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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/85

10:00 a.m., August 22, 1997

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	S.M. Al-Turki
M.-A. Autheman	H. Paris, Temporary
T.A. Bernes	C.X. O'Loghlin
	W.-D. Donecker
E.R. Grilli	N. Coumbis
D.Z. Guti	
	W.K. Gruber, Temporary
	H. Kaufmann, Temporary
A. Kafka	H.F. O'Brien
W. Kiekens	J. Prader
K. Lissakers	M. Sobel, Temporary
A. Mirakhor	
A.V. Mozhin	M. Daïri
	B.M. Lvin, Temporary
G. O'Donnell	J. Shields
	M.A. Brooke, Temporary
A.S. Shaalan	Y.Y. Mohammed
	W.F. Abdelati, Temporary
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	
	C.M. Gonzalez, Temporary
	J. Guzmán-Calafell
	J.L. Pascual, Temporary
	Y.G. Yakusha
	L.B.J. van Geest, Temporary
K. Yao	A. Barro Chambrier
Y. Yoshimura	S. Fukushima, Temporary
Zamani, A.G.	S. Joyosumarto
Zhang Z.	Han M.
A.G. Zoccali	E.L. Zamalloa, Temporary

R.H. Munzberg, Secretary
A. Mountford, Acting Secretary
G.N. Walton, Assistant

Also Present
IBRD: J.L. Fiechter, Financial Sector Development Department; African Department: G.Z. El-Masry. European I Department: J.R. Artus, Deputy Director; Y. Horiguchi, Deputy Director; B. Arnason, G. Belanger, H.M. Flickenschild, A. Magnier. European II Department: O.P. Brekk, E. van der Mensbrugghe. External Relations Department: G.V. Bhatt. Legal Department: T.M.C. Asser. Monetary and Exchange Affairs Department: M. Guitián, Director; M.D. Knight, Deputy Director; R.K. Abrams, C.A. Enoch, A. Kanaya, C.-J. Lindgren, A.M. Leone, H. Mehran, G. Mitchell. Policy Development and Review Department: J.T. Boorman, Director; J. Ferrán, Deputy Director; T. Leddy, Deputy Director; D.J. Andrews, D. Burton, L.E. Psalida. Research Department: M. Mussa, Economic Counsellor and Director; M.M. Cassard. Secretary's Department: J.M. Boughton; P. Gotur. Treasurer's Department: D. Williams, Treasurer. Western Hemisphere Department: C. Cha. Office of the Managing Director: J.A. Quick, Personal Assistant; B.V. Christensen; Office of Budget and Planning: L.A. Wolfe, Director; Office of Internal Audit and Inspection: E. Brau, Director. Advisors to Executive Directors: L.J.F. Erasmus, K.M. Heinonen, A.R. Ismael, R. Kannan, M.F. Melhem, E. Rodriguez. Assistants to Executive Directors: J.G. Borpujari, M. Carlens, C.K. Duenwald, J.K. Honeyfield, J.P. Leijdekker, D.G. Loevinger, J. Mafararikwa, D. Merino, W. Merz, A.R. Palmason, L. Pinzani, V. Rigász, D. Saha, J. Salleh, O. Schmalzriedt, T.T. Schneider.

1. SWEDEN—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Sweden (SM/97/198, 8/1/97). They also had before them a background paper on selected issues in Sweden (SM/97/205, 8/7/97).

Ms. Srejber made the following statement:

At the outset, my authorities want to convey their appreciation to the staff for stimulating and useful discussions in Stockholm followed by a report of the highest caliber.

My authorities share the staff's assessment that macroeconomic conditions conducive to accelerating growth over the next two years appear to be in place. Real GDP growth is expected to increase from around 1 percent in 1996 to around 2 percent in 1997, and reach 3 percent in 1998. Preliminary statistics confirm accelerating growth; second quarter GDP growth increased by 2.3 percent from the corresponding period in 1996, up from 0.8 percent year-on-year in the first quarter.

The government has applied a fiscal consolidation program since 1995. The initial program included structural improvements in the order of 7.5 percent of GDP by 1998, and general government budget balance was targeted for the same year.

The program is reviewed biannually. The review in spring of 1996 indicated that the budget outcome in 1997 and 1998 would fall short of the target. Consequently, further measures to strengthen the public finances were taken, thus expanding the consolidation program to a total of 8 percent of GDP by 1998.

The biannual review this spring, however, showed that the deficit in general government finances was decreasing unexpectedly fast. Already in 1996 the deficit was 2.5 percent of GDP, an improvement of 8 percent of GDP since 1994. The deficit in 1997 will be around 2 percent, while, on unchanged policies, a surplus would have emerged in 1998.

Thus, there was fiscal scope for the measures proposed in the 1997 Spring Budget Bill, aimed at reducing unemployment, without compromising the budgetary policy target of balancing general government finances in 1998. My authorities emphasize that the measures do not reflect an easing of the government's commitment to sound public finances, because the budgetary target, and thus the fiscal stance for 1998, is retained. In contrast, allowing a surplus to emerge in 1998 would have meant—in the present economic climate—an inappropriate fiscal contraction.

To underline the authorities' commitment to prudent fiscal policy, a new medium-term budgetary policy goal was adopted: a general government surplus of 2 percent of GDP over the business cycle with intermediate targets of 0.5 percent of GDP in 1999 and 1.5 percent of GDP in 2000.

The staff expresses a concern that the fiscal scope identified by the government for 1998 and onwards led to new expenditure decisions rather than efforts to reduce the tax burden. However, the fiscal consolidation had resulted in a larger decrease than anticipated in local public consumption of health care, social services, and education, to the extent that the government felt obliged to prevent further cuts in the supply and quality of these services, as well as to prevent further job losses in the local public sector. Moreover, in the current environment of high unemployment, it is relevant that increased expenditure has a more immediate impact on the labor demand than the gradual beneficial effects of lower taxes.

My authorities share the staff's concern that pressures may evolve to use future cyclical surpluses to finance potential weakening of the structural fiscal balance. However, the strengthened budgetary control measures, with a set of three-year rolling expenditure limits for the public sector, a close monitoring of overruns of expenditure limits, and the new budgetary policy goals, will all contribute to secure continued improvement in public finances.

Monetary policy in 1996–97 was conducted against the background of a significant, albeit gradually shrinking, output gap and subdued inflationary expectations. The period was characterized by improved stability in the overall policy environment, promoted by the Riksbank's adoption of an inflation target in 1993, by the policies conducted under this framework in 1993–95, and by improvements in public sector finances.

Nonetheless, with some market unrest reappearing, particularly in the krona market, the Riksbank chose not to continue the successive repo rate cuts made during 1996 into 1997. The Riksbank maintains that economic fundamentals would have justified an appreciation of the krona at the time. Instead, the krona weakened by some 6–7 percent in nominal effective terms between October 1996 and last spring, fueled by international currency movements, and perhaps also by some residual uncertainty about the longer-term stability of the economy. In recent weeks, however, the krona has strengthened again.

The staff attaches some importance to the recent increase in the growth of M0. The Riksbank is keeping the developments under close review. The 12-monthly rate of growth of M0 now seems to have settled at around 5 percent, following two years of very low—at times even negative—growth. It is the view of the Riksbank that the higher growth of M0 should be seen as a natural consequence of the recovery of economic activity, rather than as a strong signal of rising inflationary pressure.

The Riksbank agrees with the staff that, for the time being, the monetary stance is well balanced. On average, inflation in 1997 is expected to be around 1 percent, close to the lower end of the band around the inflation target, and approach the target rate of 2 percent in 1998. The most recent information indicates some pickup in the consumer price index as well as in inflation expectations, confirming the Riksbank's forecast of a moderate upward trend in prices.

My authorities agree with the staff that developments in the labor market are of serious concern. The staff expresses a concern that measures taken by the government to reduce unemployment primarily focus on reducing labor supply through education and early retirement, and that too little is done to strengthen employment growth. It is the view of my authorities that the initiatives to expand education should promote a better match between the skills demanded in the labor market and the skills available in the labor force and thus, in the longer run, promote employment and growth. It should also be emphasized that the early retirement schemes announced in the 1997 Spring Budget Bill are only temporary and should be judged against the background of the very serious labor market situation.

The government monitors labor market developments closely. Further measures to reduce unemployment and increase employment in line with the five employment policy principles laid down by the government, and referred to in the staff report, are likely.

In my authorities' view, the persistence of unemployment could, to a considerable degree, be ascribed to poorly functioning wage formation, as it has consistently resulted in wage increases that are incompatible with reducing unemployment and maintaining price stability. The main responsibility for wage formation lies with the social partners, but the government has recently appointed a commission to examine, inter alia, the possibilities to strengthen mediation procedures in order to foster better practices.

To summarize, the policy mix is conducive to growth. The fiscal program is strong and monetary policy is sound, even if challenges remain ahead in the structural area, particularly with regard to the labor market.

Mr. Sivaraman made the following statement:

The Swedish authorities should be commended for the substantial progress made to eliminate the imbalances that emerged earlier this decade. There is no doubt that Sweden stands out as a model for all those countries struggling to cut their budget deficits. It is equally heartening to note that the inflation has been brought to record low level and these achievements have led to significant credibility gains. With the continuous decline in fiscal deficit, the public consumption is bound to give a negative contribution to growth over the period. Furthermore, the fiscal tightening also implies a weak disposable income, which would suppress the private consumption. However, it is encouraging to note that the private consumption is to pick up considerably in 1997/98.

The revenue and expenditure measures implemented under the June 1995 convergence program have led to a dramatic improvement in the general government finances. Although the improvement in the general government fiscal position was the result of revenue increases and expenditure reductions, in view of the output gap, expenditure reductions should be given more importance in the immediate period. We are encouraged to note that the macroeconomic conditions conducive to accelerating growth over the next two years appear to be in place. With the low inflation and interest rates, a strong competitiveness and higher asset prices should also contribute in giving a boost to domestic demand. Under these circumstances, the staff may indicate the plan of the authorities for any additional measures to give a boost to private consumption. The staff argues that fixed investment is at a fairly high level in historical terms. Furthermore, to what extent lower interest rates and firming of housing prices would contribute in augmenting fixed investment is not clear at this stage. The staff may also clarify this position.

While I sympathize with the cautious monetary policy of Riksbank, the authorities closely watch the yield curve, given the large debt position. In the field of exchange rate, it is important for the authorities to make every effort to encourage faster productivity gains than wage increases to ensure that the real equilibrium exchange rate is increased over the medium term. Given the present exchange rate scenario, what kind of interest rate policy is to be adopted in order to narrow the output gap is an interesting question. This issue assumes more importance, once the output gap could reach almost 7 percent of GDP, as mentioned in para 29.

At present, inflation targeting in Sweden has served well the purpose. The staff may indicate the likely exchange rate policy to be pursued if the current halt to the repo rate continues in the future. With reference to Swedish monetary policy, we welcome the recent agreement among the five political parties with a view to strengthen the Riksbank and also enhance its independence. We fully share the staff concern, in particular the maintenance of arrangements for exchange rate policy to be posted with the Riksbank, which would avoid blurring of institutional responsibilities.

With respect to European Economic and Monetary Union (EMU), we are not clear at this stage whether Riksbank is correct or the Finance Ministry officials, who are guided by the recommendation of Calmfors Commission. We are more in favor of accepting the Riksbank's views which recommends an early entry in the EMU in view of the reasons given in the selected issues paper.

Unemployment is a major problem and the developments in the labor market are of serious concern. While the labor market situation deteriorated further in 1996 with a significant increase in open unemployment, we noticed a silver lining that thus far in 1997 negotiated wage settlements point to somewhat lower increases of the order of 3 percent. However, we are yet to see concrete measures pertaining to labor market reform. The reduction of open unemployment, which is to be achieved primarily through expanded education and early retirement, would reduce the labor force rather than creating the employment. While we agree with the emphasis placed on education, we must equally recognize that this is not sufficient to generate employment and this is a long-term process. Without labor market reform, these actions cannot be sustained and could be inconsistent with the objective of maintaining price stability.

With this, we wish the authorities every success in their endeavors.

Mr. Yao made the following statement:

I commend the Swedish authorities for the remarkable progress made in the economic and financial management of their country over the past few years. The fiscal deficit has declined at a fast pace, inflation has been reduced to a very low level, and the banking crisis has been resolved. Despite these commendable achievements, I have some reservations about the optimism of the staff and the authorities regarding the medium-term prospects. My concerns stem from the fact that the macroeconomic improvement has not been matched by structural reforms. Sweden remains beset by high taxes, a low saving ratio, and growing unemployment. According to the staff report, government revenue to GDP is over 60 percent. This high level of taxes does not encourage the creation or the expansion of businesses, thus contributing to the high level of unemployment. The more fundamental question is whether the Swedish economy can remain competitive in an increasing globalized environment. As shown in table 14, page 104 in the selected issues paper, direct investment in Sweden is either low or negative. Is this an indication that Sweden is not benefiting from the integration of world capital markets? The staff's view on this question would be appreciated.

Another factor that could hinder the growth prospects of the Swedish economy is the low saving rate, which is expected to fall to 2.4 percent in 1998, from 5.4 percent in 1996. Since Sweden does not seem to be benefiting from foreign direct investment, future growth will have to come from borrowing. What will be the impact on the economy? The staff seems to be saying that the increase in asset value will lead to an increase in consumption, and thus to higher growth. However, this view seems to contradict the experience of other industrial countries, especially the U.S., where the increase in net asset value has not been associated with a major increase in consumption. Are there special factors in Sweden that make the staff think that consumer behavior would be different from that in the U.S?

Regarding unemployment, I share the staff view that reform of the labor market is essential for progress in job creation. In this regard, I am concerned about the strategy that the authorities are developing to address the issue—for example, government expenditure to create jobs will only have a short-term impact. What is clearly needed is the creation of an environment conducive to the expansion of the private sector, which has been the engine of growth in countries with low unemployment.

I am in broad agreement with the Swedish authorities' approach to monetary policy, which aims at inflation targeting, as that helps the authorities to achieve the objective of keeping inflation at a low level. I welcome in particular the agreement that will allow for a strengthening of independence and management of the Riksbank. This certainly is a major step in the right direction, and will improve the policy-making ability of the central bank, as well as improve further the credibility of these policies.

Overall, I agree that, to reap the full benefits of the stabilization effort, the Swedish authorities should implement strong structural measures that will reduce the share of the government in the economy and increase that of the private sector. The second approach will not only help to increase domestic saving, but will also help to attract foreign investment. This will appear to be the primary condition for ensuring a higher growth rate and contributing to the reduction of unemployment.

Finally, I would like to commend the Swedish authorities for their excellent record on the provision of external development assistance to the poorest developing countries.

Mr. O'Loghlin made the following statement:

I want to join with staff in noting that Swedish success in dealing with some of the legacies of the economic crisis of the early 1990s has been remarkable.

The banking crisis seems to have been well and truly overcome. Inflation has been kept at a very low level. The current account has been brought from a sustained deficit into continuing surplus. More recently, the fiscal balance has improved remarkably. To reduce a deficit by more than 5 percentage points of GDP in one year would be commendable at any time. To do so in the circumstances prevailing in 1996—when the slow pace of economic growth push unemployment upward and offered little offsetting revenue buoyancy, and before debt-service outlays began to benefit to any significant extent from declining interest rates—was a particularly notable achievement.

At the same time, however, I wonder whether this turnaround will be translated into a sustainable improved performance or if, instead, it marks no more than a return to the lackluster performance of recent decades.

It may seem odd to talk about a lackluster performance when referring to a country where unemployment has been as low, and income as high, as in Sweden. But how else are we to interpret the fact that per capita purchasing power in Sweden, which was 15 percent above the OECD average in 1970, was 7 percent below the OECD average in 1994? Growth in per capita purchasing power has been virtually 1 percent per annum lower in Sweden than elsewhere in the OECD over the past few decades.

I wonder if staff would agree with me that this relative decline reflects, in particular, a sustained slower growth in productivity in Sweden than elsewhere in the OECD; and also, but very much a secondary factor, the divergence between trends in labor force participation rates in Sweden and across the OECD, with participation tending upwards elsewhere but somewhat lower now, in Sweden, than through the 1970s?

If these are the reasons underlying the relative decline in Swedish living standards, then one must ask if elements of policy there are supporting these adverse trends.

As to productivity growth, it seems arguable that egalitarianism, by limiting wage differentials, largely removes the incentive to acquire or deepen skills and personal capacity. At the same time, investment and enterprise can scarcely be facilitated by the relatively high tax burden that has been characteristic of Sweden; that burden, one suspects, is part of the reason why OECD reports that returns to capital in Sweden's business sector have been substantially below average returns across the OECD for decades. Both considerations support the staff concern about using unanticipated budgetary gains to support new expenditures rather than to dampen the current high tax burden.

Looking to the question of trends in labor force participation, we can only hope that the recent steps allowing earlier retirement will truly prove temporary. I have doubts. Unless employment grows significantly and rapidly, there will not be opportunity—without pain—to reverse this initiative. Given the outlook for economic and employment growth, such opportunity does not seem likely for years rather than months, by which time the risk is that this "earlier retirement" will have become embedded in the Swedish psyche.

Whatever else the admirable egalitarian ethic of Sweden has delivered, it is difficult to believe that it has not contributed to this relative decline in Swedish living standards; and even more difficult to believe that this ethic can survive if—as seems inevitable without policy change—living standards there fall more appreciably below those obtaining across the range of developed economies. With this in mind, I also join with the staff in their concern that recent policy initiatives do not seem wholly in accord with the five "employment principles"—in particular, that they do not seem to be directed in any significant way to improving the climate for growth in private sector employment.

In sum, while the Swedish authorities are following admirable macroeconomic policies for the shorter term, I wonder if they ought not to be looking more to this key requirement for longer-term sustainability of their social system.

Mr. Al-Tuwaijri made the following statement:

The Swedish authorities are to be congratulated on the remarkable success of their economic management on several fronts. A fiscal turnaround equivalent to over 10 percent of GDP in just three years is indeed an outstanding achievement. Also impressive are the reduction of inflation to record lows, the rapid resolution of the banking crisis, and the steady improvement in the external payments position. The resulting increased market confidence is already reflected in the recent exchange rate appreciation and the narrowing of interest rate differentials with Germany.

The authorities are, however, rightly concerned about the stubborn unemployment problem. Here, prospects have improved in view of the anticipated pick up in growth. With inflation well-contained and the output gap still sizable, the reported firming in consumer durables and housing demand is indeed welcome. Prospects are also favorable that the upturn will be sustained in the context of further improvements in the macroeconomic fundamentals.

On the fiscal front, the continued priority for budgetary balance next year and surplus thereafter is appropriate. This bodes well for the projected decline of the public debt ratio on the Maastricht definition to 68 percent by 2000. The resulting drag on domestic demand, however, will be less pronounced than the negative fiscal impact in 1995–96. Here, I share Ms. Srejber's reasoning for the spending increases that have been allowed in the context of a reaffirmation of the fiscal consolidation effort. In that connection, the new medium-term budgetary policy framework and strengthening of spending controls are reassuring.

Growth prospects have benefited from the monetary easing that the fiscal consolidation has facilitated. Indeed, as the staff points out, a case can be made for a further easing at this point. However, given the mixed monetary and exchange rate signals, I share the consensus view that it is best at this stage to keep the monetary stance unchanged.

However, growth alone clearly cannot bring about the 50 percent drop in open unemployment that the authorities have adopted as a central goal for the year 2000. Here, upgrading of labor skills and incentives for both increased labor mobility and increased job creation are crucial. The authorities' emphasis on expansion of education is therefore appropriate. The trimming of payroll taxes for small enterprises and appointment of a commission on the wage bargaining process are also moves in the right direction. I share the staff's emphasis in this connection on the importance of a remuneration system better equipped for differentiation of compensations by skill and productivity.

With these remarks, I wish the authorities further success.

Mr. Kiekens made the following statement:

I would like to congratulate the Swedish authorities for the success of their economic policies in recent years. The dramatic fiscal consolidation and the success in lowering inflation have been rewarded by increased credibility, a stronger currency, and lower interest rates. I agree with the staff that macroeconomic conditions should now lead to higher growth in the coming years. The main challenge for the authorities is now to deal with the high unemployment rate by speeding up structural reforms.

The fiscal consolidation program has achieved impressive results. The general government deficit of more than 10 percent of GDP has been virtually eliminated in only three years, which is remarkable by any standard. If the original policies had not changed, the budget would have moved into surplus in 1998, exceeding the target of a balanced budget. I learn from Ms. Srejber's written statement and the staff report that the authorities did not find this outcome attractive in the present economic climate, and has decided to avoid the surplus by increasing spending aimed at lowering unemployment.

Though we might debate the merits of this approach on economic grounds, political reality seems to put the government in a precarious situation. Public frustration runs high as Sweden enters its fifth year of historically high unemployment and third year of fiscal austerity. This threatens to erode public support for the government's reform program in the year preceding general elections. The government's desire to halve recorded unemployment by the year 2000 may have made short-term solutions based on budgetary spending politically more attractive than longer-term solutions based on structural reforms. Although I would not deny that some of these new spending measures can be justified, others, such as raising the replacement ratio for unemployment benefits, or reversing the decision to limit the duration of unemployment benefits, are obviously counterproductive.

The Swedish government stresses that the proposed measures do not affect its commitment to sound public finances. Although this sounds good, the markets do not yet seem convinced. Even if there is not any easing of the government's commitment to sound public finances, the staff presents at least two good reasons to strengthen that commitment: first, the continuing vulnerability of the budget to the business cycle, and second, the danger that governments will spend the additional revenues produced during cyclic upturns, thereby weakening the structural fiscal position. This outcome is already visible as a result of the Spring 1997 Budget Law. To effectively address the causes of the budget's vulnerability to the business cycle, the staff rightly advises embarking on a medium-term effort to reduce both expenditures and the level of taxation. I agree with the staff's analysis and advice in this respect.

The inflation targeting system adopted in 1993 has served Sweden well. It has successfully guided monetary policy to achieve low inflation, narrower interest rate differentials with Germany, and appreciation of the exchange rate. There is now room for some further monetary easing, especially if domestic demand remains sluggish, or if the krona becomes stronger. However, this window of opportunity may soon close, since the approach of EMU risks provoking a precautionary monetary tightening across the whole EU sometime in the next year. For the moment, however, monetary policy can do little more to promote employment and growth, since the key to reducing unemployment is a comprehensive structural reform of the labor market and a moderation of wage growth.

The recent parliamentary consensus on strengthening the independence and the management of the central bank is a very positive development. The political and legal ratification of price stability as the primary goal of monetary policy will further strengthen the credibility of Sweden's monetary policy.

Finally, I especially welcome the Prime Minister's announcement yesterday that he will ask, during the upcoming caucus of his political party, to preserve his political room for maneuver with respect to Sweden's participation in EMU. If Sweden can successfully implement the structural reform of its labor markets, the benefits of entry into EMU will be assured. This brings me to the last point of my intervention.

It is widely accepted that the cause of the high structural unemployment that plagues continental Europe is the rigidity of the labor markets. This clearly applies in the case of Sweden. Rigid wage formation, excessive legal protection of employment, the high taxation of labor income, and an overgenerous social security system, all are present in Sweden's labor market, and all frustrate its flexible functioning. Since the public sector no longer creates new employment, employment creation must now depend wholly on the resilience of the private sector, which for the last three decades has failed, on the whole, to create enough new jobs to offset jobs lost to economic restructuring. This cannot happen until serious labor market reforms are under way. In this connection, the new World Economic Outlook study points out that a major reason for the failure of labor market reform efforts in most EU countries has been the piecemeal reform approach. Sweden should therefore embark on a comprehensive reform of the policies and institutions affecting the functioning of its labor market. To make this possible, a broad public consensus will have to be built on the need to reform. Government must do more to educate both the public and the trade unions about the unsustainability of Sweden's traditional welfare system and the appropriate economic role of the state.

In the near term, it is essential to constrain wage increases during the upcoming round of new wage settlements. Without constraint, higher labor costs will translate into price increases; labor shedding will intensify; and low employment growth will reduce consumer spending and undermine the fiscal position.

Mr. Coumbis made the following statement:

I agree with the staff that an improvement in the fiscal position in Sweden of over 10 percentage points of GDP in a period of only three years had few parallels. Moreover, the successful implementation of inflation targeting by the central bank brought inflation down to less than 1 percent in 1996, and long-term interest rate differentials with Germany were narrowed to around 1 percentage point at the end of 1996. Therefore, I agree with the staff that all the conditions for further growth in 1997 are there.

Since I am in broad agreement with the staff appraisal and policy recommendations, I will limit my intervention to the areas of fiscal policy in 1997 and the unemployment problems.

Concerning fiscal policies, there are some differences in opinion between the staff and the authorities with respect to policies that should be followed in 1997 and beyond. The authorities indicated that they will maintain their objective of a balanced budget in 1998 and that for the medium term they will set a target of a fiscal surplus of 2 percent of GDP over the business cycle. However, the authorities, in order to face the persistent serious unemployment problem, have decided to use the additional resources from the overperformance of the budget to lower unemployment. The staff, on the other hand, had different views about the proper use of the additional resources. Although I have great sympathy with the views of the authorities, I agree with the staff that the additional resources should be used to decrease government expenditure. Previous experience in Sweden has indicated the high cyclical sensitivity of both expenditure and revenue. Moreover, both the level of expenditure and revenue and the level of general government debt are too high with respect to GDP. Therefore, the staff's argument that a much larger surplus than 2 percent is needed at the top of the cycle in order to have an average surplus of 2 percent seems reasonable. It is interesting to note that, according to simulations prepared by the staff, with a budget surplus targeted at 1.25 by the year 2000 the probability that the debt to GDP ratio will not fall below 75 percent by the year 2000 is very small. The probability increases very rapidly, however, if, by the year 2000, a deficit is targeted at, say, 1½ percent. It is necessary, therefore, taking into account the cyclical sensitivity of public finances to target large budget surpluses in order to secure a quick decrease of public debt.

The staff, moreover, suggests a medium-term program of lowering expenditures, which will allow taxes to be reduced. This policy would address some of the root causes of the vulnerability of government finances in the cycle.

The high unemployment rate in Sweden is a very serious problem. From a 4.3 percent unemployment rate in 1990, it reached 12.3 percent in 1993, and it remained stagnant since then despite a growth rate of the economy close to 8 percent during 1993–1996. The very interesting study of the Swedish labor market in the "Selected Issues" provides useful insight about the characteristics of the unemployment problem in Sweden, about the reasons of the sudden increase in unemployment in the 1990s, about the size of the NAIRU, and about the reasons for the differences in the rates of unemployment between Sweden and other European countries. Its basic conclusion was that the rapid rise in unemployment in the early 1990s in Sweden was the result of an inter-play of cyclical and structural factors. I also consider very interesting its findings that all the employment generation in Sweden in the 1970s and 1980s took place in the public sector; that the generous system of unemployment insurance, as well as the restrictive job protection regime did not contribute to the rise of unemployment; that during the period that unemployment exploded tax wedges were being narrowed; and that the average skill level required to fill announced vacancies has risen.

However, we can reasonably assume that all these factors contributed to the persistence of high unemployment during the period 1993–96, despite satisfactory GDP growth. I believe that the authorities' objective to halve unemployment by the year 2000 is too ambitious. As for the measures proposed to attain that objective, I think that some of them are in the right direction (such as the measure to expand education), while others can provide only temporary relief. In evaluating these measures, we should not forget the budget constraints indicated by the staff. Finally, I share the staff's view that their measures do not include reform proposals that would contribute to a substantial increase of employment in the private sector. Most of them simply lower measured unemployment.

I was surprised to read in the staff report that in the government's projection for the year 2000 open unemployment—including those enrolled in special education programs—accounts for more than 12 percent of the labor force, indicating no change from the present total rate of unemployment. The government's program includes funds that will be allocated to local authorities to promote employment. Moreover, I expected the measures for expanding adult education to increase the average skill level of the unemployed and thus to fill, to a certain extent, existing vacancies. I was expecting the measures to be temporary, providing relief to a number of workers.

The staff suggested to the authorities the well-known measures that would improve the supply of labor and stimulate the demand for labor, in other words measures that would make the labor market more flexible. The authorities indicated that political realities and social sensitivities did not permit them to take these measures now. Although I recognize that increased flexibility in the labor market is a necessary condition to reduce unemployment in the medium term by increasing employment in the private sector, I understand completely the difficulties the authorities are facing in this area, since in my country we have more or less the same problems. I believe that in order for the measures suggested by the staff to be successfully adopted and implemented, a broad consensus is necessary. In the case of the Netherlands, for example, it is clear that the trade unions understood the need for structural reforms in the labor market, and the measures were successfully applied. In other European countries, however, it seems that more time will be needed in order to attain a broad consensus for reforms in that area.

Before finishing, I would like to congratulate the authorities on the new law for the central bank, accepted by all parties, which will enhance the Bank's independence. This law, in addition to strengthening markets' confidence in Sweden's commitment to low inflation, will strengthen the implementation of monetary and credit policy during the period Sweden remains outside Economic and Monetary Union.

Ms. van Geest made the following statement:

One cannot but congratulate Sweden on its impressive success in the fiscal area. And ambitions for the future do not seem modest either. It is therefore with a certain trepidation that I comment on Swedish budgetary policy. The targeted surplus of 2 percent of GDP on average will enable Sweden to eliminate net general government debt by 2010 and this is obviously commendable, as it will help to face an aging population. However, the question arises whether this is sufficient to tackle the problem. In this respect, I was struck by a PPAA by Mr. Kopits of the beginning of this year, which set the unfunded pension liabilities of Sweden at 132 percent of GDP, which even starting from zero seems steep. On top of that, an aging population is associated with higher health costs. In other words, has Sweden tackled the aging issue, or are additional measures—pension reform or otherwise—required? In this respect, I would also like to join Mr. O'Loghlin in his comments on early retirement schemes. Experience in the Netherlands shows that even if they are introduced on a temporary basis, they are difficult to tighten, let alone to abolish.

Secondly, I noted that Sweden has adopted a fiscal framework with expenditure ceilings (which closely resembles the Dutch system). This would suggest that cyclical developments would only be addressed through the automatic stabilizers. I was therefore somewhat surprised to see that the authorities also wish to be able to pursue an active fiscal policy during economic downturns, especially since the automatic stabilizers are impressive indeed in Sweden due to the very high revenue burden. For all the well-known reasons, we would caution the authorities in this area.

I would agree with staff that Sweden seems to rely a bit too much on labor market programs for the solution of its unemployment problems. In the end, it boils down to creating new jobs. This would require a more moderate wage development than has taken place until now, especially as wage settlements in the more profitable export sector spill over into the sheltered ones. Moreover, especially in an egalitarian society like Sweden, wage moderation may provide a second-best instrument to ensure that wages at the lower end of the labor market gradually become more in line with productivity. While labor market programs have their uses in getting people the necessary skills and experience to enter or reenter the labor market, there is a limit to that. Now obviously one cannot dictate moderate wage developments, but the government can create conditions conducive to that. It can provide tax relief to cushion the effect of wage moderation on real disposable income. Sweden has the budgetary room to do so and this may prove a more worthy cause than the presently envisaged labor market programs. In view of the exceptionally high level of revenues, it is also bound to improve the functioning of the labor market as such. The effects of tax relief on employment can be quite substantial, if the calculations by the Swedish employers' organization are anything to go by. Wage moderation in the Netherlands is not a miracle. Tax relief and high unemployment figures created the environment in which union members were able to accept wage moderation.

In addition to wage moderation, more fundamental steps have to be taken reforming the labor market. I fully agree with staff's recommendations in this regard. The Dutch success has only come about because it was a comprehensive, not a piecemeal, strategy.

Finally, in reaction to Mr. Coumbis statement on the Dutch consensus, I would like to point out that some elements of the strategy were contentious in the beginning, most notably those in the area of labor market reforms. However, a consensus has grown over time, especially as the efforts of the broad strategy bore fruit. Waiting until a full consensus emerges may, therefore, not always be the best strategy.

Mr. Mirakhor observed that the staff papers had compared the labor markets in the Netherlands and Sweden, and it seemed that the staff believed that the Netherlands labor market structure might be a good model for Sweden to follow. He wondered how the initial conditions in the Netherlands before the adoption of labor market policies—and the emergence of the Dutch consensus—compared with current conditions in Sweden, especially in light of structural policies, including tax and competition policies.

Ms. van Geest replied that before the Netherlands had embarked on its adjustment strategy, there had been two major problems. One was a very bad fiscal situation, and the other was high unemployment. At the beginning of the 1980s, the authorities had embarked on a double-edged strategy to address both problems, having realized that the policies that had been implemented in the preceding six or seven years were not reaching their objectives. The root of the unemployment problem in the Netherlands was the misalignment of wages with productivity. That had led to major labor shedding and highly capital-intensive production. For that reason steps taken by the authorities to moderate wages had been successful in reducing unemployment. At the same time, it needed to be borne in mind that that experience might not be easily applicable to other economies. She understood that wages in Sweden, especially in the nonexport sector, might be slightly out of line with productivity.

Another reason for the success of the Netherlands authorities in reducing unemployment had been the relatively generous nature of the labor market programs, Mrs. van Geest pointed out. That had helped in the process of convincing the labor unions of the necessity of wage moderation, which in turn had slowly but surely stopped the shedding of labor, and had later led to the creation of new jobs. Those new jobs had helped facilitate the fiscal adjustment, through a reduction in unemployment benefits, which were a direct budgetary outlay. The authorities had then had to tighten some of the labor market programs, especially the benefit programs, because from the budgetary perspective there had really been no alternative. That tightening had been unpopular, but it had brought the needed fiscal relief and improved the labor market.

Competition policy was a relatively new fashion in the Netherlands, Mrs. van Geest concluded.

Mr. Zhang made the following statement:

> At the outset, I would like to thank the staff for the informative and candid reports. It is encouraging to note that the Swedish economy has made tremendous progress in recent years, especially on the fiscal consolidation front. Obviously, Sweden's better economic performance has benefited from the strong structural reform and the earlier achievement of the Maastricht fiscal criteria than other major European countries. However, the persistently high and rising unemployment is still a cause of concern as it could give rise to the renewed fiscal difficulties and caution should be exercised against addressing unemployment through a relaxation of the fiscal stance. I share the views of the staff appraisal and will make a few remarks in the fiscal, monetary, and structural areas.
>
> With regard to fiscal performance, the authorities should be commended for their ambitious fiscal target in the medium term and their resolute efforts in front-loading the strong fiscal consolidation program, which mainly contributed to the faster improvement in the fiscal picture. It is worthwhile noting that the stronger expenditure-reducing, rather than the revenue-enhancing, measures dominated the whole course of fiscal consolidation as illustrated by Table 4 on page 17 of the RED. The success of

this experience should be maintained in the authorities' future fiscal program. Notwithstanding these achievements, I share the staff concern about the less favorable developments, particularly from the following considerations. First, at the time of the economic cyclical downturn it may lead to a more serious adverse impact on the fiscal account given the high fiscal cyclical sensitivity of Sweden's public finances. Second, the persistently high unemployment will increase the burden to fiscal policy. Third, given the already very high tax ratio, it is very difficult for the authorities to intensify the revenue-enhancing measures. Fourth, given Sweden's still high public debt level (78 percent of GDP in 1996 according to the Maastricht definition on page 23 of the staff report), the high external debt level of 42 percent of GDP, and the prospective ageing population problems, it is essential that a fiscal surplus be accrued to address these problems. With this being said, I note from Ms. Srejber's helpful statement that the new expenditure decision by the government is mainly driven by the concern of burden to local government. In this connection, I observe that the local government deficit increased from 0.2 percent of GDP in 1995 to 0.3 percent in 1996. Therefore, I would like to hear from the staff the evolution of the local fiscal account in the course of fiscal consolidation and what level of local fiscal balance is appropriate in the medium term?

Furthermore, I would like to echo the staff view that the medium-term fiscal strategy should aim at reducing the high cyclical sensitivity of government finances. Therefore, reducing the heavy tax burden and the high level of expenditure will not only strengthen the health of public finance but also provide a favorable environment for job growth.

On monetary policy, the Riksbank's skillful conduct of monetary policy in line with its inflation targeting framework is commendable. It is particularly encouraging that the new central bank law will enhance the independence of the Riksbank and enable it to adhere to the price stability objective. At the present juncture, it is important to monitor closely the inflation pressures given the economic upswing.

On structural policies, I agree with the authorities that reducing unemployment should be a priority. However, such effort should be made through more labor market reform rather than through increasing expenditures. Sweden's persistently high unemployment and the lack of in depth labor market reform are of grave concern. I fully understand that in the strong egalitarian tradition, the room for maneuver is very limited for the critical part of labor market reform measures, such as increasing wage differentiation, lowering replacement ratios, and reducing unemployment protections and labor costs seems politically sensitive and unacceptable in the Swedish situation. It takes time for social partners to reach a consensus, particularly given the present comfortable fiscal situation. However, without these essential elements, it is difficult to make progress in labor market reform. The recent experience of the Netherlands and Denmark to benefit from deep labor market reform shows that high welfare countries can also achieve the social consensus and tackle unemployment problems effectively. Hopefully, this positive experience can be drawn in Sweden in the near future. In the meantime, the authorities' five-point labor market program seems practical and the authorities are encouraged to use the available budgetary resources to reduce the tax wedges.

I fully share the staff's view that the authorities should be commended for their traditional official development assistance and are encouraged to restore it to its earlier level in relation to GDP.

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

Mr. Donecker made the following statement:

I broadly agree with the staff appraisal and the thrust of the staff's recommendations.

It is indeed remarkable and impressive how Sweden has overcome the severe economic crisis of the early 1990s. The authorities succeeded in achieving a surprisingly sharp decline in public deficits, lowering inflation to historically low levels, restoring the functioning of the banking system, and regaining the trust of the financial markets. The short-term economic prospects are favorable. We particularly welcome the authorities' intentions and actions to improve the autonomy of the central bank and to set price stability as the main economic target. The only major and serious economic problem that remains is persistent high unemployment, as already mentioned by other speakers.

As regards fiscal policy, expenditure and revenue ratios to GDP remain relatively high, indicating a particular cyclical vulnerability of the government's finances. I should like to encourage the authorities, therefore, to reflect further on the staff's respective recommendations that are focused on lowering structural expenditures and taxes.

The stance of monetary policy seems to be well balanced, as noted by the staff. However, in light of the projected rise in inflation, the acceleration of narrow money, the high level of wage increases, and the narrowing of the output gap, the central bank will be well advised to monitor closely developments in the next months to reach a timely judgment on the need for monetary tightening. The inflation target range—between 1 and 3 percent—could be somewhat more ambitious in view of the good fundamentals; why not a range between 1 and 2 percent?

I fully agree with the staff's assessment that the efforts to reduce current unemployment should be more focused on structural improvements in the labor market, such as increasing wage differentiation and shortening the duration of unemployment benefits. I agree with most of what the staff and other speakers, in particular Mr. Kiekens and Mrs. van Geest, have said on the subject of unemployment, being well aware that most European states and other countries need to do more in this area.

Mr. Pascual made the following statement:

Once again, we have today before us a well-written set of papers to analyze a European economy undergoing a fiscal consolidation process. And, again, we have the opportunity to draw useful conclusions to apply in other European countries. We can see how a well-balanced set of measures can help stabilize a country and solve critical problems. However, we can also draw some conclusions about situations to avoid in the future. A too generous welfare system can generate serious imbalances in the economy. The sooner they are corrected, the lower the cost for the economy.

All in all, the Swedish authorities should be commended for the economic policy measures applied, which—even without external anchors—have reduced the fiscal deficit bringing down inflation and widening the external surplus. In addition, a critical issue—as it is the banking crisis—has been resolved positively.

However, there are no reasons for complacency. Economic growth has weakened because of the true negative fiscal impulse and unemployment continues to rise, although specific programs have been focused on this particularly unpleasant issue. Moreover, the Swedish fiscal position remains relatively vulnerable to activity shifts and its high external net debt makes the country vulnerable to depreciation in the exchange rate.

There are, then, two questions that cast some doubts about the economic future of Sweden: public sector and labor market.

Let me say before I address both questions that I see with most sympathy the egalitarian consensus that appears to be in Sweden. For most of us, for the last two or three decades, this country has been a model to follow. However, this ideal model has to be changed to fit the new economic realities. In fact, in both cases, the rigidities that this kind of model tends to impose on the economy impair its sustainability.

Fiscal consolidation in Sweden has been strong, and the results even better than envisaged. Moreover, the authorities' medium-term target seems appropriate. However, the underlying structure through which they want to achieve it does not seem to be the best. In fact, I tend to share the staff's point of view. The most part of the consolidation process has relied on revenues, and cyclical sensitivity of both revenue and expenditure remains high. Therefore, new efforts have to be made to ensure the long-term sustainability of the system.

This leads us to the second challenge: labor market reform. In fact, a great deal of the fiscal adjustment depends on the ability of the Swedish authorities to streamline social programs.

Economic growth during the last three years has not been able to generate/create employment. We can find several reasons for that. First, expenditure cuts have stopped public sector hiring. Second, the private sector has not found incentives for employment. On the contrary, some tax increases have evidenced the fiscal wedge on labor, while welfare schemes have been discouraging job-searching. Here, again, the excessively protective Swedish system hampers efficiency and growth. Moreover, I strongly believe that the most egalitarian system is one that allows most people to work. The experience of the Netherlands shows this. In this light, I would recommend the authorities to follow the staff suggestions on measures to increase both demand and supply of labor. Otherwise, the entire welfare system runs the risk of breaking down. I am sure the Swedish authorities will find the way to accommodate this kind of measure within the social and political consensus that reigns in their country.

I wish them the best of luck in this task.

Mr. Kaufmann made the following statement:

The turnaround of the Swedish economy after the severe recession at the beginning of the 1990s, with a huge budget deficit, double digit inflation and destabilizing banking sector trouble, has indeed been remarkable. The authorities' strict and credible economic policy stance has allowed interest rates to decline sharply while supporting the appreciation of the krona after its abrupt fall following the delinking from the ECU. On the domestic side, the necessary fiscal consolidation has depressed domestic demand while private consumption and business investment have made a positive contribution to overall growth. The improvement of public finances has been accompanied by a reduction of private savings, indicating growing consumer confidence. The signs are good that Sweden will finally be able to collect the longer term benefits of its anti-inflationary policies and fiscal adjustment process.

As concerns fiscal policy, the government deserves praise for its continued implementation of the 1995 convergence program, which has led to a much faster-than-expected fall in the budget deficit. It is interesting to note that the additional deficit reduction has come about largely through lower than anticipated government spending for consumption and investment. This is an indication that the improvement in the budget balance indeed represents underlying changes in entitlement and spending patterns. On the other hand, as the expenditure-to-GDP ratio has not yet declined below its 1990 level, this indicates the need for further expenditure cuts. Important elements for further improving the Swedish finances are a continued examination of social benefits, including the level and duration of unemployment pay, as well as tackling the problem of future pension liabilities.

The economic environment for pressing ahead with such sensitive reform issues appears to be favorable. With a budget deficit of 2.5 percent of GDP in 1996, Sweden is one of the few European countries already meeting the Maastricht deficit criterion. There is no reason to question the official budget forecasts, which expect a balanced budget by 1998 and a 2 percent surplus over the business cycle. This surplus as well as the low level of interest rates will allow a gradual reduction of the debt burden, extending the government's fiscal leg room in the future.

Given tight fiscal policy and an appreciating currency, the Riksbank has been able to loosen its monetary policy stance without losing sight of its inflation target of 2 percent. Although the authority's estimations of the output gap give only a tentative indication of capacity utilization, inflation is unlikely to be a problem in the near future. No changes in the present monetary stance seem to be required. We welcome the decision by the authorities for a new central bank statute that will give the Riksbank more independence and lay down price stability as the primary objective of monetary policy. This strengthening of monetary policy credibility will be particularly stability-enhancing with a view to EMU.

Given its favorable macroeconomic environment, Sweden's decision not to join the first round of participants of EMU will have few immediate consequences. It does not, however, reduce the pressure for the government to pursue fiscal adjustment and labor market reforms. These reforms are called for with a view to increase competitiveness, enhance domestic wage and price flexibility and strengthen Sweden's standing on the international financial markets. The stable relation of the krona to the euro will be crucial to avoid possibly severe economic disturbances. Market access for Swedish firms in Europe is a similarly important factor for judging the effects of EMU on Sweden.

We agree with the staff that solving the problems on the labor market is most pressing. Sweden has suffered from a sharp and persistent rise in unemployment since 1991, pointing toward not just cyclical but structural imbalances on the labor market. Further wage moderation will be necessary in order to limit job losses associated with the restructuring process and the need to be cost-competitive internationally. As part of the government's recent five-point plan for work and education we judge the emphasis on training especially worthy. These additional expenditures are likely to pay dividends later on. More immediately, tax reductions for SME's promise to stimulate the business climate and foster upstart firms. In order to trigger the desired creation of employment, it is however essential to reduce the regulatory requirements for such entrepreneurial activities.

The notable lack of job creation in the private sector points to the need to lessen costs or disincentives that hold back labor demand. In this respect, the experience by other European countries with similar labor market characteristics, most notably the Netherlands, may offer some lessons. Rather than undermining the traditional Swedish approach, which accords considerable social responsibility to the state, higher flexibility of working hours and wages may in fact be indispensable to put these social services on a stable long-term footing. Lastly, we concur with the staff that lowering payroll and income taxes, thus narrowing the tax wedge, which impedes job creation, is another "must" of rapid labor market reform in Sweden.

Ms. Abdelati made the following statement:

I would first like to commend the quality of the analysis, as well as the choice of issues, in the staff report. The selected topics are not only relevant to

Sweden, but also to a number of other countries. In particular, we note the sections on the costs and benefits of EMU, the use of the exchange rate as shock absorber, and the European employment challenge.

In 1997, the Swedish economy continued on its path of recovery under the prudent fiscal and monetary policies pursued by the authorities. The fiscal deficit was reduced by nearly 10 percentage points of GDP over a relatively short time span. Inflation is at record lows with the successful implementation of the Riksbank inflation-targeting framework and the growth of public debt, which had doubled in the early nineties, has been arrested. As noted by other speakers, as a result of this, and the successful resolution of the banking crisis of the early nineties, policy credibility was enhanced leading to the recent appreciation of the krona and near elimination of interest rate differentials with Germany. Caution will be needed in the coming years so as not to jeopardize the recovery under way.

By all accounts, fiscal consolidation has been remarkable. Especially noteworthy is the expenditure reduction of over 8 percent from 1993–97 including through cuts in transfers to households. I would like to underscore here that, unlike several other European countries, the fiscal adjustment in Sweden did not stem mostly from Eurostat accounting measures. In addition to this remarkable achievement, the authorities are targeting a further reduction in current expenditures amounting to 5 percent of GDP in spite of the additional, mostly appropriate and welcome, outlays for the education and work program. These expenditure reductions will permit further tax reductions during the same period and a significant improvement in the ratio of public debt to GDP. While we commend these objectives, we wonder if such measures are not overambitious, and would caution that markets may react adversely if these budgetary results were not attained. The staff's views would be welcome. At the same time, given Sweden's uniquely high tax ratios, we see merit in staff's recommendation that any room stemming from overachievement of budget targets be used to lower taxes further so as to stimulate private consumption, investment, and job creation.

At this point, we tend to be more concerned than the staff about the possible threat to the recovery posed by the programmed further fiscal consolidation, especially in the presence of uncertainty regarding estimates of the output. The staff considers that most of the contractionary effects of the fiscal withdrawal of 1995–96 has already been fed through the economy and that prospects are promising for recovery of domestic demand led by an increase in domestic consumption. I am less sanguine than the staff about the strength of the recovery in view of the relatively weak development of disposable income and the contractionary effect of both the ongoing as well as further planned fiscal consolidation.

With fiscal consolidation on a firm track and inflation well under control, persistent unemployment remains the primary challenge facing the Swedish authorities. The authorities are cognizant of the fact that rigid wage formation practices, generous income support programs and a large labor tax wedge are the main obstacles to the growth of private sector employment.

Hopefully, the commission appointed to recommend improvements in wage formation can forge the way toward forming a national consensus that takes into account the interests of the unemployed. However, Sweden's attachment to its egalitarian tradition and the political considerations mentioned by Mr. Kiekens are presenting serious obstacles to a number of other labor market reforms including the possibility of widening wage differentials, relaxation of job protection legislation and shortening of unemployment benefits. Like others, we are concerned about the medium-term impact and inefficacy of the short-term solutions being pursued. I would be interested in hearing staff views on the authorities' position that Sweden could compete only through high skills and not through wages, and that this can be done by expanding education further so as to strengthen Sweden's long-term competitiveness.

With these remarks, we wish the authorities similar success in the future as in the recent past.

Mr. Zamani made the following statement:

After a weak start in early 1997, activity in the Swedish economy seemed to pick up in the second quarter. As shown in the staff report, signs of recovery in domestic demand and gains in consumer confidence were observed. Investment is turning upward, and both exports and imports are rising strongly.

This rosy picture, nonetheless, should not mask the important challenges that continue to be faced by the economy. Previous speakers have touched on the various problems to be highlighted. The most important issue is unemployment, which continued to remain high in Sweden. The sluggish recovery in employment, despite the fact that total production has recouped the decline of the early 1990s, and is now above the previous high of 1990, indicates that a large part of unemployment is not cyclical, but structural. The OECD has estimated that the level of structural unemployment in Sweden is between 6 and 7 percent of the labor force. Obviously, rigorous reform of the labor market is needed, and quickly. The experience of a few European countries that have been successful in lowering unemployment, as well as of those countries that continue to fail in their efforts on this count, points to the importance of improving the working of the labor market and wage formation. While I welcome the establishment of a commission to recommend improvements in wage formation and comprehensive labor market reform, which is also essential, it is intriguing and of concern to note the sharply inverse relationship in recent years between wages and productivity—in favor of wages. This is actually a repeat of the past. I concur with the staff that such reform should include measures to improve the supply of labor and job searches, as well as measures to stimulate labor demand. I strongly believe that labor market reform must include the balancing of the rights of both employers and employees. This must now be brought to the forefront and be part of the comprehensive package of labor market reform.

The other important challenge is the public sector finances. The reduction in the general government deficit from 12.3 percent of GDP in 1993 to 2.5 percent in 1996 is indeed impressive. The government's intention to balance the budget in 1998 and achieve growing surpluses in the medium term is encouraging. However, as noted by the staff, many of the features of the general government finances that contributed to the fiscal crisis in the early 1990s—notably the high level and cyclical sensitivity of both expenditure and revenue—remain in place. In addition, the level of general government debt was sharply higher than the pre-crisis level. As the authorities anticipate an overperformance of the budget in the medium term, the surplus resources should be used, as suggested by the staff, to lower structural expenditures and taxes, which would not only lower the cyclical sensitivity of government finances, but also create room for reducing the tax wedges that most thwart employment creation and the strengthening of the macroeconomic picture. I wish success to the Swedish authorities.

The staff representative from the European I Department stated that, even though the level of foreign direct investment on a net basis presented in the balance of payments appeared fairly small, it hid a relatively large increase in foreign investment flows and did not tell the whole story. In that regard, it needed to be borne in mind that much foreign direct investment was undertaken by Swedish enterprises and that there was much investment from abroad into Sweden as well. Gross inflows had not been particularly large in 1996, but that had been a period of weak overall investment, as there had already been a large expansion of investment in the manufacturing sector in the preceding year; it had been only about 2 percent of GDP in 1996, but about 6 percent of GDP in 1995.

The Swedish government had been concerned that taxation should not discourage foreign direct investment or production in Sweden generally, the staff representative pointed out. Corporate tax rates had been brought down significantly as part of the reform in the 1990s, so as to shift the tax burden to labor, the less mobile factor of production. That notwithstanding, there was evidence, in particular from the Employers Association, that the very high tax rates continued to be an impediment to attracting high-skilled foreign workers to Sweden.

Consumption was more sensitive to stock market valuation in Sweden than it was in the United States partly because of the recent experience of Sweden, where the very sharp decline in the net assets of the household sector had resulted in a sharp increase in the savings rate, holding back consumption, the staff representative considered. With the increase in household assets, that effect would tend to be reversed. In fact, that had already been seen during the course of 1996 and continuing into 1997, as a reduction in the savings rate had supported an increase in consumption despite the weak increase in disposable incomes. The Swedish experience mirrored that of Finland in recent years where, after a similar portfolio valuation adjustment of the household sector following a similar earlier episode of a sharp reduction in net assets of the household sector, there had been a significant recovery in consumption, with rates of growth of 3–4 percent in the preceding few years.

Fiscal policy needed to look at a reduction in both expenditures and revenues relative to GDP over the medium term, because the ratios were very high, the staff representative emphasized. They were high even taking into account the fact that, because social benefits were paid on a gross basis in Sweden—and therefore taxed—they tended to be exaggerated relative to those in other industrial countries. The very high tax rates, and in particular the very large tax wedges, tended to discourage growth in the private sector and, in particular, the personal and business services sectors. Employment had grown instead in the public service sector, where productivity was not particularly high. The staff was concerned that the high level of government expenditures and revenues relative to GDP was therefore having a significant negative impact.

The requirement that the local government budgets be balanced had been waived temporarily given the difficult financial situation of the local governments, but that requirement remained in principle to be applied over the medium term, the staff representative explained. Local government budget balances had deteriorated in recent years, but the deficits remained relatively small, and fiscal responsibility at the local level was quite strong.

If the fiscal targets were not reached, a certain contingency reserve had been built in under the expenditure ceilings, the staff representative related. If that turned out not to be sufficient, the government had indicated that it was nevertheless committed to meeting the targets that had been announced for the succeeding few years. In 1996, when it had been thought that the target for 1997 was not going to be achieved, some additional measures equivalent to ½ of 1 percent of GDP had been introduced as part of the 1996 spring budget bill. Those measures had in fact been implemented as part of the 1997 budget even though, at the time the budget was finalized for 1997, the projections had been revised and had shown that the additional ½ of 1 percent of GDP measures would no longer be needed in order to meet the original targets. That demonstrated the government's commitment to meeting its targets.

The staff believed that labor market reform, not higher-skilled labor, was the key to addressing the unemployment problem, the staff representative stressed. In that connection, the Dutch model of labor market reform might prove instructive, because it had shown the implementation of reforms in a society with many of the same characteristics as Swedish society. However, one significant difference was that, in the case of the Netherlands, high rates of unemployment had persisted for a period of time, whereas in Sweden, unemployment was a new phenomenon, and there was no consensus in Sweden at present on whether the problem would likely remain or not. Officials and forecasters had been surprised by the fact that, through the recent recovery from 1993–96, little employment growth had taken place. The initial convergence and fiscal consolidation program had anticipated a significant recovery of employment. Economists were beginning to draw the conclusion, therefore, that unemployment could be a serious problem that was not going to go away on its own. In fact, the convergence of a number of cyclical and structural factors would have led to the emergence of unemployment at an earlier stage than it did, except for the fact that the government had been expanding rapidly through the 1970s and the 1980s, and the fact that Swedish enterprises had relied more on krona depreciations to maintain their competitiveness than on improving their profitability and efficiency. The realization that unemployment might persist had not yet pervaded popular thinking or the thinking of the labor unions, and in that respect, the situations of the Netherlands and Sweden in the period before the adoption of labor reform policies might be considered as quite different. An understanding of the full extent of the problem would be needed before there would be more agreement on the required measures. Also, on the technical side, the social partners were not responsible for unemployment insurance in Sweden, whereas they were—at least in part—in the Netherlands, so there was less internalization on the part of the labor unions in Sweden of the high costs associated with protecting the jobs of the currently employed, on the one hand, and maintaining the barriers to labor market entry that confronted the unemployed, on the other.

Mrs. Guti made the following statement:

As other Directors have noted, the Swedish authorities made further commendable progress during 1996 and the early part of 1997 with their efforts to lay the foundation for a resumption of strong growth in real output. Thus there has been a sharp reduction in the budget deficit in 1996, and inflation has been reduced to less than 1 percent during the first half of 1997. In addition, further progress was made in improving the health of the banking system. These advances have strengthened confidence in the authorities' policy framework and have had positive effects on long-term interest rates.

Despite these significant achievements in financial management, the ratio of both public expenditure and public debt to GDP still remains high. As the staff indicates, this feature increases the cyclical sensitivity of government finances, and poses some risks to the consolidation effort in the event of less favorable developments. Also, given the evidence of a close correlation between the durability of the adjustment effort and the share of expenditure reforms in such an effort, as well as the fact that the maintenance of such a high level of expenditure must affect economic performance through a continued high funding requirement, I would urge the authorities to consider staff's recommendation for a medium-term plan to reduce structural expenditure.

The Swedish authorities have rightly targeted the reduction of unemployment as an immediate objective, and have based their employment policy on sound principles. I specifically welcome the recognition that the majority of job creation should occur in the private sector, the decision to improve wage formation, and an increased emphasis on education and training opportunities. It is, however, clear from the staff's interesting analysis on this issue that the rising long-term unemployment stems from a complex interaction of a number of factors that affect both the supply of and the demand for labor. The experience in Europe has also shown that a piecemeal-approach does not work, and that the resolution of this problem requires the formulation of a comprehensive policy framework. I would therefore encourage the authorities to also give consideration to those reforms that have been identified in the staff report.

Finally, we wish to commend the Swedish authorities for the generous contribution to the financing of development aid.

Mr. Zamalloa made the following statement:

This chair wishes to commend the Swedish authorities for their steadfast and determined policies to overcome the 1990–93 crisis; growth has been restored, fiscal consolidation has been impressive, inflation has been brought down to record low levels, and the banking crisis was successfully resolved. In the context of these achievements, we share Ms. Srejber's conclusion that the present financial policy mix is conducive, at least in the immediate future, to growth, with the main challenges remaining in the structural area, particularly with regard to the labor market to ensure employment creation and long-term growth.

Against this backdrop, I will confine our intervention to four points for emphasis.

On the fiscal front, the 10 percent of GDP reduction in the fiscal deficit since 1993 demonstrates not only a courageous convergence program but also that the contractive effect on output from cutbacks in public expenditure was limited. The level of government expenditure, however, will remain high in the medium term, requiring a relatively high tax burden, which will adversely impact on long-term competitiveness. In this context, it is disappointing that additional resources freed by fiscal overperformance are being channeled in part to fund new public spending programs rather than lowering taxes in a manner that fosters competitiveness and long-term job creation in the private sector. The effectiveness of the strategy to combat persistent high unemployment should be based on permanent signals rather than on temporary funding schemes highly sensitive to the business cycle. Looking beyond the short run, the authorities should be encouraged to consider lowering the overall size of the public sector to sustain efficiency gains while lowering the tax wedge to promote long-term employment.

With regard to monetary policy, we share the view that the inflation targeting framework introduced in 1993 has served the Swedish economy well as inflation has continued to decline. In this connection, the decision taken by the five political parties having a clear majority in the Riksdag, aimed at strengthening monetary policy by giving greater independence to the central bank and legal status to the primacy of price stability over other objectives, is certainly welcomed. These measures, independently of EMU participation, bring the Riksbank into conformity with the Maastricht accord and facilitate an eventual entry into EMU.

With respect to EMU, we share the staff's view that the envisaged rule-based environment would, on balance, strengthen the stabilization efforts and serve to consolidate the gains of recent years. This element is particularly relevant to avert a return to a discretionary policy environment and to reduce the risk of political complacency given the degree of rigidity in the labor market.

Finally, on unemployment and labor reforms, suffice it to say that without a comprehensive labor reform program aimed at fostering employment creation in the private sector, reductions in the persistently high rate of unemployment will be disappointing. In this connection, the measures announced to combat unemployment based mainly on public sector employment programs and on the reduction of the labor force through early retirement are likely to be insufficient. In this regard, education and training to improve the skills match need to be accompanied by a more comprehensive labor reform that should include, inter alia, greater wage flexibility and differentiation, lower replacement ratios, shorter unemployment benefits, lower tax contributions on employment and more flexible regulations governing hiring and separations. Under such a scheme, Sweden would be extremely well placed to face the challenges of an integrated Europe and an increasingly globalized market.

In sum, Sweden has made impressive gains in stabilization. Their performance in the structural area, however, has been far less ambitious and highlights the difficulties in eliminating rigidities even in countries where institutional capacity is beyond doubt. The Swedish authorities should be encouraged to address these potentially constraining problems decisively and we wish them every success in their endeavors.

Mr. O'Brien made the following statement:

I wish to join the staff (and other Directors) in commending the Swedish authorities for the quite remarkable job they have done in bringing their economy out of the crisis of the early 1990s and onto a path of relative stability and growth in such a short period of time.

However, the rapidity with which the central government's fiscal deficit was reduced in 1996, through a combination of increased taxation and expenditure cuts, appears to have had unintended adverse effects. The staff has cited the fiscal withdrawal in 1996 as one of the main contributory factors in the stagnation of domestic demand in that year, and by implication, in the lower growth of output. I share Ms. Abdelati's concern whether the effects of the fiscal withdrawal have worked themselves through the economy, or whether they would surface in 1998. The staff has also identified a loss of investor confidence as a factor, but I could not ascertain the basis for such loss. I wonder if it was related to the austerity of the convergence program? Perhaps staff may wish to comment.

This also raises the issue of the timing, balance, and coordination in the implementation of an economic program that seeks to achieve several different types of objectives or targets. There is always a danger that when an undue emphasis may be placed on achieving fiscal or monetary targets very quickly, other macroeconomic variables could be significantly and adversely affected. The Swedish experience perhaps underscores the need to adopt a more holistic approach.

I agree fully with the staff that the most challenging task ahead of the Swedish authorities is to reduce unemployment. There appears, however, to be significant differences in the approach advocated by the staff and that of the authorities. While I agree with the authorities that the competitiveness of the economy should not be based on a lower-paid labor force, but on a more highly skilled one, I must also agree with the staff that the approach of the authorities does not appear to meaningfully deal with the fundamentals of the supply and demand of labor. There is clearly a need for structural reform of the labor market.

The staff report strongly suggests that the authorities recognize this need but are hesitant in the face of the potential socio-political cost. This creates a very interesting scenario and highlights the fact that the reforms necessary to place an economy on sustainable competitiveness are bitter pills for both the developing and developed economies to swallow, but perhaps even more so for the developed economy.

With regard to Sweden's membership in the European Monetary Union, I am not quite sure what is the present position. It appears that the present position of the authorities is not to join initially. However, the staff report indicates that there is clear recognition that nonmembership does not reduce the need for continuing discipline in both monetary and fiscal policy. But, I wonder whether, once Sweden's major trading and business partners are members of the EMU, Sweden's latitude for using monetary and exchange policies as shock absorbers would not be significantly reduced? The staff may wish to comment. If this is the probable case, then greater reliance would have to be placed on the competitiveness and response of the underlying economic structure. The authorities may be well advised to revisit the need and the assessment of the costs and benefits for structural reform. I would certainly encourage the authorities to review their position on structural reforms.

I wish to take this opportunity to wish the Swedish authorities every success.

Mr. Mirakhor made the following statement:

Let me first join Mrs. Guti and Mr. Yao in commending the Swedish authorities for their record of ODA performance despite fiscal consolidation and low growth; this is one Swedish model that is worth emulating by all countries, in Europe and elsewhere. I join the consensus in the Board on the recognition of the remarkable progress made by the Swedish authorities in fiscal consolidation and stabilization of the economy, as well as for their achievements of a high degree of credibility in financial markets.

I would also like to echo the observation of Directors that the high unemployment rate remains the most serious challenge for the authorities. Like Mr. O'Loghlin, I find it encouraging that the authorities have adopted an employment policy containing five principles, the second of which states that the major part of the increase in employment should take place in the private sector. The staff paper, however, indicates that, so far, no genuine labor market proposal that would foster employment growth in the private sector has been put forward. As other Directors have suggested, such a proposal would have to address some deep-rooted structural problems in the economy, particularly tax and competition policies. Structural reforms are also needed in Sweden because, while splendid results have been achieved in stabilizing the economy, one policy lesson of recent years has been that only structurally-based stabilization is durable.

Like Ms. Abdelati, I have enjoyed reading the analysis in the background papers that yielded some startling conclusions that, in turn, raised some serious concerns regarding the vulnerability of Sweden's medium-term fiscal position to cyclical influences and underscored the potential fragility of recent accomplishments. The general conclusion, with which I agree, seems to be that in addition to ensuring that the fiscal consolidation program remains on track, it is imperative that the Swedish authorities adopt and implement an ambitious and comprehensive structural reform program, in order to reduce these vulnerabilities and fragilities.

With these remarks, I wish the Swedish authorities continued success in managing their economy.

Ms. Lissakers made the following statement:

As others have noted, the fiscal consolidation in Sweden has been of truly heroic proportions, and has produced real and immediate benefits for the economy. However, there is also a lesson in this experience that suggests that fiscal consolidation and monetary discipline are no panacea for what ails Europe's economies. If the Maastricht criterion had put as much emphasis on structural reform as on fiscal and monetary discipline, Europe would have been much better off, and if the big European economies had set a better example in the area of structural reform, some of the smaller European economies might have moved a little faster on this front. It is ironic that Denmark and the Netherlands are leading by example, and that the large economies are still laggard in the area of structural reform.

Unfortunately, so is Sweden, which gives cause—quite rightly—for the staff's cautionary notes in that area, because the relationship between public employment, public taxation, and the private sector has not changed dramatically. There were some important and valuable changes in the tax measures on the corporate side, but those have clearly not solved the underlying problems or eliminated the vulnerabilities.

With regard to the specific decisions the government has taken in the recent budgets, I join those who raised some questions about the wisdom of increasing the transfers to local governments to maintain or improve social services. That looks to me, and to others, like a return to reliance on the public sector to create jobs or to maintain employment.

The decision to increase investment in education is a wise one, in particular the decision to increase the number of university places by one third. The interesting discussion about the Swedish labor market usefully highlights the growing mismatch between vacancies and labor supply, and clearly, education is the solution to that problem. The large Swedish multinationals are highly competitive, and indeed have dominant market positions in several high technology areas. They are creating thousands of jobs, but outside of Sweden, which has to do both with the tax wedge and, in some cases, with the lack of a skilled work force.

I am not very optimistic about the increase in domestic consumer demand, because as the table on page 5 points out, while real disposable income has remained stagnant in the last couple of years, private consumption has been financed partly by a reduced savings ratio. The tax burden on households has increased, and the burden on the economy of the value-added tax has increased. I wonder whether, given the projected savings ratio of 2.4 percent, households would be willing to continue to reduce their savings cushion, and taking into account as well the low level of confidence in the economic outlook of the country.

Mr. Lvin made the following statement:

We commend the authorities' exemplary fiscal policy. While I would concur with the staff about the appropriateness of focusing on an early tax reduction in view of the unexpectedly successful pace of fiscal consolidation, instead of on increasing expenditures, the general approach seems to be quite credible. However, it would be reasonable to call the crisis truly over only when the debt level is brought back to its original level, which is still far out of reach.

What looks less obvious is the sort of justification given to the decision to increase expenditures—namely, to improve the unemployment outlook. Emphasizing this aspect over others, such as a widely felt need to improve public services, effectively means that the public sector exists primarily to provide employment, and not to serve the community. This leads me to one of the core issues currently debated in Sweden and in the staff documents: employment policies. The staff notes that the full employment Sweden enjoyed in the 1970s and early 1980s was due entirely to public sector expansion. Thus, we may now realize that this success was practically doomed from the very beginning, as the public sector was clearly too big.

I cannot agree with the staff that the unemployment insurance system was not responsible for the emergence of unemployment, for two reasons. First, because the stringent requirements attached to the benefits should be viewed as effectively discounting their net value and, correspondingly, any practical loosening of these requirements should be viewed as an increase in the net value of benefits. Second, because the overexpanded public sector looked suspiciously like a close substitute for unemployment. While it is impossible to discern the hidden unemployment component of the public sector, it is probably not insignificant. Therefore, the turnaround in unemployment may look less dramatic and unexplained. Also, an overexpanded public sector and generous social security benefits tend to artificially increase the labor participation rate and to exacerbate the problem of unemployment at a later stage.

More generally, it appears from the staff documents that the old way of reasoning still dominates, according to which almost all elements of economic policy, which may or may not be desirable on their own merits, are held to account for their influence on employment. This logic obscures the fact that the major—if not the only—cause of systemic unemployment is the state unemployment benefits system. Indeed, Box 3 of the staff report notes that, in the absence of unemployment benefits, all other factors—such as job protection provisions, the heavy labor tax burden, and an ineffective wage bargaining system—would have resulted only in pronounced labor market segmentation, but not unemployment per se. At the same time, it needs to be recognized that if unemployment benefits are set at a high enough level, unemployment could be generated even in a system with perfect labor mobility and no distortions.

Turning specifically to the five points of labor market policy as laid out in the 1997 spring budget bill, one is tempted to ask a number of questions. For example, does state-sponsored education really help to put people to work, or does it rather help to disguise open unemployment and create rising pay demands by future graduates? And why are public sector services given priority over transfers? While both need to be trimmed, is it not true that monetary payments promote efficiency better than payments in kind, especially if the latter incorporate subsidies on essential public services. It is also not clear what price stability—commendable as it is—has to do with employment. After all, Keynes's illusions seem to be long dead, and wage negotiations now follow closely price dynamics, thus leaving little space for employment effects.

Regarding the wage moderation issue, any nationwide or sector-wide wage policy would be distortive, inefficient and detrimental to the public welfare if compared to a market-based wage policy. I seriously doubt that we are morally entitled to urge others to let their incomes drop. The staff points out that the key issue for employment policies is to increase the demand for labor, but I fear that this theory is based on good intentions rather than sound assumptions. There is no such thing as demand for employment per se. There is demand for services, which cannot be but specific. Labor itself is not a benefit; it is an unavoidable sacrifice that must be used with economy in all instances.

On the other side of the coin, there is a very real market demand for unemployment, as expressed in the form of offered benefits. Therefore, there is only one way to fight unemployment effectively—to reduce the relative real value of unemployment benefits to make the opportunity costs of unemployment too high. This may sound politically incorrect, but the Fund is about the only institution able to say this openly, and an opportunity to clarify things should never be missed. In practical terms, were it to be decided to reduce income and labor taxation, care would have to be taken to preserve the current net value of social benefits from rising, taking into account the fact that they are taxable benefits.

Regarding monetary policies, the now fashionable approach of inflation targeting must be further scrutinized. The background paper asserts that the overheating at the end of the 1980s was caused by a credit boom. It is clear, on the one hand, that simple inflation targeting cannot prevent such a scenario when measurable inflation looks low and monetary policy effectively continues to fuel an artificial cyclical expansion. On the other hand, an attempt to control many variables, including how to measure hard to interpret asset prices, would render the whole policy purely judgmental and discretionary.

Different opinions appear to be expressed by the Calmfors commission and the Riksbank on the EMU issue. I would concur with the Riksbank's view that the costs of maintaining a fixed exchange rate are overstated by the commission, and that the benefits of an independent monetary policy are overstated. I see a contradiction in the commission's point about the need for exchange-rate-initiated real wage adjustment in a low-inflation environment. If developed economies are intent upon ensuring that persistent inflation will be a phenomenon only of this century, they have to make nominal wages flexible. There is no other way, and exchange rate policies cannot substitute for it. I wish the Swedish authorities every success in their endeavors.

Mrs. van Geest commented that, concerning the wage moderation issue, it was difficult to ask people who were currently employed to take cuts in their wages. At the same time, account needed to be taken of the employment prospects of future workers, and it was that perception that had finally helped the labor unions in the Netherlands to convince their members to accept the idea of wage moderation. Regarding the demand for labor, relative prices decided the combination of capital and labor; if labor was very expensive, there would be less demand for it.

Mrs. Paris made the following statement:

I thank the staff for having provided a bright set of papers, and I join with previous speakers in commending the Swedish authorities for the remarkable improvement achieved in the fiscal situation and in controlling inflation. It is now particularly encouraging that macroeconomic conditions conducive to accelerating growth over the next two years appear to be in place. One cannot, however, but be struck by the very uncertain impact of growth on employment, and I concur with the staff that the absence of a genuine labor market reform proposal that would foster employment growth in the private sector is regrettable.

While I welcome the emphasis placed on education, I encourage the authorities to adhere to a medium-term program of lowering public expenditures, which would allow for a reduction in the tax wedge, which is very high. Wage moderation and a less-centralized wage bargaining system are also to be promoted.

I agree that the current stance of monetary policy is well balanced, and I highly welcome the adoption of the new law that enhances the central bank's independence. The decision not to seek to participate in EMU initially does not lessen the need to tighten financial policies and follow labor market reforms. The consequences of such a decision will need to be looked at very closely, as there is a good chance that this could lead to the development of a dual currency system. I wonder whether the staff could provide its views on this.

Mr. Brooke stated that he endorsed the staff report and agreed with all its recommendations. An issue that perhaps had not been covered as extensively as he would have liked was the pension system. He understood that a cross-party agreement had been reached in 1994 on a new and more sustainable system, but implementation of the new agreement still had not happened. He would like to support other Directors' remarks on the need to address the system. Perhaps Ms. Srejber or the staff could comment on what the plans were for moving ahead with the system.

In response to a comment from Ms. Lissakers, Mr. Brooke said that labor market reforms in the United Kingdom had begun about 1984. The United Kingdom had been progressively reducing the unemployment benefit remuneration rate and liberalizing the labor market since then, but it was a long process that needed to be dealt with in a comprehensive way. Positive results had begun to be seen in 1991 and were impressive by any country's standards, in his view.

Mr. Donecker said that pension reform was, as Mr. Brooke had pointed out, a long and difficult process, as the Netherlands and other countries had found out. Nations had established pension systems that protected the poorest and had elaborated social safety nets. Dismantling those safety nets was no easy task, because the majority relied on them and trusted in their continued existence and quality. Nevertheless, countries should make their populations aware that certain changes were needed, and they should begin to tackle them. The German authorities were also engaged in that process, but they recognized that time would be needed for a successful outcome.

Mr. Sivaraman said that he fully endorsed what Mr. Donecker had said. That perspective needed to be taken into account in discussing the problem of developing economies as well. Many of those countries had followed the practices and principles of developed countries. Their trade unions had gained strength because they had emulated the American and British trade unions. Fortunately or unfortunately, they had become too strong. Developing countries likewise encountered strikes, lockouts, riots, and violence in the process of structural reform, privatization, and the dismantling of the public sector.

Ms. Abdelati commented that the staff had pointed out the need to upgrade skills, but several of the measures to improve the labor supply were not considered politically feasible to the authorities at the present juncture. While improvements in education alone might not resolve the unemployment problem, perhaps that, in combination with more palatable measures, such as a reduction in taxes, might go a long way to resolve it. She wondered what was the staff's view on that point.

The staff representative from the European I Department stated that the consumption projections were one of the important uncertainties in the demand forecast. The trend so far in 1996 had been of a strengthening of domestic demand, which was assumed to continue into 1997. Ms. Srejber had referred to the preliminary national accounts data for the second quarter, which showed that, on a year-on-year basis, private consumption had increased in the second quarter by about 3 percent, compared with the same quarter of 1996. Automobile purchases had been an important contributor to the strength of demand. There was a significant pent-up demand for durables, especially cars, because the Swedish fleet was the oldest in Europe. Whether or not saving was going to be squeezed even more was an open question, but the staff would expect a continued decline in the savings rate.

There was also much pent-up demand for housing investment, the staff representative explained, and in that context, the question whether the movements in interest rates could be expected to have an impact on housing demand was relevant. At the same time, it needed to be borne in mind that there had been an excess supply of housing as a result of the asset bubble of the late 1980s, which had been accompanied by overinvestment in new construction. In 1996, the government had tried to jump-start construction by providing incentives, which was why there had been a jump in investment in housing in 1996, which had then collapsed in 1997. The government's one-year program had had the effect of advancing spending to 1996 from 1997 and perhaps also from 1998. At some point, housing investment was bound to restart, because it was at an extremely depressed level. Also, mortgage interest costs had fallen by 10 percent in 1996 as a result of the easing of monetary policy. Those factors would support a recovery of housing investment at some point. In fact, housing prices were now just starting to pick up, and vacancy rates to come down. The assumption that housing investment would rebound was built into the projections for 1998, even though it had been expected to occur earlier.

Mr. Sivaraman observed that in a country like Sweden, which was more or less a welfare state, it was unlikely that there would be tremendous activity in the housing sector, because housing demand might have been satisfied. Any increases were likely to come about only through replacement demand or marginal growth in population.

The staff representative from the European I Department responded that there had been an increase in population in Sweden, partly as a result of a fair amount of immigration. Housing demand had been satisfied at one point. In discussing housing demand, however, not only new construction was considered, but also maintenance. In fact, the program in 1996 had supported renovation as well as new construction.

The pause in investment that had occurred in 1996 had been widely expected, because of the very sharp increase in investment—in manufacturing, in particular, and in the export-oriented sectors—that had taken place following the large depreciation of the krona in 1992, the staff representative explained, but the staff would not characterize what was happening as evidence of a loss of investor confidence related to the convergence program. In fact, there had been an unbalanced character in the recovery for an extended period of time, with the export sector leading it, which had led to sharp increases in investment and an expansion of capacity. That expansion was now beginning to taper off.

The Riksbank targeted inflation, not the exchange rate, the staff representative pointed out. The exchange rate was one of several factors with a bearing on future inflation, and it was monitored carefully. Recent exchange rate movements in that respect were believed to reflect a combination of different cyclical positions between various countries, as well as expectations concerning EMU and some special factors, in particular a rebalancing of portfolios by insurance companies as a result of the liberalization of rules concerning their investment portfolios. The exchange rate did have an impact on the Riksbank's view of the inflation outlook, and therefore it did affect its decisions on monetary policy, but it was not a case of exchange rate targeting per se.

Regarding the scope for using the exchange rate as an absorber following the start of EMU, the earlier experience of Sweden regarding the asynchronous shocks in that country relative to the rest of Europe was instructive, the staff representative considered. Those asynchronous shocks had been dominated by the demand side, meaning primarily financial policies followed in Sweden, rather than the supply side, but also the evolution of wages. The exchange rate had been validating those inappropriate demand management policies. If Sweden were to try to use the exchange rate to continue validating such inappropriate demand management policies or wage increases after the start of EMU, it would very quickly find itself again in a higher inflation environment, which was not what Sweden wished. Sweden wanted to remain in a low inflation environment. Therefore, given that commitment to a low inflation environment, the possibility of using the exchange rate as a shock absorber for inappropriate demand management policies would be limited. The exchange rate could still be used to offset shocks originating on the supply side, but the view of the Riksbank was that the Calmfors commission had exaggerated the scope for using the exchange rate to offset asynchronous shocks. When the relative contributions of supply and demand shocks to the overall contribution of asynchronous shocks were taken into account, it would appear that the view of the Riksbank was the correct one. Supply shocks had not been an important contributor to earlier changes in the real exchange rate, and therefore, unless the environment changed altogether, the opportunities to use the exchange rate effectively as a shock absorber would be limited.

There had been a multiparty agreement on pension reform, the staff representative acknowledged. The various elements of that reform had been described in the Occasional Paper issued by the staff team that had been working on Sweden at the time. The pension reform was stuck in the parliament, and there had been no recent developments. The staff intended to take up the issue of pension reform with the authorities following the next election to see what the government had in mind. As Mrs. van Geest had pointed out, the unfunded liabilities were quite substantial, although it was not clear whether they were worse or better than the average for other OECD countries.

The dual currency system was of concern in particular to financial markets in Sweden, as well as to the Riksbank, as there was likely to be a huge financial market denominated in euros, the staff representative said. The question was whether businesses in Sweden would continue to operate primarily in krona. If Sweden stayed out of EMU, there was the concern that the public sector might operate in krona, the household sector might operate mostly in krona, and the rest of the economy might operate in Euros.

Ms. Lissakers remarked that there were many examples of economies that operated in a similar way. Two-thirds of Latin America operated in a dual currency system. Many other countries were highly dollarized. Large Swedish corporations were already semi-dollarized, in that they funded themselves largely in dollars, they sold and marketed in dollars, and increasingly they paid their work force in dollars, because the work force was outside Sweden. There was a high likelihood that that would be the result if Sweden were to remain outside the EMU, but she wondered whether it would really be as big a jolt as the central bank suggested, or whether it would be a gradual evolution, one that to some extent was already under way.

The staff representative from the European I Department said that he agreed with Ms. Lissakers that over time there would be more use of the euro, and that it would not be a jolt.

Ms. Srejber thanked her colleagues for their analysis and advice, which she would convey to the Swedish authorities.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They welcomed Sweden's remarkable success in bringing the fiscal deficit and inflation under control over a relatively short period, and in resolving the banking crisis successfully. Given those successes, they considered that the significant credibility gains Sweden had achieved in financial markets, as reflected in significantly lower interest rate differentials, were fully warranted.

Nevertheless, Directors underscored the need for improvements in macroeconomic stabilization to be complemented by structural reforms to strengthen medium-term employment and growth prospects. The main task ahead was to reduce unemployment, which would require continued fiscal consolidation and labor market reforms.

Directors endorsed the target of a balanced budget in 1998, which would carry fiscal consolidation further. Given the vulnerability of government finances to adverse cyclical developments, and the need to lower government debt, Directors also supported the long-term goal of an average annual surplus of about 2 percent of GDP over the cycle. They cautioned against a repetition of the earlier experience of weakening underlying structural balances at times of cyclical strength. In that regard, several Directors expressed concern about the recent use of the room for maneuver that had emerged under the fiscal targets to fund new spending programs to reduce open unemployment.

Directors expressed concern at the high cyclical sensitivity of public finances, which reflected the very high levels of government expenditure and revenue in relation to GDP. They considered that the heavy tax burden was an obstacle to growth and employment creation in the private sector, and suggested that the main fiscal policy objective for the medium term should be to achieve a significant reduction of both expenditure and taxes while also meeting the target for the fiscal balance. Such a fiscal stance would not only lower the cyclical sensitivity of government finances, but also create room for reducing the large tax wedges—created by payroll and income taxes—that were serious obstacles to job creation in the private sector.

Directors commended the Riksbank's conduct of monetary policy, based on inflation targeting, that, in tandem with a restrictive fiscal policy, had brought inflation to a record low level. Noting that monetary conditions had continued to ease as a result of the depreciation of the krona during the first half of 1997, Directors concurred that the overall monetary stance appeared, for the time being, well balanced.

Directors welcomed the recent multiparty agreement to enhance the Riksbank's independence, and enshrine price stability as the primary objective of monetary policy into law. That would further strengthen confidence in Sweden's commitment to low inflation, and facilitate the implementation of monetary policy. Directors emphasized that the decision not to seek to participate in EMU from the start did not lessen the need for tight financial policies, and for rapid labor market reforms.

Directors expressed serious concern about developments in the labor market, as Sweden appeared to be moving toward the persistently high unemployment rates that had become characteristic of European labor markets over the previous two decades. Several Directors regretted that the government's plan for reducing open unemployment relied more on shrinking the labor force through expanded education and early retirement than on private sector employment creation. Directors considered that expanding education and training, while essential to allow workers to upgrade their skills, would not be sufficient to resolve the unemployment problem. A few Directors cautioned about the tendency of early retirement schemes to become entrenched, even when introduced on a temporary basis. Directors therefore called for a bold and comprehensive program of labor market reforms, drawing on the experience of the Netherlands and some other European countries, in order to address structural rigidities, and foster employment growth in the private sector. Such reforms would also serve to foster further productivity gains, and help maintain Sweden's competitiveness in increasingly globalized international markets. The importance of labor market reforms for supporting fiscal consolidation was also noted by several Directors. Some Directors also drew attention to the importance of pension reform, in view of the aging of the population.

To strengthen the demand for labor, Directors recommended that greater consideration be given to a strategy that used the room for maneuver that had emerged on the fiscal side to narrow the wide tax wedges. Several Directors also saw a need to improve the supply side of the labor market by reforming unemployment benefits and the social security system, and easing job protection provisions. They also suggested that wider wage differentiation was needed in Sweden.

A number of Directors welcomed Sweden's record of providing generous official development assistance, and expressed the hope that it could be restored to its earlier level in relation to GDP.

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

2. BANK-FUND COLLABORATION—STRENGTHENING FINANCIAL SECTORS

The Executive Directors considered a staff paper, prepared jointly by the staffs of the Fund and the World Bank, on Bank-Fund collaboration in strengthening financial sectors (SM/97/200, 8/1/97).

Mr. Shaalan made the following statement:

The purpose of the paper under discussion is to clarify the division of responsibilities and the ways to strengthen collaboration between the two institutions—beyond what was stated in the Joint Statement of the President of the World Bank and the Fund Managing Director. The paper elaborates on what was stated in the Joint Statement, but essentially adds little, particularly from an operational perspective. This may very well be because of the nature of the subject—and it may be impossible to do a whole lot more with it.

Part of the problem may lie in the premise of the paper, namely that it is possible to make a clear distinction between the Bank's and Fund's work in financial sector reform. I do not believe that a distinction between what are called "sectoral and developmental aspects of financial systems" and "macro-economic aspects of financial systems" is easy, or even possible. The paper itself recognizes the substantial amount of overlap between the Fund and Bank in the areas of banking supervision and regulation, and bank restructuring. Other areas where it is equally difficult to make such a distinction include: analysis of the share of nonperforming loans, high interest rate spreads, poor provisioning, high foreign exchange exposures, and the issue of directed credit. Monitoring developments in these areas and related policy advice cannot be said to fall under the domain of one of the two institutions. The paper may be understating the extent of the overlap.

The paper also states that "existing channels for collaboration between the Bank and Fund have generally worked well." Let me be candid. While we are assured that effective collaboration was evident in the recent negotiations with the Thai authorities, I do not agree that collaboration has worked well. A number of concerns have been raised in the Board in specific country cases as well as in the context of the Review of experience under ESAF-supported programs where it was noted that effective cooperation was amiss in this area. There have been some instances where we have encountered lags between Fund assistance and Bank support for structural reforms, and in some cases this delay is believed to limit or undermine the success of the stabilization effort.

I was rather surprised by the classification of responsibilities in Section III where the Bank is to take the lead in general, but the Fund may temporarily play a leading role in many instances and "when there is a need to move quickly." This is confusing to the staff and to the authorities. In many countries, the Fund provides policy advice and technical assistance in areas of banking regulation and supervision at the same time that World Bank staff is preparing a financial sector loan. It does not seem sufficient to state that the managements of the Bank and Fund will "require country teams to keep each other fully apprised" of their financial sector activities and "require routine sharing of information." Have we fully explored the possibility of a structured delineation of the functions of each institution? In this light, I wonder whether it is possible to provide more details on the "new mechanisms to be established" or the "procedures for collaboration in financial sector activities" that are referred to in paragraph 7 of the Joint Statement but not developed in the paper.

If we accept that collaboration needs to be strengthened, and if a clear delineation of functional responsibilities is not possible, then does it make sense, for example, for the two institutions to produce a country-by-country list identifying which institution is taking the lead this year for the overall financial sector program and in each specific area within that, and also listing key individuals in charge of such responsibility so as to ensure that staff and the authorities know who to communicate with?

By overstating the effectiveness of existing mechanisms for collaboration and understating the extent of the overlap between the two institutions, we create a semblance of clarity without providing sufficiently clear guidelines to staff or serving the best interests of our member countries. It may very well be that there is no way to improve collaboration and reduce overlap without merging the functions in the two institutions, an action that incidentally would also generate budgetary savings. I would be interested in staff's views on this idea.

It appears that the Fund, because of the nature of its involvement with member countries, and because of the nature of the Bank's work, which sometimes requires a longer preparation period, is shouldering an additional substantial burden in the area of financial sector reform. This has resulted in an unacceptable workload on top of an already over-stretched staff. This cannot and should not be permitted to continue.

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

The management and staffs of the Fund and Bank are to be commended for the joint paper on strengthening financial sector collaboration. This is a timely document that we welcome.

The fundamental importance of sound financial sectors for economic health is underscored by the reality that three-fourths of the institutions' membership have experienced banking difficulties in the past 15 years. Clearly, the international financial institutions have a role to play in promoting financial stability. But defining that role is a complex task and raises critical questions about the mandates of the institutions, the use of scarce human and financial resources, and promoting synergies across 19th Street rather than duplication. With this paper, Fund and Bank staffs have meaningfully begun to address these questions and the many concerns raised by Directors.

Perhaps what is most significant about the joint paper is that it was prepared. The effort that went into this endeavor brought staff of the two institutions together, advanced mutual understandings of the international financial institutions' activity in financial sectors and led to a cataloguing of areas that must be tackled in improving collaboration. In this spirit, we take special note that the Bank has created a Financial Sector Board, which is expected to improve overall coordination of the Bank's financial sector activities, and we would like to hear from the Bank representative how the board will operate.

At the same time, the effort to define the roles of the international financial institutions and strengthen their collaboration is a work in progress and we are closer to the beginning than to the end. Ultimately, it is the implementation of collaborative procedures in concrete country cases that will count. Thus, our procedures and their implementation must be kept under continuous review at all levels.

Against this background, some general observations on the role of the Fund and Bank and specific points on the areas for coordination are warranted. To harken back to previous statements from our chair, we highly appreciate the Fund's efforts to strengthen its financial sector capabilities. This is a welcome response to this era of increased globalization of financial markets and greater complexity in the financial environment, which has prompted the Heads of State of major countries to call for stepped up international efforts.

In the 1989 Concordat, the final compromise, ascribing primary responsibility to the Bank on sectoral and development issues and to the Fund on macroeconomic matters, was taken in the context of the growing importance of structural reforms to the achievement of each institution's objectives. But the financial sector soundness agenda even more profoundly blurs the distinctions between the international financial institutions. This is a realm in which microeconomics and macroeconomics at times are hardly distinguish-able. Macroeconomic problems, such as an excessive surge in private capital inflow, can expose unsound operational practices in the banking system. But unsound operational practices in the banking system—inadequate transparency, accounting standards, supervision, regulation, resolution strategies—can give rise to large macroeconomic costs. Any effort to disentangle these forces is rendered more complex by the reality that often both are present. In short, it is not clear that distinctions between the macroeconomic and microeconomic dimensions of financial soundness can be made as easily as would be suggested by invoking the language of the Concordat.

The Fund is known internationally for the excellence and drive of its staff and its organizational flexibility, which has allowed the institution to flourish while adhering to its basic principles. The staff has unique insights into its members and contacts with financial officials worldwide. This is why the international community has long turned to the Fund as its first line of defense. But our staff resources are limited and the banking sector is an area that is fraught with moral hazard and involves intensely "nitty-gritty" work. Thus, as the Fund further proceeds into this new and blurred terrain where the lines of demarcation are not clear, it must combine its usual and welcome ambition with a healthy dose of judicious restraint. At the same time, for collaboration to succeed and for the Bank to play a leading role in critical areas of the financial sector agenda, it must respond with greater speed and flexibility.

Regarding general objectives and responsibilities, the paper before us has spurred the institutions to work more closely together. But we are not as sanguine that, as suggested in paragraph 22, existing channels for collaboration have worked quite well. Furthermore, the text often reflects a country bias, ascribing responsibilities in a country to the actor already on the ground, rather than aiming at a more functionally oriented strategy with greater definition of areas of primary concern. We very much appreciate that management and staff are setting up improved procedures for closer collaboration and offering concrete pledges on information sharing. Also, it merits emphasis that other multilateral development banks, especially the EBRD, have a role to play in strengthening financial sectors. These roles should be nurtured, a subject we may need to revisit down the road.

Regarding evaluating financial systems, careful evaluation of financial systems is the best protection against facing large and painful costs down the road. Indeed, the Fund's main role in the financial sector agenda is surveillance, and—consistent with paragraph 9—the job of alerting members of weaknesses in their banking systems and supervisory regimes; encouraging countries to adopt guidelines and standards developed by the supervisory community; and monitoring progress toward that end. These tasks, and many others noted in the paper, will involve an enhanced role for MAE. Could the staff clarify what additional staff and financial resources it intends to bring to this effort, within the overall administrative budget constraints of the Fund.

Regarding the Bank's role, the discussion in paragraph 10 seems broadly appropriate, though the last sentence conveys again the false impression that neat distinctions can be drawn between developmental and macroeconomic assessments. The basic principles outlined in paragraph 11 are oriented toward minimizing duplication, while the call for reciprocal joint missions in paragraph 12 is most welcome. We hope that staff's work on the framework for sound banking will go a long way toward providing the guidelines on whether financial sector policy frameworks conform with best practices. However, we would also reiterate that the "guidelines" should not be overly prescriptive or lead to second-guessing of the supervisory community.

On technical assistance and bank supervision and regulation, the treatment of technical assistance rightly stresses the need for minimizing duplication and ensuring strong coordination on-the-ground and in Washington. These are more important principles than the delineation of functional assignments per se. It is our understanding that Fund technical assistance is provided free of charge, while the Bank's technical assistance is not free and is only offered in the context of a lending program. Does this create a bias toward using Fund technical assistance, and if so, have Fund and Bank staff taken steps to remedy the situation? Also, could the Bank representative clarify and amplify on the intended meaning of the last sentence in paragraph 14 regarding a stepped up Bank role in this area.

Bank supervision and regulation are treated in the paper solely as an issue concerning technical assistance. But insofar as supervision and regulation are an important issue for Fund surveillance as well as Bank-led efforts in terms of systemic bank restructuring and lending, this focus is too narrowly drawn. While we would agree that there is a role for both institutions to provide technical assistance in this area, staff should outline their thinking on their roles in supervision and regulation in areas beyond technical assistance. Additionally, the suggestion that there is "no simple criterion for deciding which areas of banking supervision and regulation should be addressed by each institution that applies in every case" is excessively vague and imprecise. More generally, we would reiterate that the Basle Committee, in conjunction with a wider circle of bank supervisors, is responsible for developing core principles, practices, and norms for international bank supervision.

Concerning banking system restructuring, lending and crisis situations, the strong emphasis on the Bank assuming primary responsibility on financial sector reform, including the privatization and restructuring of banking systems, is consistent with the sense of the Board. We also welcome the emphasis on the need for close coordination on financial sector conditionality; for consistency between Fund and Bank recommendations; and for all aspects of collaboration, including joint missions, to operate swiftly and effectively in crises. It is noted in the paper that the Fund may temporarily play a role in restructuring, especially where it has been active, where there is a crisis, and where such reforms are relevant for macroeconomic performance. But macro concerns are almost always present. On the basis of prior experience, could the staff inform us what time frame it would view as "temporary?" Also, the paper implies the Bank is not able to move quickly in crises, especially on page 9 where it states closer coordination between the international financial institutions will help ensure the Bank's more timely involvement. Could the Bank representative inform us about how quickly the Bank can move in a crisis and what is being considered to ensure a more rapid response?

In concluding, this chair thanks management and staff of the two institutions for the heightened focus on the financial sector agenda. We also appreciate their efforts to establish clearer procedures to review the effectiveness of collaboration. But it did not escape our attention that there was little discussion of a prospective role for Board involvement in this area. We believe the Board can play an important role in ensuring effective collaboration between the two institutions as they strengthen their focus on financial sector stability. Accordingly, we would request that Fund and Bank staff prepare a short paper ahead of the next Annual Meeting, assessing progress in implementing the strengthened collaborative procedures as evidenced by specific country experiences.

Mr. Sivaraman made the following statement:

I welcome the opportunity to discuss Bank-Fund collaboration in strengthening the financial sector as we have just been able to put in place a program in a country that has suffered from a serious crisis.

Over the years, both the Fund and the Bank have been diversifying their objectives with the Bank focusing on particular areas of an economy when it steps in with project assistance and the Fund more on the attainment of macroeconomic stability and a sustainable rate of growth in the case of those countries where it has a program. In view of the fact that both the organizations have their objectives of macroeconomic stability and growth, it is difficult to imagine a situation when there will be no overlapping of functions. We have to, therefore, recognize this fact and act in a manner that our efforts are complementary, additive and not in any way jeopardize each other's activities. The substance of the paper I believe is contained in paragraph 2, which states "the Bank is primarily concerned with the sectoral and developmental aspects of financial systems in developing countries, while the Fund's involvement in financial sector issues, including in its surveillance, relates primarily to the macroeconomic aspects of financial systems and markets in all member countries." Inevitably, as the macroeconomic aspects are dependent on the structural and developmental issues relating to financial systems, to draw a clear line of demarcation between the roles of the two institutions would be very difficult.

There may be several countries in which the Bank is not operating, even though they could have access to Bank assistance. It is likely that difficulties may emerge in the financial sectors of these countries and it is the Fund that may become aware of these developments and step into the country to resolve or to assist in the resolution of a crisis. If the crisis centers around the financial sector, and the country is not in need of sectoral financial assistance, it is the Fund that would have to provide the necessary technical expertise and guidance in resolving the crisis and ensuring that the country gets back on track. The Fund in certain cases may have a regular program or a mere Fund-monitored program with or without technical assistance. The question of Fund-Bank collaboration arises only in respect of those countries where either the Bank is already operating or there is a perceived need for the Bank also to step in along with the Fund to resolve a situation. In such cases, I see no difficulty in both the institutions delineating their areas of actionable responsibilities and cooperating with one another in achieving the general objective of strengthening the financial sector. It is true that this is easier said than done as there has to be proper team leadership and good rapport established between the Fund and the Bank teams working in the country. I do not know, nor does the paper provide any clear insight into this, whether there are advance consultations between the Fund and the Bank teams on any issue pertaining to the financial sector perceived either by the Fund or by the Bank in the first instance. The only problem, therefore, that I can visualize is the extent to which the teams handling the problem are aware of one another's actions and whether the team leaders and members of the missions are willing to share information. The effectiveness of the operation of both the institutions therefore rests on the shoulders of team leaders of the missions of the Fund and the Bank. The objectives have been well elaborated in paragraph 5 of the staff paper.

Unlike in the case of the Bank, the Fund invariably has Article IV consultations on an annual basis with every member country and there is a window open to the Fund to assess, evaluate and discuss with the authorities any problem that they perceive in the financial sector of a member country. As detailed discussions are held on the report on Article IV consultations and the Executive Director representing the member country has an opportunity to convey the concerns of the Board, apart from the summing up that is sent to the countries, the Fund probably is in a better position to alert a member country of any emerging problem that its staff has detected. It would be useful that simultaneously this warning signal is conveyed also to the Bank so that if any sectoral project has to be prepared for Bank assistance, the concerned departments in the Bank would be in a position to take immediate action.

The primary responsibility should be vested with the country desks in both institutions and the country desk will also coordinate as to which institution will take responsibility for technical assistance in specific fields. Any differences emerging in the country desk meetings should be referred to the joint consultation between MAE and the Financial Sector Board and in this context, I would suggest that MAE and the Financial Sector Board meet at least each quarter and I am not agreeing to the staff suggestion of six months as six months is too long a period. Furthermore, the Joint MAE/Financial

Sector Board Consultation Group should report to the respective Boards, and MAE could also use the informal country meeting, if there are any development that deserve the attention of the Executive Board. Hence, I would like to approach this problem in a two-tier method. While the lower at the country desk level, and the upper tier at the level of MAE and the Financial Sector Board.

In regard to technical assistance, it is acknowledged that there will be an overlap. This can be reduced if there is an understanding between both the institutions in that if the Bank is providing technical assistance, the Fund need not do so. Scarce human resources can be used elsewhere and the situation of both the institutions' technical experts working in the same country can be avoided.

In conclusion, I feel that given the diversified objectives of both the institutions, there will inevitably be an overlap in the functioning of the institutions; the burden of ensuring that the efforts of both the institutions are optimized falls on the shoulders of the mission leaders to the countries; there should be no hesitation in sharing information amongst team members; the team leaders should delineate the areas of responsibilities so that duplication is avoided and economy in resource utilization is achieved; and the Fund, in many cases, will be in a better position to sense emerging problems in a country on account of its annual consultations and hence it should immediately alert the Bank so that the latter can be ready with a program of assistance that the country may seek from it or vice versa.

Mrs. Guti made the following statement:

The staff paper provides a good basis for the way forward in an area that has proved to have wide macroeconomic implications and is receiving increased attention. The staffs of the Bank and the Fund have done a lot of work in financial sector issues and indeed, there are still many problems that undermine the soundness of banking systems and current efforts aimed at formalizing a joint approach by the two institutions in dealing with these problems are a welcome step in the right direction.

Collaboration between the Bank and the Fund has been well under way in many aspects of financial systems and there is amble evidence of this joint effort, particularly in program countries. However, there has also been substantial overlapping of activities by the two institutions in this area. This has led to duplication of effort, waste and sometimes confusion. It is therefore pertinent that in areas where commonality of interests of the two institutions is greater than differences, both staffs should desist from trying to magnify differences and forge toward closer collaboration.

Moreover, in program countries and those in crisis situations, there is a very thin line, if at all, between structural, sectoral, developmental and macroeconomic aspects of financial systems and markets. Under these circumstances, overlapping has led to conflicting signals from the two institutions, sometimes resulting in confusion to the authorities and contributing to weaknesses in program implementation and delays in undertaking remedial action in crisis situations.

An area not discussed in the staff paper is how Bank and Fund conditionality should be applied in this joint effort. There has been a tendency for unnecessary multiplicity of conditionality, obviously arising from the overlap. In this regard, there should not only be a clear delineation of responsibilities to avoid duplication, but also the Bank and the Fund should collaborate and present the conditionality to the authorities as a package. There is no doubt that the credibility of such conditionality is enhanced and that the urgency of policy implementation is reinforced if the two institutions speak with one voice.

The staff has mentioned the challenges to closer collaboration posed by the posting of World Bank managers to the field. Unlike the staff, I see this as a strength. If the areas of concern to both institutions are well understood, coordinated and presented as one package, the Bank field managers and Fund resident representatives who are on the ground should ensure the timely implementation of policy measures, assisted by missions from Headquarters.

On technical assistance and training, joint missions are preferable, allowing both micro and macro aspects of financial systems to be well cemented thereby providing a coherent message to recipient countries. This also ensures that the best talents of both institutions are utilized, resulting in savings and more efficient use of scarce human and financial resources by the Fund, the Bank and the authorities.

I look forward to seeing more concrete details of Bank-Fund collaboration in financial sector issues.

The Director of the Monetary and Exchange Affairs Department stated that a larger role for the Fund in the area of financial sector strengthening would clearly have resource implications for the Fund and, in particular, for the Monetary and Exchange Affairs Department. In that respect, he concurred with the remarks of Ms. Lissakers and Mr. Sobel that the Fund would need to continue to operate under a tight resource constraint and within the framework of the current budgetary guidelines. However, this implied that strict selectivity would have to exercised by the Fund with regard to the country cases it chose to focus on. He would be in close consultation with the area departments to ascertain which countries should be chosen, bearing in mind the aforementioned constraints. The current level of resources would be insufficient to cover all the countries that his department had already been told would require its involvement, so some disciplined prioritization, as well as redeployment of resources, would clearly be in order. Fortunately, some of the work that had traditionally been covered in technical assistance had been provided more recently in the context of surveillance, so there was some resource fungibility between technical assistance and surveillance activities. In addition, in the area of technical assistance, resources would need to be redeployed away from a variety of topics that had been covered toward specific, urgent financial sector issues.

Although it was true that technical assistance from the Fund—but not from the World Bank—was almost free to the recipient country, that did not imply that it was automatic, the Director emphasized. The Fund had to ration technical assistance on the basis of not only the need for the advice, but also whether the advice tended to be heeded. In that respect, he did not perceive the bias toward the use of the Fund's technical assistance to which Ms. Lissakers and Mr. Sobel had referred in their statement.

The Fund's work in the area of financial sector supervision and regulation would have to extend beyond technical assistance, a fact that the Board had been confronting for the preceding 18 months or so, the Director pointed out. That issue had arisen first in the context of the discussion on bank soundness and macroeconomic policy, and then in the subsequent discussion on the framework for sound banking, at which time it had been indicated that financial sector issues would need to be dealt with in greater detail in the context of Article IV consultations. The staff saw a role for the Fund in disseminating the principles of organizations such as the Basle Committee, as well as the best practices of the countries that were more advanced in the area of bank supervision and regulation. To a certain extent, the Fund would need to help define the role it would play; new ground was being broken, and not everything could be defined precisely ex ante. The staff would be gathering experience and refining the extent of the Fund's role in disseminating the basic principles.

The staff representative from the Policy Development and Review Department commented that Mr. Shaalan and Ms. Lissakers and Mr. Sobel had raised questions about the extent to which the paper had or had not specified a clear division of responsibilities between the Bank and the Fund in financial sector work. Mr. Shaalan, in particular, had suggested that a problem with the paper was its premise that it was possible to draw a clear distinction between the roles of the Bank and the Fund in the financial sector. The staff's view was in fact the opposite, namely, that the interaction between the macroeconomic and central banking aspects of the financial sector, on the one hand, and the structural and developmental aspects, on the other, was so close that the drawing of distinctions between the roles of the two institutions in many areas was in fact quite difficult. The staff would fully agree with Ms. Lissakers and Mr. Sobel that the microeconomic and macroeconomic aspects of financial sector issues were frequently hardly distinguishable. That was why the paper had gone only so far in presenting a clear division in responsibilities and had indicated several areas in which there might be some functional overlap. The two institutions had a legitimate interest in providing technical assistance in some common areas, although certainly not in duplicating work in individual countries.

Concerning Mr. Shaalan's question as to whether the staff had fully explored the scope for a structural delineation of responsibilities, the staff representative continued, the staff had looked carefully at that issue and felt that it had pushed it in the staff paper about as far as was sensible and feasible. To go any further would have risked restricting one or the other institution in some of the areas of overlap, and that would have limited the ability to respond quickly and flexibly to the needs of members. While delineating more clearly the areas of responsibility might have limited the problems of duplication, it would probably also have created severe problems of gaps in coverage. In that general connection, Mr. Shaalan had also asked whether it was sensible to merge the functions of the two institutions. In his view, that would be asking for trouble, and it probably would not work very well, as the problems of coordination would be far greater than they were at present.

In suggesting that Bank-Fund collaboration had worked well in practice in the past, the staff was not intending to sweep any problems under the rug, the staff representative emphasized. It was his impression that there had been few problems in terms of the two institutions talking to each other, particularly at the level of the country desk, and few disagreements about what needed to be done to strengthen financial sectors in most countries. At the same time, there were sometimes disagreements about what the priorities should be in particular countries, as the Fund might want the Bank to undertake reforms of a certain kind, perhaps to fit in with the Fund-supported program, which did not at that time coincide with the Bank's priorities. The staff hoped that the procedures that had been elaborated in the paper would go some way to solving that problem. When genuine differences of opinion arose between the two institutions, it was important that they be brought first to the attention of the senior management of departments and regions, and if a common understanding was not reached, then they should be brought to the attention of the managements of the institutions.

Timing and speed of operation was sometimes an issue, and there was often the criticism that the Bank moved more slowly than the Fund, the staff representative continued. The staff hoped that the procedures that were being put in place would ensure the timely involvement of the Bank in financial restructuring and reform, but it needed to be borne in mind that it was not always the problem of the Bank. Sometimes the Fund wanted solutions to complex problems to fit in with its financial program slightly faster than was feasible. Figuring out the extent of problems in financial systems and estimating the true problems in portfolios and the necessary restructuring took time. The Fund needed to be reasonable in its expectations about coordinating with the Bank. While the staff hoped that the procedures that had been put in place would go some way toward addressing those problems, it would be unrealistic to expect them to settle all the differences.

The staff had attempted to go into some detail in the paper about the procedures for collaboration, the staff representative considered. There would be three tiers of cooperation on country issues, with the country teams playing the major role. Senior staff in the regions and area departments should be involved at an early date if there were unresolved issues. If that was not sufficient to solve the problem, then the managements of the Fund and Bank should quickly be informed and involved. Financial sector work programs would be formulated looking six months ahead. There were provisions for information sharing, and for six-monthly meetings between the senior staff of the Monetary and Exchange Affairs Department and the Financial Sector Board, with special emphasis on crisis situations. While the staff wished to put in place an adequate structure for collaboration, it did not want to burden itself with unnecessarily cumbersome and possibly unworkable procedures merely for the appearance of collaboration. The staff believed that the procedures would be effective, but, as several Directors had emphasized, it would be important to keep them under close review and to correct and strengthen them if needed.

Comprehensive, country-by-country lists of the areas of responsibility of each organization would be prepared, and the Monetary and Exchange Affairs Department and the Financial Sector Board in the Bank would share their detailed plans for technical assistance by country and area, the staff representative explained. He was not sure whether or not more elaborate coordination measures might be needed in that area. Regarding banking sector restructuring, the paper had suggested that the Fund might temporarily play a role in crisis situations, but that the Bank should normally take the lead, which was what had happened in the case of Thailand. In that case, the Fund and the Bank had worked together closely initially, with the Fund somewhat in the lead, but then the Bank had taken over fairly quickly with the implementation of the restructuring plan that had been agreed jointly as part of the initial work. Ms. Lissakers and Mr. Sobel had wondered what was meant by the statement that the Fund would be temporarily involved, and in that regard, the experience of Thailand was also instructive, as the hand-off to the Bank had been quick. A less ideal precedent had been Bulgaria, where the Fund had found itself in the lead for several months on banking system restructuring. The staff did not envisage that that would be the case in the future. Even as the Bank took the lead, however, it would be important for the Fund staff to be closely involved with the Bank and to participate in Bank missions. In cases like that of Thailand, where financial problems were at the heart of the issue, the macroeconomic and financial program implications of financial sector restructuring would be crucial, and the Fund and Bank would have to work closely together for quite a long time.

The case of Thailand was a good example of the new procedures already at work, the staff representative concluded. The cooperation evidenced in that case had been very much in mind in framing the staff paper and in setting out procedures for collaboration. The joint effort on Thailand could be regarded as a reflection of the procedures that had been newly laid down.

The staff representative from the World Bank stated that the Bank's Financial Sector Board had had the first opportunity to coordinate with the Monetary and Exchange Affairs Department in autumn 1996. Each organization had reviewed the programs of the other and had had the chance to identify potential problems.

Questions had been raised about the ease of coordination with the Bank in the light of the Bank's organization, whether the Bank had the capacity to act quickly and to cover the full range of countries in need of technical assistance, and the Bank's role vis-à-vis surveillance, the staff representative recalled. The placement of the Bank's country directors in local offices had arisen out of senior management's concern that the Bank was losing touch with its client countries. That would be discouraged, and communications would be improved, by moving Bank operations closer to the client. At the same time, the Bank recognized the importance of a focused and consistent approach, especially in the financial sector. That would be effected by the use of technology to link the local offices with senior management in Washington. The Bank was also putting increased emphasis on the develop-ment of a comprehensive but flexible country assistance strategy for each country. The Bank's new organization was unlikely to affect the degree and character or collaboration outlined in the staff paper, in his view.

The Bank was organized primarily according to regions, not sectors, the staff representative pointed out. Each of the six regions in the Bank would be expected to have its own technical assistance capacity. In the case of the financial sector, however, each region would have a lead specialist, supported by staff. In that way, the staff would get to know each region far better than in the context of a more centralized structure.

The Financial Sector Board, which he chaired, included a lead financial sector specialist from each of the six regions, the staff representative continued. The Board would meet on a regular basis—at present, every week—in Washington to determine the priorities in the financial sector with the objective of ensuring consistency and quality control in a decentralized organizational framework. The Board would ensure that financial sector missions included expert staff from a number of regions. In his view, the Board would be an able counterpart to the Fund's Monetary and Exchange Affairs Department.

The Bank's senior management had for some time made it clear that it expected the Bank to build its capacity in the financial sector, the staff representative went on. Under the strategic compact, which had been discussed in the context of the budget earlier in the spring, $18 million would be provided over the succeeding three years to build the capacity of the Financial Sector Board to provide technical assistance in the financial sector area unrelated to lending operations. About 12–15 additional senior financial sector specialists, both for the Board and the regions, would be hired as well. The Bank had also begun to charge, on a pilot basis, modest fees to countries and certain organizations, such as the Inter-American Development Bank (IDB), for financial sector support, allowing the Bank to better leverage its resources. Countries were more concerned about the expertise of the technical assistance staff when they had to contribute to the cost of the assistance. Those initiatives would enable the Bank to make a material addition to the amount and quality of resources it was providing.

How quickly the Bank could move in the event of a financial sector problem depended on the region and the likely character of Bank assistance, the staff representative explained. In that context, it needed to be borne in mind that putting together a financial sector adjustment loan was often complex, partly related to the fact that the financial sector adjustment loan portfolio had come in for some measure of criticism from the internal auditors. A common criticism was that the Bank moved too quickly and with insufficient knowledge, and that the program was not designed as well as it could have been. At the same time, the Bank's growing acquaintance with and expertise regarding the issues, as the experience in Thailand had proved, was enabling the Bank to move more rapidly. He hoped that technical assistance loans would be approved in a matter of weeks rather than months. In that regard, it was to be hoped that the case of Thailand would be a model. It would be important for a Fund staff member to be included on the forthcoming Bank mission to Thailand, as close cooperation and coordination between the Bank and the Fund in dealing with the financial sector problems in that country would be crucial to success.

The Bank would become involved in Fund surveillance in the process of diagnosing emerging financial sector problems, the staff representative considered, and as part of the development of a country assistance strategy. It was to be hoped that, to a large degree, the Fund would be able to identify those countries with financial sector problems through its surveillance, with the Bank following up on that lead with a more intensive diagnosis. In that connection, as part of the appraisal process for financial intermediation loans, the Bank analyzed both the individual institutions and the financial infrastructure, so that a comprehensive understanding of the program risks and the Bank's exposure could be secured.

Mr. Sivaraman observed that, because the Fund had regular consultations with its members, it was probably in a better position to catch the signals of an impending crisis than the Bank was. In that connection, he wondered whether, in the context of Bank-Fund collaboration, there was a full sharing of information between Fund and Bank missions. Also, he wondered what might be the implications for collaboration in a case in which a country did not wish to borrow from the Bank, but the Fund had identified an incipient financial sector problem.

The staff representative from the World Bank replied that it was his understanding that the Fund would share financial sector information with the Bank. In a case in which one organization, but not both, were involved in a country, it was to be hoped that the further involvement of the one might encourage the authorities also to invite the involvement of the other, as had been the case in Thailand, where the Fund had taken the lead. The Fund had made it clear that the involvement of the Bank would be beneficial. If there were a banking crisis, and a country absolutely refused to deal with the Bank, he was not certain how the Bank would proceed, but it was to be hoped that such situations would be very rare.

Mr. Donecker commented that, regardless of the preferences of the country, in the event of a banking sector crisis, both organizations should be involved. Even when a country wished to deal with one institution rather than the other, the staff should insist on the involvement of both, to ensure that all the available expertise was brought to bear on the problem.

Mr. Sivaraman said that he wondered what would happen in the event of a financial sector crisis developing in an industrial country, where there was no Bank involvement. Would the Fund still be expected to bring in the Bank, or would it act alone? In his view, it needed to be recognized that, in the case of industrial countries with potential banking crises, the Fund might have to continue to take the lead.

The staff representative from the World Bank commented that he would not expect the Bank to become involved were, say, the United States to have a banking sector problem.

The staff representative from the Policy Development and Review Department said that it would be appropriate for the Bank to be involved in banking sector problems in emerging market countries. Industrial countries often had a wealth of expertise that they could draw on themselves, and they might not be in need of detailed technical assistance.

Mr. Autheman made the following statement:

> I was prejudiced against this paper by the disappointing memory of a short note that had been circulated before the spring meeting, but I must confess that I find this paper not that bad, it is even rather good. A merit of this paper is first of all the preparatory work that led to it, and second its frankness in acknowledging that one cannot draw a precise border delineating the roles of the Fund and of the Bank.
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> I have no major difficulty with the arrangement proposed in paragraph 24, stressing that in the domain of banking system restructuring the Bank's mandate suggests that it should take the lead, but acknowledging that in some cases the Fund may have to act without waiting. There are many reasons for this. It may be that the Bank is not willing or not able to lend to a country, as we have seen recently in Bulgaria. It may also be that the country is not willing to borrow long-term from the Bank for a purpose like the redesign of its prudential organization. I always have respect for finance ministers who are unwilling to borrow for activities that do not generate export receipts.
>
> We also have to take into account the fact that there is a club-like relationship between the Fund and the central bankers all over the world, and some form of technical assistance may be better arranged through the Fund, which has the capacity to convince other central banks to come and join its own missions. Therefore, while belonging to those who want to stress the importance of the Bank role, I have no major difficulty in acknowledging that such a rule requires exceptions.

Mr. Shaalan and Ms. Lissakers stressed the issue of the overlap. I must confess that I am less concerned by the overlap than by the void. Until two years ago, there was not much concern in the Fund about the importance of the soundness of the banking sector. Indeed, I remember discussions in this Board where the issues of banking liberalization and a rapid move toward indirect monetary policy were emphasized much more than the issue of the strengthening of the banking sector. Clearly, the Fund has reacted to events and has placed great emphasis on that priority. Since the Fund is a centralized and narrowly-focused institution, it has been quite easy for it to move in that direction.

One has to be aware that the Bank is an institution with much broader coverage, apparently the same membership, but completely different preoccupations. I have not so far perceived among my colleagues in the Bank the same degree of concern as among my colleagues in the Fund. Issues such as health, education, and environment are much more in the minds of the Bank than issues such as financial sector reform. Mr. Burton was, I think, right in pointing out the fact that any improved collaboration will not substitute for a lack of sense of priority. I would not want to ask more of the staff. I think that trying to interfere in the precise drafting of this paper would be micromanagement, but the Board must be certain that the membership of the two institutions is pressing the Fund and the Bank with a similar degree of strength. So far, it is not something I have perceived.

Therefore, although it is too late, according to the rule, to make a proposal for the agenda of the Development Committee, I would suggest that the Board consider reviewing the draft provisional agenda and adding to the agenda the discussion of this paper, not in order to enter into details, but in order to get from the membership the needed pressure to make sure that this will remain a priority.

Mr. Donecker made the following statement:

First, I would like to thank the staff for the very helpful, concise and comprehensive paper. I have no problems endorsing its main recommendations and objectives for the collaboration between Fund and Bank, however, I am afraid I am more skeptical with regard to the status quo.

The paper correctly refers to the broad guidelines in the Concordat of 1989, which provides an appropriate basis for collaboration between the Bank and Fund on financial sector work. While the Bank is primarily concerned with the sectoral and development aspects of financial systems in developing countries, the Fund relates primarily to the macroeconomic aspects of financial systems and markets in all member countries. In this regard the recently established "financial sector board" in the Bank hopefully will promote the predominant role of the World Bank in the area of structural reform in the financial sector.

It is important that the Fund concentrates on the role given to it by its mandate as a monetary institution. It should cooperate very closely with other international institutions and, in particular rely on their specific expertise. Especially with regard to the implementation of internationally accepted standards and best practices, we particularly welcome the envisaged cooperation and feedback of World Bank and Fund with the Basle Committee, given that, in these areas, the rule-making capacity of other international bodies has to be respected.

I am afraid the so-called special provisions do not reflect this division of labor adequately. According to staff, it is suggested that the Fund may play a comprehensive role in financial sector issues in those countries where the Bank temporarily is not involved, particular so in cases of an emerging or open crisis situation.

Such a "first come" approach will lead to confusion of responsibilities and inconsistencies. It may—by the way—also lead to a progressive takeover of financial market responsibilities by the Fund as quite frequently—and thanks to its flexibility and efficiency—the Fund tends to be the first one to get involved.

The traditional division of responsibilities between Fund and Bank must be respected by both institutions. There should be the general assumption that in all its member countries the Bank should deal with the structural questions of the financial sector, irrespectively whether it is financially involved or not. It is up to the Bank to establish the appropriate instruments for technical advice in this financial sector work with or without providing financial support at the same time.

It is undisputed that in cases of actual or potentially imminent crises the Fund, due to its catalytic function, has a leading role. But this role should remain limited to its macroeconomic surveillance role possibly providing needed technical assistance and to the negotiation of an adjustment program and on bringing other responsible actors together. In this context, whenever structural problems in the financial sector are a substantial part of the problem, the Bank has to get involved right from the beginning to address them. Ideally, the financial sector reforms proposed and supported by the Bank should be integrated into the Fund supported stabilization reform program as bench marks with fixed implementation schedules.

In the past there certainly have been weaknesses in Bank/Fund financial sector collaboration. There is definitely still much room for considerable improvements.

The new SDDS should help to identify balance of payments imbalances at an earlier stage and should also help to tackle problems when they arise. Both institutions—Fund and Bank—are required to react to these signals in a timely manner with due regard to their respective mandates.

Finally, in principle, we welcome the intention to conduct regular reviews of financial sector collaboration between the Bank and Fund. In this regard we would welcome, if these reviews—similar to the recently provided

ESAF review—would address and analyze a few exemplary cases in a self-critical manner. The case of Thailand should definitely be included in the first review. Needless to say, however, that these reviews should, of course, be far less extensive than our staff's most recent ESAF review.

In any case we support Ms. Lissakers and Mr. Sobel's request that Fund and Bank staff prepare a short paper ahead of the next 1998 Annual Meeting, assessing progress in implementing the strengthened collaborative procedures as evidenced by specific country experiences.

The Chairman said that he had taken note of Mr. Donecker's suggestions.

Mr. Yakusha made the following statement:

The recent crisis in Thailand shows once again how important it is to detect and address financial sector weaknesses at an early stage. Both the Bank and the Fund have a mandate in this area, and I think it is fair to say that the collaboration and division of labor between the two institutions have not always been satisfactory. Let me start out by saying that the paper before us goes a long way in addressing this. In fact, I suspect that the very production of this paper has been a useful exercise, as it forces both institutions to take a good look at what each should do.

I broadly agree with the content of this paper. In fact, I have just one concern. The basic weakness in the division of labor appears to be in the area of financial sector restructuring. The prime responsibility in this area lies with the Bank. However, as this sometimes needs to be done in a crisis situation, it is important that the restructuring process gets up to speed very fast. The problem is that the Bank's procedures are not always equipped for a rapid response, and as a result, the Fund temporarily fills the gap. A well-known case from my own constituency, where things did not go as smoothly as planned, is Bulgaria. More recent examples where the Fund stepped in ahead of a Bank program are Mongolia and Thailand. Let me note that I have no quarrel with these individual cases. However, we need to address the root of why the division of labor turns out opposite to what one would expect. Clearly, it is not satisfactory that the Fund takes on an additional mandate by default. There are three concrete measures I see to redress this problem, two of which are contained in the paper.

The first measure is better surveillance over the financial sector. In the case of Thailand, a primary reason the Bank cannot get a program up and running quickly is that the magnitude of the financial sector problems was not uncovered until the last moment, and the Bank had not been present in the country's financial sector before. This is something the Fund can help with. Through better surveillance of members' financial sectors, the Fund can detect problems at an early stage, and get the Bank involved more quickly. Therefore, I welcome that the Area Departments are devoting more attention to financial sector issues, and the concrete measures have been taken to that end. In some cases, the Area Departments are provided with a 'financial sector note' to brief them on the issues. In addition, MAE now accompanies the missions in some cases. Ideally, the information that results from this improved surveillance should be automatically conveyed to the Bank. To this end, it could be useful to have a more standardized collaboration mechanism between MAE and the Bank's Financial Sector Board. Perhaps the staff could comment what specific steps one could take to this end. As a final note on surveillance, I welcome the intention to come up with a joint framework for looking at financial sectors. The Core Principles developed by the Basle Committee can serve as a unifying element.

Next to the steps to improve surveillance, a second concrete measure has been taken on the Bank side. The Bank's early involvement is constrained first of all because it takes time to get a program up and running, and secondly because not every country will request a Bank program. For both reasons, the Bank needs mechanisms to be involved outside of the program context. The paper announces that supplementary resources have been made available to increase the Bank's nonlending and technical assistance, outside of the program context. This is very useful, and as I understand these initiatives are already put to practice in the case of Thailand.

A third concrete measure, would be to increase the speed with which Bank programs get up and running. This is something I missed in the paper. To take the cases of Thailand and Bulgaria again, it seems that roughly half a year is needed to get a Bank program approved. If the Bank is to be responsible for restructuring, including in an emergency situation, this is simply too long. And although some technical assistance or other nonlending activities are useful in the interim, ideally these activities should be structured and planned in a program context. In the case of Thailand, I understand that some sort of interim-program is envisioned, in anticipation of a more comprehensive loan program. I would be interested to hear from the World Bank representative what has been done in the case of Thailand, and if this will be replicated in future cases.

Let me end by saying that we welcomed this paper. It would be useful for both Boards to evaluate the mechanisms for improved collaboration in a year or two.

Mr. Bernes made the following statement:

This topic is a frustrating one—frustrating for a Board that felt that the responses from the staff have not yet met the perceived need, and frustrating for the staff and management, who feel that they are not quite sure what it is that the Board is looking for.

This frustration was captured to some extent by what Mr. Autheman said: that there was a void out there. We must realize the context. A broad consensus has emerged internationally only recently, in no small part due to the Chairman's leadership, on the need to strengthen members' financial sectors. There was a need to develop generally accepted principles of sound banking, where the Bank for International Settlements, which should play that role, was lagging. Fortunately a substantial effort has been made, prodded by the international community, including this organization.

We are now focusing on the division of labor between institutions in promoting sound banking. To use Mr. Autheman's words, there is a void. The starting point is that neither the Fund nor the Bank—nor the other multilateral development banks—currently has the capacity to do what is needed, and most of us recognize that. This capacity must be built up, in terms of both human resources and structures. What some would like to see is a starting point: the model, the blueprint—recognizing that we are starting to face real challenges, as well as resource constraints. The staff does not want to put undue constraints on itself, and we operate in different time frames, different contexts, and different countries. Nevertheless, of course we are going to cooperate and share information. There is a concern on the part of some that the system one could end up with may not, because of the dynamics of certain organizations, be the same as what might be desired. That is part of the dynamics we see here, and perhaps part of the frustration.

The paper before us today is a step forward, and a response to the request Directors made in our last discussion on the need for further elaboration. As Mr. Donecker said, the need for elaboration was reinforced by the lengthy ESAF review, in particular because it found that performance was poorest in the banking sector and public enterprise reform, the two areas in which Bank-Fund collaboration is most critical. That underlines once again that perhaps past experience has not been what it could be. Like Ms. Lissakers, I have some doubts that existing channels of collaboration have worked as well as they could have. This, therefore, provides additional motivation for work. While the paper is a step forward in delineating respective roles, as others have said, we are at a very early stage; this is complex. There is legitimate reason for overlap, as the paper notes, but there is the need to avoid duplication, which is a much more difficult task.

I agreed with most of the comments of Ms. Lissakers and Mr. Sobel. As they and others have noted, the principles and modalities to enhance Bank-Fund collaboration outlined in the report will need to be tested in real situations. I would therefore emphasize the importance of regular reviews of financial sector collaboration between the Bank and the Fund.

To support the implementation of the proposed framework, consideration might be given to reviewing the collaboration experience in recent episodes of banking crisis, such as the cases of Bulgaria or Jamaica. As the Executive Director for Jamaica, I think I can say that the collaboration has been good between the institutions.

Some cite Thailand as the new model for collaboration between the Fund and the Bank in the financial sector. I would equally be interested to know, over the course of the last year, what was the nature of the collaboration, and what reinforcements there were between the organizations. To understand the Thai model, it is not sufficient to look just at the current program; rather, the situation needs to be looked at in much greater depth.

An external evaluation of the respective roles of the Fund and the Bank in the provision of financial sector advice could provide useful input for our efforts to enhance collaboration and to identify areas in which this can be strengthened.

Mr. Yoshimura made the following statement:

Recognizing that the conditions in financial sectors have a significant impact on macroeconomic performance, the Fund has paid increased attention to the stability of the financial sector. Against this background, I welcome today's opportunity to discuss how to improve Bank/Fund collaboration in financial sector work. However, I am somewhat disappointed and—to use the words of Mr. Bernes—frustrated—to see a staff paper on this subject that does not contain concrete suggestions. The staff and Bank representatives' response today is also not so persuasive, as they explained the ad hoc nature of the collaboration. We are discussing this subject because we are not satisfied with the result of that ad hoc collaboration, and that collaboration must be improved. To accept a continuation of ad hoc collaboration would be unsatisfactory.

Upon reading the staff paper, I noticed that the general provisions for collaboration, which are supposed to be communicated formally by management to the staff, would provide an important basis for collaboration between the Bank and the Fund. However, the paper does not indicate in meaningful detail exactly what these general provisions are, or how they address the issue of collaboration between these two institutions. I doubt that our discussion today will be useful without knowing more details of these provisions. We must have the provisions in detail so that we are able to discuss this issue more concretely.

As the staff paper points out, the Concordat of 1989 clearly defined the framework of the division of responsibilities between these two institutions. Based on the Concordat, their work should be organized in a way that minimizes the overlapping of work, whereas the staff paper admits to the potential overlapping in various aspects. As many Directors admit, I also understand that some overlap is unavoidable, but every effort should be made to include a well-defined mechanism to avoid mutually contradicting policy advice in the context of such collaboration.

The staff paper not only fails to present such a mechanism to facilitate collaboration, but it even fails to show us how to properly determine which institution should take the lead in financial sector work in certain circumstances. Rather, the paper recognizes a relatively unclear factor, such as relations with the authorities or the preference of authorities, as contributing to determining the lead. Further consideration in this regard is needed. On this occasion, I would like to stress the importance of cross collaboration, not only between the Bank and Fund, but also in respect of other regional and international financial institutions and international regulatory bodies, as previous speakers pointed out. In order to make such multilateral collaboration effective, we have to start by clarifying better the respective roles of the Fund and Bank and the nature of their collaboration.

Finally, I hope that the framework for collaboration between the Bank and Fund in financial sector work will be defined and concretely established through further discussions on this subject. Therefore, the suggestion in the staff paper to have a regular review of financial sector collaboration is welcome. I also support Ms. Lissakers and Mr. Donecker's suggestion to review the experience of collaboration.

Mr. Gruber made the following statement:

This paper on Bank-Fund collaboration on financial sector issues provides a more detailed description of the fields of possible interferences and of the core competencies of the two institutions than the earlier joint statement on this topic. However, in many specific issues the division of labor continues to remain vaguer than we would have wished for. The degree of overlap is remarkably high. Although we recognize that this stems from the strong interrelations that exist between the developmental and macroeconomic aspects of financial sector issues, we should try to define more precisely the activities of the institutions. This might not be feasible at this stage, since the role of the Fund in this area is evolving rapidly. However, this could be one of the goals of the proposed future reviews of Fund-Bank collaboration in this sector.

We agree with the staff that the principle that the Bank is primarily concerned with the sectoral and developmental aspects of financial systems in developing countries, while the Fund's involvement in financial sector issues relates primarily to the macroeconomic aspects of financial systems and markets may well serve as a broad framework, but is not sufficient to allow a clear division of responsibilities between the two institutions. Moreover, also a more strict delineation, for instance along the lines of activities (evaluation/ surveillance, technical assistance/training, banking restructuring/lending), on the one side, and the operation level (central bank as a lender of last resort, banking supervision and regulation, and individual banks) on the other, either may not be feasible for the time being or may not be desirable in allowing a certain flexibility.

Under these circumstances, to avoid duplication, close day-to-day and case-by-case coordination and collaboration between Fund and Bank is necessary in those countries, where both institutions are operating or are going to operate. The paper mentions the necessity of strengthening collaboration between the institutions. However, besides the regular meetings between MAE and FSB on the coordination of technical assistance, the paper does not propose any new concrete measures to improve the current situation. While we agree that existing channels of communication have more or less been satisfactory, they will not suffice in the future. As the Fund has taken on a more important role in financial sector issues, the danger of duplication has increased. And the large areas of overlap described in the paper will also increase the competition between the two institutions, which again heighten the risk of turf battles. We think that this would necessitate improving the current ad-hoc cooperation and introducing a higher degree of institutionalized collaboration.

Turning to specific areas of collaboration, we would like to highlight particularly the importance of early collaboration between the two institutions in cases where bank system restructuring requires budget support. Early involvement of the Fund can in these cases ensure that the restructuring approach chosen fits into the macroeconomic and fiscal framework. Furthermore, we welcome the strong collaboration, including joint missions, planned in crisis situations. It is noted in the paper that Fund involvement in such cases can even comprise an involvement in banking restructuring. Like other speakers, we were interested in what way and time frame staff would view such involvement. The staff's comment on this issue has been very helpful. Whereas we see the necessity of a possible Fund involvement in banking restructuring in crisis situations, we still fully support Mr. Sivaraman, who asks to immediately alert the Bank of any emerging problem in the financial system that Fund staff has detected, so as to allow the Bank—which actually should take the primary responsibility in banking restructuring—to be prepared for immediate assistance and to avoid, whenever possible, any Fund involvement in this area.

In conclusion, although the paper cannot fulfill all our (perhaps unrealistic) wishes concerning the definition of clear competencies of the two institutions, we think that it is particularly helpful as it discloses the fields of possible interferences, defines some criteria to determine the responsibilities of each institution on a case-by-case basis, and as it highlights clearly the need for an improvement of the collaboration between Fund and Bank in their day-to-day business. These guidelines now need to prove their worth in practice. We welcome the intention of the staff to monitor the effectiveness of collaboration by regular reviews. We agree with Ms. Lissakers and Mr. Sobel that the Board should, in one way or another, be involved in these reviews and support the request that Fund and Bank staff prepare a short paper ahead of the next Annual Meeting (1998), assessing progress in implementing the strengthened collaborative procedures as evidenced by specific country experiences.

Mr. Guzmán-Calafell made the following statement:

With the increasing importance of financial sector issues in the world economy and the more active involvement of the Bretton Woods institutions in addressing these issues, the need for more efficient mechanisms of coordination between the Fund and the Bank has naturally acquired added importance. This need is further underlined by the complementary roles that these institutions play in their financial sector work, and by the limited resources available to carry out this important task.

In evaluating the ideas included in the paper, one can depart from the staff's comment that, so far, "existing channels of collaboration between the Bank's regions and country departments and the Fund's area departments have generally worked quite well, avoiding unnecessary duplication in individual cases or significant problems of inconsistent policy advice." If this conclusion is correct, it is reasonable to believe that the foundations for the delineation of the framework for a strengthened collaboration between the two institutions included in the paper are solid. I am concerned, however, by the reservations expressed by many Directors regarding the efficiency of the existing channels of collaboration between the Bank and the Fund. I note the staff's reaction to those views, but I am still troubled by the evident discrepancy in perceptions, and I wonder what can be done in this regard.

I can endorse the proposals put forward by the staff. I welcome in particular the measures contemplated to seek a more effective provision of technical assistance and training by the two institutions to those countries demanding this support. I would only like to make three additional comments:

First, it is not fully clear to what extent the framework described in the report departs from the approach that is being followed by the two institutions at present. I get the impression from the paper and from the staff's comments that a good number of the elements of the framework have been in operation for some time. I find a clarification on this important, in light of the doubts expressed by a number of Directors on the merits of the existing channels of collaboration.

Second, while the framework depicted in the paper seems to provide a good basis for an adequate collaboration between the Bank and the Fund on financial sector issues, the lessons derived from our recent review of the experience under ESAF-supported arrangements are a remainder that we must not be over optimistic. Like Mr. Shaalan and Mr. Bernes, I note that during that discussion many Directors saw scope for an improved coordination between the Bank and the Fund in areas of overlapping interest, despite the fact that it was precisely in these areas where some of the more serious problems had been detected in the review carried out several years earlier. One of these areas was precisely bank restructuring.

Third, the staff proposes to carry out regular reviews to monitor the effectiveness of collaboration on financial sector issues between the Bank and the Fund. These intentions are welcome especially in view of my previous comment, but like Ms. Lissakers and Mr. Sobel and others, I would be interested in a further elaboration by the staff on the prospective Board involvement in this process.

The Chairman said that he had been intrigued by Mr. Guzmán-Calafell's suggestion that the Board become more boldly involved—without approaching micromanagement—in reviewing the experience with Bank-Fund collaboration in financial sector work.

Mr. Guzmán-Calafell explained that he agreed that micromanagement should be avoided at all costs. His recommendation was for the Board to be kept informed of developments in the application of the collaborative framework. There should be relatively frequent discussions on the collaboration that was taking place. In that context, the suggestion of several of his colleagues to consider a paper reviewing the experience with collaboration in the financial sector before the 1998 Annual Meeting would go a long way toward meeting his concerns.

Mr. Han made the following statement:

I welcome the staff paper's elaboration on the Joint Statement of the World Bank President and the Fund Managing Director, and wish it could better promote the collaboration between the Fund and the Bank. I am in broad agreement with this paper and would like to make brief comments for emphasis.

I generally concur with the staff that existing channels for collaboration between the Fund and the Bank have worked reasonably well. Yet, there are still certain areas where more effort on the part of both institutions is needed to strengthen or specify the collaboration mechanism on financial sector issues. Moreover, we join the staff and other speakers in stressing the importance of conducting regular reviews on the collaboration between the two institutions, to keep up with their evolving roles in the financial sector.

Given that all kinds of financial sector issues facing member countries are closely related, it is inevitable to see some overlap in the interests and responsibilities of the Fund and the Bank. Nonetheless, the two institutions should jointly make every effort to ensure that unnecessary duplication or possible gaps in coverage in future work are avoided. To this end, except for routine meetings between the staff and the management of both institutions, we believe it would be important to increase Bank staff's participation in the Fund Article IV missions and Fund staff involvement in the Bank missions, or to form joint missions when necessary, for a greater number of countries, rather than just for a limited number of cases.

Technical assistance is important for both the recipient country and the two institutions, and would be more effective if the two institutions could work together more closely when the joint efforts of both institutions are necessary. In this regard, I associate myself with Mrs. Guti that joint missions are preferable to provide a coherent message. With increased globalization of financial markets and rapid changes in the financial sectors of member countries, there are a growing number of cases where one institution's expertise may not be sufficient to solve the issues facing technical assistance missions or where inconsistent advice could possibly emerge if each institution provides separate technical assistance. These cases clearly call for the formation of joint technical assistance missions.

In the process of strengthening Fund/Bank collaboration in their financial sector work, it is also essential to enhance cooperation with other institutions, especially in the banking supervision and regulation areas. In cases where the problems to be resolved go beyond the combined institutional capacity of the two institutions, it would be desirable to expand the two institutions' joint missions, to include experts from other institutions, such as BIS, the Basle Committee, and regional development banks or from relevant central banks.

Mr. Zoccali made the following statement:

We welcome this further attempt to operationalize the overlaps and gaps that might exist in Fund and Bank collaboration so as to meet the challenge of strengthening financial sectors in member countries in a manner that prevents or reduces the likelihood of disruptions to growth and macroeconomic stability. We are convinced that weak domestic financial systems have become, in a world of integrated markets and liberalized capital movements, the key element behind episodes of financial instability; generating not only costly national tradeoffs in fiscal and social terms but also significant spillover effects.

It is clear that the Bank and the Fund are uniquely placed to make a difference in this regard. Rather than just concluding that the broad framework for collaboration based on the 1989 Joint Memorandum on Bank Fund Collaboration "has generally worked reasonably well," we would have preferred, given the recurrent characteristics, for example, of the most recent financial crisis and the domestic and international consequences of weak financial systems, generally a clearer operational blueprint to ensure that collaboration will be more effective in the future.

The multifaceted nature of the issue, the differences in the time frame under which the Bank and the Fund operate, the Bank's own reorganization and the Fund's limited staff resources call for a pragmatic and evolving approach predicated on achieving the basic objective of avoiding either duplication or gaps in coverage in future work. In this regard, we generally support the proposals before us. The yardstick for measuring the effectiveness of the strengthened financial sector collaborative procedures, however, should be their contribution to reducing the incidence of country specific instability, including recurrence of past weaknesses.

We see a strong case, therefore, for beefing up preventive technical assistance and financing by the Bank, particularly in the areas of banking supervision, prudential regulations and sectoral development, in addition to leading the way in banking sector restructuring. Prevention requires consistent diagnosis, nonconflicting advice and orderly institution-building, which, in turn, must be accompanied by effective follow-up and improved coordination when remedial actions to correct identified financial sector weaknesses are called for by the authorities.

We are less concerned by the prospect of some overlap, given the natural interaction between the macroeconomic and structural and developmental aspects of financial systems than by late, insufficient or nonexistent response while the institutional division of labor is being sorted out. Time in resolving financial sector difficulties is of the essence.

Pragmatism calls for fullest use of the Fund's comparative advantage based on the expertise it has developed, the quality of the dialogue established with member country authorities and its demonstrated ability to react quickly. We, therefore, agree with the Fund's temporary involvement in crisis situations. It is important, however, that the Bank be prepared to move in more quickly and take the lead in bank restructurings. The current reorganization of the Bank and the strengthened financial sector collaboration procedures should serve to establish a timelier working relationship with member countries under its sectoral and development responsibilities, not just when financial sector weaknesses have evolved into full-fledged crisis. In this regard, we look forward to a more precise delimitation of operational responsibilities between the Fund's surveillance activities and the Bank's sectoral and developmental responsibilities over time, to help minimize the problems associated both with inconsistent policy advice and different assessments of the financial sector policy framework or of the fiscal costs of restructuring, and to improve the institutional response mechanism to financial crises, keeping in mind that the costs stemming from gaps in responsibilities far exceed those associated with some overlapping.

If the strategy for strengthening financial systems is to be more than a formal priority, collaboration in crisis situations should also not lead to a simultaneous reduction in the capacity of both institutions to deliver the technical assistance and training necessary to continue development and support of sound financial systems in other member countries.

Given the frequency and widespread nature of banking and financial crisis, it is essential that the Fund in the exercise of its surveillance responsibility not circumscribe its assessments regarding adequacy of financial sector policy frameworks to emerging market economies. In this context, the Fund should encourage and facilitate collaboration among national supervisory authorities and other competent bodies to bring about not only greater acceptance of internationally accepted standards and best practices but also to provide feedback on the implications of assessment findings in light of particular emerging market experiences for the enhancement of international norms.

In sum, we see no alternative but to be pragmatic in this field and look forward to regular result-oriented reviews of progress in implementation of the strengthened procedures for financial sector collaboration between the Fund, the Bank and other participating regional development institutions in a manner that is not limited to program countries.

Mr. Joyosumarto made the following statement:

We welcome today's discussion on joint Bank-Fund collaboration in financial sector work. The issue of strengthening the financial sector has assumed grave importance in today's globalized economy. As we share many of the views and concerns expressed by the various authors in their statements, we would just like to state the following.

Given that there is often no clear division between the micro and the macro in financial issues, we would like the staff to present in more detail how the collaboration between the Bank and the Fund in strengthening financial sectors is to be implemented operationally. How the coordination of the decision making and review processes of the two Boards of Executive Directors is to be conducted must also be clearly spelt out.

We note from footnote 1 on page 3 that collaboration with other institutions is not covered in this paper. It is recognized that Bank and Fund staff may not often have the necessary expertise, and there are staff constraints in both institutions. Serious considerations must therefore be given to including the involvement of the BIS and other multilateral development banks, as well as the participation of member countries in providing relevant technical assistance. We would prefer to see a single comprehensive paper, showing in detail the framework of collaboration among all institutions involved, rather than having a series of papers and trying to piece together on our own the whole picture for our authorities.

On page 3 paragraph 5 of the paper it is stated that "Collaboration between the Bank and Fund will aim to ensure that: (i) financial sector problems in all countries are promptly identified." We are concerned that, implicitly, this exercise only addresses financial sector crisis in developing countries, as the World Bank does not operate in industrial or advanced economies. It must be recognized that major problems in the financial sectors of the industrial or advanced economies can happen and can have significant systemic effects on regional and the global economy. Could the staff clarify what are the existing mechanisms to address financial sector problems in the developed economies?

Mr. Al-Turki made the following statement:

Recent economic developments in emerging market economies are a reminder of the national, regional, and global implications of problem-ridden financial systems in today's rapidly integrating world economy. The Bank and the Fund are therefore rightly at the forefront of international efforts to promote sound financial systems. Since the issues inherently overlap, a well-functioning collaboration is clearly essential to avoid duplication and inefficiency.

The report is reassuring that Bank-Fund collaboration has continued to work reasonably well in line with the 1989 Concordat. Areas that the staff has singled out for improvement in the present context include identification of country-specific weaknesses, division of labor, and maintenance of consistency between the Bank-led micro-level restructuring of financial systems and the Fund-led macroeconomic adjustments and structural reforms. Here, the focus should be on extension of practices that have contributed to the satisfactory aspects of Fund-Bank collaboration. Let me add a few remarks here for emphasis.

First, effective, timely and comprehensive exchange of information is critical. Continuation of senior staff meetings on a routine basis is important. On a working level, the priority should remain on a regular exchange of work programs and relevant country-specific information. Here, existing modalities may have to be modified in view of the Bank's ongoing reorganization. The recent creation of a Bank-wide Financial Sector Family and Financial Sector Board is welcome. I am, however, unclear whether practices at the Fund would also require adjustments. Staff comments will be welcome.

Second, regarding improvements in the Bank-Fund division of labor, it is important to recognize that a substantial overlap is unavoidable since the Bank and the Fund differ only in their perspectives on financial sector issues. Here I agree that the Bank should indeed normally take the lead in financial system restructuring. At the same time, the Fund has to be in a position to provide not only a global view of the issues but also the macroeconomic guidance that individual countries may need at times of crisis. Therefore, the focus has to be on what is being done rather than on whether the Bank or the Fund is on the lead.

Third, uniformity of approach across countries is critical. I am therefore looking forward to the guidelines that Bank and Fund staffs envisage to evaluate conformity of national financial systems to internationally accepted standards and best practices. In that context, I welcome the proposed systematic feedback to the Basle Committee for enhancement of international banking norms. Reliance on international best practices will greatly facilitate improved Bank-Fund collaboration on reform and restructuring of the banking system. Prior Bank-Fund consensus on broad guidelines would be particularly helpful in view of the lead that the Fund may have to take in crisis situations of countries where the Bank has been less actively involved in financial sector restructuring.

The paper, while outlining an important agenda, is unclear on the next step. I will therefore appreciate staff views on the next practical step toward guidance and monitoring of a more effective Bank-Fund collaboration on financial system strengthening.

Mrs. Gonzalez made the following statement:

I welcome staff's exposition of existing procedures and suggestions to strengthen collaboration between the Fund and the Bank in financial sector issues. I agree with Ms. Lissakers that we are only at the beginning of clarifying the framework and I share the expectation for a stronger and more clearly defined collaboration in the period ahead. I appreciate the difficulties that such clearer delineation of responsibilities could entail but it seems that it *would be crucial to do so if the two institutions are to achieve maximum* efficiency and effectiveness in their work.

My impression is that there is great degree of flexibility in the activities of the two institutions in the financial sector, and that in practice, no strict criteria are followed in determining what each can do in the field despite their specified mandates. While welcoming many of the suggestions put forward in the paper, I believe the collaboration could be further strengthened. The Fund, through its regular bilateral and multilateral surveillance is better placed to identify weaknesses, i.e., provide warning signals about existing or emerging problems in the financial systems, particularly in the banking systems, of member countries that could potentially have significant macroeconomic implications. Having done this, the Fund could quickly share its findings with the Bank, which could in turn participate in the design of policy advice or remedial measures that could be included in the Article IV consultation report or otherwise communicated directly to the authorities. Depending on the scope and severity of the problems identified in the Fund assessment, the Bank can follow through the work by undertaking an in-depth examination of the problems, especially those that would call for structural reforms, and provide appropriate recommendations, in coordination with the Fund.

Assistance in the area of structural reforms and bank restructuring—be it financial or technical in nature—would seem to fall more within the responsibility of the Bank. Two clear exceptions would be technical assistance in the areas of central banking and development of money and foreign exchange markets, which would fall within the domain of the Fund. The Fund (through its regular surveillance functions) could in the main, be responsible for monitoring the overall health of the financial sector and the paper entitled "Toward a Framework for Financial Stability," which is scheduled for publication shortly would provide helpful guidance to staff in this regard. On the other hand, the Bank, in coordination with the Fund and the authorities, could be responsible for working out a detailed plan of action to strengthen the financial system of a member country over the long-term. Adherence to agreed mandates would be essential as it would minimize overlaps, avoid duplication and enhance specialization resulting in more optimum utilization of limited resources in the two institutions and a better provision of services to member countries.

Sharing of information and work programs by country teams would certainly be helpful in avoiding overlaps and in systematizing the approach to financial sector issues. However, I would reiterate the need to clearly delineate primary responsibilities which should be adhered to in general. Where quick action is necessary and the Fund is in a position to provide the needed assistance, there should be no hesitation to do so. Responsibility should, however, be passed on smoothly to the appropriate institution at the earliest possible opportunity. In turn, the Bank should establish a mechanism by which it can act on vulnerable/problem situations quickly as this will be crucial to the promotion of macroeconomic stability in the countries concerned.

Finally, I welcome the proposal to regularly review the procedures for financial sector collaboration and their implementation and support Mrs. Lissakers's suggestion for a short staff paper reporting on the progress in implementing the strengthened collaborative procedures prior to the next annual meetings. In this connection, we would appreciate the inclusion of Mongolia among the countries in which actual experiences will be assessed.

Mr. Shields made the following statement:

My reaction to this paper was rather like Mr. Autheman's. I was surprisingly reassured by it. I agree with everything Mr. Autheman had to say in this area, in particular about the different approaches in the Fund and the

Bank and the way to address these differences in the future. What the staff representative from the World Bank had to say about the way these matters are addressed in the Board actually supported those feelings. The only area in which I slightly differ from Mr. Autheman was the suggestion that this subject be put on the Development Committee's agenda. My mind is open on that, but we already have two seminars on this topic, so we may be overdoing it. We should talk about this when the agenda is fully discussed.

I was reassured by the forward-looking elements of the paper, and the way in which collaboration will be ensured in the future, in particular, the different ways in which this topic will be managed. However, I would have liked to have seen more detail in the paper, including perhaps some recent case studies, such as Bulgaria and Mongolia, in order to make us feel fully confident about our approach. It would have been helpful to have the problems laid out, balanced against the procedures that are now being put in place, so that we could assess whether they were going to achieve what they intend. I hope that the next review, which we are asking for before the 1998 Annual Meeting, will look at experience from now on, including Thailand, but also perhaps with some references to the problems identified in the past, and some assessment of whether or not they have now been resolved.

An important aspect of surveillance will be the formulation by the staff of a joint set of guidelines between the Fund and the Bank about whether the authorities have actually implemented a financial sector policy framework that is consistent with internationally accepted standards and best practices for identifying significant problems. I hope this work will be concluded fairly soon. I wonder, also, whether these guidelines might include agreed conditionality criteria, or ways of approaching conditionality criteria, so that we are assured that both the Fund and Bank will be moving in the same direction. We will need to check these suggestions in their final implementation, but one aspect that we probably should know a little bit more about in advance is what the staffing implications are likely to be. In countries in which these issues are not a great concern, one would not expect to have a specialist from the Monetary and Exchange Affairs Department on the mission for the Article IV consultation, for example. Presumably, the desk economist would be responsible for identifying vulnerabilities. That raises the question of training and qualifications and the overall burden that is put on the teams themselves. This should receive adequate attention and high priority, but we need to take account of available resources and priorities between different activities.

While we are looking primarily at the issue of collaboration between the Fund and Bank, there is also the issue of collaboration with the regional development banks and with the Basle committee and other interested parties. A companion paper should implicitly set out ways in which this collaboration can be ensured in the future.

Regarding the sharing of information, the paper itself implies that there could be circumstances in which the authorities would object to the transfer of information. I would like a slightly stronger reassurance that this is not going to be a major problem.

The Chairman commented that the Basle Committee was not provided with the instruments to conduct surveillance activities that paralleled or supplemented the Fund's own surveillance activities. For that reason, it would be some time before staff of the Basle Committee were included in Fund missions for Article IV consultation discussions.

Mr. Shields remarked that his main concern was that all the organizations concerned should move in the same direction. There could be collaboration between the Fund and Bank and individual central banks in financial sector work, in his view.

The Chairman replied that a number of organizations tended to tap the same pool of resources for financial sector work, the pool of the Group of Ten central banks, which was rapidly being exhausted. However, the Fund and Bank had training capabilities. That might help to ensure that, over time, there were people with the right competencies to work on financial sector issues.

Ms. Srejber made the following statement:

> Like previous speakers I welcome this opportunity to discuss the framework for cooperation in the financial sector activities between the Fund and the Bank.
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> There can be no disagreement on that increasing emphasis must be given to financial sector work in both the Fund and the Bank in the time ahead, and that the two should provide their input to the global concerted international strategy that is being worked out to foster financial stability—each institution with primary responsibility in its area of expertise. We are dealing with an issue where large demands are being put on limited resources.
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> I think it is a fair simplification to say that what this Board is concerned with is that the Fund must neither overstretch its available resources—and by that I mean both the skills and the number of persons—nor its mandate.
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> Like others, I take note of the difficulties involved in this exercise of defining the respective roles for the Fund and the World Bank. In this respect, I share many of the reflections expressed by Ms. Lissakers and Mr. Sobel in their statement on the joint paper and the need for further work. I would think that a greater distinction between the micro- and macro-aspects in financial sector strengthening is feasible. Clearly the micro and macro are interlinked, but the micro involves knowing details of banking, details of the financial shape of banks, and of bank restructuring, whereas the macro deals with the interrelationship between the macro economy and the health of the financial sector. I do not think we should overrate the difficulties in drawing such a distinction—it can be compared to the division of work in many countries between a central bank, with the overall responsibility for the system, and the supervisory authority, with the responsibility for the institutional details.
>
> The necessary procedures for collaboration between the Fund and the Bank naturally will have to be pursued by intensifying cooperation through the existing channels, and this should include frequent routine information sharing on all levels among staff and management of the two institutions in various

areas, as well as communication in the field. New mechanisms, however, may also be helpful.

These provisions, which certainly will facilitate collaboration, are not the substitute for the working out of a clearer delineating of responsibilities between the Fund and the Bank.

The paper presented to us is not yet very specific either on operational issues, or on the available human capital. I thus join other speakers in their call for a clearer operational blueprint.

Let me comment on what there is. I welcome that, under the general provisions for collaboration, Fund area departments will be expected to raise the case for earlier involvement by the Bank when they have concerns about the state of the financial system (cf. para. 19). I welcome greater emphasis on joint missions. I welcome greater emphasis on cooperation in the field between missions and resident representatives. But while the principles outlined for the division of labor in the report broadly follow previously established provisions for collaboration, their leeway is large, making them open to interpretations. I am concerned about some of the formulations in the paper, for instance, paragraph 16–17, where the paper seems to suggest a more far-reaching mandate for the Fund than has been the understanding regarding banking supervision and regulation, by the formulation that the Fund can go into the microeconomic level in countries where the Bank is not active. The report dwells on procedures that would help ensure that the combined institutional capacity of the Bank and the Fund is sufficient to satisfy technical assistance needs in these areas. As regards the Fund's advising on regulatory and supervisory issues, this must, to our mind, always fulfill a substantiated, important systemic macroeconomic need. Also, on the issue of which institution takes the "lead role" in cases where both institutions are present, it is suggested that this could possibly be determined on the basis of the resource constraints faced by the two institutions at a particular moment (cf. para. 16). The argument that the Fund "needs to be in a position to provide advice on supervision and regulation to all its membership and hence go to countries where the Bank is not "active" does not strike me as particularly convincing.

I continue to believe that the Fund's role regarding banking system restructuring (cf. para. 18) predominantly should be that of identifying, analyzing and advising on the macroeconomic impact and policy response of bank restructuring strategies. The phrase that the Fund "temporarily" could play a role in banking system restructuring is perhaps not altogether satisfactory. In paragraph 24, a quick read can give the false impression that both the Fund and the Bank have equal roles to play in banking system restructuring, one taking the lead on the other, depending on the circumstances.

I do recognize, however, that in certain circumstances—in suddenly disrupting crisis situations—the Fund may have to quickly very temporarily take the lead if, in a specific country, no other institution steps in. But this should be truly the exception.

I warmly support (cf. para. 25) the suggestion in the report that there be regular reviews on this issue. Both Boards need to be involved. I thus support Ms. Lissakers' request for the first follow-up paper to the Board, focusing on specific country experiences and assessing progress in implementing the "strengthened collaborative procedures," in a year's time.

Turning to the cooperation with other organizations, I welcome the pledge to maintain a close collaboration with the Basle group through periodic meetings with the Basle Committee regarding the internationally accepted standards and best practices (cf. para. 12). A similar reference should be made regarding training (cf. para. 20).

Mr. O'Brien made the following statement:

We welcome this opportunity to discuss Bank/Fund collaboration. Recent developments have pointed to the need for intensifying Bank-Fund collaboration for the purposes of ensuring that responsibilities and procedures that are helpful to the international financial community, in particular for the avoidance of the development of crises, are put in place.

The point to be stressed is that it is virtually impossible to establish a clear, simple, and viable division of financial sector responsibilities between the two institutions. While cooperation must proceed in an experimental fashion for the time being, we see the need for a more structured, transparent, and flexible framework for continued cooperation. This is clearly a task that should involve the Boards of both institutions.

The Fund has decided to pay increased attention in its surveillance to broad financial sector issues rather than limiting itself to macroeconomic issues. This is both welcome and necessary. The Bank and Fund will cooperate, of course, as they always do.

Both institutions will be involved in the provision of technical assistance where there will be an unavoidable degree of overlap. The most helpful way in which duplication will be avoided is for senior staff of both institutions periodically to review overall technical assistance plans. The role of the Fund is influenced by the fact that it has to provide advice on supervision and regulations to its entire membership including countries where the Bank is never active except as a supplier of resources. Training should be made available on a similar basis as other forms of technical assistance.

As is the case now, the Bank will continue to take the lead in financing sector reform programs and the Fund will provide its financial assistance in support of broad macroeconomic adjustment programs. The staff has suggested that Fund assistance may be supplied under policy conditions related to financial sector reforms where they are relevant and critical to macroeconomic performance. We broadly support this position, particularly when the state of the financial system is likely to affect the viability of the Fund's program. One can draw the analogy with governance issues that could undermine the Fund program.

We would agree that financial system restructuring is primarily a matter for the Bank with the exception, of course, of central banking. We would stress again, however, that otherwise one cannot ascribe responsibility to one rather than the other institution. It is a multifaceted endeavor. Saying that it is a multifaceted endeavor stresses that financial sector restructuring is a responsibility that should be shared by a number of international financial institutions, and not left only to the Bank. I agree with Mr. Yoshimura's position on this aspect.

Of course, the emergence of crisis situations must clearly engage both institutions.

Mr. Prader made the following statement:

During our March 28 meeting on the Framework for Sound Banking, this chair and others expressed interest in a clarification of the division of labor in this area between the Fund and World Bank so as to avoid duplication of effort, reduce the cost to the Bretton Woods institutions of providing Financial Sector Advice, and improve the quality of the advice and assistance offered to our member countries.

We therefore welcomed the Joint Statement on Collaboration in Strengthening Financial Sectors issued by the Managing Director of the Fund and the President of the World Bank made on April 26, 1997. In our view, the more detailed framework for Bank-Fund collaboration presented now in document SM/97/200 adds more information and further clarifies the situation, but ours is only one opinion among many that rate the value added by today's document to the Joint Statement all the way from zero to a very large contribution indeed.

Of course these difficult issues can never be settled in every small detail and guidelines can never anticipate every conceivable source of conflict or overlap, but certainly the descriptions of the issues and the answers to problems presented in the staff papers are satisfactory in most respects. Our experience with the 1989 discussion on Bank-Fund collaboration and the resulting Concordat shows that such guidelines for cooperation—whether general or applying to a specific field—can only be as good as the spirit of cooperation between the managements and staffs of the Fund and Bank, and that every approach to cooperation needs to be pragmatic. If the managements of the two institutions do not get along together and do not support their staffs in times of conflict, such agreements are not worth the paper they are written on. Last but not least, the users of the Fund's and the World Bank's advice will have a significant impact on the collaboration between the two institutions, and to a large degree can determine whether this collaboration is fruitful or not.

The situation is further complicated by the fact that the World Bank is in the midst of a lengthy process of downsizing and restructuring, which has made it an uncertain and unpredictable partner for member countries. This situation may require—hopefully for a limited time—a larger involvement on the part of the Fund, an institution that is less unsettled and traditionally possesses more continuity. I should say that Mr. Fiechter's presentation today gives the impression that the World Bank's financial sector assistance is organized in such a complex manner that effective cooperation may not be possible. Nevertheless, it should be possible, once the World Bank's restructuring has been completed, to decrease the level of the Fund's involvement accordingly.

However, it cannot be excluded that the present division of responsibilities between the Fund and Bank could turn out to represent the beginning of an open-ended mandate of the Fund in fields that were originally considered the exclusive province of the World Bank. There should be effective checks on the Fund's involvement.

Besides additional clarifications of the two institutions' respective fields of activity, I would consider the introduction of an effective hard budget constraint on Fund's involvement in financial sector activities to be a principal safeguard against the materialization of such a scenario. Estimates of the cost of these new activities would be helpful and necessary. It is unfortunate that our efforts to introduce user fees for the Fund's technical assistance have been unsuccessful. Such fees would encourage member countries to use technical assistance more cost-effectively, would limit excessive use of Bretton Woods advice.

The regular reviews of financial sector collaboration proposed in the staff document offer another means of controlling the growth of such activities and preventing duplication of effort. At present we have little or no information on the effects, in member countries, of our technical assistance and advice. While we have a structured and transparent process for reviewing countries' macroeconomic performance under Fund programs, Directors receive no information on technical assistance missions and have no means of checking the outcome or usefulness of these missions. It would therefore seem worthwhile to include in the design of Fund programs a statement of what expertise will be needed in the Financial Sector, along with an outline of the respective roles of the Fund and the World Bank and the costs of such consultation. Reviews of Fund programs should then report to what degree the accompanying advice was actually implemented. The Fund should also have the option of cutting off its financial sector advice if there is evidence that the authorities are remiss in their cooperation and implementation of it.

Finally, we can support the request of Ms. Lissakers and Mr. Sobel for a brief status report on Bank-Fund collaboration in the financial sector before the Annual Meetings of 1998.

Mr. Barro Chambrier made the following statement:

I welcome this paper on Bank-Fund collaboration as a starting point for establishing the ground rules for cooperation between the Fund and the Bank staff on this increasingly important issue of strengthening financial sectors in member countries. I agree that this is a complex issue, and as our role is evolving rapidly, I would tend to share Mr. Autheman's view that it is sometimes difficult to draw a precise border.

By the very nature of our work, there is bound to be some overlap as regards the responsibility of the two institutions. The potential for problems to emerge has been elaborated by previous speakers, and I share these concerns. However, by establishing some basic rules, we can avoid duplication of activity and smooth out difficulties, and that can only be beneficial to our members.

We must take seriously the risk of having a void in certain areas. I was a little puzzled by Mr. Autheman's remark that the World Bank Directors are more concerned than Fund Directors about questions like health, education, and the environment, and that the Bank is less concerned about the issue of financial sector reform. This brings me to the issue of which institution might take the lead. This issue might be revisited. I realize that this is an area in which difficulties may arise, and perhaps we need to be clearer as regards responsibilities. As the proposals stand now, I do not think it will be very helpful to the staff. Moreover, I note that these new responsibilities will make additional demand on our already limited resources. In this case, we will have to consider the implications of the additional costs.

I would also favor joint missions. Joint missions and a close channel of communication can prevent the sending of contradictory messages, and that is what is needed. Our countries must have timely technical assistance from both the Fund and the Bank. However, when both the Bank and the Fund have lending programs in a country, satisfying the targets under each institution's program may cause some problems, and in these cases it would be critical for the staff to keep in close consultation and not impose conditionalities that create difficulties for the other institution, or lead to a multiplicity of conditionalities. Policy advice will have to be consistent. In any case, I share the view that this is a learning process for which we need to consider as well a concrete procedure, and to show a certain degree of flexibility with regard to the specific situation on the ground. I share the view that we could revisit these issues again in a year or two.

Mr. Daïri made the following statement:

I welcome the paper on Bank-Fund collaboration on the financial sector. While Directors have rightly indicated that Bank-Fund collaboration, so far, has not been flawless, I believe that the ongoing efforts may help optimize the use of resources and the complementarities between the two institutions. However, I suggest that these proposals should be finalized only after consultation with some member countries. Adequate collaboration between the two institutions can only be achieved if concerns and preferences of member countries are also taken into consideration.

In this respect, I share Mr. Sivaraman's concern regarding countries that do not borrow from the Bank. I believe that the Fund should not press a country to borrow from the Bank, or any other institution, if its balance of payments position does not warrant such borrowing. However, whenever the need arises, member countries should be encouraged to draw on the Bank's technical assistance and advice.

To avoid duplication or conflicting advice, joint missions should be the rule to countries where both institutions are involved in financial sector issues. In such cases, the efficiency of technical assistance may be strengthened if the terms of reference of technical assistance were proposed jointly by the two institutions.

On the issue of information sharing, while there should be no limitation between the two institutions as a matter of principle, there may be exceptional situations where national authorities may wish to share sensitive information with only one of them, particularly in crisis situations. The staff may wish to elaborate on whether the intention is that information collected during their discussions with the authorities will be shared with the Basle Committee during the envisaged periodic meetings. If so, I believe that such sharing of information should be subject to prior approval of the authorities.

The Fund's role in the financial sector should expand beyond the banking system to cover nonbank financial institutions, insurance companies, and pension funds. Of course, as with banking sector issues, the Fund should deal basically with macroeconomic aspects. Some reference to the Fund's role in this regard should be included in the joint statement of the Fund Managing Director and the President of the World Bank.

I support Mr. Bernes's call for an external evaluation of Bank-Fund collaboration in the financial sector. This evaluation should review, among other issues, areas of redundance or conflicting advice, as well as the gaps in the involvement of the two institutions, referred to by Mr. Zoccali. It should also address the important issue of the timeliness of the involvement.

The staff representative from the Policy Development and Review Department stated that some Directors were concerned that all was not well with the state of Bank-Fund collaboration. The best way to alleviate that concern, in his view, would be to implement the procedures set out in the paper and return to the Board with a review of the experience in concrete cases in a year's time.

The new procedures for collaboration built on the extant ones, the staff representative explained, but the sharing of the six-month programs for financial sector work between the Fund and the Bank was a significant innovation. The commitment to regular contacts between the Financial Sector Board in the Bank and the Monetary and Exchange Affairs Department in the Fund, with an emphasis on information sharing and crisis management, was also new. The general provisions on collaboration, which would be circulated to the staff shortly, would bring out all those elements in more detail.

The staff did not expect major problems in the implementation of the commitment to share information, the staff representative observed. Of course, there could be instances in which very confidential information held by one organization could not be shared with the other, perhaps because of the concerns of the authorities of the country that had provided it, but the staff hoped that those instances would be rare. The staff had not yet given much thought to the sharing of information with the Basle Committee, but it was his understanding that the intention was not to share information about the state of financial systems, but rather, about principles and best practices.

Organizational changes would probably not be needed on the Fund side for dealing with the Financial Sector Board at the Bank, the staff representative confirmed. The Financial Sector Board would tend to make the organizational structures between the two institutions more compatible, in fact. Concerning the steps to be taken to improve collaboration between the Financial Sector Board and the Monetary and Exchange Affairs Department, the key one would be the commitment to regular meetings. The staff representative from the World Bank, who was the Chairman of the Financial Sector Board, was in close collaboration with his counterparts in the Monetary and Exchange Affairs and Policy Development and Review Departments, which would be continued.

The staff representative from the World Bank commented that there appeared to be a consensus in the Board on the need for more specific information on the mechanisms for Bank-Fund collaboration in financial sector work. There was also the view that the staff should not assume that the status quo was sufficient. In his view, the proposed program, as described in the staff paper, would go far to address the concerns that had been expressed by Directors.

Directors also clearly had an interest in trying to leverage the expertise and influence of the two organizations so as to encourage countries to move quickly, when necessary, to promote sound banking, the staff representative continued. In that vein, the suggestion for joint missions would facilitate more timely involvement and intervention, as well as an earlier and smoother hand-off from the Fund to the Bank.

As the framework for collaboration between the Fund and the Bank in financial sector work was almost finalized, it was now time to try to work to bring into the structure the regional development banks as well, especially the Asian Development Bank and the European Bank for Reconstruction and Development, the staff representative considered. The other development banks and the major central banks that were providing technical assistance in the area of bank regulation and supervision should also be made a part of the collaboration process at some time in the future.

The Chairman commented that the discussion had clearly been useful in clarifying the situation with respect to collaboration in financial sector work between the Fund and Bank in particular, and between the institutions that provided technical assistance in that area more generally. The way ahead was now demarcated more clearly, in his view. The next step would be to implement the structure for collaboration that the staff had elaborated, and to see how it worked in practice. The Board would have an opportunity to review the experience in the period ahead, with a view to promoting further institutional and procedural refinements.

The Chairman made the following concluding remarks:

> Executive Directors welcomed the opportunity to discuss Bank-Fund collaboration in financial sector work. They viewed close cooperation between the Bank and the Fund in this area as crucial for maximizing the effectiveness of the combined efforts of both institutions in helping countries to strengthen their financial systems. Directors viewed strengthening such cooperation as an

urgent priority. Some Directors also referred to the need to draw on the experience of other organizations in their areas of expertise.

Directors broadly endorsed the principles and modalities for cooperation set out in the staff paper. They agreed that, although the 1989 Concordat continued to provide an appropriate overall framework, there was a need to clarify the roles of the two institutions, as well as to better define and strengthen procedures for collaboration in the financial sector. In particular, Directors stressed the role of collaboration in ensuring that emerging financial sector problems in all countries were promptly identified, that each institution took the lead in its own areas of primary responsibility, that duplication of activity in areas of mutual interest was avoided, and that there was full coordination between the Fund's macroeconomic analysis and the Bank's sectoral policy recommendations.

Many Directors would have liked a clearer delineation of the spheres of responsibility of the two institutions. Many Directors also recognized that overlap in some areas—especially banking supervision and regulation, and banking legislation—was probably unavoidable given the interaction between macroeconomic and central banking, and structural and developmental aspects of financial systems, and also because of differences in the country coverage, and the time frame within which the two institutions worked. While Directors agreed that there was no simple criterion for deciding whether the Bank or the Fund should take the lead in providing technical assistance in areas of overlap in particular countries, they emphasized that duplication of activity in individual country cases should be avoided.

Most Directors stressed that banking system restructuring was the primary responsibility of the Bank. Nevertheless, many Directors felt that it would be necessary for the Fund to play a role in banking system restructuring in crisis situations, especially in countries where it had been more actively involved. However, they emphasized that those instances were expected to be rare, that the Fund's involvement in such cases should be temporary, and that the implementation of restructuring programs should be handled by the Bank. Some Directors noted that, in light of the Fund's mandate, they expected the Fund to focus on the macroeconomic implications of such reforms. Directors hoped that the Bank, through the strengthening of its financial sector activities, including the establishment of the Financial Sector Board (FSB), would be in a better position to respond quickly and flexibly to assist with the design of financial sector restructuring programs in crisis situations. Directors also emphasized the role of the Bank in helping to identify specific benchmarks for banking system restructuring to be incorporated in Fund financial programs. Early involvement of the Bank was viewed as being crucial in that regard. Given the potential macroeconomic and fiscal implications of banking system restructuring, Directors stressed the importance of close and early cooperation between the Fund and Bank in all cases.

Directors stressed the need for the consistent and vigorous implementation of collaboration procedures. They agreed that the first line of responsibility for collaboration should rest with Fund area departments and

Bank country departments and regions. The country teams in the two institutions should be responsible for day-to-day coordination. The elaboration of financial sector work programs would help to ensure that each institution took the lead in its areas of primary responsibility, and was fully informed of the activities planned by the other institution, and that duplication was avoided. Directors noted the importance of regular contacts at higher levels, particularly for resolving any outstanding issues. Directors placed particular emphasis on close coordination in financial crises, and several Directors emphasized the importance of joint missions in those circumstances.

Directors welcomed the procedures for close cooperation between the Monetary and Exchange Affairs Department and the FSB at the Bank in planning technical assistance. A number of Directors attached particular importance to full information sharing between the two institutions, and hoped that any exceptions, because of concerns on the part of the authorities about confidentiality, would be very rare. They stressed, in particular, that the Bank should be alerted at an early stage regarding a perceived emerging need for Bank involvement or diagnosis.

Several Directors noted that the reorganization at the Bank, especially the relocation of an increased number of country managers to local offices , had potential implications for collaboration on financial sector work. They urged Fund staff, including resident representatives, to make the additional efforts necessary to ensure adequate contact with Bank counterparts in local offices. Several Directors expressed concerns with respect to the work load for staff, and pointed to the need for increased training efforts as a consequence of increased involvement in those issues. Other Directors requested careful analysis of the budgetary implications in further reviews of the topic.

Directors stressed that the effort to strengthen collaboration was very much a work in progress. They attached great importance to monitoring progress with Bank-Fund collaboration in financial sector work, particularly as the roles of the two institutions were evolving, and in view of the reorganization at the Bank. Directors, therefore, welcomed the intention to conduct a review of collaboration in this area, including experience in individual cases, prior to the 1998 Annual Meetings.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/74 (7/18/97) and EBM/97/75 (7/21/97).

3. ANNUAL REPORT, 1997—DESCRIPTION OF ARTICLE IV CONSULTATION WITH PEOPLE'S REPUBLIC OF CHINA

The Executive Board approves the draft description of the Article IV consultation with the People's Republic of China, as set forth in EBD/97/74, Supplement 3 (7/11/97), for inclusion in the 1997 Annual Report.

Adopted July 18, 1997

4. GUIDELINES ON MINIMUM CIRCULATION PERIODS FOR EXECUTIVE BOARD DOCUMENTS

The Executive Board approves the revisions to the Guidelines on Minimum Circulation Periods for Executive Board Documents, as set forth in EBD/97/66, Supplement 1 (7/15/97).

Adopted July 18, 1997

5. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAM/97/117 (7/15/97) is approved.

APPROVAL: April 27, 1998

REINHARD H. MUNZBERG
Secretary