brought about a desired consolidation of the banking sector."

Thus, we would caution against drawing too many general lessons on the handling of banking crises from what have been the experiences of the countries mentioned in the paper. As the causes of massive banking sector problems and the circumstances of countries vary, so do the solutions between countries. Moreover, the crises may no longer be acute but, in many cases, it is still too early to pass final judgment on the strategies chosen; systemic bank restructuring is a multi-year process as rightly noted by the staff. The common denominator is perhaps that for all countries which have experienced systemic bank problems, it is easy to recognize the linkages between macroeconomic policies and the state of the banking system, as well as the two-way nature of that relationship.

All six issues raised for discussion concerns the possible role of the Fund with respect to systemic bank problems. The general Fund approach, namely "a stable macroeconomic framework" and "case-by-case" gives the Fund a role, both in preventing crises from occurring and in assessing the macroeconomic implications and the appropriate policy response should they occur. A stable macroeconomic framework is the most important factor in avoiding major swings in the economy and thus in reducing banking problems due to problem loans. However, we find that the Fund should not take up new activities in areas where other international organizations or national authorities have comparative advantages. This is particularly relevant for the microeconomic aspects of the banking sector, including monitoring where the national authorities must be at the forefront.

Accordingly, the Fund has an important role to play in preventing systemic bank problems due to its role in promoting macroeconomic stabilization and, likewise, as regards macroeconomic implications of systemic bank restructuring, the Fund has a capacity in assisting member countries in analyzing problem situations early and giving advice. But where does successful banking restructuring begin and where does it end? To use the staff's own definitions, "Systemic bank restructuring comprises a comprehensive program to rehabilitate a significant part of a banking system. Programs typically encompass an array of microeconomic, institutional, and regulatory measures. In many cases banking sector problems begin with poor management, and operational restructuring of individual banks must be an integral part of a systemic response. In all cases of successful systemic bank restructuring, attention must be given to a broad range of microeconomic measures." These are the vital "nuts and bolts" elements of systemic bank restructuring which are necessary for the strategy to succeed, but where we have great difficulties in seeing the Fund as having the expertise and resources needed to contribute in a meaningful way. These programs also have significant macroeconomic aspects and implications, and it is these linkages between the banking system and macroeconomic policy which make banking restructuring programs an important issue for the Fund to address. But we would delineate the Fund's role to identifying, analyzing and advising on the macroeconomic impact and policy response of bank restructuring strategies. Therefore, there would not seem to be a need for the Fund to give special focus to systemic bank restructuring in its surveillance activities. It should also be borne in mind that the national authorities ultimately manage and resolve their own banking sector crises.

On the second issue for discussion, we find that the Fund should address problems affecting the sector as a whole rather than bank-specific issues, and on bank restructuring the main role of the Fund is to analyze the implications of bank restructuring on macroeconomic policy and vice versa. While we would feel comfortable to leave bank-specific issues mainly to the World Bank and other international organizations with the necessary competence (together with the national authorities), we feel it important that the Fund has a thorough understanding of them.

On the third issue, we can be brief, as we fully agree that the use of debt-based instruments for bank restructuring may have significant effects on aggregate demand and debt sustainability, and that in cases where there is a major reliance on debt-based instruments for bank restructuring this should be reflected in medium-term fiscal scenarios.

We also agree in principle that member countries with major bank assistance outlays might usefully complement standard fiscal measures with the proposed "augmented balance," although this might be difficult to apply. Transparency in recording the losses and realistic valuations of assets will facilitate analysis of the fiscal stance developments over time, and help restore confidence. It is for this reason that the principles and recommendations laid down in section IV.B in the document may form a good starting point for work in this area, but further studies should be made with respect to the provisions for the "augmented balance" and the details to be included in it.

On the issue of a trade off between supporting bank restructuring and the timetable for achieving certain macroeconomic goals, we agree that the possible trade off should be reflected in the Fund's advice in accordance with its surveillance obligations. There may indeed be cases where a looser monetary policy compensated by a tighter fiscal policy would be conducive to bank restructuring, but it is important that such loosening doesn't conflict with the overriding objective of monetary policy, and we agree with Mr. Bernes that bank restructuring is best undertaken in the context of monetary policy geared toward the achievement of price stability. Furthermore, one should be careful of not taking such trade offs for granted. There may actually be cases where, for instance, a tighter overall policy stance through its impact on the confidence and interest rates can lead to higher growth and better conditions for the banking sector even in the short term. Moreover, the importance of sustained stability-oriented polices cannot be overemphasized, and it deserves to be borne in mind that a systemic banking crisis is often caused, or becomes aggravated, by an unstable fiscal policy. If the economy is facing major problems, there are clear limits to what could be done to avoid banking problems. Postponing or stretching economic reform will most likely only stretch and possibly increase the pain of banking problems. Even though it could be tempting to pursue a policy of forbearance vis-a-vis the banking sector and stretching the process of economic reform, this is likely only to create subsequent problems. It will create the potential for moral hazard problems and give rise to large swings in the velocity of money as the confidence in banks shifts. Thus, in most instances, there seems to be no choice between banking soundness and appropriate policies from a macroeconomic perspective.

The macroeconomic implications of systemic banking restructuring may have relevance for a number of Fund activity areas. However, it is important to take advantage of the competence outside the Fund, including the experience from countries which have successfully dealt with banking crises, and to avoid duplication with other institutions. It is therefore necessary to cooperate with other IFIs, particularly with the World Bank, as long-term restructuring will be dealt with mainly by the World Bank. With respect to the World Bank, the paper indicates that discussions on the modalities for cooperation with the Fund are ongoing, and we would naturally appreciate some briefing as to their nature.

The Director of the Monetary and Exchange Affairs Department noted that the staff had already taken a number of steps to strengthen the Fund's surveillance of members' financial sectors. For example, the staff had prepared papers on bank soundness and macroeconomic policy; payment systems, monetary policy, and the role of central banks; systemic bank restructuring; a framework for sound banking in member countries; and currency board arrangements—which had implications for the role of the central bank in financial sector soundness and its ability to act as a lender of last resort. The staff of the Monetary and Exchange Affairs Department (MAE) was working with the staff of area departments to try to strengthen the staff's capacity to focus on financial sector issues in the context of Article IV consultations. The Fund had begun to send staff with financial sector expertise on the Article IV missions to those countries where it was considered that financial sector issues should be accorded greater attention. Furthermore, the Research Department was providing the staff, on a regular basis, information on market perceptions of members' financial sectors.

The staff of MAE was implementing a program to familiarize the staff across the Fund on banking sector issues, the Director continued. The previous week, MAE had had a seminar on banking soundness, and there would be another seminar on the same subject the following week. MAE had also hired a number of consultants, with extensive experience in prudential regulation and supervision, and had brought in outside experts to share their views on the subject. In January, the First Deputy Managing Director had chaired a round table meeting on banking soundness at which outside experts from both industrial and emerging market economies had participated. The recent seminar on central banking organized jointly by MAE and the IMF Institute had provided an opportunity for the staff to obtain the views of central bankers and senior supervisors on banking soundness issues in a global financial environment. Moreover, MAE was working with the Statistics Department to improve its statistical base in order to keep a better record of financial sector developments in member countries.

Despite the substantial steps taken so far to improve the staff's ability to deal with financial sector problems, he would raise two notes of caution, the Director said. First, in view of the constraint on resources, the staff would have to be selective and prioritize work in the area, by addressing those countries in which the financial sector problems were the most acute, and within those countries, it would have to focus on those aspects that were the most urgent. Second, no matter how much work the Fund did in the area, it would not be possible to put in place a foolproof "early warning system," which would ensure that the Fund was always successful in detecting banking crises before they occurred.

On the issue of collaboration with other institutions, particularly the World Bank, Directors shared the staff's view that the Fund should avoid duplicating the work of the World Bank, the Basle Committee, and other international bodies, the Director observed. There was a widespread sentiment that the Fund should rely on its comparative advantage. The Fund staff had a long history of cooperation with the World Bank staff at the operational level. In the financial sector area, since mid-1996, MAE staff had been working with its counterpart in the Bank, the Financial Sector Development Department, to strengthen collaboration. They were providing joint training to government officials and consulting each other in the advice and technical assistance to members, to ensure consistency. They had taken other steps to enhance their cooperation at all levels; for example, the senior staffs of the two departments had held a joint retreat in 1996 to discuss their respective activities as well as member countries' programs; they had improved the procedures for exchanging reports and draft papers, and they were also sharing information on technical assistance, training, and country-specific issues for those countries in which the Fund or the Bank expected to be involved in the future. On the question of whether the Fund and the Bank should devise more formal mechanisms for cooperation, the staff was of the view that the issues concerning financial sector soundness were evolving, and the staffs of the two institutions were learning in the process of addressing those issues. The steps the staffs had taken were part of an ongoing process that did not lend itself easily to the setting of a formal mechanism to identify critical situations and delineate overly precise responsibilities.

The Fund staff had also been strengthening its cooperation with other institutions, ,the Director noted. The Fund and Bank staffs had been coordinating their work with the Basle Committee, and they were participating in the meetings of the Group of Ten working group on financial stability in emerging market economies. For several years, the Fund staff had been coordinating its technical assistance in the transition economies with the World Bank, the BIS, and the central banks of the transition economies. The Fund had undertaken joint technical assistance missions with the World Bank and regional development banks in Mongolia, Jamaica, Bulgaria, and Venezuela. In the case of the Russian Federation, the Fund staff held regular meetings with the World Bank and other institutions providing technical assistance to Russia in order to coordinate and review their technical assistance activities. The Fund was also coordinating the training provided in the context of an EU (EC/TACIS) program on technical assistance to the central banks of Russia and Ukraine.

Most Directors shared Ms. Lissakers's view that Fund surveillance could be a useful vehicle for alerting members to weaknesses in their banking systems and supervisory regimes, for encouraging countries to adopt guidelines developed by the supervisory community, and for assessing progress to that end, the Director observed Thus, clearly, the Fund had an important role to play. On the respective roles of the Fund and the Bank, he would note that, as Mr. Toribio had emphasized, the Fund's responsibility for macroeconomic stabilization gave the institution a clear policy interest in banking sector soundness. Several Directors stressed that the microeconomic institutional details of restructuring would normally fall within the purview of the World Bank and regional development banks rather than the Fund. They agreed that the Fund should address problems affecting the sector as a whole, rather than focus on bank-specific issues and on bank restructuring. On the latter, the main role of the Fund was to analyze the implications of bank restructuring for macroeconomic policy and vice-versa. Mr. Bernes had raised an important point, namely, that when the source of banking system fragility was a macroeconomic shock, there was a strong case for the Fund to play a leading role in its resolution through the design of appropriate macroeconomic policies. In that context, Ms. Lissakers had observed that, in cases in which a Fund-supported program was responding to a financial crisis caused in part by weaknesses in the banking sector or in the supervisory regime, the Fund-supported program could appropriately include conditions to restructure banks and strengthen the supervisory regimes, and that such conditions should be established in collaboration with the World Bank.

Thus, although the Bank had the main responsibility for the microeconomic and institutional aspects of restructuring, there were occasions when the Fund would have little choice but to participate—and even take the lead—if banking fragility were due to a macroeconomic shock, the Director considered. That was the rationale behind Mr. Toribio's point that it was often difficult to draw a clear line demarcating the responsibilities of the Fund and the Bank in bank restructuring. The staff was of the view that, as in other domains of interest to both, it was not possible to demarcate precisely the responsibilities of the Fund and the Bank in bank restructuring. There was a fairly broad area of common interest, and the main question was how best to collaborate in handling the issues that arose in that area, so that the advice of the two institutions was mutually consistent and effective in resolving banking sector problems.

The paper had stressed the importance of the operational aspects of bank restructuring, which were often ignored but were critical for solving the "flow" problem, that is, for avoiding banking problems ahead, the Director noted. There was no doubt that the way to ensure that banking problems did not resurface was to make sure that operational restructuring was done properly.

It had been stressed by Ms. Lissakers that the staff should be more proactive in urging bank privatization, the Director noted. In that context, he would only note that the staff had urged members to privatize state-owned banks, but had cautioned that it was important that the privatization be implemented properly.

With respect to "best practices" for deposit insurance, in the paper on bank soundness and macroeconomic policy, the staff had advised against introducing a deposit insurance scheme in circumstances of widespread bank insolvency or crisis, the Director recalled. Thus, a deposit insurance scheme should be introduced at normal times and in the context of a proper incentive structure, supported by appropriate supervision and by a properly functioning lender of last resort capability on the part of the central bank. In order to reduce moral hazard, a deposit insurance scheme should be introduced with limited coverage. At the same time, coverage should not be so limited so as not to be credible. At the central banking seminar a few days earlier, one of the speakers had recalled the experience of a country with a limited deposit insurance scheme, but which had eventually provided coverage beyond the limits when it had been faced with a banking crisis.

The "too-large-to-fail" principle was fraught with moral hazard, the Director considered. While there was no hard-and-fast rule as to what constituted "too large," a trend was developing to move away from that principle, and that trend should be encouraged. For example, in Latvia, the authorities had allowed a large bank to fold. In those cases, in which a bank was considered too large to fail, intervention should ensure that an appropriate incentive structure was in place, that is, the shareholders and managers were held accountable.

Directors had also raised the question as to whether there was a trade-off between bank restructuring and the timetable for achieving macroeconomic goals, the Director of the Monetary and Exchange Affairs Department stated. In other words, the question was whether the goal of price stability should be compromised while the banking sector was restructured. Most Directors felt that one should not run the risk of endangering price stability. The staff agreed with Ms. Srejber that care should be taken not to take such trade-offs for granted and the price stability goal should not be sacrificed. At the same time, it should be borne in mind that too rigid a pursuit of price stability could entail a worsening of a systemic banking problem, which, in turn, could endanger the implementation of sound monetary policy. The trade-off, in the staff's view, was not one of a choice between ensuring the soundness of the banking sector and attaining price stability, but between attaining price stability at present or in the future. If the emergence of a systemic banking crisis meant that the authorities would have to appear to deviate from their immediate price stability goal, the staff considered that if the intervention was appropriate, such a deviation would not be harmful for the long-term objective of ensuring price stability. Moreover, the best way of not endangering price stability was to ensure that the banking system was sound and to prevent a crisis from erupting in the first place.

The Director of the Fiscal Affairs Department noted that the staff had used the "augmented balance" approach for calculating the real costs of restructuring in the case of Mauritania. However, it was very difficult to do the same for other countries because the necessary information was lacking. Indeed, that was precisely the reason for the staff's recommendation to use the augmented balance, so that it would have the necessary information to calculate the real costs of restructuring. The augmented balance would allow for a more transparent recording of costs. On Mr. Toribio's question regarding the inclusion of public sector deposit transfers in the augmented balance, he would note that, if deposits were transferred from sound banks to unsound banks in order to restructure the latter, the transfer would be considered a loan, and would therefore be classified as contributing to the fiscal deficit. However, it was often difficult to determine what the intention was behind a transfer, which made it difficult to accurately classify the transfer. The staff agreed with Mr. Borpujari that bank restructuring was not the only contingency for which an augmented balance might be justified; there were other reasons to use such an approach. The staff's suggestion was not that the augmented balance replace the GFS-based balance but that it be used in addition to it. The staff's main point in suggesting use of the augmented balance was that it would be useful to have a system under which all the quantifiable costs of government assistance for bank restructuring operations were clearly recorded.

Mr. Wijnholds made the following statement:

The topic discussed in this joint product of FAD and MEA is one of wide interest. The soundness of the banking system is a prerequisite for a healthy development in all types of economies. A significant number of countries experienced banking crises in the last couple of decades, and new cases continue to appear. Since there are important linkages between the banking system restructuring and macroeconomic policy it is evident that the Fund should pay close attention to banking problems. I will come back later to the question of the limits of the Fund's involvement.

A strong point of the paper is that it is based on experience across a wide array of countries, enabling the authors to find a significant number of 'best practices that appear to be robust across countries.' However, I would like to raise a few issues in this regard. It would appear that some of the assessments are based on quite recent experiences, and are perhaps too fresh to be fully meaningful, a point clearly made in Ms. Srejber and Mr. Andersen's statement. For instance, one may find it difficult to agree with the favorable evaluation of Kazakstan's experience as regards a systemic restructuring strategy, and it seems too early to know whether the burden put by Latvia's authorities on depositors will not have adverse effects—in terms of confidence in the banking system—which could exceed, through their lasting consequences, the favorable immediate impact of minimizing the cost for the budget. A further discussion on the trade-off between short-term costs and longer-term benefits, and vice versa might therefore be useful.

Obviously, the economic and political circumstances were quite different from one country to another, hence the restructuring measures adopted by each country were dissimilar. But it seems to me that it is not only the differences in banking system structures, but also the peculiarities of relationships between the banks and industry that deserve further attention of the staff when discussing restructuring strategies and instruments. In many countries, some of them already included in the group discussed in the paper, ownership in the banking sector tends to be closely related to ownership in other industries. Often, enterprises tend to have a stake in at least one bank, as well as banks having shares in other industries. Sometimes, this process has been accelerated by debt-equity-swaps, during the rehabilitation of either banks or enterprises. A discussion regarding bank restructuring should take into account the implications of this situation. If deficiencies in the legal and institutional framework are at play, the Fund should signal this to the competent national and international authorities. Perhaps the staff can elaborate on this matter either during the discussion or in a revised version of the paper.

Turning now to the issues for discussion. The Fund should certainly carefully analyze the different causes of a systemic bank crisis (problems within banks, in the institutional framework and/or in the macroeconomic environment), helping to determine the extent of Fund involvement in cases of financial sector stress. Because of its surveillance task the Fund staff is well-placed to identify structural distortions, including systemic problems in the banking sector, and to assist countries in developing appropriate macroeconomic policy responses. The staff can explore and analyze the main causes—in general terms—of systemic bank problems, but the practical difficulties in this regard should not be underestimated (e.g., confidentiality of supervisory data). Moreover, there is a certain trade-off between an analysis at a general level and approaching banking problems at a microeconomic level.

Insofar as the macroeconomic environment is an important factor contributing to problems in the banking sector, the Fund should play a role. However, the macroeconomic situation is not always the main cause of major banking crises, although macroeconomic shocks—for instance a recession or monetary tightening—may trigger such a crisis. In most cases, weaknesses in the financial system or in the banking sector itself are the underlying problem.

The often serious budgetary implications of systemic bank restructuring offer an additional reason for the common Fund practice of presenting medium-term frameworks for budgetary policies, saving/investment balances and the external position. This will help clarify the sustainability of certain economic developments and the adequacy of the policy response.

I agree with the staff that there does not seem to be a pressing need to adjust the—GFS-based—standards for fiscal balances to incorporate the fiscal impact of bank restructuring operations. Nevertheless, it is important to have insight in the overall budgetary situation, including those costs that are recorded as financing items 'under the line'. The 'augmented balance' concept could contribute to the necessary insight. However, the wish for transparency should not hamper the restructuring process itself. Moreover, there could be tension between transparency and confidentiality. This pertains particularly to qualitative and quantitative information on (temporary) liquidity support provided by independent central banks, which are not part of the government; it is their prerogative to decide whether to make their support public or not. In addition to the 'augmented balance', it would be useful if specific cost/benefit analyses of systemic bank restructuring could be made, difficult as it may be, in order to facilitate (political) decision-making on a restructuring package. Experience shows that firm political support for such a package adds to the chances of its successful implementation. In order to calculate these fiscal costs it is not sufficient, however, to compare the 'augmented balance' with the GFS-based balance, as some 'normal' fiscal costs are included in the latter balance; these would have to be explicitly identified in the expenditure accounts.

When banking system fragility is not forcefully addressed in a timely manner, it will crucially undermine macroeconomic stability, in particular the central bank's ability to pursue a price stability objective. Moreover, as noted in supplement 2, the trade off between supporting systemic bank restructuring and achieving price stability has generally not been large. Nevertheless, it is important that national authorities remain aware of the possibility that a conflict between these different goals may arise. As a sound banking sector is a crucial prerequisite for an effective monetary policy, priority should be given to bank restructuring when there is a systemic threat. In this context, achieving macroeconomic balance is likely to require a greater fiscal effort. This would help reduce inflationary pressures by limiting domestic demand growth and by lowering the need for (indirect) monetary financing of the budget. But it would also help place the public finances on a firm footing, as the transfer of nonperforming assets to the government would imply the need for a higher primary budget surplus over the medium term.

Finally, I would like to address the issue of the Fund's role relative to other bodies in addressing problems in the banking sector. It is clear that there is a role for the Fund in this area, but also that there are limits to this role which are, however, not always easy to define or to agree upon. It is nevertheless desirable that we try to do so as this matter seems to be causing some tension between the various interested parties. Mr. Bernes' remarks on the delineation of responsibilities among institutions are most helpful in this regard. He broadly suggests that the Fund could monitor adherence to internationally-set prudential regulations—and here I would underline the leading role of the Basle Committee on Banking Supervision in developing such regulations—while the World Bank would take the lead in restructuring problematic banking sectors. I would also add that in the context of bank restructuring issues we would expect the Fund to concentrate on the macroeconomic policy side of things. I also support Ms. Srejber and Mr. Andersen's exhortation that the Fund should not take up new activities in areas where other organizations or national authorities have comparative advantages.

Like Mr. Bernes and others, I therefore favor active exploration by the staff of enhanced cooperation in the area of systemic bank restructuring with the World Bank. I believe, however, that the problem should also be addressed at the Management level amongst the institutions, perhaps leading to a joint statement by the heads of the Fund and the World Bank on this matter. I would also hope that in your summing up of this discussion, of perhaps on some other occasion, you could indicate what role the Funds sees for itself, that its intentions are honorable—so that we can take away some of the tension with other parties—and that the Fund intends to work closely with other institutions in this area.

The Acting Chairman noted that, at the seminar a few weeks earlier organized by the Monetary and Exchange Affairs Department, the Managing Director had given a speech on banking sector soundness, which, he believed, had served to allay concerns about the Fund's involvement in that area.

Mr. Wijnholds remarked that the speech had been given in a restricted setting; thus it would be useful to explain the Fund's intentions in that area.

Ms. Srejber, agreeing with Mr. Wijnholds, commented that not everyone had been assured by the Managing Director's remarks at that seminar.

Mr. Evans made the following statement:

I understand Mr. Wijnholds's and Ms. Srejber's concerns about what their central banking authorities are saying. I think that this seminar, as the Acting Chairman mentioned, has helped to reassure people; but there is certainly need for further clarification, and I will come back to that in a moment.

I believe that this is a very good set of papers, and I congratulate the authors. I hope that after a little editing we can get these papers published soon, and I agree broadly with the main elements of the papers.

One of the key messages that I take away from all this is the need for the Fund to promote the role of market forces in the financial sector so that the appropriate incentives will be in place before systemic problems arise. I want to mention three aspects of promoting the role of market forces that got, in my view, insufficient emphasis in the papers.

The first is well covered by Ms. Lissakers and Mr. Sobel. I would like to see the Fund and the Bank to more active in urging bank privatization, because of the huge problems in so many state banks. Second, I would emphasize the enormous gains from competition and openness to foreign banks. A banking system that contains as a significant element branches or subsidiaries of oversees financial institutions, and particularly the large multilateral banks, will benefit from the usually high standards encouraged by overseas regulators of such banks, and these will be a valuable model for domestic banks. The third aspect is the need to create incentives so the market can work better. We want to see rating agencies more active; we want to see less frequent examples of auditors approving what turn out to be poor balance sheets; we want to see banks and supervisors with better incentives to produce accurate information.

In this connection, I hope that the staff will consider favorably and build on the Argentine example set out in Mr. Zoccali's helpful statement of requiring banks to issue bonds and pass a market test, and also perhaps consider further the lessons from the New Zealand experience. So, I see in response to the question in paragraph 84 the main area of Fund involvement as being preventative, through surveillance and policy advice with the aim of promoting appropriate market structures and supervisory and transparency arrangements to prevent crises from developing.

On other issues highlighted in the paper, I agree that the use of debt-based instruments to finance bank restructuring should certainly be considered in a medium-term framework. The authorities, and I believe the public and markets, need to be aware of the full financial costs of government intervention, and medium-term fiscal scenarios can help here. But given the size of many government bailouts needed, we should recognize that the medium-term approach would not require that restructuring costs be immediately offset by tax rises or expenditure cuts in other areas. I endorse the proposed augmented balance approach, but again I doubt whether this balance is a suitable target variable in the short term.

On the possible trade-offs between banking sector restructuring and price stability, I agree with Mr. Bernes and Ms. Srejber that bank restructuring is best undertaken in the context of a monetary policy geared to the achievement of price stability. Realistically, the speed with which this objective is targeted may have to depend on the fragility of the banking system. The slower the speed, the greater the need for fiscal policy to bear more of the burden.

Looking forward—and on this I look forward to the further papers that the staff is preparing for discussion next month—first of all, what should the international community be doing to help countries create a robust financial system? Second, what should be the role of the international financial institutions and, in particular, of the Fund?

I believe creating a robust financial system requires, as the papers make clear, not only a set of rules for banking supervision, but also good practice in other areas—macroeconomic, fiscal, accounting, audit, legal, transparency, etcetera—and indeed in securities and other financial markets. We need a set of guidelines or best practices which have at their heart the banking sector and its supervision, but which are much wider than that. I see the present set of papers as a valuable contribution to this.

So far as the banking sector is concerned, we need to incorporate the work of the Basle Committees, including those which have a membership well beyond the main industrial countries. There is an issue on whether one single set of banking standards—for example, a capital adequacy ratio—is suitable for all, or whether the standard should vary to take account of, for example, greater volatility and risks in some markets. I believe conceptually it is clear that high risks should be reflected in some way in capital standards, but practically that, of course, can be very difficult. I would be grateful for staff views.

Turning to the Fund's role in surveillance, I certainly favor extending our role to take more account of the fragility of financial sectors. We will need, as the staff said, to be selective about this. But I believe it would be helpful to include, in more Article IV missions, somebody with hands-on skills in banking supervision. Such a person could often come, with the agreement of the country concerned, from outside the Fund, e.g. from another central bank. I would envisage, in our surveillance work, contacts with the Finance Ministry, central banks, supervisors, markets, and indeed some individual banks.

The objective would be to give advice and, where appropriate, technical assistance, to a country where our surveillance indicated a need for strengthening the financial sector. But we need to tread very carefully. The Fund does not have the skills or resources to act as a global banking supervisor, and should not attempt to do so. Moreover, it would be hazardous for the Fund to lend its authority, particularly in public, to a conclusion that a particular banking sector is sound, and I would ask the staff to comment on such hazards.

In cases where we recognize the need for action to strengthen the banking sector, what is the role of the Fund? First of all, I believe we should take full account of all of this in our macro policy advice. We should consider technical assistance for the central authorities. But only in very exceptional circumstances, for example where the World Bank is not involved in the country, and where the problems of the banking sector boil down to one particular state bank, should the Fund be prepared to play a role in restructuring an individual bank.

As the staff said, the World Bank and regional development banks should take the lead in advising on, providing assistance for, and lending in support of individual banks as part of a restructuring policy framework in which the Fund should be closely involved. The World Bank will have to get used to operating more quickly than in the past.

So, the message here to the Fund and World Bank staffs is that there are separate roles here, but we must work closely together. I have to say I do not feel able to rely on the general assurances that the staff offers us, welcome though these are. I think it is necessary for the two institutions to present, as Mr. Wijnholds suggested, a joint paper to these Boards, setting out who does what. Perhaps the staff could comment on their willingness to provide such a paper.

Finally, I would like to suggest as part of the next step that we consider how best to consult the private sector. Market participants, rating agencies, banks, other financial institutions—we need to explain what we are trying to achieve, how we want to involve the private sector, and what we have in mind for the Fund to do. This is not a criticism of what has happened so far. We need to get our own ideas in some sort of order first. But I do think that at some stage, in the near future, it would be helpful to prepare, for example, a consultation document and also to talk to groups, like the Institute for International Finance, the G-30, and large Fund managers. I would welcome staff comments on these ideas.

Mr. Ono made the following statement:

Let me begin with the Fund's role on banking system issues.

I agree with the staff assessment that systemic bank problems and the restructuring programs to deal with them have considerable macroeconomic consequences. What is the Fund's expected role on these issues? The answer seems rather clear to me. Since one of the Fund's core roles is to provide helpful advice on general macroeconomic policy to member countries, it is possible and useful that the Fund support the authorities on banking-related issues from the macroeconomic point of view.

Allow me to share several examples of this:

As a surveillance function, an important Fund role might be to assist member countries in identifying banking problems, and evaluating their risk, at an early stage.

The Fund might warn member countries when macroeconomic conditions pose risk to the banking sector.

Regarding restructuring policy, the Fund can also help member countries' authorities benefit from the experience of (other) member countries, as outlined in Supplement Two.

Having said this, I would like to state my reluctance regarding the Fund's getting involved in micro-level policy issues such as restructuring. To prevent a banking crisis, close monitoring of each bank's activities is essential. How can the Fund help work toward this end? In my opinion, its role should be quite limited: helping authorities realize that monitoring of banks is essential and helping them take advantage of surveillance opportunities. The actual monitoring, however, should be left to the authorities themselves. The reasons for this are quite simple: first, the Fund would have difficulty accessing confidential information about specific banks and, second, the Fund's intellectual superiority is more in the area of macroeconomics than, for example, in that of microeconomics banking supervision. For these reasons, the Fund's engagement in the field of banking supervision should be kept to a minimum. Furthermore, regarding banking supervision, duplication with the Basle Committee's activities should be avoided.

One other possible role for the Fund might be technical assistance, since the Fund could, in this way, help strengthen member countries' supervisory framework. Once again, however, close cooperation with other international organizations—such as the World Bank—should be required.

I would now like to comment briefly on a related Board decision. First, I would like to call the Board's attention to last week's Board meeting on governance issues, during which the banking field was categorized as a core activity of the Fund. This chair remains skeptical about the suitability of this classification and, furthermore, I must point out that the definition of governance is still controversial. I therefore think it appropriate to discuss the Fund's engagement in the banking field separate from the issue of governance.

Also unresolved is the amount of human resources that the Fund should commit to banking-related issues. I would like to re-emphasize this chair's position, which was first stated during the session on the Medium-Term Budget Outlook: "Where there is the possibility of duplication of work with other organizations, namely the World Bank, the BIS, and regional development banks, the Fund's role should be clarified before additional resources are allocated."

As for the third item under "Issues for Discussion," I agree with the staff that the use of debt-based instruments for bank restructuring may have considerable adverse effects on debt sustainability. In planning a decisive fiscal operation of this sort, it is important that all types of assistance be quantified and assessed in the context of a comprehensive medium-term macroeconomic framework.

The staff's proposal regarding an "augmented balance" seems interesting, and further detailed feasibility studies should be forthcoming. Expanded use of this method could clarify the total cost of banking crises and could then facilitate appropriate burden-sharing of the losses.

Regarding macroeconomic policy, in some cases there might be the possibility of a tradeoff between macroeconomic stability policy, on the one hand, and policies for recovering from banking crises, on the other. I don't think that the latter should be emphasized at the expense of the former. The cost of maintaining low interest rates in order to support the banking sector—for example, the extra burden on depositors and the potential risk of inflation—should not be underestimated. In addition, it should be noted that policies promoting lower interest rates have a negative side effect: they save the "life" of banks which ought to close down. In sum, one possible prescription for dealing with banking crises would be to coordinate relevant policies in the following way: deposit insurance schemes should be well-designed and a micro bank supervisory framework should be established in order to prevent or minimize macro-systemic effects of banking problems; as mentioned above, efforts should be made to avoid overburdening monetary policy; and if necessary, fiscal support should be provided. However, this kind of fiscal support should be limited to cases where there are no effective alternative policy instruments.

Finally, I would like to comment briefly on distribution of Board documents. I am concerned that if documents were distributed indiscriminately there might be an unanticipated reaction on the part of market participants. I would therefore like to ask management and staff to show utmost care regarding these documents and their distribution. (If a particular document is to be published, appropriate editing or sanitization will be necessary.)

Mr. Waterman made the following statement:

There is no denying the general importance of this subject and I congratulate staff on a good set of papers. At the same time, I would repeat a point that I have made before that we need to remember that intermediation is wider than the core banking sector and significant problems can be generated by specialized banks or nonbanks. We saw that with the S&L crisis in the United States, the problems that Barings ran into (both recently and late last century), and in my own country where a number of sizable problems in the banking sector were sourced to the failure of related nonbank institutions.

I agree with others that it is generally important to get governments out of the business of banking and introduce greater competition, but a more deregulated environment where the banks' balance sheets are demand, rather than supply, driven, can present its own challenges and problems. Some of the problems of excessive/inappropriate lending are reflected in banks' balance sheets in a deregulated environment that would have previously been a problem for the nonbanks.

We can't expect to be able to identify specific financial problems at an early stage, particularly where they relate to weak or crooked management. But it may be possible to identify weaknesses in prudential and regulatory structures in terms of capitalization requirements, exposure limits, reporting arrangements (including auditing arrangements), regulatory oversight, and so on. Where such weaknesses are apparent, the Fund has a role in pointing them out to the authorities and encouraging institutions like the BIS, the World Bank and other organizations to provide assistance. I believe this is consistent with what Mr. Guitian has said.

As a result of surveillance and other activities, the Fund is also likely to pick up on other straws in the wind that might point to emerging problems in terms of such variables as bank lending, inflation, sharp changes in the volume and composition of capital flows, nervousness in bond and exchange markets, and so on. As Mr. Bernes has noted, what might become shocks for the banking system will not always originate in that sector and it is important in those circumstances to make sure that the solution is directed at the primary source of the problem, as well as any specific collateral damage to the banking sector.

In terms of the approach to the resolution of specific banking sector problems, it is easy to agree that moral hazard requires that the losses should be absorbed as far as possible by those who created them or had an interest in the bank and ignored the emerging problems. In the first instance, that means management (removal) and shareholders. Where you draw the line after that is more problematic. I agree that it is generally difficult politically to expect small depositors to shoulder much (if any) of the cost, therefore, where the capital base is exhausted, some form of government involvement is probably inevitable. It may also be an argument to having higher capitalization requirements in countries where lending has a higher risk associated with it, as well as more conservative exposure limits and so on.

So in extreme situations, some form of government involvement in sorting out the problem is inevitable. And that raises issues about the pros and cons of deposit insurance. Where there is a major problem there may be advantages in not leaving the restructuring task to the supervisors alone, particularly if they are part of the problem. But given that they are going to be the main repository of skills and knowledge in this area, it is hard to see them being excluded completely. I agree, however, that any financial assistance should come directly from the government and not be provided by the central bank.

There is no doubt that if the problem is sizable, the cost to national budgets can be a big issue. Where there are sizable losses, they have to be borne somewhere in the system and there is a lot to be said for making sure they are largely borne by the responsible players. But there are often externalities in all of this, particularly when a crisis is impacting on confidence in the banking system as a whole. If government assistance is unavoidable, it will necessarily weaken the fiscal situation, unless there are offsetting measures. The costs may be deferred (spread out) but they can't be avoided.

A weakened financial system clearly complicates the operation of both monetary and fiscal policy; and can impact importantly on the economic situation and outlook.

In terms of the overall policy mix, you clearly need to be flexible in crisis situations but, like others, I suspect you can also overestimate the degree to which reliance on stabilization policy can be shifted from monetary to fiscal policy. Confidence can be badly damaged during a banking crisis and, apart from addressing the basic problem and sorting out the inevitable mess (which takes some time), there can be no hard and fast rules. In such a situation, I'm not sure that it is realistic to talk about a possible trade-off between a loosened monetary policy and a tighter fiscal policy; assign issues to one side, and there I side with those that favor monetary policy focusing on inflation control. By the time major problems in the banking sector become apparent to both the banks and the authorities, the banks themselves are likely to become very cautious about balance sheet expansion, even though renewed lending to creditworthy borrowers is likely to be an important way of growing out of the problem that have been encountered. We saw this in the 1980s when excessive lending and the associated bad debts eventually resulted in an overly-cautious attitude to bank lending. They were not attitudes that could always be changed by a moderate reduction in official interest rates. The scope to tighten fiscal policy may well be limited by the overall level of confidence, although clearly the immediate cost of a banking crisis to the government needs to be recognized fully in the public accounts and a means of financing them be sorted out at an early stage.

I agree that it is very important to record the government's involvement both correctly and in a transparent way in the government's fiscal accounts and, as the paper argues, there should be consistent treatment across countries. Maybe I've misunderstood the point but it is not clear to me why staff favor an augmented measure of the fiscal balance rather than extending the current GFS-based measure of the fiscal balance to include some, if not all, of the costs of bank assistance operations. In principle I favor having an agreed framework for treating any transactions involving government assistance to the banking or other sectors on a consistent and agreed basis; seem to be addressing a general problem with government accounts. At the same time, I can see an argument for the augmented approach if it is basically a pragmatic approach to measuring the impact of banking crises, recognizing the time involved in getting agreement to changes to the GFS.

Finally, I agree with much of what Mr. Bernes and others have to say about the respective roles of the Fund and the Bank. This is not a matter that is addressed in any detail in the paper but it is important that, if there are any major differences between ourselves and the Bank, they be sorted out. As Ms. Lissakers says, systemic bank re-structuring should be the primary domain of the World Bank but we need to sort out how the Fund and the Bank are to interface in crises situations where the financial sector is a key part of the problem. There is a need to move quickly in these situations; if the Bank is to work effectively with the Fund, the Bank may probably need to change some of its practices to provide for a more rapid response. I can join those who see value in a joint Fund/Bank staff paper on this general issue.

Mr. Mori made the following statement:

We wish to thank the staff for the comprehensive set of reports on the important issue of Systemic Bank Restructuring. We share the views expressed in the conclusions of the document, and therefore focus our comments on certain issues that deserves special remarks.

The complex policy challenge for countries experiencing banking sector problems is to achieve an orderly restructuring process. This consists of improving the finances and operations of individual banks, while at the same time redressing deficiencies in the operating environment and configuration of the banking system. The basic principles for restructuring instruments are outlined in the staff report. Among them, special mention has to be made as regards the criteria of cost effectiveness, ease of implementation, and consistency with sound macroeconomic policy, to the extent that they involve the designing of adequate strategy for policy mix, and time frame to cope with a country's specific banking problem.

Systemic bank restructuring has to be dealt with quickly and decisively. However, the process may frequently require several years in certain situations; as noted in the papers, one has to pay due regard to the principles of first cost effectiveness, as "short term cost cutting can result in higher costs over the longer run" and, second ease of implementation, as "the easiest path in the short term, may result in more difficulties later."

Regarding financial policy implementation, one has to consider that macroeconomic stability and banking sector soundness are mutually reinforcing. In the process of a systemic bank restructuring, policy makers face the problem of making the policies for attaining macroeconomic stability compatible with the restructuring process. As staff noted, "establishing and maintaining macroeconomic stability is necessary for successful bank restructuring." However, to achieve macroeconomic objectives, policy instruments, either monetary or fiscal, require careful implementation.

Monetary policy is constrained to the extent that its tightening may exacerbate solvency problems. The fiscal consolidation required may be unacceptable or impractical within the time frame of the restructuring process. Under certain circumstances, concessional external financing may be necessary to allow a more gradual economic adjustment. As the staff pointed out, "in the case of a liquidity crisis triggered by domestic or external events, contingent foreign lines of credit should also be secured."

In conclusion, the right design of appropriate phasing in of macroeconomic policy implementation is an essential element in a smooth bank restructuring process, requiring prudent approach to fine-tuning the different policy choices.

We agree that there is a need for the Fund to focus on systemic bank restructuring specially in its program design and technical assistance. Given the effects of macroeconomic policies on systemic bank restructuring, economic adjustment programs have to be implemented bearing in mind the need to accommodate appropriately the banking sector problems, "stretching out the timetable over which the macroeconomic objectives are achieved." The provision of technical assistance is essential to support a member country's bank restructuring efforts; enhanced cooperation with the World Bank in this area is welcome.

However, concerning surveillance, we share the view of other Directors that the Fund's contribution seems to be more far-reaching if the Fund continues its policy of considering the macroeconomic aspects of an individual member country, as well as of seeking global stability. Institutional and microeconomic aspects of bank restructuring seem to be better managed by institutions that already have expertise on these subjects.

Mr. Donecker made the following statement:

The set of papers before us on the issue of systemic bank restructuring and the documents provided by other Directors make for very interesting and fascinating reading. This is certainly one of the occasions where one would love to have more time to delve deeper into the subject matter, and where one also has all sorts of comments on staff and colleagues' findings. This is, however, neither the time nor the place to get into the details, but instead to concentrate on some major aspects of systemic bank restructuring and macroeconomic policy issues. Nevertheless, I want to express my thanks and appreciation for all the work and thought that went into these concisely written, excellent staff papers.

Having said this, allow me first some general remarks before I turn to the issues for discussion proposed by the staff.

To sum up my impressions of this set of staff papers, I believe there is too much discussion of microeconomic aspects and too little about macroeconomic issues, about the special mandate and role of the international financial institutions, and about the role of international banking supervisory agencies in this field. If I understand management's intentions correctly, it is planned to have another round of discussions, concentrating on the macroeconomic and supervisory aspects, plus intended division of labor among the international financial institutions on the basis of further staff papers in March. I would welcome this very much. Is my understanding of the intended approach correct?

The banking sector is of particular importance for macroeconomic policies. It is also true that the way in which systemic banking restructuring is designed and carried out has macroeconomic implications and has, of course, relevance for the Fund's work. This relevance, however, cannot and should not overrule the fact that the Fund has no direct mandate to deal with systemic bank restructuring. Lead responsibility in providing guidance and assistance for bank restructuring is, and should remain, in the hands of the World Bank and the regional and multilateral development banks.

The primary responsibility for ensuring the soundness of a national banking system and its compliance with internationally agreed prudent standards must continue to rest with the respective national authorities. Given the responsibility of the World Bank for bank restructuring on the one hand, and the Fund's interest in the macroeconomic implications of the structure and soundness of the banking sector on the other hand, there is certainly a need for close cooperation and coordination between both institutions.

Within this cooperation, each institution should concentrate on areas of its core competence and special expertise. Both should complement each other. In other words, competition in providing a "full-service package," in satisfying existing or imaginary needs in the area of systemic banking restructuring must be avoided, particularly as such competition could easily lead to incompatible advice and would overextend Fund staff resources. I therefore fully support Mr. Lissakers's and other Directors' position that systemic bank restructuring is, and should remain, the primary domain of the World Bank and the regional multilateral development banks. We also agree with Ms. Srejber that the Fund should not take up new activities in areas where other international organizations or national authorities have a comparative advantage.
After these general remarks, let me respond to the issues for discussion.

On the question to what extent the Fund should assist member countries to identify problem situations early, in our view the Fund's role in the context of its macroeconomic surveillance should be to address imbalances and weaknesses in the banking sector, and to encourage the strengthening of banking supervision and the financial sector. It should be clear, however, that the Fund's role cannot be to act as a banking supervisor, but only to act as a policy advisor. Needless to say, they should continue to provide technical assistance in this field. The Fund cannot substitute for the supervisory responsibilities of the national authorities, but the Fund staff can draw the attention of the national authorities and of the international community to perceived weaknesses in a particular banking system or in the supervisory framework of a member, respectively, in potential weaknesses in the prudential standards of international supervisory agencies.

On the question about strategies for the restructuring of nonviable banks, that is, the need to address banks' specific financial and operational issues, the paper raises very interesting aspects in this regard. These technical details, however, are more or less microeconomic issues, which are not within the mandate of this institution.

With regard to the inclusion of debt-based instruments for bank restructuring in medium-term fiscal scenarios, the staff rightly draws attention to a number of macroeconomic effects in the area of monetary policy and external policy, respectively, the impact on aggregated demand. The Fund should, of course, take these macroeconomic effects into account for its medium-term consideration. Negating them would impair the quality of its policy advice.

On the question regarding budgetary recording of government-supported bank restructuring operations, broadly-speaking this is an issue of fiscal transparency. We support the view that all liabilities stemming from quasi-fiscal operations related to bank restructuring should be recorded in the budget. Thus, we agree with the staff in principle on the advisability of its proposed augmented balance approach. It appears to me that more work needs to be done on this subject, though.

On the question of a possible conflict between systemic bank restructuring on the one hand, and the achievement of certain macroeconomic goals like price stability on the other hand, we would caution against the notion that a more accommodating monetary policy would be more supportive to bank restructuring than the consequent pursuit of the price stability objective. Even if this were the case, this supportive effect would have to be carefully weighed against negative effects of high inflation. Here, much depends on the individual country's overall economic framework and situation, particularly its actual policy mix, at the time a structural banking crisis is diagnosed. In our view, what is needed most in cases of banking crises is the restoration of confidence and a clear medium-term orientation, which may be difficult to achieve with weak monetary policies. We find ourselves very much on the side of Ms. Srejber here. In theory, it may be conceivable to compensate for a weaker monetary policy by a tighter fiscal policy. However, the lags involved in the implementation of fiscal policy, and the fact that most systemic banking crises place a heavy additional burden on the shoulder of fiscal policy— notwithstanding the often-existing political hurdles against such a compensatory tightening of fiscal policy—make this approach highly questionable. I fully agree with the staff that the best way to avoid having to make difficult strategic decisions here is to implement proper measures early enough to ensure that one's banking system is sound and remains sound.

On the question whether the Fund should focus on systemic bank restructuring in its surveillance program design, technical assistance and research activities, the key issue here is an efficient division of labor and the avoidance of duplication of work among, and/or conflicting advice from, the international institutions. In this context, I fully subscribe to Mr. Bernes's and Ms. Lissakers's blueprint in which the Fund monitors the adherence to international prudential regulations set by the BIS or other regional banking supervision agencies, while the World Bank has the leading role in bank restructuring and of providing financial assistance in this respect. Surely it is conceivable that an international institution does not fulfill its mandate as properly or sufficiently as the international community can expect it to do. The proper response, however, cannot be to shift the responsibility for that particular job to another institution, but rather to encourage the institution concerned to shape up to its given tasks. In this context, I believe that the World Bank could play a more active role in the field of bank restructuring.

This leads me directly to the last question on exploring mechanisms for enhanced cooperation with the World Bank. I note from the document that there are ongoing discussions between the Fund and the World Bank on modalities for enhancing coordination. We would have appreciated to get some information on the status of both institutions' cooperation in this field, and I am grateful for the staff's introductory remarks on this subject. I think it would have been also quite helpful to have some of this in this paper. I do not quite understand why there was no room in the comprehensive set of papers to address this issue in more detail.

We see room for improvement of the cooperation in the area of banking issues between the Fund and the World Bank. The same is true with respect to the clearly advisable closer cooperation with the specialized multilateral banking supervisory agencies. We would have welcomed the participation of the World Bank in the preparation of this set of documents, for instance. Let me stress once again that, from the viewpoint of the desirable and agreed division of labor among the international financial institutions, systemic bank restructuring and the provision of funding from the international financial institutions for this purpose clearly is part of the core business of the World Bank. "the Fund surveillance," in the words of Mr. Lissakers, "can be a useful vehicle for alerting members to weaknesses in their banking systems and supervisory regimes; for encouraging countries to adopt guidelines developed by the supervisory community; and for assessing progress toward that end." Notwithstanding the so far apparently insufficient cooperation between the Fund and the World Bank in this area, the key question and major challenge here is to define more precisely the division of labor and responsibilities of both institutions according to their given mandate and accumulated expertise, and then to expect both institutions to execute their respective duties in close cooperation among themselves and with the international banking supervisory bodies. Like Ms. Lissakers, Mr. Wijnholds, Ms. Srejber, Mr. Evans, Mr. Ono and Mr. Waterman, we believe that both institutions should work out such a division of labor in this area in a format that can be considered by both Boards, taking into account the views expressed today and also in our next discussions on supervisory issues and others.

The Acting Chairman observed that consideration had been given to addressing the issue of the division of labor between the Fund and the Bank in banking sector soundness in the current paper. However, the staff and management had felt that that would have detracted from a discussion on bank restructuring, and furthermore, it would have been premature to discuss the respective roles of the two institutions prior to discussions of bank soundness and bank restructuring. The responsibilities of the Fund and the Bank in banking sector issues would be discussed in a forthcoming paper, scheduled for discussion in March.

Mr. Coumbis made the following statement:

I join previous speakers in congratulating the staff for this set of very good papers, which will be useful to policymakers in dealing with systemic problems in the banking sector. It is quite clear from the sample of countries used in the study that problems in the banking sector are not limited to developing or transition economies; industrialized countries have also faced problems in the banking sector.

The staff indicates that there is no single appropriate strategy for all countries that have to restructure their banking system. However, the empirical analysis of common characteristics of bank restructuring based on a survey of 24 countries indicates that certain issues must be addressed in all cases if the adjustment is to be successful. Among them, the most interesting, in my opinion, are the following: (1) early diagnosis of systemic banking problems, and especially weaknesses in the supervisory environment; (2) inefficient bank management, weak regulatory framework, excessive and distorted taxation, and problems connected with state banks are often the main causes of systemic banking problems. Weak performers in the sample survey failed in most cases to face and solve these problems. On the contrary, strong performers took prompt and efficient action in dealing with them. (3) Moderate– and substantial–progress countries in the sample made extensive use of mergers and/or closures of banks. In the same group of countries, loan workout units played an important role, while among slow-progress countries this scheme was established by only half of them. (4) In substantial-progress countries in the sample, comprehensive restructuring was carried out by specialized agencies. In 75 percent of slow-progress countries, on the other hand, the central bank was the only agency responsible for bank restructuring. It should be noted, however, that, as Mr. Shaalan points out, in many cases the central bank is the only qualified institution available to oversee restructuring. There is no doubt that in such cases the central bank should undertake the lead role.

I noted Ms. Srejber's and Mr. Wijnholds's reservations of these points, and agree that we should be careful in drawing general conclusions and general remedies. However, I believe we can draw some general conclusions about the issues that have to be addressed in order to have successful restructuring.

With respect to allocation of losses and costs from bank restructuring, it seems that the typical country experience indicates that the public sector usually absorbs a large share of the accumulated losses of the banking system. It is a very difficult problem, and the solution depends on a particular country's circumstances. However, as we will see in the following topic, a priori methods of distributing the costs of restructuring would help in a more fair distribution of restructuring costs and avoidance of moral hazard.

I agree with the staff's view that while problems in the management of individual banks are the basic causes of bank failure, when a substantial portion of the banking system is close to a crisis situation, then it is clear that broader problems are present in the banking sector as a whole, or in the environment in which the banks operate. As the most important problems in the structure of the banking system that can affect the profitability and efficiency of individual banks, I would point out conditions of the extent of competition, as well as the dominance of the market by state-owned banks.

As for the operational environment of the banks, this is characterized, as the staff points out, by the political, legal, and administrative environment in which the individual banks operate. For a systemic restructuring of the banking sector, solutions have to be found to problems connected with both the banking structure and the operational environment of the banks. For the former, country experience illustrates a range of solutions. Closures and mergers were used in more successful cases, as well as giving licenses for new entries and joint ventures with foreign banks.

For the operating environment, in most cases of systemic banking problems, the legal and administrative infrastructure is quite deficient. Moreover, the political decision for the best restructuring action is usually very difficult. For the difficulties in the political decisions, the staff indicates that an explicit deposit guarantee scheme may be an easy solution, but it may result in a situation in which the government is financially responsible for most of the losses of the banking system. A better solution perhaps would be to form a deposit insurance agency in time—of course, not in a crisis environment—which would cover private deposits of failing banks up to a certain amount and would be funded by the government and the banks. In this way, the losses would be allocated as transparently and as equitably as possible among government, banks, and individuals. Moreover, the agency can be designated as a lead agency which would undertake, with the cooperation of the central bank, the supervisory authorities and the ministry of finance, the implementation of the restructuring process. I agree with the staff that it is not always wise for the supervisory authority or the central bank to become the lead agency. However, both of them have an important role to play in correcting shortcomings in the accounting, legal and regulatory framework, and in improving supervision and compliance.

On the questions concerning the role of the Fund in early detection of banking problems and whether the Fund should, in its surveillance, in program design, in technical assistance and in research activities, include systemic bank restructuring in its work, I have the following remarks.

In the Board discussion of the budget, in our interventions we stressed that the Fund should not extend its involvement in the banking area beyond its own area of expertise, and that it should cooperate closely with the World Bank. I would add that the work of the Basle Committee should also be taken fully into account. It should be noted, however, that the Fund compared to these organizations has the advantage of consultations with all the countries of the world. At least once a year, staff members will visit most countries and will be able to have discussions on banking problems with government officials, the central bank, the banks, and the business community. They are, therefore, potentially well-placed, and in a better situation than the staff of any other organization, for early detection of problems in the banking sector. As a matter of fact, they know the general economic situation of the countries better than any other international organization does. They also have a very good idea of the structure of the banking system and its operational environment. Moreover, based on its rapport with the central banks and with the supervisory authorities, the staff mission, with the help of experts from MAE, can easily be in a position to know if the accounting, legal, and regulatory frameworks are in place, if the laws about supervision are sufficient, and if the supervision department is staffed with the proper personnel. The Fund staff, therefore, as we stressed in last year's Board discussion on bank soundness and macroeconomic policy, should continue in its regular consultations and program negotiations to give advice, possibly with the help of experts from MAE, on how to improve the soundness of the banking system. However, like Mr. Bernes and other speakers, I do not believe that the expertise of the Fund staff extends to the micro management of banks in distress or in crisis. I think that the World Bank is better placed for this kind of work, where needed.

I also think that both the Fund and the Bank have the necessary expertise for technical assistance missions and research. Therefore, I would suggest close cooperation in these areas, and in the case of technical assistance the decision should be made by each organization on a case-by-case basis on the grounds of previous knowledge and work done in this area in each specific country. This is why I do not believe that all this can be written in a paper and have a delineation of activities of each organization a priori. I think and I believe that these problems have to be solved on a case-by-case basis.

In the area of supervisory rules and regulations, I think that the expertise of the Basle Committee has been established over the years. The Basle Committee has helped organize regional groups of banking supervisors all over the world, with whom it maintains close relations, and is able to advance its work on new rules connected with prudential standards and on the value of cooperation of banking supervisors on regional and international levels. The role of the Fund in this particular area was discussed extensively in last year's Board discussion on bank soundness and macroeconomic policy. We confirm our views on these issues.

On the importance of general economic conditions for the sustainability of the restructured banking system, the staff indicates, "macroeconomic recovery and stabilization assist the recovery in the banking system. Where necessary, a program of macroeconomic stabilization, therefore, should be instituted in tandem with bank restructuring." It is interesting to note that the staff, on page 62, Supplement 2, suggests that the empirical results indicate "cases where restructuring measures of the banking system have succeeded, even where the macro situation remained weak. This is consistent with the best practice review, that actions should be taken promptly without waiting for the upturn of economic conditions to undertake difficult restructuring measures." I agree with this position of the staff.

As for the possible effects of stabilization and/or cyclical policies on the soundness of the banking system, they were, again, discussed extensively in last year's Board discussion on sound bank soundness and macroeconomic policy.

With respect to the impact of bank restructuring on macroeconomic policy, I associate myself with the relevant comments made by Mr. Bernes in his statement.

Finally, with respect to the importance of data on reliable information provided by the Bank and the international efforts that should be undertaken to improve the quality and timeliness of data, I associate myself with the Managing Director's address at the Seventh Banking Seminar.

Mr. Morais made the following statement:

I found the staff papers to be useful on two fronts: they draw attention to one of the key components of a modern economy—the banking system—and the importance of having it function in a sound and effective manner. The papers also make a strong case as to why bank restructuring should be considered as part of a comprehensive economic program.

It is almost a truism that a weak and inefficient banking system is detrimental to the smooth functioning of an economy. As such, reforming the system should be a matter of priority, where serious problems exist. All countries have to be vigilant, regardless of their level of development, and proper supervision is important. However, developing and transition economies have to be particularly careful to recognize systemic problems at an early stage because the impact can be more disruptive and the fiscal burden very high. The Fund can play a major role in assisting these countries through its technical assistance program. Obviously, where restructuring has to take place, this must be factored into the design of adjustment programs.

Systemic bank restructuring necessitates a comprehensive effort. It must also be carefully done, with the implementation of the strategy left to those with the requisite technical expertise. Although the modalities for reform must be tailored to the individual country circumstances, the broad principles regarding the need for cost effectiveness, simplicity in the instruments chosen, equitable distribution of losses, and minimizing the public sector burden would seem to be the basis for developing a framework for action.

The nature of public sector involvement is particularly important because of the macroeconomic implications. This is one of reasons why financial sector reform should take place in the context of an overall adjustment program. However, low-income countries could face a dilemma in responding to the exigencies of fiscal consolidation and the requirement of capital injection from the public sector into the banking system. The argument has been made that private capital is preferable to government-provided funds, and that may be the case; however, when the private sector is small or not well developed, government's role become important. In fact, it would appear that in most cases of bank restructuring in recent years, the government, by a large margin, has been the main source of capital injection. This raises the question of the role of external financial assistance in cases where the public sector in low-income countries might need help in implementing a bank restructuring exercise. It would seem that the World Bank could play a major role in such countries.

Once bank restructuring has taken place, the need to institutionalize preventive measures is crucial in order to build confidence in the system. The authorities cannot just bail out banks, they must take action to improve management practices and deal with other sources of bank weakness. In this connection, the argument can be made for an expanded role for the central bank, especially in developing countries, beyond the single objective of attaining price stability. The safety and soundness of the banking system should be a very important objective; otherwise, exchange rate pressures that emerge out of an unsound banking system are likely to run counter to the objective of price stability. The extent to which a trade-off between systemic bank restructuring and the achievement of price stability is permissible is something that would depend on individual country circumstances. It seems that there is no clear policy prescription that would apply to all countries.

Mr. Sivaraman made the following statement:

What strikes me from the detailed analysis of Bank restructuring contained in the excellent staff papers is the question what is the trade off between Bank autonomy and intervention to ensure stability and security of the Banking system. In all the cases analyzed, the State or one of its agencies intervened either to restructure or to regulate effectively. Ms Lissakers has devoted a whole section to this in her Gray. It is also true that in several cases where Banks are either state owned or fully regulated have equally been beleaguered by crisis. The question that is often asked is where State owned banks are doing well and can be made to adhere to all internationally accepted norms whether there is a need to privatize them fully. This is an area which should be of concern to us when we talk about privatization of the banking system in the context of restructuring.

I am also not able to understand clearly whether banking crisis is more a phenomenon of a State controlled banking structure. This does not seem to be so looking at the problems banking structure has faced where they are largely in private hands.

Wherever restructuring has taken place, the State has injected capital in diverse forms. Regulations have been tightened further to improve supervision and make it more penetrating and less superficial. The risk in portfolios of banks is growing with greater mobility of funds. The increasing number of money market instruments is also making supervision complex. The setting up of a proper Banking Supervisory Authority either under the central bank or as an autonomous agency which makes its evaluation report of every Bank public seem to be essential in the context of an increasingly private enterprise run competitive banking system. It may be necessary to locate the area in banking management where autonomy ends and regulation takes over so that there is a proper balance between the two. The Fund can play a useful role assisting authorities to frame proper regulations for effective supervision without undermining autonomy.

The second important factor which will lend credence to an autonomous banking system is the existence of a debt recovery agency under a statute to which recourse can be taken to by the banks to recover dues on Non-Performing Assets (NPAs). Private owners of banks should not be led to believe that in a crisis, willy nilly the State will step in to prevent it. Fund should advise member countries on the need and mechanism of such an independent machinery to deal with the recovery cases of banks.

As Banking crises can snowball into a major economic crisis, Fund should carefully monitor development in the banking system and promptly draw the attention of the governments to any visible sign of emerging bank problems. While Article IV consultations does provide the Fund with a periodic opportunity, the SDDS can be augmented to include banking data so that Fund staff can monitor developments and watch for problem signals at all times. In this effort, there can be cooperation amongst the World Bank, BIS and the Fund.

Bank specific financial and operational issues can be tackled best by the State authorities or the central banks if there are appropriate Banking Statutes in place. Fund can assist member countries on request to design, or modify suitable Banking laws to enable the State, central bank or any other Banking Supervisory Body to tackle Bank specific problems provided the World Bank has not already stepped in. Where, however, the problem is of the banking structure as a whole, the Fund's responsibility becomes more onerous and there will be a need to draw the attention of the authorities to tackle the problem before it goes out of control and has wider ramifications.

All the methods of government assistance to resolve banking problems have their macroeconomic impact depending on the existing fiscal scenario. In whichever way banks are to be assisted by the State, there is a need to study the medium term impact of the method of assistance. All the assistance given by the government should be transparently reflected in the budget so long as the instrument used has a direct bearing on government finances. If fiscal costs are quantifiable and can be related to a fiscal year, I see no reason why they should not be included in the overall balance as explicit items for subsequent parliamentary control and audit. Only those costs which cannot be directly or even indirectly relatable to government budget of a fiscal year should be included in the augmented balance. We can thus avoid the uncertainties in what can be shown in the augmented balance.

A major bank restructuring program may undermine some objectives of monetary policy and the burden will therefore have to be borne by fiscal policy. To what extent the trade off can take place will have to be determined by specific cases. It is a difficult question in a general way.

In conclusion I would like to endorse the last para of Mr. Zoccali's statement.

Mr. Zhang made the following statement:

I wish to begin by expressing my appreciation to the staff for providing us with the well-written and very informative papers. The comprehensive analysis in these papers has added a new dimension to the discussions of banking system issues. I can support the publications of these papers, with appropriate editing.

With the increased innovation and deregulation of financial activities as well as the rapid globalization of financial markets, banking systems almost everywhere are significantly challenged, and their soundness is increasingly of worldwide concern. Given the Fund's mandate to promote international monetary cooperation and exchange stability as well as its expertise in macroeconomic areas, the close linkage between the banking sector and macroeconomic policy suggests that it is not about whether the Fund should play an important role in systemic bank restructuring and maintaining banking soundness, it is about how and to what extent the Fund should get involved and how labor should be divided and coordinated with other international financial institutions.

Systemic bank problems usually arise from one or a combination of many factors, such as individual banks' poor internal governance, deficiencies in the operating framework, lack of sufficient supervision, an unfavorable macroeconomic environment, as well as external shocks, all of which eventually involve significant macroeconomic consequences. In this regard, the Fund should, in my view, mainly through its Article IV consultations and technical assistance programs, help assess the soundness of member countries' banking sectors, or help analyze the causes and macroeconomic implications in the event that there are obvious or impending signs of systemic bank problems, and subsequently recommend a policy mix for maintaining bank soundness or systemic bank restructuring from the macroeconomic perspective. In the course of providing assistance for member countries to conduct systemic bank restructuring, it is essential for the Fund to have as clear a division and coordination as possible with other international financial institutions. For example, the operational and institutional aspects of bank restructuring are widely thought to fall within the expertise and experience of the World Bank and regional development banks, while the regulation and supervision recommendations and guidelines of the BIS and Basle Committee have been adopted in a growing number of countries. Therefore, the prompt establishment of the mechanisms for enhanced cooperation with other IFIs would facilitate the Fund's efficient involvement in member countries' bank restructuring. We would like to encourage the staff to make further studies on this subject and look forward to hearing from them about their findings and recommendations.

This being said, I would like to make a few comments on the content of the papers, with which I am broadly in agreement. As the banking sector plays a pivotal role in every economy, the goals for undertaking bank restructuring across countries have been quite similar, and in most cases, require comprehensive measures at the microeconomic, institutional, regulatory, and macroeconomic levels in a multi-year process. However, with the significant differences in individual countries' initial conditions, the degree of market maturity and stage of economic development, the principal causes of bank problems, and, consequently, the strategies for bank restructuring as well as the sequence and timing of structuring measures may vary from country to country. For instance, the internal governance of, and the operating environment for, the banking sectors in developing and transition countries are generally weaker than in advanced economies; the tasks for strengthening the operational and institutional building in the former are therefore much more demanding.

Once systemic banking problems are properly identified, comprehensive policies and instruments need to be promptly designed and implemented. We share the staff view that instruments chosen for financial restructuring should be cost effective and simple to implement, distribute costs equally, and minimize the public sector burden. However, the effectiveness and eventual success of financial restructuring could only be achieved with increased emphasis on the operational restructuring of individual banks, especially through strengthened internal controls, corporate governance, and accounting systems. This is particularly the case for developing and transition countries where the banking sectors are commonly short of advanced management skills, therefore strong efforts should be made to address internal management deficiencies. Except for the financial and operational strengthening of individual potentially viable banks, elimination of deficiencies in the operating environment and the configuration of the banking system are also critical in keeping the banking system sound. Particularly for those countries in their initial stages of economic development, or in the transition from a centrally planned system toward a fully market-based one, accelerating efforts to foster market forces and increase competition is one of key elements in bank restructuring, as market discipline can reinforce banks' incentives to operate safely by driving unsound banks out of business. In the broad sense, carrying forward enterprise reforms would also improve the operating environment for the banking sector; it is particularly meaningful to complement bank restructuring by enterprise reforms in transition and developing economies. The improvements in the financial and institutional infrastructures, such as the payment system, legal framework, interbank liquidity market, and an appropriately designed safety network, would greatly contribute to the soundness of the banking system. Given the incidence of failures in internal governance and market discipline even in the most advanced economies, it is essential to strengthen prudential regulation and supervision in line with market developments and the institutional environment.

The soundness of a banking system rests largely on the health of the whole economy. A stable macroeconomic environment is conducive to efficient saving and investment decisions, which, in turn, promote sound banking. In this respect, the Fund could play a unique role in preventing member countries' banking sectors from being affected by macroeconomic shocks, through, for instance, closely monitoring member countries' macroeconomic policy developments, or helping design an appropriate policy mix taking into account the implications for the soundness of the banking system. On the other hand, since systemic bank restructuring usually entails significant policy responses, the Fund could also make important contributions in the design of the macroeconomic policy elements of a bank restructuring strategy in a medium-term framework. In recapitalizing insolvent banks, private capital injection is, to the most possible extent, preferred over public sector funds. When it is inevitable that public sector funds be used, we believe fiscal resources should be the first and primary reliance. However, the fiscal response to bank restructuring, in whatever form, should be based on the principle of minimizing public sector costs, maintaining debt sustainability as well as budgeting the full costs, including contingency costs, in a transparent way. Once it is deemed necessary that the fiscal response step in, prompt action is vital to avoid incurring additional fiscal costs caused by lack of such early action. I share the view that central banks should avoid providing new financial resources to problem banks so as to prevent bank restructuring from expanding money supply and driving up inflation. Central bank involvement in systemic bank restructuring may draw on the experiences of those substantial progress countries which refrained from using instruments other than central bank liquidity support. I believe at least that the monetary response should stick to the prerequisite that the primary goal of safeguarding price stability must not be sacrificed when the policy measures under a bank restructuring strategy are incompatible with the pursuit of the primary goal.

Mr. Fremann made the following statement:

The set of documents prepared by the staff is a valuable contribution on systemic bank restructuring and its macroeconomic aspects and implications. Overall, this chair has no serious disagreement on the suggested guidelines and we fully support the approach in terms of best practices. Therefore, I would limit my comments to some institutional issues and the role of the macroeconomic framework.

On institutional issues, concerning the designation of the agency for restructuring, I find it difficult to establish specific rules in particular on the basis of past experience (SM/97/1, Sup. 2). The need for a specific scheme, separated from the central bank or the banking supervisor, seems to me less important than the political consensus on the restructuring process and, consequently, the efficient coordination among competent institutions (Ministry of Finance, central bank, banking supervisor, etc.).

On macroeconomic responses, the staff papers rightly emphasizes the fiscal implications of banking restructuring. Past experience suggest that the budget is de facto the lender of last resort of the banking system. In this regard, I consider that the "augmented balance" approach is useful as it provides a clear and useful tool for estimating the overall implication of the banking restructuring for the budget. But, beyond the methodology, what matters is the transparency of operations.

Even though the budget is acting as LLR, limits need to be applied to this fiscal burden. In a case of a systemic banking crisis, when capital has become a scarce resource, reduction of the fiscal cost will require, in most cases, the use of mergers and closure of insolvent banks. There are almost three reasons for such a policy: first, if financial support to the banking sector is large, the initial financial burden is highly likely to rise in the future; second, impact on aggregate demand is difficult to assess but is potentially expansionary and inflationary; third, the alternative approach of offsetting the fiscal cost of financial restructuring by a strong contraction of expenditures or investment is not fully convincing and carries the risk of damaging the real economy and, subsequently, the banking sector itself.

Limiting the fiscal cost of banking restructuring would also reduces the need for relying excessively on the monetary policy. We acknowledge that at a first stage, a liquidity injection or relaxation of reserve requirements would certainly be warranted in order to offset the depressing impact of the banking crisis and to impede a generalized liquidity crisis. But, once the banking restructuring process is on track, countries have to refrain from using extensive use of central bank instruments, the cost of restructuring relying ultimately on the public budget: in other words, the lender of last resort function will be performed by the budget. Therefore, the following rules should generally apply to the central bank's interventions: liquidity support measures must be on a short-term basis; long-term financial support from the central bank is not appropriate and in any case should be backed by the government; lending to solvent institutions would generally be a relevant rule though it may be difficult, when a timely reaction is needed, to discriminate between solvent and insolvent financial institutions. But this suggests that, once the insolvency of a bank is established, the cost of financing has to be transferred to the budget.

Turning now to the role of the Fund on banking restructuring, I will consider the following three issues of identification of problems, adjustment programs and enforcement of reforms.

An active role of the Fund, in particular through its Article IV consultations, is warranted when it comes to the assessment of the soundness of member countries' banking sectors and early identification of systemic banking problems. At the same time, we need to look carefully at the implications for the banking sector of our policy advice.

When a systemic banking crisis emerges, there is certainly a need for the Fund to foster the restructuring process and to ensure the consistency of a comprehensive package of reforms. A clear example here is the fiscal costs of restructuring and their implication for fiscal policy targets. Therefore, conditionality can provide for some structural benchmarks in financial sector reform, which indeed has to go along with decisions which are often critical to conditionality, such as interest rate liberalization. At the same time, caution should be exercised: I would be reluctant, for example, to adopt unrealistic targets such as an average solvency ratio for the banking system.

Implementation of banking restructuring, that is microeconomic and institutional details of bank restructuring, calls for enhanced cooperation with other international financial institutions in order to avoid duplication of work. In this regard, I would tend to believe that we should continue to rely, on a case by case basis, on the acknowledged expertise of the World Bank to design specific operations along with Fund programs. Two different levels of coordination seem advisable: first, in order to reach a common understanding of general principles, the set of papers prepared by the staff could be an appropriate basis for discussion with the World Bank; to ensure consistency of actions between the two institutions, the extension of the methodology of policy framework papers of ESAF programs could be warranted.

Mr. Kaeser made the following statement:

I welcome this opportunity to discuss the highly complex issue of systemic bank restructuring and macroeconomic policy. With one reservation, I commend the staff for the excellent papers produced for this discussion. I wish also to thank colleagues who produced written statements, which contributed to shaping the discussion.

What I do miss in the staff papers, especially if they are to be published, is an introductory section stating as has been suggested by Ms. Lissakers-Mr. Sobel, by Mr. Shaalan and others that in the field of banking an ounce of prevention is worth a pound of cure. It is very much the same as for financial crises. As other international financial institutions act only if they are invited to do so by member countries after the emergence of a problem and as only a part of the membership is likely to seek the support of the World Bank and of other IFIs in such cases, it seems obvious that the Fund has a major, I would say a unique, role to play in the prevention of systemic bank crises, which can hit developing countries, countries in transition and industrial countries. This role is based on its surveillance function. As noted by Mr. Bernes "among international financial institutions, the Fund is uniquely placed through its Article IV consultations, to regularly assess the soundness of member countries' banking sector, and to identify at an early stage systemic banking problems." I would say that the recent IC Declaration on "Partnership for Sustainable Growth" stresses the importance of the soundness of the national banking systems for the international community and we will have to define the extent as well as the limits of the Fund's mandate in this field. The Fund will certainly have to make sure that member countries have put in place the necessary institutional framework to secure a strong prudential regulation and supervision and that the member countries eventually follow internationally agreed guidelines. In this respect, I guess that the Guidelines of the Basle Committee have been established for banks working in a relatively stable macroeconomic environment. Could the staff tell who is supposed to adjust the guidelines for instance with respect to the capital requirements for banks working in an unstable environment. It is obvious that stringent capital requirements and the build-up of generous loan loss provisioning is the best means to prevent the outbreak of systemic banking crises. Member countries do not always follow prudent policies in this respect.

The Japanese banking system would probably be in a better position if the authorities, eager to maximize their fiscal income, would not have followed during the eighties a very restrictive policy concerning the build-up of provisions before taxes.

One has to recognize that a restrictive policy concerning the build-up of provisions before taxes greatly increases the risk that the government will later have to inject public money in the banking system at a later stage.

The Fund has, however, also an important role to play in the resolution of bank crises, but this role is less clear cut than in the field of prevention. As the staff paper shows, the choice of the instruments to achieve bank restructuring has effects on the macroeconomy and imposes constraints on the objectives of a macroeconomic program.

If there are trade-offs between macroeconomic goals as for instance price stability (which may require a tight monetary stance) and the stability of the banking system (which is enhanced in the short term by a more generous money supply), the best solution may depend very much on the specific economic situation of the respective country. Abandoning the restrictive monetary stance to help insolvent banks may bring short-term benefits but increase overall costs of banking restructuring. We tend, therefore, to agree with Mr. Bernes' view that generally an appropriate macroeconomic stance in the context of systemic bank restructuring would be to maintain monetary discipline while transferring the cost of restructuring to the public budget. Looser money supply may only be an option when the banking crisis primarily is due to liquidity shortages (and not to problems of insolvency).

The strategy to achieve bank restructuring should be well embedded in the macroeconomic policies and designed simultaneously in an iterative process implying national authorities, the Fund, the World Bank and regional development banks so that a consistent package can be designed. While the World Bank and regional development banks would provide advice on how to address the structural sources of financial fragility and on alternative instruments of bank restructuring from a sectoral and microeconomic perspective, the Fund should concentrate on macroeconomic causes of financial fragility and the macroeconomic implications of the choice of instruments to achieve bank restructuring. The staff should, therefore, actively explore mechanisms for such an enhanced cooperation in this area with other international agencies, in particular the World Bank.

In order to assess correctly the fiscal implications of a given instrument, the budget should, or course, record them comprehensively. We, therefore, support the proposition that member countries with major bank assistance outlays resort to an "augmented balance" concept, which would incorporate the major quantifiable fiscal costs of bank assistance operations that are not already included in current definitions of the overall balance.

Country cases reviewed in the papers show that a successful banking restructuring implies not only the need to address issues facing the sector as a whole but also bank-specific financial and operational issues. Unless these issues are dealt with, banking problems may reemerge in the future. Only potentially viable banks merit restructuring; nonviable banks should be closed down. The assessment of the various banks and the enforcement of operational and financial measures should be made by a national authority, preferably an independent special agency or the supervisory authority, the deposit insurance or the banking association, and not the Fund.

Since I have been in this country I have made some limited progress in the field of political correctness, but obviously not enough to understand what the staff means on page 8, paragraph 16, of the main document, when they write that the overall strategy should be approved by the parliament or equivalent.

Mr. Joyosumarto made the following statement:

Observations showed that systemic banking problems could arise from variety of reasons, even in an environment of well developed and mature systems of banking supervision. As highlighted in a recent speech by the Managing Director on the Challenges of a Sound Banking System and I quote "One fundamental cause of banking problems is poor management, and more broadly, weak internal governance by owners and managers. These weaknesses are frequently brought to light by adverse macroeconomic developments, which have a negative impact on all banks, but tend to affect poorly managed ones most heavily." Unquote.

More often, remedial actions to rectify systemic banking problems were very costly, economically and financially. Thus, as correctly pointed out in the staff paper, as soon as systemic banking problems are recognized, comprehensive policies need to be formulated without delay to prevent further deterioration, minimize the cost of restructuring, and reduce the likelihood of a liquidity crisis. In preventing systemic banking problems, member countries should adopt appropriate prudential standards. Emphasis should be placed on external oversight of banks in line with the development of financial markets as well as on market discipline and internal bank governance. In the formulation of economic policies, it is necessary to take into account the condition of the banking system, both as key objective and as a constraint on policy. I agree with the staff that the supervisor of the banking system need to be more vigilant in assessing the condition of the banking system by close scrutinization of data on the solvency of banks, present and potential operational efficiency, profitability, cash flows and the capacity of the system as a whole to provide necessary financial services to the economy. For today's discussion, I will touch on a number of issues put forward by the staff.

First, on the extent the Fund should assist member countries identify the problem and mechanisms for enhanced cooperation with international financial institutions. The Fund clearly has a role in assisting countries identify problem situations early through its surveillance exercise by devoting greater attention to banking and financial sector issues. This could be done in the context of the Article IV consultations, the regular submission of data to the Fund by member countries, technical assistance and program design. I agree with other Directors that care need to be taken to avoid duplication with the work of the international financial institutions. Furthermore, with the view that the Fund may lack resources and expertise in this area, I fully agree that the staff should actively explore mechanisms for enhanced cooperation in systemic bank restructuring with other international financial institutions, particularly with the World Bank.

With respect to the annual Article IV Consultations, member countries might be reluctant to discuss sensitive banking issues with the Fund. To overcome this, the staff may wish to suggest to the Board a set of standard information required from the banking system of all member countries as part of regular submission of data to the Fund, albeit with some differentiation between certain groups of countries in recognition of different level of banking sector development.

The second issue I would like to touch on is regarding whether the Fund need to address bank-specific financial and operational issues as well as issues facing the sector as a whole. As a general rule, the Fund should only address issues facing the banking sector as a whole since the authority is responsible for the micro aspect of the sector as implied by Article IV, Section 1(ii) of the Articles of Agreement, whereby members are obligated to promote stability in the monetary system. Furthermore, several country may seem to be facing similar banking problems, but due to differences in stage of development, resources availability, level of openness of the economy, a standard remedy for same problem of different countries may not be effective. These underlying characteristics are best known by the respective authority. Nonetheless, it is also clear from Article V, Section 2(b) that the Fund could get involve in bank-specific financial and operational issues if so requested by the authorities.

Third, I would like to touch on the importance of medium-term fiscal scenarios and the proposed "augmented balance." As pointed out in the paper, I agree that the use of debt-based instruments for bank restructuring may have significant effects on aggregate demand and debt sustainability. Needless to say, presentation of a medium-term fiscal scenarios in cases where there is substantial reliance on debt-based instruments for bank restructuring is very important. This should apply to all countries concerned, including those with very low initial debt stocks and strong primary balances, so as to be transparent. On this note also, I do not foresee any problem with the proposed "augmented balance" as a complement to the standard fiscal measures in countries with major bank assistance outlays at it would facilitate assessment of implications in the context of a comprehensive medium-term macroeconomic framework.

One issue for comment: experiences in many countries show that there are very close relationship between banking institutions and nonbank financial institutions. The relations are not only complementary, but also competing, and in some extent, overlapping. Because of this, to achieve the macroeconomic stability, or more exact monetary stability, we have to consider the reaction on nonbank financial institutions. Otherwise, the achievement of macroeconomic policy in restructuring the banks, may be neutralized by the reaction by nonbank financial institutions. We expect a comment by the staff on this.

Mr. Barro Chambrier made the following statement:

From the outset, I would like to join previous speakers in commending the staff for providing us with a useful set of papers which outline the design of the macroeconomic policy in the context of bank restructuring. The issues covered in these papers constitute a valuable complement to the discussion we had last March on bank soundness and macroeconomic policy. I can also support publication of these valuable guidelines for bank restructuring after the necessary editing.

It is, indeed, important to recognize that a well-functioning banking system and the continued implementation of sound macroeconomic policies are mutually reinforcing for any country in the process of adjustment. One should also keep in mind that the role of the banking system is to mobilize a large portion of domestic and foreign resources in order to allocate it efficiently among alternative uses in the economy.

Among the many causes that have led to the crisis of the banking system in most of the cases in my constituency are an unstable macroeconomic environment, government intervention in the allocation of bank credit, and deficiencies of bank management and of governance structures. Having said this, and before commenting briefly on some of the issues, I would like to share with the Board some of the general conclusions that were reached for some countries of our constituency at the workshop on bank restructuring organized in Libreville last December.

During that workshop it was noted that some of the main factors that constitute the prerequisite for the success of a bank restructuring program are: (a) the need to identify and clearly define the respective roles of the various architects involved in the restructuring process such as government, banking commissions, shareholders, central banks, and donors; (b) the need for stabilizing the macroeconomic environment; (c) the importance of rehabilitating the judicial system and formalizing banking laws; (d) the strengthening of bank supervision, the implementation and the following up of restructuring plans; and (e) the need for effective management of the process of liquidating nonviable institutions and the reduction of government involvement in the capital and commercial management of banks.

Turning to some of the issues, I agree that it is vital to make earlier diagnoses of the problems facing the individual banks and the banking system, and to adopt a well-planned strategy that will allow the implementation of comprehensive policies at an earlier stage. In this connection, the experience with Fund members has confirmed that some decisions are to be taken rapidly in order to optimize the condition for the success of the Bank restructuring. In other words, the Fund can play a useful role as an early warning system.

These decisions are concerned in particular with who is going to bear the losses on one hand, and on the other hand the need to differentiate which banks can be restructured successfully and which are not viable in order to adopt, if necessary, a firm exit policy. Once the problems are well identified, it would be crucial to design a restructuring plan with the aid of technical assistance from the Fund. However, while there are some limits to the role played by the Fund in this area, close collaboration with other international financial institutions will be critical for the success of this process.

As regards the division of labor among the international financial institutions, I agree with Mr. Cserés that it is important to take into account each institution's strength. It can also be necessary to reevaluate the respective roles in promoting banking reforms and restructuring so that the different institutions should complement each other.

On the impact of bank restructuring in the decision of macroeconomic policy, I agree with Mr. Shaalan that both monetary and fiscal policy and the goal of price stability will be constrained by the monetary impact of the banking problems and the fiscal need of restructuring. I found very relevant the staff's remark on price stability now or price stability later.

On operational restructuring, I agree that failure to undertake adequate operational restructuring can be the reason for the successive round of financial restructuring. It is therefore important to provide sufficient resources to appropriately restore banking soundness in order not to jeopardize the sustainability of this system. Nevertheless, it would be wise not to waste these resources, and it is therefore important that the sequencing of the restructuring take into account the stabilization policies.

I would like to add that I agree with the staff's findings that it is important to ensure that a legal and institutional framework is in place to promote sound banking. It is also necessary that supervision and prudential regulations are improved and that the structure of the banking system does not inhibit competition or profitability.

Finally, all these very useful guidelines do not imply that there exists some standard medicine that could be applied to all cases. On this point, I share Ms. Srejber's and Mr. Andersen's views in considering that each case should be taken separately and each country's aspect should be given the necessary priority.

Mr. Mahdavian made the following statement:

I join other directors in their commendation to the staff for the valuable, interesting, and comprehensive papers for today's discussion and support their publication with appropriate editing.

A very important issue addressed by the paper is: who should be responsible for assessing the strength or weakness of the banking sector and the design and implementation of the restructuring program. I agree with the staff's view that the central bank should be consulted at all stages. In this context, the U.S. experience of shared responsibility is very instructive: with the Federal Reserve acting as lender of last resort, the office of the comptroller of the currency in charge of regulation and supervision, and the FDIC administering insurance and responsible for the design and implementation of restructuring. It is interesting to note the degree to which the FDIC is able to limit FED financing of troubled banks. While I agree that central bank intervention in the restructuring, in particular as regards its financing, may conflict with the conduct of monetary policy, it is true that the institution in charge of the day-to-day supervision may not be best suited to assess the banking system in a crisis situation and to design adequate corrective measures since it may underestimate the extent of the problem lest it is accused of poor monitoring performance.

Regarding tax treatment of losses, the choice between restrictive or generous treatment may be linked to the depth of the financial system and its degree of diversity. The deeper and more diversified the system is, the more limited the tax treatment becomes without jeopardizing economic activities. I also agree with the staff that conformity in regulatory and tax treatment of losses present substantial advantages in terms of administrative and monitoring costs, but should not be an overriding objective. Loss treatment from the two different perspectives should be designed with due consideration to country circumstances.

I note that Supplement 3, Appendix Table 1 on international comparison of loan loss provisioning methods, include only industrial countries. Some coverage of how and why developing countries choose between different methods of loan loss provisioning could have been useful.

I also appreciate the importance attached to an appropriate sequencing of financial sector liberalization and to the strength of regulation and supervision. In this respect, the experience of countries that have successfully carried out their financial liberalization without systemic banking crises would have been useful.

Turning to issues for discussion, I have the following comments.

It is imperative that the Fund draw the authorities' attention to the importance of a sound banking system and adequate regulatory framework and supervision in the context of its surveillance or program discussions. Here, I share the sentiments in the grays that the Fund would better achieve its objectives by concentrating on macroeconomic issues as well as financial sector issues. It should only address bank specific issues, if so requested by a member country, and if no other international institution provides it with due assistance. However, in the context of a Fund program and where the individual bank's situation may threaten its achievement, the Fund may become involved in bank specific issues drawing on resources and skills of other international institutions.

On the potential role of the Fund as it relates to the question of bank restructuring, it seems that the answer would have to be considered in light of resource requirement and the degree of involvement of other international institutions in this area. Whereas the issue of bank soundness is relevant to the Fund, bank restructuring encompasses a wide range of microeconomic analysis and decisions that are by nature outside Fund's mandate. Clearly, the macroeconomic implications of bank restructuring should be an important concern of the Fund. It seems that most bank crises described in the staff papers occurred either prior to the strengthening of Basle Committee guidelines on prudential regulation, or as a result of lax regulation and supervision. Therefore, while it is appropriate for the Fund to strengthen its involvement in bank regulation and supervision, the degree of Fund involvement in microeconomic issues of bank restructuring will obviously be dictated by the constraint on its resources in the context of its priorities.

Finally, greater Fund involvement in microeconomic issues of bank restructuring, whether in the context of its surveillance concerns or in a program setting, requires access to detailed information that member countries may consider highly sensitive. The question is whether the need to have such data would be consistent with the provision of Section 5(c) of Article VIII which states: "members shall be under no obligation to furnish information in such detail that the affairs of individuals or corporations are disclosed."

Mr. Mozhin made the following statement:

I welcome the excellent multi-faceted analysis by the staff of systemic bank restructuring issues prepared for this discussion. The set of papers supporting major conclusions and recommendations contains a wealth of updated country-specific empirical information on members' past experience in dealing with bank crises. To be credible, the analysis of systemic bank problems has necessarily had to rely on a profound and detailed understanding of wide-ranging organizational, accounting, financial, tax and other purely sectoral matters. I am not overly concerned about the rather technical and microeconomic nature of the supplementary papers, as they reflect a somewhat broader trend in the Fund to view macroeconomic problems through the prism of inefficiencies in the structural area and vice versa. Incidentally, this trend has a major bearing on the Fund-World Bank relationship, as it becomes more and more difficult to delineate their areas of responsibility on matters and programs involving systemically important structural components.

My authorities fully support the recent efforts to expand the Fund's role with regard to promoting bank soundness and providing the membership with timely expert advice both through the regular surveillance process and at a time of actual bank crises. It is of paramount importance for program countries, including many transition economies, to be able to tap the Fund's technical assistance in these areas, sometimes, on very short notice, particularly, in the absence of extensive prior preparatory work on financial sector adjustment loans by the World Bank or regional development banks. In those instances, where the latter institutions have previously been involved in designing restructuring programs for the banking sector, the Fund's role should be complementary in making sure that the linkages between macroeconomic policy and banking systems are fully appreciated by the authorities and duly reflected in the member's macroeconomic program. Of course, full sharing of information and research on banking sector issues between the Fund, the World Bank, regional development banks, and the BIS and relevant G-10 organs, as well as closer coordination among them are sine qua nons if excessive duplication of efforts is to be avoided.

The future analytical work by the staff could, perhaps, be usefully pursued both with a broader scope in mind to include the issues of soundness and restructuring of the financial sector in general, and a more narrow focus on financial and banking sector problems of various groups of countries with similar economic characteristics. The recent experience in some transition economies has demonstrated, for example, that large-scale pyramid investment schemes could trigger confidence crises of such magnitude that they could overshadow the problems of the banking sector per se. To my mind, a separate look at the systemic problems in the financial and banking sector of transition economies is fully warranted, considering the staff's finding that bank crises may recur for as long as public enterprise restructuring is not complete. In this regard, I welcome the staff's note in Supplement 2 to SM/97/1 of special issues of bank restructuring in transforming economies, which indicates that their ratio of nonperforming to total loans varies from 14 to 63 percent. The estimate cited by the staff that some 50 percent of commercial banks' loans in Russia may be nonperforming is very alarming to me, as most of the banks are closely linked to each other through the interbank market, and failure of one of them has the potential of triggering a systemic banking crisis. Only two of the twelve CIS countries (i.e., Kazakstan and the Kyrgyz Republic) have initiated systemic bank restructuring with regard to the formerly specialized banks that dominate the financial system. This underscores the need for urgent additional efforts on behalf of the Fund and the international financial community to assist these members both in early formulation and in implementation of their bank restructuring strategy. In this regard, Poland's experience with concomitant restructuring of both banks and public enterprises might serve as a useful guide to success.

In principle, I agree with the staff that there is no single strategy for successful restructuring of a banking system that the Fund can recommend to its members.

Therefore, I tend to see the value of this discussion in that it helps to crystallize the precious elements of the Fund's collective wisdom coming from a critical assessment of past lessons learned by its members in the process of overcoming crises and distress in the banking sector.

In this, I would attach as much value to candid negative advice ("Don't do it!") as to positive recommendations. Despite the staff's criticism of the use of inflation by Yugoslavia during the 1980s as an instrument to raise bank income and reduce the real value of impaired loans in banks' portfolios, I am under the impression that in the papers the staff seems to avoid being openly critical of some specific measures and instruments employed by the members, and pays somewhat more attention to emphasizing the best practices. For example, it is not clear to me from a reference in the text to the rapid reduction in central bank credit to commercial banks as a factor behind the Russian interbank market crisis in 1995, whether the monetary program of the authorities was appropriate at the time.

Finally, let me briefly address the questions raised by the staff in the main paper. Yes, the Fund is uniquely placed to be among the first to identify systemic bank problems in member countries in the course of its surveillance, program-monitoring and technical assistance activities. Strategies to resolve these problems will need to be designed on a case-by-case basis, taking into account the overall macroeconomic situation of the member, financial costs of restructuring and administrative capacity of the authorities, the extent of government involvement in the economy, in the banking sector and credit allocation activities and other relevant factors. Members' medium-term debt sustainability analysis should include various scenarios regarding potential financial costs of a bank restructuring operation in those cases where the risks of such developments are perceived to be rather high. In-built contingency financing mechanisms should be incorporated into respective adjustment programs. Use of debt-based instruments needs to be studied carefully, taking into account the total stock of domestic and external debt, and the moral hazard associated with government bail-outs of insolvent banks.

The proposed introduction of an "augmented balance" as a way of budgetary recording of the costs of government-supported bank restructuring efforts seems to be a sensible idea, which may need to be undertaken in the overall context of promoting transparency of recording quasi-fiscal and off-budget financial operations among the membership. This issue should be also closely related to the Fund's work on developing guidelines for government financial reporting.

On the issue of trade-offs between the pace of achieving macroeconomic objectives under the program and the need to support systemic bank restructuring, my views coincide with the position stated by my predecessor, Mr. Tulin, during the discussion in March 1996. As a rule, the independence of central banks in the task of ensuring price stability should not be subject to any trade-offs, and fiscal policy must bear the bulk of the burden of whatever government support may become necessary for the "centrally planned" (as the staff put it) bank restructuring exercise.

I can support early publication of the present staff papers in view of the general desirability of attracting wider attention of the public and policy-makers to the problems and lessons in bank restructuring around the world. Perhaps, such aspects that were highlighted at a recent seminar in the Fund on a related subject by Gerald Corrigan, former head of the Federal Reserve Bank of New York, should be emphasized somewhat stronger in the published text: policy makers must recognize that the banking sector must be profitable in order to be able to attract private capital, and that problems in the banking sector need to be addressed without delay because problem loans should be managed actively and professionally to reduce the amount of financial losses and limit the contagion effects of bank failures.

Mr. Borpujari said that the question of a constraint on Fund staff skills to address banking sector issues can be overstated. The Fund staff could, after all, develop expertise in new areas. The real issue was whether one wished the Fund to be involved in areas that went beyond the Fund's traditional mandate. His chair believed that it was important for the Fund to be selective in the type of issues it was involved in; thus, even if the Fund staff had the skills to work on certain issues, it was not necessary that the Fund be involved in them. He agreed with Mr. Donecker that the Fund should avoid going beyond its mandate, and also agreed with those Directors who stressed that bank supervision and related issues were primarily the responsibility of the national authorities. He shared Ms. Srejber's view that the Fund's traditional approach, namely, to ensure a stable macroeconomic environment and to address systemic bank problems on a case-by-case basis, should be followed. Last, on the augmented balance, it should be borne in mind that utilizing such a concept would add to the complexity of the analysis. Like Mr. Donecker and Mr. Waterman, his chair felt that further work on the concept was needed.

The Director of the Fiscal Affairs Department observed that several speakers considered that the budget should be the lender of last resort. The staff agreed that it was not always feasible to place the burden of stabilization on fiscal policy, as there might be political economy constraints in making the necessary fiscal adjustment. One had to compare the cost of fiscal adjustment with the cost of slightly higher inflation; while in most cases, one would prefer less inflation, there might be situations in which the cost of fiscal adjustment—either in terms of distortive taxes or cutting essential government spending—might be very high; in those circumstances, a slightly higher inflation might not be that deleterious.

It would not be appropriate to incorporate the augmented balance in the GFS-based measure of the fiscal balance, the Director considered. The GFS was a precise concept and included only the cash outlays for bank assistance in a single year. By contrast, the "augmented" balance incorporated noncash and quasi-fiscal operations on an accrual basis. The IMF Institute was in the process of abandoning the GFS and moving to a system that incorporated quasi-fiscal costs on an accrual basis. However, it would take some time for the new system to be in operation, and in the meantime, the staff was suggesting that the authorities take a best estimate of the fiscal costs of restructuring. The authorities would then have to determine how to finance those costs and over what time period to undertake the restructuring. Some Directors considered that the fiscal costs should not be borne in a single year, but should be spread out over a period. It was in that context that the medium-term fiscal scenario became a relevant issue.

The staff was preparing a paper on fiscal transparency, the Director of the Fiscal Affairs Department stated. While the need to respect the confidentiality of central banks' operations was important, that should not stand in the way of assessing the central banks' assistance for restructuring, and on that basis to gauge the fiscal costs of restructuring.

Ms. Lissakers commented that the direct fiscal cost of bank losses might in fact be the smallest portion of the cost to the economy of a banking crisis. In her view, postponing or stretching out the fiscal costs of restructuring could result in much higher costs to the economy; thus it was preferable to incur those costs right away, if necessary, by accommodating somewhat higher inflation.

The Director of the Monetary and Exchange Affairs Department stated that the Fund staff would discuss with its counterparts at the Bank the division of labor between the two institutions, and, on that basis, a short paper would be prepared for the Board's consideration. He would note that the area department staffs of the two institutions were cooperating and coordinating their activities on a daily basis. On banking sector issues, the staffs would continue to exchange views and advice, as well as share information on countries deemed by the staffs to be in need of greater attention. MAE would be discussing with the Bank staff banking system problems in those countries in which the Bank was, or expected to be, involved, with a view to delineating the specific responsibilities of the Fund and the Bank. Furthermore, while the staff was not suggesting that the Fund would be involved in the microeconomic aspects of bank restructuring, as some Directors had mentioned in their statements, the Fund staff would need to be aware of the microeconomic aspects of the restructuring.

There was a clear link, as Directors had pointed out, between the nonbank financial institutions and banks and the staff would endeavor, to the extent possible, to asses the situation of the nonbank institutions as well, the Director continued. In this context, he noted that considerable work was under way to harmonize regulations and standards for banks and for securities and insurance companies, at both the national and international levels.

On the question of whether the state-owned banks should be privatized, the staff was of the view that, if the management of those banks was sound, that is, if the public sector banks were operating as efficiently as private sector banks, there was no a priori reason to privatize them, the Director of the Monetary and Exchange Affairs Department considered. The only issue was the extent to which banks should be in the public sector domain—a decision that rested with the national authorities. Finally, on the risks involved in the Fund staff giving a "clean bill of health" to an individual banking sector, he would note that the staff was careful in its assessment of banking sectors, and recognized the risk of complacency on the part of national authorities, if the Fund gave a positive assessment.

Mr. Donecker remarked that the question of privatizing public sector banks was a philosophical one, reflecting choices made by national authorities. There were good reasons not to privatize public sector banks that were operating efficiently. For instance, the savings banks in Germany were sound and played an important role in the economy; thus there was no a priori reason to privatize them. At the same time, it was true that, to the extent that the capital of public sector banks was underwritten by the state, they were prone to undertake riskier activities than private banks. The issue of the staff giving a banking sector a "clean bill of health" was a difficult one; in particular the staff would have to be careful and exercise considerable prudence in sounding a warning on any member's banking system. Specifically, he wondered how widespread and serious a banking problem would have to be in order for the staff to deem it appropriate to sound a warning about the entire banking sector.

The Director of the Monetary and Exchange Affairs Department said that he hoped that the staff would not be expected to pass judgments on members' banking systems. The staff saw its role to be one of monitoring and advising the authorities about potential problems in the banking sector and discussing issues related to supervision and regulation.

The staff representative from the Monetary and Exchange Affairs Department observed that there had been substantial discussion internationally on ways to reflect the relative riskiness of assets in the prudential guidelines. The staff considered that it was not sufficient to observe the Basle Committee's 8 percent capital adequacy ratio; there was strong agreement in the Basle Committee that it would be preferable to go beyond that minimum ratio. The prudential minimum for the ratio should be based on the relative riskiness of a bank's portfolio and could vary from country to country and from bank to bank. However, formulating the appropriate ratio required a sophisticated accounting framework and good rules for loan classification and provisioning. If those rules were not in place, or if the loan provisioning were insufficient, capital would be overstated and the ratio would be meaningless. The Fund, the Bank, and regional groups of bank supervisors were discussing with the authorities the possibility of adapting prudential ratios to the varying circumstances in specific countries. They were also discussing the matter with the Basle Committee Secretariat.

The staff had not emphasized privatization in the paper because, it was difficult to privatize banks in the middle of systemic restructuring operations, because there were typically no buyers, the staff representative from the Monetary and Exchange Affairs Department noted. However, the staff did stress privatization in the context of a member's medium-term strategy. It was also trying to develop "best practices" for a framework of sound banking. In the regard, increased emphasis should be placed on the incentive structure and the role of market discipline, which would encourage the entry of private sector banks in the banking sector. That would also imply greater role for accounting firms, auditing firms, and credit rating agencies, with domestic and international operations. A number of large private companies had already begun to prepare themselves to be more involved in the banking sector; for instance, the six largest accounting firms were increasing their expertise on issues such as loan valuation, and the large rating agencies were becoming more interested in banking guidelines and principles in order to have better information on which to base their credit ratings.

Ms. Lissakers remarked that the Fund should be a more vocal advocate of privatization as a strategy to prevent banking crises from erupting. The issue was not one of private versus public ownership, but rather the degree of transparency in the relations between the financial intermediary and the use of financial services. Experience had shown that the "arms length" relationship and transparency in transactions were more likely to occur in private sector banks, provided interlocking relations between banks and industry were not pervasive in the private sector.

Mr. Donecker cautioned that, in assessing members' banking systems and in interacting with the private sector, the Fund should be careful not to be, or appear to be, a rating agency.

The Acting Chairman made the following summing up:

Executive Directors welcomed the opportunity to consider the relationship between systemic bank restructuring and macroeconomic policy, and commended the papers for providing a timely and very useful contribution to the understanding of a complex and increasingly important issue. While welcoming the papers' approach of reviewing the experiences of a large number of countries to distill "best practices," a few Directors cautioned that, in some cases, the experience with bank restructuring was too recent to allow firm conclusions to be drawn.

Directors broadly agreed with the main conclusions of the staff papers. They noted that a wide range of member countries had undertaken systemic bank restructuring programs in response to banking sector crisis or financial sector distress. As the costs of widespread banking problems could be very high, Directors stressed the need to contain those costs through effective resolution strategies. Recognizing the importance for the Fund of linkages between systemic bank restructuring and macroeconomic policy, as well as the potential for spillover effects in an environment of globalized financial markets, Directors considered that there was a need for the Fund to give greater attention to those issues and for further work, especially on the implications for Fund operations.

Directors generally agreed that the Fund was uniquely placed, through its activities related to surveillance, program design, and technical assistance, to play an important role in alerting members to weaknesses in their banking systems and their legal and regulatory regimes, and in encouraging and monitoring adherence to internationally set supervisory and prudential guidelines. The focus of that role should be on the macroeconomic implications of systemic bank restructuring strategies. The Fund should exercise caution in making an assessment of members' banking systems so as not to be, or appear to be, a "rating agency." It was also emphasized that responsibility for monitoring and implementation of banking standards and bank restructuring rested in the first instance with national authorities.

Directors stressed that the Fund should avoid duplicating the work of the World Bank and other international and regional organizations, and most Directors indicated that the World Bank and other multilateral financial organizations should take the lead in the microeconomic and operational aspects of bank restructuring. Directors looked forward to the active exploration of mechanisms for enhanced cooperation with the World Bank and other international organizations. I note the suggestions for a clear joint statement by the two institutions delineating their respective roles, and we will consider the feasibility of this, either through a joint statement by the Managing Director of the Fund and the President of the World Bank or by a joint paper. I note also the suggestion for more consultations with the private sector.

Directors agreed on the importance of early detection of systemic banking problems and the prompt implementation of comprehensive policies to address them in order to avoid substantial increases in their costs. In that context, it was observed that successful restructuring strategies, besides addressing macroeconomic and structural problems and their implications, should include both financial and operational restructuring of banks. Implementation of a successful restructuring strategy required strong political support, a clear institutional framework, and a thorough diagnosis.

Directors noted that country experiences showed that a variety of instruments were available to implement banking system restructuring policies. They agreed that the instruments chosen in individual country cases should ideally be cost effective and simple to implement, distribute losses equitably while minimizing the public sector burden, avoid generating future moral hazard problems, promote good governance, and be consistent with sound macroeconomic management. Directors also agreed on the importance of designating an agency with lead responsibility for bank restructuring, monitoring the process closely, applying firm exit policies, and putting in place appropriate asset management and loan-recovery policies. Directors emphasized the need to correct weaknesses of the legal and institutional framework, including banking supervision. Directors agreed that banks' tax obligations should not be arbitrarily reduced, but that the opportunity should be taken to reform inadequate tax treatment of loan losses and provisioning.

Directors noted the importance of building sound banking systems by promoting a competitive, open environment with a level playing field. In that context, some Directors urged that special attention should be given to the privatization of state-owned banks. Some also called for more liberal entry of foreign banks to enhance competition. Others recommended that, in the context of the transition economies, enterprise and banking sector restructuring could usefully be pursued in parallel.

Directors emphasized the need for an assessment of the macroeconomic implications of bank restructuring programs and their medium-term implications for debt sustainability. Ensuring consistency with macroeconomic stability, many Directors noted, often required substantial fiscal adjustment. Moreover, Directors underscored that any public sector financial assistance to banks should only be provided in conjunction with a comprehensive and credible restructuring program. Directors generally agreed that, for countries with major bank assistance operations, the proposed "augmented" fiscal balance, which incorporated the major quantifiable costs of bank assistance operations, would usefully complement standard fiscal measures and would facilitate comprehensive, transparent, and consistent recording of such operations, but cautioned that the "augmented" balance should not be used as a performance target. In view of the linkages between banking and nonbank financial institutions, the design of bank restructuring programs should also take into account the impact of bank restructuring on nonbank financial institutions so as to ensure macroeconomic stability.

Directors observed that systemic bank restructuring complicated the conduct of monetary policy because the effectiveness of particular monetary instruments could be reduced and because the information content of particular monetary and credit aggregates could become distorted. A number of Directors considered that those complications could necessitate more reliance on fiscal policy, but others wondered whether shifting the stabilization burden to fiscal policy was feasible in many cases. In addition, Directors noted that, while the central bank might need to extend substantial liquidity support to viable banks, it should not be drawn into providing solvency support or long-term financing of bank restructuring operations.

On the question of a trade-off between bank restructuring and the timetable for achieving macroeconomic objectives, some Directors agreed with the staff that, if the pursuit of tight macroeconomic policies exacerbated solvency problems and ultimately raised the overall cost of bank restructuring, the possibility of lengthening the timetable for achieving certain macroeconomic objectives should be considered. A number of other Directors, however, suggested that there might not be an inherent trade-off, unless liquidity was scarce or the capacity for fiscal adjustment was limited. They were of the view that bank restructuring was best undertaken in the context of a monetary policy geared to price stability. A tight overall policy stance, through its beneficial effects on confidence and interest rates, could lead to higher growth and better conditions for the banking sector, possibly even in the short run.

Directors supported publication of the staff papers after revision to take into account the Board discussion.

4. EXECUTIVE DIRECTOR

The Acting Chairman bade farewell to Mr. Calderón on the completion of his service as Alternate Executive Director for Brazil, Colombia, the Dominican Republic, Ecuador, Guyana, Haiti, Panama, Suriname, and Trinidad and Tobago.

APPROVAL: June 6, 1997

REINHARD H. MUNZBERG
Secretary