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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 09/19-1

10:00 a.m., February 25, 2009

1. Initial Lessons of the Crisis

Documents: SM/09/33; SM/09/37 and Supplement 1, and Supplement 2

Staff: Caruana, MCM; Blanchard, RES; Moghadam, SPR

Length: 5 hours, 34 minutes

Executive Board Attendance

D. Strauss-Kahn, Chairman
J. Lipsky

Executive Directors	Alternate Executive Directors
	M. Majoro (AE)
L. Rutayisire (AF)	K. Assimaidou (AF)
P. Pereira (AG)	D. Vogel (AG)
H-S. Lee (AU)	
W. Kiekens (BE)	
P. Nogueira Batista, Jr. (BR)	
	J. He (CC)
R. Guzmán (CE)	
M. Horgan (CO)	S. O'Sullivan (CO)
A. Fayolle (FF)	
K. Stein (GR)	
A. Kishore (IN)	
A. Sadun (IT)	M. Xafa (IT)
D. Kotegawa (JA)	
	M. Daïri (MD)
A. S. Shaalan (MI)	
A. Bakker (NE)	Y. Yakusha (NE)
J. Henriksson (NO)	J. Bergo (NO)
	A. Lushin (RU)
A. Alazzaz (SA)	A. Al Nassar (SA)
P. Warjiyo (ST)	A. Chua (ST)
T. Moser (SZ)	
M. Lundsager (UA)	
A. Gibbs (UK)	

G. R. Kincaid, Acting Secretary
S. Maxwell/J. Young/T. Orav, Assistants

Also Present
ECB: G. Pineau, F. Ramon-Ballester. African Department: B.V. Christensen, A. Sayeh. Asia and Pacific Department: J. Felman. European Department: M. Belka, A. Chopra. External Relations Department: C. Atkinson, K. Langdon. Fiscal Affairs Department: C. Cottarelli, M. Keen. Finance Department: D. Andrews, A. Tweedie. Institute: R. Chami, E. Clifton. Legal Department: T. Laryea. Middle East and Central Asian Department: A. Tahari. Monetary and Capital Markets Department: N. Blancher, J. Caruana, A. Chailloux, J. Fiechter, M. Jones, A. Narian, M. Swinburne, C. Towe. Office of Budget and Planning: S. Tiwari. Office of the Managing Director: D. Citrin, E. Ramirez Rigo, J. Rosales, T. Ter-Minassian. Research Department: O. Blanchard, S. Claessens, G. Dell'Ariccia, H. Faruqee, L. Laeven, J. Ostry, K. Singleton, K. Srinivasan. Secretary's Department:

P. Gotur, M. Yslas. Strategy, Policy, and Review Department: T. Bayoumi, A. Bhatia, R. Blavy, R. Goyal, I. Mateos y Lago, R. Moghadam, R. Teja, T. van der Willigen. Statistics Department: R. Heath, A. Leone. Western Hemisphere Department: R. Babihuga, N. Eyzaguirre, S. Phillips, G. Terrier. Senior Advisors to Executive Directors: W. Abdelati (MI), C.Dahlhaus (GR), O. Demirkol (BE), Y. Friedmann (NE), M. Kaplan (UA), D. Kihara (JA), S. Krishnan (IN), B. Lischinsky (AG), E. Nyambal (AF), L. Palei (RU), J.Poulain (FF), N. Raman (ST), N. Riad (MI), S. Rouai (MD), F. Spadafora (IT), Y. Tok (ST), A. Umaña (CE), E. Valle (CE), R. Weber (SZ), Z. Zhang (CC). Advisors to Executive Directors: S. Alnefaee (SA), C. Denk (GR), J. Estrella (BR), K. Fisher (UK), E. Haryono (ST), O. Hendrick (AG), R. Hills (UK), J. Hukka (NO), M. Jakoby (BE), A. Jbili (MD), G. Jung (SZ), P. Kanithasen (ST), S. Keshava (SA), J. Kwakye (MD), L. Lephoto (AE), S. Lin (UA), H. Malothra (BE), D. Mevis (BE), C. Mira (CE), D. Muradnazarov (SZ), E. Ndong Ondo Bilee (AF), P. Ray (IN), S. Rottier (BE), J. Sulemane (AE), D. Tartari (SZ), N. Thapa (ST), C. Thompson (AU), P. Wood (UA), H. Yung (CC).

1. INITIAL LESSONS OF THE CRISIS

Mr. Shaalan and Ms. Abdelati submitted the following statement:

We thank staff for the set of papers that distill early lessons from the ongoing crisis and respond to the call made at IMFC meeting this past October. We appreciate staff's efforts in pulling together for today's discussion various aspects of the crisis and its implications for Fund surveillance, macroeconomic policy, regulatory reform and liquidity management. Additionally, the papers see a need for modifications to Fund governance that aim to improve its effectiveness, some of which already enjoy broad support but others are less-clearly justified at this time and debatable.

Lessons for Macroeconomic Policy (Supplement 2)

Years of stable inflation and low interest rates spurred excessive optimism and risk-taking, encouraging financial institutions and policy-makers alike to ignore the build-up of systemic risk associated with asset price booms and rising leverage. Should monetary policy have been tighter? Should the framework for monetary policy incorporate the long-term impact of asset price increases on inflation and growth? Should fiscal policy reduce the bias in favor of debt financing and other distortionary incentives? Did the so-called global imbalances and large net capital inflows from surplus countries play a key role in the crisis? To what extent was the build-up of risks similar to that in other episodes of rapid credit expansion? While we appreciate staff's discussion of these issues and we can debate the relative influence of each of these factors and explore ways to mitigate their impact in future crises, the role of each of these factors is not easy to quantify, particularly in view of the interaction among them. However, there is reason to believe that the root cause of this crisis originated from a build-up of systemic risk due to a lapse in the regulatory framework that was not adequately foreshadowed by our surveillance framework. We should ensure that this message is not lost or diluted when discussing all the other potentially contributing factors that appear to be of secondary order.

Section III leaves no doubt that credit growth and capital inflows per se were not the issue, but it is rather the degree of leverage, lower lending standards, greater risk-taking, and lax regulations that obscured asset values and the extent of risk. This view is plainly put forth in the second sentence of paragraph 9 of Supplement 2, "the main culprit, however, must be seen as deficient regulation." Therefore, it came as a surprise that the first policy issue raised in paragraph 11 is "the need to revisit when and how to react to large imbalances through macroeconomic and structural policies that affect saving and investment." This is not to make light of the mounting risks to the U.S. economy stemming from a combination of high household indebtedness and large fiscal deficits that could have potentially led to a disorderly adjustment through the exchange rate—an issue that was taken up in several WEO discussions and did not materialize. Instead, more attention was warranted to the financial sector's build-up of systemic risk and hidden leverage through complex off-balance sheet instruments—something that could have prevented the crisis if adequately brought to light. This message does not seem to come through in Supplement 1, which is slanted toward emphasizing global imbalances, multilateral surveillance, and the need for more deliberations by a high profile forum of key players (as discussed further below).

There are some important contrasts between the U.S. and Europe (paragraph 25-26). For instance, capital inflows to the U.S. responded to the flight to quality inherent in U.S. Treasury securities, while in Eastern Europe the attraction was to high yield of risky assets. In the case of the U.S., the credit expansion was associated with a decline in lending standards and an increase in leverage of borrowers in some regions, while in Eastern Europe lenders apparently ignored the unhedged nature of foreign currency borrowing by households. Besides foreign currency risks, is there other evidence of a relaxation of lending standards in the U.K., Spain, and Eastern Europe?

With respect to macroeconomic policy to prevent future crises, we see a greater role for procyclical prudential policies than for the use of monetary policy and modifications to tax policies. There would seem to be limited scope for interest rate actions since there is no evidence that monetary tightening since 2003 had any impact on subprime lending, and higher interest rates could have further exacerbated capital inflows. However, there is considerable scope for the monetary authorities to influence market behavior through their statements and general analyses of financial and economic trends. As with Fund surveillance, the Fed's analyses and communications did not capture or foretell the extent of systemic risks, and this underscores the need for staff to continue to develop and refine such measures.

Regulation and Liquidity Management (SM/09/33)

On the subject of regulation, we broadly support the priorities identified in the Companion Paper with an emphasis on expanding the perimeter of financial sector surveillance, discouraging regulatory arbitrage, addressing procyclicality of existing rules, and filling informational gaps.

Coordinated action is necessary to avoid switching activities to off-share centers and foreign banks, and to facilitate speedy response when liquidity and solvency concerns arise. There is growing recognition now that absence of an international legal framework governing the supervision and regulation of globally and regionally important firms generated a fragmented and uncoordinated policy responses witnessed so far. The lack of agreement over burden sharing schemes was particularly problematic, and the remedial measures suggested in paragraph 38 are well-placed.

The paper also raises important considerations in redesigning central bank liquidity frameworks, particularly with respect to the appropriateness of the target short-term interest rate in periods of market dysfunctionality, and the risk of blunting monetary policy signaling stemming from increased recourse by central banks to 'quasi-fiscal' instruments. We expect the staff to take the lead in further refining the analytical underpinnings of these core central bank/monetary policy issues in the period ahead.

Lessons for the Global Architecture and the IMF (Supplement 1)

While we share many of the views presented in this four-part paper, it is also the one we find most problematic. The topic of cross-border arrangements for financial regulation is covered in two of the other papers, which convincingly argue against the "go-it-alone" responses seen in the earlier phases of this crisis. The case for adequate Fund resources and flexible facilities to respond to the various liquidity needs of members is the subject of separate Board discussions. We see considerable scope, however, to better sharpen the message in the section on surveillance and make it consistent with the lessons culled in Supplement 2. As for the section on policy coordination and Fund governance, we would prefer to have had a cogent elaboration on the perceived shortcomings, proposed reforms, and their inter-connection. We now turn to these two points:

It is generally agreed that our surveillance did not sufficiently identify or warn of the build-up of systemic risks. With respect to the quality of IMF warnings in the lead up to the crisis, we would emphasize two of the weaknesses put forth in Box 1, namely, the underestimation of systemic risk and the optimistic bottom-line assessments and hedged messages. Two implications follow from this. First, going forward, we need to place more attention on analysis of systemic risks including through focus on asset price booms, leverage, risk concentration in large banks, and hidden or off-balance sheet risks. Second, and equally important, our messages should be sharper and more convincing and not muted or obscurely embedded in lengthy discussions. We wonder if these key messages aren't lost when discussing solutions on page 6 as the section does not seem to address the previously identified key problem in Fund surveillance, namely, "a generally optimistic view on advanced countries and on financial innovation."

In the section on policy coordination and fund governance, we concur with staff's assertion that "For surveillance and crisis resolution to be effective, discussion of policy responses should take place with the relevant officials—those with authority and legitimacy to respond." Normally, such discussions take place during Article IV consultations as well as during the rare occasion when multilateral surveillance discussions take place, in addition to interactions between staff and management with the authorities during staff visits, visits by officials to the Fund headquarters during the Annual Meetings, and bi-annually within the IMFC. Staff should spell out where they see the shortcomings in this process, as we should avoid jumping on the bandwagon of change for the sake of it. Furthermore, considering that our surveillance analyses failed to adequately identify the nature of systemic risks and our surveillance reports hedged the key messages and painted a rosy picture, didn't this in itself compromise the potential for an effective discussion of policy responses? We therefore question whether it is "fragmentation of surveillance" and Fund internal governance structure that prevented the relevant policymakers from acting on Fund advice or rather the hedged communication of risks and lack of specificity in our advice.

Staff proceeds to identify a separation between "mandate" of the Board and "power" of ministers and governors to act, a separation that they consider to have caused a shift in policy discussions to the G-7, and later the G-20, because of a perceived "flaw" in the IMF where "formalistic ways" discouraged engagement by senior policy makers. Staff identifies a need to give "IMFC ministers and governors a higher profile forum for focused interactive deliberations and decisions." We find something lacking in this reasoning:

- It is far from clear how these perceived "flaws" inhibited the effectiveness of multilateral surveillance (paragraph 7, bullet 1), or how "for the IMF, formalistic ways discouraged engagement by senior policy makers" (paragraph 7, bullet 3).

- How, in the staff's view, would "giving IMFC ministers and governors a higher profile forum for . deliberations and decisions" have helped avoid the crisis or better respond to it? It might have helped in making a convincing case if staff had been able to trace back the crisis to specific weaknesses discerned in previous IMFC deliberations and communiqués.

- Is there a tension between staff's proposal to rebalance quota shares and Board representation toward emerging and developing countries and staff's suggestion of the need for a forum within the Fund that is more suited to deliberations by "key global players"? If the idea were to replicate the G-20 representation within the IMFC, this would go counter to the stated objective of rebalancing representation. Of course, we also strongly oppose a strengthening of the role of a non-representative G-20 with respect to the IMF's mandate.

In our view, the views expressed in Supplement 1 on surveillance weaknesses and on policy coordination and fund governance deserve more careful consideration and we hope the sections will be re-worked in the coming weeks. The main paper should be revised accordingly.

The Fund is heading into turbulent and challenging times that are likely to worsen over time and will require intensive surveillance and a high demand for Fund resources with a rise in exceptional access cases. In these circumstances, the Executive Board's decision-making role and mandate are all the more important as they bring an integral element of legitimacy and credibility by assuring country authorities that their Executive Directors are scrutinizing these activities with a view toward even-handedness and appropriate program design.

Mr. Pereira and Mr. Vogel submitted the following statement:

Drawing lessons from this crisis is our own key responsibility as an institution intended to ensure global financial stability and economic growth. Exposing weaknesses in our effectiveness and underlying deficit in ownership, the crisis has highlighted the need of urgent reforms. Our immediate response to the crisis will most likely determine whether in the future members will have confidence that they can rely on the Fund for insurance or risk management through effective surveillance. Much more than only detecting weaknesses in financial markets or failures in its regulation is at stake. While of critical importance, they will be relevant to minimize the prospect of future crises. It is now imperative to help countries get through this global financial and economic meltdown, addressing the major deficiencies in international coordination and cooperation still prevailing in the global architecture. The Fund has a critical role to play as a crisis responder in a world where huge financial needs of advanced countries will chock off the credit supply to the developing world for years to come. Today's discussion must embrace the opportunity to collectively reflect on this institution's cooperative nature and the changes in economic doctrines and paradigms. Crisis should bring progress too.

We find the staff report extremely helpful and enlightening. A fundamental market failure that sweeps any belief about "market discipline" and its self-healing powers is, indeed, at the root of this crisis. Some market failures proved to be lethal in the era of financial globalization. This crisis is like no other we have ever experienced, but at the same time draws aspects from past crises in one: bursting real state bubbles in advanced countries, such as the one hitting Japan in the 1990's; bank runs driven by liquidity and insolvency problems as in the 1930's; disruption of capital flows that trigger domestic and currency crisis as in the Asian crisis in the late 1990s, and a world in which monetary policy has limited traction power (liquidity trap), a reminiscent of Japan in the 1990s. Admittedly, when the bubble in the housing market started, many economic agents and institutions made the same mistake as in past episodes, trusting that "this time asset increases and, more generally, growth will be forever sustaining on". Economic cycles do exist and there is a strong need to identify them. We agree that the Fund should contribute to this related work. At the same time, we believe that this crisis was somehow avoidable, signaling flaws and fragmentation in the global architecture that call for the acceleration of governance reforms.

The magnitude of this crisis is not only explained by fragmentation. The most distinctive characteristic is that this time financial liberalization recycled excessive liquidity within the advanced countries' own borders, affecting the sources of global growth and engendering more severe economic downturns. Financial innovation managed to lure lenders in advanced countries to buy over-priced assets. This triggered a cycle of high indebtedness and mounting external imbalances. Lending booms typically feed into stock market bubbles as regulatory flaws generate the incentives for borrowers to use bank loans to buy risky assets, with these bubbles ending up in banking crises and recessions. As a result, the world economy is experiencing a full-blown financial crisis, encompassing severe stress in banking, securities, and foreign exchange markets all at the same time. This crisis proves that arm-length financing and security markets have in fact amplified the markets' inherent pro-cyclical behaviors, entailing significant output losses. The markets' self-regulation failed in preventing recurrent episodes of irrational exuberance.

In this context, we broadly agree with the staff that lessons must be drawn along three different dimensions: regulation, macroeconomic policy responses, and reform of the global architecture for stability. In the first field, the false assumptions underlying market discipline failed to head-off the looming threat. The problem with informational asymmetries, moral hazard, and principal agency in financial markets is certainly not new, but these elements all together have been critical in explaining this crisis, exposing huge weaknesses in corporate governance (compensation schemes), loan origination, and underwriting standards. The procyclicality of lending was fueled by financial innovation as never before, in particular with relationship to asset values. New financial instruments and their growing complexity masked the underlying risks and, more importantly, policy makers and regulators ignored the larger fact that risk remained concentrated in entities linked to the core banking system. Neither risk management -market discipline- nor regulation worked. Admittedly, financial innovation and financial conglomerates were supposed to be the magic solution for the 'global diversification of risk'. In practice, it results in a huge moral hazard cost to the taxpayers. But the failure of the financial system will impose especially high cost for those at the bottom, exacerbating global income and wealth inequalities.

We support that these sets of failings call for fundamental reforms in the regulatory perimeter, in the role of rating agencies, in addressing pro-cyclical behaviors, in ensuring greater market transparency, and re-examining systemic liquidity managements. Despite the emphasis on capital adequacy, capital regulation was imposed- through Basel II - in a way that allowed the buildup of significant leverage and promoted procyclicality. More importantly, large systemically important segments (the so-called shadow banking system) have been outside the scope of regulation. We fully agree on the need to extend the perimeter of regulation and supervision in order to ensure that all financial activities that pose economy-wide risks are covered. We support those prudential rules to be applied to all financial institutions, based on the risk of underlying activity and considering the type of institution undertaking. This crisis also proves that "size matters" and that the moral hazard implicit in too-big-to fail firms must be within the regulatory cordon. We also give great importance in addressing the titanic conflict of interest in credit rating agencies. Their fault in corporate governance border on fraud and further actions must be agreed upon beyond changing compensation schemes and instituting codes of conduct.

The need of a systemic liquidity management is also a key lesson from this crisis. Policy makers missed the impact of the loss of market liquidity that sustained a complex web of financial relationships. Substantive ad hoc measures were adopted but their effectiveness was limited as long as many institutions continue to face insolvency problems. A self-reinforcing process could not be avoided despite liquidity injections: declining asset values damaged balance sheets, forcing further asset sales. In emerging market economies, a double problem poses incommensurable challenges: 1) the lack of sufficient reserve currency; 2) the tradeoff between providing needed liquidity support and the risk of facilitating capital flights. We wonder if the staff could further elaborate on these specific challenges for developing countries and explain the potential role of prudential regulations or capital controls to minimize the deleterious impact of foreign bank operations in the de-leveraging process.

We concur that the crisis is also the result of macroeconomic policy failures and prevalent economic doctrines. After years of high global growth and stable inflation, it was broadly assumed that monetary policy in its own was sufficient to sustain an upward business cycle. However, that assumption was inaccurate and the growing risks were not identified until it was too late. We take note of the staff's recognition that the increasing popularity of inflation targeting scheme geared monetary policy nearly exclusively to stabilize inflation, perhaps missing the impact of excess liquidity and leverage in asset price bubbles. We also claim that inflation remains contained not only due to the effectiveness of monetary interventions but rather due to global productivity gains from the recent integration of labor-intense economies into the world trade system.

Since many past assumptions have proven wrong, it is now clear that central banks must take into account asset price movements, credit booms, leverage, and assess the build up of systemic risks. As the staff clearly pointed out, no asset bubble is alike, but when the boom is associated with high leverage in financial, households or corporate sectors, systemic risks are around the corner. On fiscal policy, the staff's assertion that a negligible role can be assigned in the run up of the crisis deserves second thoughts.

Whatever the reasons are behind global imbalances, we observe that another critical lesson from this crisis has to do with speculative flows. They can lead to sharp exchange rate appreciation, putting pressures on countries' domestic demand beyond the absorptive capacity of the economy or the preparedness of its financial markets. The adverse effect of a sudden reversal and their strong impact are well known from this and past crises. Even the staff now claims that monetary policy may work poorly in this context (higher interest rates make domestic assets even more attractive, fueling more speculative flows).

We are hopeful that these lessons will soon permeate into the Fund's policy advice. Being humble with comments, recommendations and preached dogmas in the interaction with the authorities is one of the lessons to be learned. For instance, in the past, this and other institutions have spoken about the need to avoid pro-cyclical fiscal policies, on which we agree if a country's circumstances allow it. However, we missed considering that perhaps more important is the need to deal with the procyclicality of capital, which has clearly exacerbated the cycle and critically contribute to the crisis. Banks in developed countries, for instance, were encouraged to lend short-term to developing countries, providing greater liquidity to the former but leading to greater instability in the latter. Thus, pro-cyclical monetary and fiscal policies were often foisted on developing countries. Similarly, when developing countries experienced financial crises, strong concerns on moral hazard were given much more importance over other potential risks related to economic, financial and social consequences of these crises. This Chair has often underscored that there could be banks under good or bad regulations and/or supervisions, but neither public banks nor private banks are bad intrinsically. Many times, some recommendations urged countries to choose sound banks to be saved, leaving behind problematic banks and, consequently, their depositors. Likewise, when this institution rightly recommended the importance of having a low and stable inflation, vulnerabilities that significant increases in asset prices bring about were not considered. While creating vulnerabilities in the medium-term, there were benefits in terms of credit growth and economic activity in the short-run for developing countries. Nevertheless, advice aimed at allowing ample flexibility to the exchange rate could have contributed to increase vulnerabilities.

Finally, in drawing lessons from the crisis, revisit the global architecture and the role of the IMF in the global economy must be of the essence. IMF surveillance has remained weak and incomplete, underestimating the combined risk across sectors, the importance of financial sector feedback and spillovers. More importantly, the building blocks of effective surveillance of systemically important advanced countries were missing, under the tacit presumption that vulnerabilities and risks come from developing countries. Even when the problem of global imbalances was understood, the Fund was not perceived as a legitimate platform for international cooperation and coordination. Similarly, the Fund still lacks the resources and lending instruments to effectively respond to this crisis.

In this context, we agree that four key areas deserve consideration. Governance reforms need to urgently address the democratic and effectiveness deficit by, first and foremost, rebalancing quota shares and increasing the voice and representation of developing countries. While noting that the staff proposes a set of reforms in that vein, we put a word of caution in the need to preserve an adequate sequencing. For instance, higher political involvement could be desirable, if and only it is preceded by a substantive realignment of quota shares and a more representative Board-IMFC that reduces the overrepresentation of advanced countries. On surveillance, we remain unconvinced that an Early Warning Exercise could replace the needed multilateral coordination for policy actions. In fact, we are concerned about the staff's call for a restrictive group of countries "with authority and legitimacy to respond". On paragraph 8 of SM/09/37 Supplement 1, the staff proposes "a body of top policy makers, small enough to be effective but with wide enough representation to be legitimate, is needed for effective collaboration on policies to address systemic risks". In its conclusions, the staff states "a group of policy makers with the ability and mandate to take leadership in responding to systemic concerns about the international economy *should be formed*". Is the staff suggesting the creation of a different G-s? Could an institution with universal representation call for an ad hoc group to take the lead in our own mandate? We strongly disagree with that proposal and we would like the staff clarifications on this area. Finally, on lending facilities, we agree that the Fund's financing have continued to focus on supporting adjustment through loans rigidly tie to conditionality and that this crisis should be a good opportunity to meet the financing and insurance needs of all members.

With these remarks, we thank the staff for a well-written set of papers.

Mr. Sadun and Mr. Spadafora submitted the following statement:

We thank staff for a set of thought-provoking papers, touching upon intertwined crucial issues raised by the global crisis. These are being extensively discussed at the international level, in order to provide the needed coordinated response to the ongoing events.

Drawing the correct lessons from the crisis is a precondition to strengthening the international financial architecture. Staff papers and their macro-financial analyses and policy proposals in the areas of core competence are testament to the Fund's ability to contribute to this effort, which also greatly benefits from the Fund's participation in the G-20 and FSF working groups.

Financial Regulation and Supervision

A broad international consensus is emerging on a few overarching principles to reinforce the global financial system, such as boosting its capitalization, discouraging excessive leverage, and enhancing transparency.

Staff correctly underscore the appearance of a "shadow" banking system in some advanced countries as one of the primary causes of the crisis. In line with the G-20 Action Plan, a review of the perimeter of regulation is in order to avoid the build up of systemic risk in sectors currently not regulated or less regulated, and to ensure that, in the medium-term, all systemically important institutions are subject to appropriate oversight. To maximize its effectiveness, more stringent regulation should be firmly implemented and enforced consistently across countries. The establishment of supervisory colleges for all large cross-border financial institutions is a key element for improving international cooperation on financial supervision.

Measures to reduce procyclicality will also contribute to crisis prevention at the global level, as they help discourage the accumulation of risks and leverage in the financial system in good times. In the same vein, it will be important to design prudential rules that "internalize" systemic risk and impose a much more stability-oriented perspective. This "macro-prudential" dimension to regulation will require a strengthening of its links with micro-prudential norms.

Finally, we agree with staff that information gaps have played a significant role in sowing the seeds of the crisis. Lack of information on risk exposures is underpinning the role of uncertainty as a shock multiplier. We thus support a multilateral approach to filling information gaps.

Macroeconomic Policies

Staff provide a balanced assessment of the potential benefits to macroeconomic stability that could arise from adding a "leaning against the wind" dimension to monetary policy. The ability to discriminate between "good" and "bad" booms is a precondition of such a policy stance. While this ability may improve, making "actionable" assessments remains difficult. We also believe that the absence of a formal mandate to financial stability does not prevent central banks from factoring in this objective in the design and conduct of monetary policy. For example, central banks can take into consideration asset price movements in so far as they pose a risk to price stability. As illustrated by the crisis, this risk certainly exists in the case of asset price cycles accompanied by large changes in financial leverage. More generally, the relationship between monetary policy and financial stability requires further reflection and analysis.

In our opinion, strengthened prudential regulation, notably its countercyclical component, is the first line of defense against excessive leverage, asset price bubbles, and financial instability. Other than minimizing the potential for such developments, prudential regulation should favor appropriate capital and liquidity buffers to enhance the banks' ability to withstand abrupt declines in asset prices.

Moreover, to the extent that asset price bubbles arise from excessive risk-taking in the shadow banking system, crisis prevention policies, including prudential regulation, should address first and foremost the reasons that have given rise to such a system, while strengthening the detection power of supervisors.

We agree with staff that global imbalances, and their underlying causes, have played a role in the build up of systemic risk. Macroeconomic policies should thus be geared toward avoiding the accumulation of such imbalances and the attendant risks to global stability. While the current focus of macroeconomic policies should remain on containing the crisis in the short-term, it is crucial to maintain a medium-term orientation toward stability and sustainability in order to anchor expectations, enhance the short-term effects of such policies, and ensure a lasting recovery. It is also appropriate to envisage credible exit strategies to be implemented once the macroeconomic environment returns to more normal conditions.

Global Architecture and the IMF

Improving the Fund's crisis prevention and resolution capabilities is a major component of the effort to strengthen the global financial architecture. Surveillance is key in this regard. The crisis has shown the importance of better understanding macro-financial linkages, particularly in the boom phase, as well as cross-country lending and borrowing activities.

Against this background, it is imperative to give more content to the call for improving financial sector surveillance and its integration into the Article IV consultation process. To this end, the long-awaited Financial Sector Guidance Note would represent a welcome step forward. We also see merits in making the FSAP mandatory for systemically important countries. A revamped and better focused FSAP, and an increased commitment to follow up on its recommendations, would be instrumental in strengthening the traction of surveillance.

This last objective would be greatly facilitated by a more precise identification of systemic risks and vulnerabilities, so as to formulate "actionable" recommendations to policy makers. The joint IMF-FSF Early Warning Exercise is a major step in this regard. It is fully consistent with the Statement of Surveillance Priorities, approved by the Board in October 2008, and the G-20 Action Plan. The enlargement of the FSF will help augment the potency of the exercise.

We support a comprehensive review of the Fund's lending framework, aimed at rationalizing and streamlining instruments and conditionality. While we remain willing to be convinced of the need for a new crisis prevention instrument, we are ready to discuss new proposals, notably those aimed at improving the role and characteristics of precautionary arrangements. In this context, conditionality should remain a centerpiece of Fund lending, as ex post requirements are key devices to ensure the credibility and proper implementation of Fund programs.

Finally, in line with the G-20 Action Plan, we believe that the reform of Fund governance is a medium-term issue, as the primary and most immediate task facing the international community is the resolution of the current crisis.

Mr. Kishore submitted the following statement:

We thank staff for a set of well-written papers which attempt to collate the main lessons that can be drawn from the ongoing global financial crisis. We recognize that these are formative steps towards etching a much larger canvas of engagement of both national authorities and supranational institutions but they lay a foundation for the way ahead in terms of crafting focused and specific courses of action in shaping the framework of monetary, fiscal and financial sector policies as well as the global financial architecture. Accordingly, we set out what may be regarded as our initial responses to the papers.

Macroeconomic Policies

Diagnosis

The paper on lessons for macroeconomic policies does well to identify several important factors in the initial conditions that contributed to the mutation of the crisis into its present form. In our view, the obsessive focus of monetary policy on the inflation objective may have actually contributed to the asset price bubble. Low and stable inflation anchored by the credibility earned by monetary policy resulted in lowering returns on investments in the real sectors of the economy and made investing in financial assets more rewarding. This arbitrage opportunity created by monetary policy setting could have been a major force driving the relentless search for yields that led up to the current crisis. In this context it is important to recognize the limits and dangers of monetary policy accommodation. We are, however, puzzled by the scanty attention paid to the sub-prime mortgages in fuelling the crisis. The so-called 'mild' recession in the aftermath of the dotcom crash was essentially due to the role of monetary policy in transferring the bubble to the housing sector and then lax regulation took over. We also believe, supported by a considerable body of empirical evidence, that regulation of the financial sector guided by the Basel I minimum capital standards has been inherently prone to increasing the riskiness of balance sheets. In order to meet the capital requirements, banks took to stripping their balance sheets of the most rewarding assets, securitizing them and trading them off-balance sheet and/or placing them with special purpose vehicles. We also do not agree with the contention in the paper that lending based on collateral is hazardous. Is it not important to ensure that the collateral is of the highest quality and that functioning markets exist for these assets to enable continuous price discovery? Staff Comments are welcome.

Global Imbalances

In our view, the analysis of global imbalances in the paper is flawed and lacks even-handedness. While it is stated that interest rates were low, this is ascribed to high saving in Asia and oil surplus countries. The fact that low interest rates were engineered by accommodating monetary policy in the post-dotcom years to transfer the bubble, aided by the moderation in inflation, that this fuelled high consumption and negative saving in some advanced economies is almost ignored in the paper. Furthermore, the strong global preference for U.S. assets referred to in the paper reflects an obfuscation between cause and effect. The paper correctly points out that the large US fiscal deficit was one of the main factors behind global imbalances and then contradicts itself by stating that the fiscal deficit played a stabilizing role. In reality, massive fiscal deficits were being run over a period when the rest of the world was committed to fiscal rectitude, including rule-based fiscal responsibility in several countries. The resulting oversupply of US treasuries actually crowded out all other forms of assets and led to the phenomenon of capital running uphill. It needs to be recognized that Asia has habitually been a high-saving region, a fact which has been lauded in earlier Fund analyses. Is it not that only when these savings were pulled in by huge fiscal deficits in some advanced economies that global imbalances became worrisome? We seek clarification from the staff.

Implications for Monetary Policy

We do not agree with the view taken in the paper that the task of monetary policy is made easier by distinguishing between bad booms and good booms. This is difficult, as admitted in the paper—"as often with early warning indicators, the ability of existing empirical models to distinguish "good" from "bad" booms is relatively low"(page 7; paragraph 19). In advanced financial systems, as recognized in the paper, this is even more difficult and complicated by the involvement of households. The appropriate approach is a risk-minimization strategy in which all booms are monitored carefully and continuously with a view to intervene in the interest of macro-financial stability, if warranted. Credit/GDP ratios should not be seen in isolation; they should be monitored in conjunction with the composition of credit, leverage indicators such as credit-deposit ratios and exposures to sensitive sectors. We fully endorse the position taken in the paper that mandate of monetary policy should include macro-financial stability, not just price stability. We are, however, surprised by the ensuing volte-face—"financial stability….need not be an explicit target of monetary policy"(page 11; para 32). We believe that monetary policy should be assigned the objectives of both price and financial stability with relative weights depending on underlying circumstances. We support the need for greater cross-border and multilateral coordination.

Implications for Fiscal Policy

The analysis of the role of fiscal policy is inexplicably light in the paper. We believe that fiscal policy had a major role to play in the run-up to the crisis by being accommodative and masking the incubation of the causal factors. The existence of large fiscal deficits in some advanced economies also facilitated a flight to safety when risk aversion set in and this was reflected in sizeable capital outflows from a host of emerging countries which were at the periphery of the crisis and got hit by knock-on effects as the contagion spread. We agree with the view that fiscal buffers could be established in boom times but wonder why the paper falls short of specific suggestions. One possible approach is to estimate trend levels of tax buoyancy so that when tax buoyancy rises above trend in good times, it provides a trigger for calibrated cutbacks on pre-decided elements of discretionary public expenditure. This would help to build up fiscal headroom which, as the current crisis has shown, is vital in the event of a downturn. We also agree that tax distortions could have played a role in asset price volatility and warrant closer scrutiny.

Financial Regulation and Supervision

Modes of Regulation

It is commendable that the staff paper has recommended expansion of the perimeter of financial supervision and regulation. One of the lessons learnt from the present financial crisis is that financial institutions often take advantage of regulatory arbitrage and treat otherwise regulated activity as off-balance sheet or assigned to some non-regulated entity. The dilemma for the regulator is, therefore, how to be comprehensive? Two specific questions may be raised in this connection. First, what is the preferred mode of regulation—a single regulator for all financial intuitions or multiple regulators for different institutions? Second, what should the role of central banks in the regulation of financial institution? The second question has serious implications about the interface between monetary policy and prudential norms. After all, in situations in which monetary policy, operating almost exclusively via policy interest rates, turns out to be ineffective in handling a financial crisis, prudential norms would be the appropriate tools for curbing the excessive risk taking tendencies of the financial institutions. Indeed, stability in its broadest connotation is the reason why monetary authorities exist. In this vein, we argue that monetary policy and financial regulation and supervision should be unified—or re-united where they have been divorced - under the aegis of a single authority. This would require a blending of pure monetary instruments such as interest rates, reserve requirements and open market operations with regulatory tools such as capital, provisioning, risk weighting, exposure limits etc. in varying proportions depending on the assessment of macroeconomic and financial conditions. Were efforts in select countries to separate regulatory and the monetary authorities misplaced? What is the staff’s view on this issue?

Have Basel Norms Failed in Dealing with the Crisis?

The documents have candidly noted that the prevailing policy considerations were flawed in important respects and even go to the extent of pointing out that the steps that were taken to strengthen the regulation of financial institution within this perimeter could well prove to be insufficient. Many of these lessons need to be taken into account in re-evaluating the appropriateness of Basel II norms and their applicability in the evolving scenario. In fact, one of the messages in the current context is perhaps the inadequacy of a single-minded emphasis on simplistic capital-based norms for financial institutions in dealing with the crisis. Supervisory oversight and due diligence cannot be substituted by imposition of capital based norms and exclusive reliance on them. While reorienting Basel norms for an extended set of financial institutions this aspect needs to be kept in mind.

Information Gaps

The necessity of bridging the information gaps in dealing with a crisis can hardly be overemphasized. One may recall that in the aftermath of the Asian financial crisis, the establishment of Special Data Dissemination Standard (SDDS) in 1996 was prompted by the widely held view that the crisis was partially attributable to a lack of market information and transparency. Are there going to be new initiatives by the Fund for data dissemination in the context of the current crisis? Can we expect some innovative and useful regulatory data-base development from efforts such as, the joint IMF-FSF collaboration? We seek clarification from the staff.

Systemic Liquidity Management

A major source of discomfort about the solution package for the current financial crisis is the asset quality in the central bank balance sheet in some countries. Furthermore, the staff has rightly raised broader concerns about the increased use of “quasi-fiscal” instruments by the central banks. While the paper recommends mechanisms to transfer these assets to fiscal authorities, it is necessary to consider the costs involved, including the potential impact on the health of public finances and the ultimate burden, perhaps unjust, on the tax payer. It is important to deal with these issues in a transparent manner. It is also necessary to draw up contingency plans to deal with problems in passage such as central bank losses and quasi-fiscal costs, the ongoing disconnect between massive liquidity injections and credit crunch, the threats of liquidity trap and deflation arising out of the accommodative stance of monetary and fiscal policies, and the threats to the outlook that current liquidity management poses in terms of future inflation and volatility in capital flows.

Global Financial Architecture and the Fund

We appreciate the candor in the staff papers in highlighting the critical issues facing the Fund governance which are compromising the effectiveness of the IMF as the multi-lateral mechanism of choice for crisis resolution and safeguarding global financial stability.

Surveillance

On surveillance, we welcome the long overdue recognition that it was not appropriate to have focused on surveillance of emerging market economies as the possible loci of future crises and having actually overlooked the building crisis in the core of the global system. We would expect that this would finally lead to "even-handed surveillance" in the true sense of the term. We value the IMF for its near universal membership and as the only forum where risks which emanate from anywhere in the system, and in particular from the core, can be highlighted and discussed. Surveillance of systemically important countries, in particular, the advanced countries at the core of the system is the most significant public good that the Fund delivers to the large number of its members who are developing countries. We look forward to the concrete steps that would be taken to make such surveillance more effective. At the same time, we also expect that these measures do not add to the surveillance obligations of developing countries, who by all accounts have not caused this crisis and are the victims of its ill-effects.

Multilateralism

On multilateralism, we welcome the Fund's staff's explicit recognition of the need for a central locus for responses to global economic crises. While the failure of the Fund to assume this role is recognized as is the need to reform the Fund, we feel it is also important to recognize that the networks that exist outside of the Fund, including the G-20 and the expanded FSF, cannot be wished away and they play a useful and complementary role. Global financial stability is perhaps too important and significant to be left exclusively to one organization. The existence of other networks adds to creative tension and helps to optimize outcomes, sometimes by reminding the Fund of its own short-comings. We believe that the Fund with its near universal membership, technical expertise and established infrastructure needs to be at the centre of any global response to a crisis. But in order to play this role, it also needs to be substantially reformed.

Issues in Governance Reform

The first and most important reform will undoubtedly be a significant and meaningful quota and voice reform. As is well known, quotas play multiple roles in the Fund. This crisis has clarified thinking on a number of issues and rapid action has been taken on issues and in a manner that would scarcely have been conceived even a few months ago. A substantial quota increase with appropriate rebalancing on an accelerated calendar by the end of 2010 has to be an essential part of the crisis response. Such a reform will address issues of adequacy of resources and of enhanced access for many countries. But most importantly it should lead to a significant shift in the vote shares from advanced countries to developing countries and emerging markets. The quota reform should be forward looking by significantly enhancing the stake in the Fund of those dynamic emerging market countries and regions of the world which have the potential of enhancing growth momentum.

We also welcome the suggestion to make the Executive Board and the IMFC more representative. There is an urgent case for redistributing the chairs held in the Executive Board on a more equitable basis amongst the regions of the world. It may also be necessary to re-organize some of the constituencies to achieve such redistribution. However, keeping in view the need to preserve the balance between representativeness and effectiveness, we do not favor an increase in the overall size of the Board.

An important element of the representation reform in the Fund is the need to move to a truly open choice for Fund management. Unwritten rules which reserve the position for certain regions or countries are anachronistic and need to be changed, unambiguously and demonstrably.

This brings us to a slightly more difficult question. The staff paper attempts to make a case for a higher level policy engagement of Ministers and policy makers in the affairs of the Fund, with a decision-making role. This raises the question as to what the decision-making rules would be for such a policy group—would it be voting on the basis of the present voting shares in the Executive Board or would it be a consensus based body? If it is to be consensus based decision making, the IMFC as it exists should suffice, with some changes to the formalistic structure of meetings. On the other hand, if decisions are to be vote based, then any such "political mechanism" should be put in place only after meaningful quota and voice reforms are first effected.

Concluding Remarks

We fully recognize that governance issues are intrinsically and intricately intertwined with why the Fund and the global financial system failed in the crisis. However, we have two sets of very critical issues for discussion in the present set of staff papers—on the lessons relating to financial sector regulatory and supervisory failures and macro-economic imbalances; and the governance issues of the Fund itself. Both sets of issues require equal and adequate attention. Hence, while recognizing linkages, it is important to provide adequate time to focus on the issues separately to ensure that discussions are focused, in-depth and yield desired results. We would suggest that time is allotted separately to discuss both sets of issues given their importance.

While the staff papers have followed an easy and readable format in diagnosing problems and identifying solutions, what the paper lacks is a clear perspective on the next steps. In some areas, such as Fund lending instruments, follow-up action is already being taken. However, in other areas, greater clarity on the road map and time frame for implementing the identified solutions would be very crucial to preserve the credibility of this exercise. Inevitably, the way forward will involve intensified multilateral coordination backed by concerted affirmative actions by the all stake-holders. We look forward to a sequel to these papers highlighting the next steps in this endeavor at the earliest.

Mr. Warjiyo and Mr. Kanithasen submitted the following statement:

We welcome the opportunity to discuss some of the lessons learned from this crisis. Many of the issues brought up by staff have been introduced in other discussions but the unified analysis is helpful in guiding our search for solutions. We appreciate the detailed background work that staff have done as the basis for these papers. For that same reason, we also expect that this meeting cannot do justice to the complex and sometimes controversial issues that staff have laid out. Many of the questions under consideration deserve much more debate than one short meeting. At the outset, we would like to underscore the point that as we draw lessons from the crisis, it is important for the Fund to see how these lessons can be integrated into Fund surveillance and policy dialogue with members. In drawing these policy conclusions, we must remember that we cannot prevent booms and busts, though recognizing that today's regulations and capital market practices may have aggravated these cycles. Stricter regulation alone will not prevent the next crisis and risks swinging the pendulum towards stifling innovation and development. It is pragmatic and sound policies and strong macroeconomic fundamentals that are our best buffers.

We were surprised that the papers did not cover the recent measures on financial sector restructuring, in particular those of the United States and other advanced economies. Given that they have immediate bearing on the policy-making, we call on Management and staff to urgently come up with a paper discussing this issue. We also note that signs of financial and trade protectionism are on the rise and the risks from these forces are real. The stakes are high and we call on the Fund to continue to make strong calls about the pitfalls of such policies. It should be pointed out that the short-term gains of protectionist measures would ultimately be frustrated by the long-term cost of imploding world trade and loss of jobs.

Synthesizing the Lessons Learned

Staff have come up with lessons grouped into various issues, but we think a more focused picture would emerge if specific lessons could be synthesized for the different groups of countries affected by the current crisis.

For core countries at the epicentre of the crisis, we see the fundamental problem was the market failure resulted from individual institutions failing to achieve a solution to the principal-agent problem: Incentives for managers to bend the rules for quick personal gains overrode their responsibility to properly manage risks. This was aided and abetted by regulation that subscribed to an a priori belief that some segments of the market could be self-disciplining, not recognising that the system was a unified whole. To a large extent, staff show an understanding that regulatory arbitrage and opacity allowed more risk to be kept on the balance sheets of systemically important institutions than previously thought.

Having said that, we suspect the problem ran deeper: even if the risks were properly off-loaded from banks' and originators' balance sheets, the consequences would have been substantial for two reasons. The first was because large-scale leverage was inherent in the original instruments by virtue of being built on mortgages. Staff make an important observation that the consequence of the bursting of the dot-com bubble was mild in comparison to the deflation of a debt-driven housing bubble. By that fact alone, the bursting of the housing bubble was always going to be a significant event. Second, it is not clear that risks could have been off-loaded from the balance sheets of systemic institutions, given that institutions in the shadow banking system were becoming “systemically important”. Even if these assets were properly offloaded to non-bank financial actors, we think that their role as a major source of liquidity would have meant that, when asset prices turned, there were always going to be systemic consequences. The true lesson here appears to be that it would have been more prudent to focus on the process of originating the original assets as the first backstop.

For peripheral countries affected through their deep trade and financial links with core countries, market failure was characterized by sudden stops as sentiment turned, despite their sound policies. The Fund has been able to provide immediate and, hopefully adequate, financing and should stand ready to financially support crisis-affected countries, if requested. A bigger issue for these countries will be how they handle volatile capital flows going forward, a challenge they have in common with all emerging market economies. In particular, the Fund has to think carefully about how risks arising from direct borrowing by households and companies in foreign currency that bypasses domestic banks are dealt with. As staff have noted, tightening monetary and prudential policies do not seem to apply given the structural constraints. In these circumstances, the manner in which capital account liberalization is undertaken and the safeguards that should be in place needs to be re-examined.

Finally, a third group of countries that did not develop strong financial links with the core are being affected mainly through real flows, and the loss of financing related to trade activities. Most countries in Asia fall into this category. Those exporter countries who were prudent to use the opportunity afforded by high commodity prices to build fiscal space and adequate reserves are more capable of shielding their economies, but others are not. For these countries, some internal realignment will need to take place but it must be recognized that structural change cannot deliver immediate results. In addition, like other emerging market economies, these countries have been subjected to perverse capital flow reversals stemming from U.S. dollar liquidity shortage in the global financial market. Therefore, this group also remains dependant on the policy actions being adopted by countries in the core group. The Fund’s role here should be to encourage structural change while fully endorsing appropriate counter-cyclical policies. The Fund also has a valuable role to play in reassuring markets about the soundness of the fundamentals in this group.

In the longer term, however, the Fund should play a leading role in advising countries on how to manage capital flows. While the issues surrounding these challenges continue to command the Fund's attention, we believe there should be a rethink about how countries manage these flows, taking into account, inter alia, their size and openness, the stage of financial market development and exchange rate regimes. There is no one-size fit all rule that can be applied to all countries.

Finding the Way Forward

Staff have come up with a wide array of recommendations. What we hope to see as a follow-up is more in-depth recommendations tailored to the needs of different groups of countries outlined above. We wish to highlight four key issues, all of which need timely policy advice and action:

The first deals with macro-prudential policies, many of which are being re-discovered from previous crises. One of the lessons learned from the Asian crisis was to find a way to tear down the barriers that divided macroeconomic and financial policy-making. The Fund was very much involved in this through the development of macro-prudential indicators, the conduct macro-stress tests, and assessments of the financial sector through FSAPs. Unfortunately, these efforts were not as successful as we had hoped. In some part, this was due to weaknesses in these instruments, but we suspect the larger reason was the asymmetry in the treatment of different members which, we feel, bias toward developing countries. Nevertheless, we think that these instruments remain valuable when applied in an even-handed manner and that the Fund has a useful role to play in key areas, consistent with its mandate.

A comprehensive plan to overhaul the way we compile indicators, conduct stress tests and assess financial stability is needed. The enormity of the task should not stop us from starting in the first place. The Fund should begin with turning the Coordinated Compilation Exercise for FSIs into a global risk map project. FSAPs, which should be conducted for all systemically important countries at regular intervals, should help identify key risk areas.

The Fund needs to fully recognize that risks could come from any direction. Staff have rightly pointed out that surveillance after the Asian crisis was premised on the notion that emerging market economies were at risk of systemic instability. The proposed reforms to the EWE, in particular the compilation of vulnerability indicators to include advanced economies, move in the right direction. More will be needed to ensure that the Fund is able to make itself heard clearly in these countries, and not just in emerging markets and developing countries.

A re-think of the orthodox policy toolkit of monetary and fiscal authorities ought to be a priority. After witnessing how the massive central bank interventions have failed to reverse the decline, one should acknowledge with some humility that there are limits to the current policy toolkit in the face of large and fast-moving capital flows. This is where out-of-the box thinking by Fund staff on how to enlarge the policy toolkit would be useful.

Second, we need to rethink the way we regulate and supervise the financial sector. Admittedly, the Fund has a more supportive role in this regard. In our view, the belief that the market could be segmented between classes of institutions needs to be re-examined. The key lessons follow from the fact that the financial system connects all types of institutions, and that to be effective, regulations need to recognize this.

Whatever supervisory model is used, we need to enhance coordination between regulators, beginning with domestic regulators and supervisors, both among themselves and with macroeconomic policymakers. There were coordination failures in a number of countries where different domestic regulators failed to keep their colleagues informed of emerging risks. In addition, it is clear that central banks are an integral part of the regulatory framework by virtue of being lenders of last resort, and should not have abdicated their traditional roles.

We agree with staff that supervisory powers are still inadequately defined in the case of systemically important non-bank players. However, we missed practical suggestions on ex ante definitions of "systemically important". The new rules will call for greater transparency as a minimum. As mentioned in Supplement 2, ultimately what matters is what institutions hold the credit risk and what is their liability structure with regard to maturity and currency mismatches, and leverage. In this connection, we welcome European leaders' recent announcement to push for action in this area.

We also need to enhance international coordination on the financial sector regulation and supervision. For regulated institutions, we need to better operationalize the guidance coming from the main standard setters. The Basel Committee, for example, could do more to reach out to non-members, particularly in its policy making and implementation. In our view, many of the principles underlying the Basel II standards were appropriate. In particular, greater risk should attract a higher capital charge, and that risk management needs to have a stronger role in operational and strategic management. Some of the specific aspects, however, need to be reconsidered. For instance, more work needs to be done on correlations across risk types under stress conditions.

In addition, regulators will need to fill in gaps such as the absence of international standards for prudential and capital requirements for systemically important non-bank financial institutions, such as exchanges, clearing houses, and securities firms.

We need to find ways to foster cross-border regulation and supervision, particularly in relation to globally active banks. Supervisory colleges may be the way to go, but more efforts need to be made to harmonize regulations, accounting standards and tax systems to prevent arbitrage.

The Basel Committee announced in January 2009 that it will broaden the mandate of its Accord Implementation Group to look not only at Basel II implementation, but also the implementation of all risk management standards and guidance. The group will be renamed the Standards Implementation Group (SIG). How will this affect the work of the Fund in implementing the FSAP? Have there been discussions between the Basel Committee and the Fund on their respective roles and the need to avoid duplicative efforts in this area?

This leads us to the third point on rectifying existing information gaps. An important outcome of the Asian crisis was the SDDS framework but thus far, we have not seen a similar consensus arise on data gaps in the financial sector. The deep gap in risk disclosure was an amplifying factor in this crisis. It is not clear that there are immediate solutions to these questions but at the very least, clarity in all these areas would have helped. Emphasis should be given to collecting cross-border data, arguably where the deficiency is most pressing. To date, have not pieced together a global or even regional financial stability map that shows the financial linkages and cross-border exposures to different instruments. The availability of such a global risk map would enable supervisors to pinpoint where the important risk drivers are, and conduct overall systemic risk analysis to properly guide policies and early warnings. This is not a new idea, the BIS and the recent Issing Report have both called for it, but the concerns about data sensitivity and competitiveness have limited progress. This is an important area where the Fund can play a proactive role.

The fourth issue deals with the role of the Fund. The Fund's traditional roles of providing effective surveillance to lessen risks, and ensuring adequate financing in the event of a dislocation remain highly relevant. What needs to change, however, is the focus of these activities. We have already noted some of the shortcomings in the surveillance process and how these might be rectified. We also have firm views on the Fund's financing role, which we look forward to discussing in future meetings. In this discussion, we would like to focus on the nature and scope of the Fund's policy advice.

On monetary policy, advice has shifted from inflation targeting towards a broader view on what policy should achieve. We agree with staff that monetary policy should remained focused on the primary objective of containing inflation, although central banks need to take a greater account on financial stability assessment and asset price movements and build up of systemic risk when formulating their monetary policy response. Monetary policy is a blunt tool if used to deal with speculative booms and that bubbles may best be addressed by prudential or administrative measures. The recommendations to make capital buffers and provisioning requirements, including those of non-bank financial institutions, more counter-cyclical are perhaps the more appropriate remedies.

The Fund has always shown a bias towards free movement of capital. The recent experience in a number of Eastern European countries exemplify how sudden reversals in capital flows can have highly disruptive effects. As a first preference, we think capital account liberalization should be gradual and move in tandem with financial deepening to better manage the risks associated with it. If the Fund continues to advocate a more ambitious capital account liberalization timetable, then it should stand ready to provide the necessary financing when reversals occur. Moreover, we believe that pragmatic approach, including with regard to exchange rate flexibility and the use of prudential or administrative measures, is necessary in designing policy mix for dealing with capital flows.

Finally, we agree with the staff that strengthening multilateral coordination, i.e. the institutional arrangements for policy action, should be an integral part of reform on global architecture and the IMF. In particular, we reiterate our call for the urgent need to review the quota shares sooner than the gradual process envisaged at the last quota review, with a view to enhance the voice and representation of emerging and developing countries. We believe it is best to discuss this issue separately, along with other issues on governance of the Fund including the ministerial council. We urge the Management to bring this governance issue for a Board discussion in the immediate future.

Mr. Lee and Mr. Thompson submitted the following statement:

We would like to congratulate staff on an excellent set of papers that provide a timely, comprehensive and well-balanced discussion of the initial lessons from the still unfolding crisis. This work is in line with the expectations of the IMFC and G-20 Leaders that the Fund take a leading role in drawing policy lessons from the current crisis and recommending effective actions to restore confidence and stability. We are particularly pleased that the papers elaborate solutions rather than just retelling the story of what caused the current crisis. At the same time, it is appropriate that the solutions are couched in terms of more general principles, rather than detailed and specific policy measures, since these will need to be defined by national and international regulators and standard setters based on specific country circumstances.

An obvious question when approaching these papers is whether the staff have struck the right balance in terms of coverage and attached the right priority to the various policy lessons. On the whole, we think they have got the balance right, but with such a broad range of policy recommendations, we think the papers could have provided more explicit suggestions on how to prioritise actions, which could contribute to more effective and timely implementation. For example, on measures to address the pro-cyclicality in the financial system, the suggestions on what to do about compensation structures would seem to be more easily achievable in the short-term than the suggestions about adopting a more macro-prudential approach to financial regulation. This is not to say that the latter are not important, just that in a practical sense they are going to be more difficult issues to work through and on which to achieve the necessary consensus. As mentioned above, it is important for individual countries to adapt these principles to their country circumstances and to define clear, monitorable action plans for implementation.

While it is vital that we act now to draw lessons and formulate policy responses, it is also important to recognize that the crisis is still unfolding and far from resolved. As such, any lessons drawn now must still be considered tentative, and policy recommendations should therefore avoid being overly prescriptive or definitive. It is in this context that we think the papers could have taken a more open approach to some questions that are still outstanding, recognizing that a lot of work is underway in a number of different fora and that, on some issues, there is still little international consensus on the best way forward. For example, whether measures such as leverage ratios—prior to the crisis most widely used in the United States banking system—would have helped lessen the crisis is an open question that is still being considered. Likewise, the question of whether prudential policy should be more or less discretionary needs further work and the answer may ultimately depend on the strength of a particular country's institutions and the political support given to regulators.

An important feature of the crisis is the way in which it has evolved through a number of phases, from a financial crisis initially focused on the United States, to a real economy crisis in advanced countries and, most recently, to a broader crisis threatening the economic stability of emerging and developing countries. While many of the lessons from the earlier phases of the crisis are covered in these papers, we would also emphasize the need to focus on what can be done to deal with the latest phase of the crisis. The most pressing issue is how to prevent the drying up of capital flows to emerging economies as a result of risk retrenchment in advanced economies and the rise of financial protectionism more broadly. In this respect, we would encourage the Fund to take a lead role in developing a coordinated multilateral strategy to prevent the excessive withdrawal of capital from emerging economies, including a consideration of using moral suasion on key capital market players. While the breadth and severe impact of the crisis on banks may reduce the willingness of policymakers to engage in moral suasion, such a strategy is likely to be less costly than the international community having to restabilize those economies suffering capital flight. Moreover, such a strategy would also avert the need for emerging economies to implement prudential measures (such as capital controls) to stem capital outflows, which could undermine their longer-term access to foreign funds. Finally, we would also caution against the wording that has been used in the final sentence of paragraph 21 of the paper 'Initial Lessons of the Crisis' (SM/09/37), which could be misinterpreted as the Fund encouraging financial protectionism.

While clearly the crisis has taken on a global dimension now, it is still important to recognize that some of the specific underlying problems identified in the papers, such as some of the deficiencies in financial regulation and supervision, are relevant to some countries more than others. While we acknowledge that the intention of these papers was not to take a country-specific approach, we also think it is important to avoid creating a misperception that the problems were common across all advanced economies. For example, the growth of the shadow banking system appears to have been concentrated in just a few, rather than all, advanced economies. Similarly, the fact that some countries' financial systems have been relatively unscathed by the crisis can also be instructive as a point of comparison in drawing lessons from the crisis.

Financial Regulation and Liquidity Management (SM/09/33)

We broadly agree with the lessons in this paper for financial sector regulation and supervision and central bank liquidity management. We agree that there is a need to review the perimeter of financial regulation and possibly expand it to include all systemically important financial institutions. At the same time, we would highlight the practical difficulty of identifying systemic importance, both across countries and across time, which cautions against being too definitive at this stage about the types of institutions that should make it into a revised regulatory perimeter. What is more important is that the regulatory perimeter is made sufficiently flexible to accommodate changing circumstances. Experience tells us that, wherever one draws the line, those with a relatively higher risk appetite will seek to move outside it. The challenge for the regulator is to ensure systemic stability while not seeking to curtail the private management of risk which is a central role for any financial system. In this context, we would stress the importance of ensuring that, in each jurisdiction, there is a single agency charged with the responsibility for overall systemic stability, and which, therefore, would be accountable for keeping the regulatory boundary under review. Arguably, this need not be the prudential regulator, whose energies are more likely to be focused at the level of the individual institution, but there would need to be close and effective collaboration between the two.

This paper also calls for financial supervisors and regulators to take greater responsibility and become more responsive to risks. While the suggestions to close information gaps can help in this regard, it should also be acknowledged that supervisors and regulators may need more resources and expertise to fulfill their responsibilities and keep up with financial innovations. In some countries, they may also need the political, and possibly legislative, support to take some actions against institutions.

While recognizing that inappropriate regulation can create new sources of regulatory arbitrage or instability, it is important not to place too much weight on the concern that regulation might stifle financial innovation. Recent events would suggest that insufficient or misconceived regulation is more of a problem than excessive regulation.

Macroeconomic Policy (SM/09/37 Supplement 2)

We think this paper somewhat overstates the case that central banks were unaware of the build up of systemic risk associated with the strong growth in asset prices, credit and leverage. Instead, from a practical perspective, we would argue that central banks did recognize the build up of risk, as is evident from the many central bank warnings (in speeches/articles, etc.) about this issue in the years leading up to the crisis. In hindsight, central banks probably misjudged the risk/reward trade-off in choosing not to use monetary policy more directly to deal with this issue. As such, we welcome the suggestion to re-open the debate on the role for monetary policy in responding to credit booms, though we would emphasize that the discussion needs to carefully consider the difficult trade-offs involved (for example, what increase in interest rates would be necessary, and what unemployment rate would a country be willing to bear in insuring against the risks of a crisis), as well as the practical difficulties of identifying speculative booms. There will also be trade-offs in terms of diluting the effectiveness of monetary policy in controlling inflation that need to be considered. Given the myriad challenges and risks associated with using monetary policy in this way, the burden to curb credit booms should first be on enhanced prudential and supervision policies.

Global Architecture and the IMF (SM/09/37 Supplement 1)

We welcome the lessons drawn in this paper about the role of the Fund and global governance arrangements. We particularly support the calls for more in-depth and pointed analysis of systemic risk and threats to the global economy, and for strengthening the Fund's surveillance function more broadly, particularly in the area of financial sector surveillance. We agree that the proposed IMF-FSF early warning exercise is a useful step in this direction, but this needs to be accompanied by more frequent and high-level discussions on systemic threats and a greater willingness of members to respond to these threats. On the coordination of the global response to the crisis, we agree that more needs to be done to reform Fund governance, including the enhancement of the voice and representation of emerging and developing countries. This applies also to the FSF, where we support an expansion of membership to include key emerging market economies. Finally, we would note that there is a lot of work ongoing in various forums, including the IMFC, G-20 working groups, and Manuel Committee, on issues relating to reforming the IMF. Given the importance of achieving consensus on these issues, we would urge close collaboration between these groups, particularly in areas where there is direct overlap.

Mr. Alazzaz submitted the following statement:

I thank the staff for a set of comprehensive papers on the initial lessons of the financial crisis. The staff analysis will make a useful contribution to the work underway in various fora to improve the functioning and resiliency of the global financial system. Here, I welcome the focus on identifying priorities for action rather than the specifics of various policy measures, which will need to be defined by national regulators and international standard setters.

The key message of the paper is that optimism created by a long period of high growth, low real interest rates and volatility, and policy failures are at the root of market failure. Indeed, the favorable economic and financial conditions of recent years led market participants to expect a continuation of the benign, low volatility environment. This weakened incentives to conduct due diligence of borrowers and counterparties. Moreover, a build-up in leverage not only resulted in the enormous growth in size of many financial companies, but also exposed these companies to greater risks of insolvency in the event of a minor decline in asset values. The increase in leverage also worsened the effects of financial disturbances once market liquidity dried up. The lack of oversight on the complex financial instruments and on many major financial companies, including hedge funds, also contributed to the current crisis. Other factors include an inbuilt conflict at credit rating agencies (CRAs) and an over reliance on CRAs by investors.

Turning to lessons for financial sector regulation, I broadly agree with the analysis. In particular, it is important to extend the perimeter of financial sector regulation to ensure that all activities which may pose systemic risks are appropriately overseen. In this regard, subjecting all financial institutions within the expanded perimeter to disclosure requirements should help in assessing the systemic risk. It is also important that all systemically important institutions should have adequate resolution regimes and that counterparty risk management is improved. Reducing conflicts of interest at the CRAs is also critical. The staff has also made useful suggestions regarding procyclicality and information gaps. In particular, building up capital during upswings and allowing these buffers to be drawn in a downturn need to be explored. However, any changes would need to be implemented once the current crisis has abated, given the unsettled conditions in financial markets and the need to support the recovery of the real economy. Compensation structures at financial institutions also need to be changed to discourage excess risk-taking. On liquidity management, major central banks have responded flexibly to extend the scope of their operations to prevent a meltdown in the wake of crisis and it is an opportune time to learn the lessons for redesigning liquidity frameworks.

Turning to the lessons for macroeconomic policies, the debate about the role of asset prices in formulating monetary policy is not new. Here, the staff argues that central banks should adopt a broader macro-prudential view, taking into account in their decisions asset price movements, credit booms, leverage, and the build up of systemic risk. It should, however, be noted that lax lending standards rather than loose monetary conditions played the central role in the U. S. sub-prime crisis, which contributed to the bursting of the U.S. housing bubble and then spread swiftly in an unexpected manner and turned into a severe global financial crisis. I also note from the staff paper that "tighter monetary conditions in the Euro area did not prevent Western European banks from investing in risky U.S. mortgage backed securities and from lending aggressively in foreign currency to Eastern European households." Indeed, these developments underscore the critical importance of prudential and supervision policies to prevent future crises. On fiscal policy, I agree that it is important to utilize the period of high growth to cut public deficits and debt so as to increase the fiscal space.

As regards global imbalances, the risks highlighted over the past years of a sudden reversal of large capital inflows into the United States leading to a disorderly adjustment, including the value of the dollar, did not pan out as predicted. On the contrary, the dollar has strengthened after the crisis. In this connection, I would like to reiterate the views of Mr. Shaalan and Ms. Abdelati that "there is reason to believe that the root cause of this crisis originated from a build-up of systemic risk due to a lapse in the regulatory framework that was not adequately foreshadowed by our surveillance framework."

Finally, the role of early warning systems, better integration of financial sector issues into the WEO and Article IVs, and surveillance of all sources of systemic risk have been discussed on other occasions. Issues relating to Fund governance are also receiving attention separately. Here, I agree with Mr. Sadun and Mr. Spadafora that "the reform of Fund governance is a medium-term issue, as the primary and most immediate task facing the international community is the resolution of the current crisis."

Mr. Bakker submitted the following statement:

At some stage, as the present crisis evolved, a lack of confidence in the financial sector and the functioning of markets intensified the crisis. The importance of confidence suggests that we have a problem of multiple equilibria, and the global economy now seems to be heading towards a bad equilibrium. From this three important conclusions emerge: a) the Fund needs to focus on the appropriate macro-economic policy mix to make sure that the crisis will bottom out soon; b) supervision of financial institutions and markets needs to be enhanced in a coordinated manner; c) the Fund needs to take the lead in better coordination of policies in order to mitigate the crisis.

Macroeconomic Policy Mix

The Fund may need to pay more attention to the macroeconomic policy shortcomings and inconsistencies as it is charged, first of all, with surveillance over macroeconomic policies. The consumption-based and housing-boom-driven growth model of recent years has shown its limitations. This model was supported by too low real interest rates and at times fiscal excesses, and financed by ample supply of liquidity, fueled by global imbalances and associated large scale capital flows. We are now confronted with a growing negative feedback loop from financial to real sector and vice versa, and the collapse of trade.

The macroeconomic policy mix should be the subject of Fund analysis when deriving lessons of the crisis, not just separate elements, such as appropriateness of monetary policy reaction to asset price booms. Such analysis may show that consumption has been supported by growth in virtual incomes. Thus, the development of the shadow financial sector, described so well in the staff paper, may be put in the context of a failing growth model in countries with clear asset price booms. Fund surveillance should have identified the global financial stability threats from such a growth model.

With the benefit of hindsight we should have questioned the sustainability of the boom for world trade in recent years. The present near-collapse of global trade highlights another important element of macro financial linkages that is becoming increasingly important to emerging markets and exporters.

Supervision of Financial Institutions and Markets

The supervision model should reflect the financial system, i.e. it should operate across sectors. Staff rightly argues that the perimeter of financial supervision should be broadened and made more flexible. A functional model provides more effective supervision than a traditional sectoral model, as it incorporates spill-over effects between sectors and promotes cross-sectoral consistency. It prevents regulatory arbitrage and reduces regulatory white spots or overlaps, thereby also reducing administrative costs for the financial sector.

Prioritization of strengthening of financial regulation will be needed, all the more because, as stated by staff, “all solutions carry costs”. In this respect authorities need to be more specific on the goal of supervision, e.g. only informing market participants so that efficient decisions are made, or safeguarding financial intermediation so households and firms will always have access to their assets and banks remain capable to supply credit.

The idea to mitigate pro-cyclicality by using two capital levels—for booms and downturns, respectively—deserves further consideration. We would prefer not to do this by adjusting the minimum requirements over time, as suggested, but by distinguishing (1) a target level which banks should aim for during the upturn of the cycle, and (2) a regulatory minimum which banks should always hold and to which banks can draw down capital buffers during downturns. Between these two levels, net earnings may provide an effective adjustment mechanism which can be compatible with banks’ own incentives (e.g. by limiting dividends as long as capital coverage is below the target levels).

Although the introduction of a leverage ratio is worth exploring further, I would caution against relying too much on this measure. Recent experience shows that simple leverage ratios have not picked up on banks’ increase in leverage through off-balance activities of higher embedded risk. If a leverage ratio encourages further financial innovation to circumvent this minimum requirements, it would be counterproductive.

Bank risk management systems should better capture collective actions of market-makers, risk cross-correlations and time-varying volatilities. Comparing this staff paper to the one discussed by the Board in early April 2008, we note that the problems in bank risk management systems are not covered in this paper. It is the responsibility of supervisors to see that the implementation of bank risk management systems captures the true spirit of regulations and not just abides by the mechanical rules. In particular, the latest episode seems to suggest a strong need to move to regime-shift models of financial asset prices.

Credit ratings should capture the full economic cycle. Staff argues that a differentiated scale is used for rating structured products. In addition, it may be argued that products that have been in use for less than a full economic cycle should not be rated at all, nor should any overlying structures. Similarly, capturing the full cycle may also prove necessary to operationalize staff recommendations for establishing risk-based compensation schemes in the financial sector.

Global Architecture and the IMF

We agree with staff that an important lesson from the global crisis is that international surveillance needs to be improved. As capital movements become increasingly important, surveillance should have a greater emphasis on financial sector work, external links and spillovers. Better integrating the Fund's financial analysis with its macroeconomic work could be done, as suggested, by integrating the FSAP into Article IV. This may serve as a formal way to tighten relations between MCM and desk economists in area departments, and increase the weight of bilateral financial sector surveillance. It would mean increasing financial sector resources expertise in the Fund.

Institutionalizing follow-ups on flagged risks are at least as important as improving surveillance. As noted in Box 1, the Fund did raise many important issues that intensified the current crisis as they erupted, however, lack of follow-ups played a certain role in their downplay. A joint Fund-FSF Early Warning exercise may help to increase the collaboration of the advanced large economies in such follow-ups. To get the most attention and improve follow-ups the Early Warning List should be kept short and focused and a system to monitor follow-ups should be put in place.

There is a clear need to strengthen multilateral coordination. I believe this is a more promising route than to focus solely on governance reforms. I agree that quota shares should better reflect the shares in the world economy. This could be done by bringing forward the next general review of quotas by two years.

We share staff's view that the Fund's financing toolkit should be reformed to include an effective crisis prevention instrument and alleviate the stigma of approaching the Fund. Moreover, to give confidence to markets that the Fund stands ready to assist its members in this financial crisis, we support a doubling of Fund resources. The fastest and least complicating way of doing this would be through increased borrowing arrangement. Firstly, by concluding bilateral agreements, as was recently done with Japan, and secondly, through expansion of NAB/GAB. We look forward to concrete staff proposals at short term, so that these can be discussed in the upcoming IMFC.

Mr. Gibbs and Mr. Hills submitted the following statement:

We thank staff for a wide-ranging and thought-provoking set of papers. We had a number of comments.

Macroeconomic Policy

Causes of the Crisis

There were many, interconnected causes of the crisis, and we broadly concur with the narrative the paper establishes. On the macroeconomic side, a combination of the disinflationary effect of the increase in the global labor force (as emerging markets become integrated into the world economy), and credible monetary policy frameworks, contributed to low global interest rates and low levels of risk premia, and to increasing global capital flows. At the microeconomic level, investors engaged in a 'search for yield' that was met by increasingly complex financial products; at the same time, firms and individuals in some developed countries increased their leverage, encouraged by low borrowing costs. The realization that certain assets linked to subprime mortgages were riskier than previously predicted triggered the drying up of liquidity in those markets and led to investors losing confidence in their ability to value those assets. As markets froze and institutions failed, the system as a whole came under threat.

Inflation Targeting

We feel that the discussion of the mandate of monetary policy rather underplays the continued benefits of inflation targeting, within a wider policy framework. It is now obvious that the (successful) pursuit of price stability through monetary policy over the 'Great Stability' period did not prevent the build up of an unsustainable global economic situation. That might lead one to want to use monetary policy to try to smooth credit cycles as well as target inflation.

But there are two arguments against that, and we do not feel that the papers refute either of them. The first is that it is difficult to meet two objectives with one instrument—indeed, actively undesirable to attempt to do so, since it compromises monetary policy's ability to meet either objective. The second is that monetary policy is rather a blunt tool for addressing asset price and credit booms.

This strongly suggests that, rather than extending the mandate of monetary policy, it would be more effective to develop an additional policy instrument (or set of instruments) to stabilize the growth of the financial sector balance sheet. There is an ongoing international debate on the optimal design of such instruments, but examples of measures that could potentially provide incentives for banks to reduce the volatility of their own balance sheet include: dynamic provisioning (i.e. amending the accounting system to recognize likely future losses); varying regulatory capital floors with the cycle; counter-cyclical liquidity limits; or capping loan-to-income or loan-to-value ratios. To the extent that global capital flows contribute to macroeconomic imbalances (and respond to only a limited extent to domestic policy actions), international co-ordination would also be an important element of this policy mix.

Global Architecture and the IMF

Surveillance

We agree with the basic diagnosis that, although the Fund (in common with other official bodies) did identify some potential vulnerabilities, these were "insufficiently specific, detailed or dire enough to gain traction with policy makers" (p.2). We also agree with the main recommendations for improving the Fund's surveillance. In the past, we have strongly supported an increased focus on macro-financial linkages and multilateral surveillance (including regional reports), and the development of a joint Fund-FSF early warning system. The aim of these proposals is to sharpen the focus of surveillance on risks and spillovers and improve the traction of the Fund's policy advice.

Governance Reforms

We are broadly supportive of the governance reforms suggested in Section III of the background paper: enhancing the effectiveness of the Fund's governance, and better aligning the participation and voice of members with their weight in the global economy while enhancing the voice of low income countries. On the second of these, we note that there remains much to be done by Members to implement the last quota review—work identified by the IMFC as urgent. On the first, we would particularly emphasize the importance of engaging IMFC ministers and governors on key policy questions, which would provide increased political guidance and strengthen the political commitment to the Fund's work. We have argued in the past that this could be achieved by the establishment of a Council and we continue to see merit in that proposal.

In addition, we would stress that establishing the Fund's legitimacy in the eyes of its members is not purely about governance and voice. A truly legitimate Fund must be sufficiently resourced, develop flexible facilities that are responsive to its members' needs and carry out its surveillance mandate with increased effectiveness. The most urgent priorities are to address the resourcing of the institution and its facilities to address the deepening crisis.

The potential governance agenda is a broad one with far reaching implications and the different strands of the debate—although often discussed separately—are interconnected. For example, greater responsibility for the decisions of the Fund brings with it a stronger commitment to provide the Fund with necessary resources. Broad though the coverage of this paper is, there are almost certainly other governance issues that would likely be raised once more detailed work began. It will take time for the membership to work through these issues to reach a consensus. We should be alive to the risks of too much near-term focus on issues that, to the wider world, look like internal matters. And we should recognize that thinking about the sort of Fund we need may develop as the crisis itself moves through different phases.

That said, the crisis provides an opportunity for a fresh look at the issues as well as high level political focus on the mandate and role of the Fund as well as other international institutions. As a Board, we should welcome such focus and be ready to respond to the opportunities it creates by working through potential reforms across a broad front: finance, facilities, surveillance, the mandate of the Fund, as well as governance.

Financing

We have supported immediate action to increase substantially the IMF's resources, so that it can increase its lending capacity as appropriate. The deteriorating global economy makes this more urgent, and we believe that at least a doubling of the resources available to support the membership is necessary. We strongly agree that the Fund needs to reform its financing toolkit to make conditionality more tailored and targeted, and to allow greater flexibility on access limits. We continue to see the attraction of guarantees for rollover of sovereign debt as one way to make more effective use of Fund resources, though we acknowledge that the Articles do not provide for this. We will return to these issues in more detail at the separate Board meeting on this subject later this week.

Regulation of Financial Institutions and Markets

We are happy with the basic thrust of this paper. The following are comments primarily on the detail.

Perimeter of Regulation

It is clear that the coverage of prudential regulation in recent years has been too narrow, and the paper poses the most important considerations when considering how to extend the perimeter. There is a strong argument that firms should be regulated according to the economic substance of their business rather than their legal form, and that, rather than focusing on systemic institutions per se (which runs the risk of being too static a characterization) it could be better to look at systemic circumstances. We would be interested to hear staff's views on the types of institution (e.g. hedge funds, shadow banks, investment banks) that they envisage would be subject to higher levels of prudential oversight as a result of their suggested criteria.

Mitigating Procyclicality

In para 24 on counter-cyclical capital requirements, it would be useful to know whether the objective of "mitigat[ing] procyclical effects" refers just to counteracting the tendency of minimum capital requirements to rise during a downturn., or more generally to mitigating the whole range of procyclical tendencies in the financial system.

Cross-Border Cooperation

The paper makes many helpful comments about improving cross-border co-operation amongst supervisors (in which we would also include central banks, finance ministries and resolution authorities). We note that the FSF's Resilience Working Group has earlier this week produced a draft set of principles for cross-border co-operation on crisis management, including the development of a common systemic impact assessment framework, and a handbook for authorities engaging in firm-specific contingency planning, which could be extremely helpful in this respect.

On the legal framework (para 38), we would stress that "convergence of banking legislation" should refer simply to the need to understand the legal barriers in other relevant jurisdictions. Changing legal structures simply to harmonize them would be much more problematic, and unnecessary.

On corrective actions, we agree that it is useful to have agreed in advance the principles used to begin the resolution or bankruptcy procedures of a global firm, but fear that "common criteria" might be a little too prescriptive, given that each case is likely to differ materially.

Detailed ex ante discussions in 'peace time' are a particularly important element of this framework—both to smooth the practical arrangements (e.g. on communicating and interpreting the data that will be shared) and to co-ordinate policy (e.g. an ex ante discussion of the strategic firm-specific options open to supervisors in crisis). Free exchange of information is an important element of this process, where appropriate.

Role of the IMF

We would be interested to hear how staff see the IMF's role on financial regulation issues evolving. In general, the paper does not seem to claim a direct role for the Fund—appropriately, given its areas of comparative advantage—but in places there is some implied extension (e.g. in para 40, the Fund is envisaged to work with the Basel Committee and World Bank to develop guidelines for dealing with cross-border bank supervision and resolution).

Mr. Horgan and Mr. Purves submitted the following statement:

The staff should be commended for compiling an impressive set of papers before us today, which explore a wide range of initial analytic and policy considerations relevant to the prevention of future financial crises. At the outset, it is important for the IMF to explore these issues. Greater debate is needed not just on the financial-sector, monetary and fiscal policy dynamics of the current crisis, but also on the state of today's global economy.

As we work to re-start private capital markets, we must also begin to think about public entities, and how the international community will cope with possible corporate or sovereign debt crises. Given the current state of private markets, sovereign default would arguably be more detrimental than in past cases, causing a further loss of general market confidence and another flight to cash and 'quality' investments like US T-bills and gold. The severity of the crisis has brought to attention the prospect of possible capital controls, and it will be important for the Fund to monitor developments on this front, the corresponding impact on capital flows, and provide an opinion on both the benefits and costs of their existence.

In sum, we are all witnessing a shift in concern amongst regulators and policymakers from that of liquidity management to heightened consideration of solvency issues, both in public and private spheres. At the Fund, we continue to engage on the design and implementation of important new precautionary lines and facilities to handle these challenges. Given the uncertain nature of the crisis and that we learn as we move forward, it is important that we continue to take stock and engage further on the broader question of how we wish to see the IMF emerge from the crisis—whether in a more traditional role, or evolving towards an insurer-based model, as raised by the staff in their document. This would also include a discussion about whether we have the appropriate fee structure for these facilities, and the nature of their conditionality. In the meantime, the IMF must continue to be out front, seeking ways to work with member governments to mitigate the risks of the uncertainties we face.

We focus our comments according to three broad categories. First, what is an appropriate macro-prudential approach to financial regulation and compensation structures that mitigates pro-cyclicality, promotes robust market-clearing arrangements and accounting rules, and facilitates systemic liquidity management? Second, what are the considerations that need to be made for maintaining a strong macroeconomic framework to address anomalous performance, such as credit booms and asset price movements? Third, what architectural measures could help to re-align and strengthen the degree of success with achieving strong macroeconomic policy and prudential oversight?

Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management

The paper complements the work underway by the Financial Stability Forum (FSF), national authorities, standard setters and the G20 (and their working groups) to devise and propose tangible policy responses to improve macro-prudential oversight. In this respect, the staff highlights what can also be referred to as an important checklist that could be used by authorities broadly seeking to improve their systems. We have four core comments:

First, establishing a perimeter of financial regulation seems to require at the outset a clear understanding of those actors in a system that could present a systemic risk if the macro-prudential framework were not calibrated/or functioning in an optimal way. In calibrating a framework, identifying a desired behavioral outcome—such as promotion of transparency of firms for the benefit of investors and regulators; discouraging regulatory arbitrage; and discouraging procyclical behavior—should influence not only the number of actors deemed to have systemic importance but the resources required to regulate them. As a simple illustration, some jurisdictions have conservative average asset-to-capital multiples on a consolidated basis that do not exceed 20-to-1, which has contributed to institutions avoiding some of the more egregious lending practices seen elsewhere. It also has helped manage the scope of systemic risk by actor, and associated resources required for regulation.

Second, the paper remains silent on the topic of misaligned incentives. It has been belatedly recognized that the severing of the long-term relationship between originator and borrower contributed to a decline in credit quality. Further, within several global financial institutions, there were also inappropriate incentives created by the funding of trading desks at risk-free rates and poorly designed compensation structures. Indeed, there is ample evidence of serious principal-agent misalignments within major financial institutions, and that addressing this issue is a key element of improving the macro-prudential framework. If the scope of oversight were to include compensation, regulators would need to consider carefully compensation incentives within a broader assessment of the robustness of risk-management and internal-control systems.

Third, the paper singles out the failure of market discipline, but this is not entirely correct. It is widely understood that market discipline is most pronounced during the downside of an economic cycle. If it has failed, we cannot escape the fact that part of the failure is due to lack of an adequate framework for large financial firms to fail/reorganize. For this reason we agree with the staff that a critical lesson of the crisis and a key component of a new financial architecture is establishing ex-ante rules for dealing with insolvent financial institutions that operate internationally. However, in seeking to construct new arrangements we must also ensure that we do not swing the pendulum too far, creating a regulatory framework that makes banks impervious to failure in the future. If we unintentionally create this type of moral hazard we all but assure ourselves of another crisis in the near future.

Finally, it is also important to consider linkages to ensure that taking action in one instance does not run counter to desired outcomes. For example, it has been recognized that higher capital requirements to limit leverage should be introduced, but only once recovery is underway. Starting today would only accentuate the deleveraging process. The same might be true with placing an OTC derivatives market on an exchange or in a clearing house, depending on how margin requirements might change. The creation of good macro- prudential oversight requires an appropriately balanced and reasonable assessment of practical implementation.

Lessons of the Global Crisis for Macroeconomic Policy

The paper discusses the role of inflation targeting in this crisis. It is important to note that an inflation target framework per se cannot be shown to be destructive to macroeconomic stability. Some have suggested that the message from the crisis is that countries should consider price level targeting—i.e. a more transparent inflation target—as a more effective way of avoiding the risk of hitting a liquidity trap.

The document also suggests that central banks were overly focused on narrow inflation targets, and thus ignored the growing problems in the financial system. On the contrary, there are cases where inflation targeting is compatible with financial stability (as witnessed in the Canada). We found that the issue of how to use monetary policy to avoid asset price bubbles could be explored further in the document. Eminent members of the Federal Reserve Board have spoken convincingly on the undesirability and inability of central banks to broaden their mandate to bursting asset bubbles. The conclusion that central banks are quite able to spur asset bubbles, but less able to burst them, is something we must keep in mind when discussing revamping the role and toolkit of central bankers.

In that vein, given the toolkit of most central banks, the best that monetary policy can do is to lean against asset price booms and busts, leaving the heavy lifting to countercyclical macro prudential regulation. In this respect, the crisis exposed a deeper problem: uncertainty over who is responsible for financial stability. Clearly establishing the roles and responsibilities of central banks and regulators, including clear lines of communication and co-operation, is paramount for effective macroeconomic policy and financial stability.

On the causes of global imbalances, certainly more attention should have been paid to US fiscal policy and lower consumer savings rates. However, it takes two to make an imbalance. Other countries have not been attentive enough to their roles in maintaining imbalances, either through slower exchange rate adjustments, insufficient domestic demand, etc. Massive accumulation of foreign reserves may have made some sense from a self-insurance point of view, but it surely contributed to the crisis. On this latter point, exploring options that provide incentives for countries to avoid excessive foreign reserve accumulation is paramount.

The discussion on fiscal policy could pay more attention to issues concerning the ongoing fiscal policy response to the crisis: i.e. what is the optimal composition (expenditure vs. taxation)?; does coordination matter?; and what are the medium term consequences of dramatically larger deficits and debt?

The paper also referred to the need to have exit strategies on liquidity management—but this issue is broader than what is being considered by the Fund. There are a number of actions that need to be taken to deal with the crisis that will need to be unwound: rising fiscal deficits that will have to be reigned in; banks being encouraged to lend to promote consumer spending, while over the longer term banks will need to increase their capital bases; interest rates are at historical lows and will need to return to more 'normal' levels; and government involvement in a range of sectors including the financial sector will need to be phased back to more 'normal' levels.

Lessons of the Crisis for the Global Architecture and the IMF

While the paper rightly notes past weaknesses in Fund surveillance (both in the identification and communication of threats) and rightly notes the failure of the 2006-2007 Multilateral Consultations on global imbalances, the document could also benefit from mentioning the important steps that have already been taken to address some of the issues related to surveillance, lending and governance (both external and internal).

We are also pleased that the Fund identifies the need for greater member buy-in for heeding advice that is candid and even-handed. It is important at this juncture that IMF members also hold a common view of the principles for promoting international monetary stability (avoiding beggar-thy-neighbor policies, promoting medium-term adjustment to structural changes, etc.). Without this, it will be hard for the Fund to promote coherent, coordinated responses to future threats.

On scope, it is also paramount for the IMF to find a way to get more traction with systemically important countries, especially on financial sector issues. While mandatory FSAPs are a good first step, they should also be published in a timely manner. Similarly, we are pleased that the IMF is moving away from model-based discussions of early warning systems and is focusing more on a comprehensive and coherent approach to identifying and assessing systemic risks/vulnerabilities to global financial stability and evaluating expected outcomes. Finally, while our focus here is on the Fund the future role of other pertinent multilateral organizations such as the OECD should also be captured. We note the document was silent on this front.

Mr. Ge and Mr. Zhang submitted the following statement:

The global financial crisis that originated in the United States has caused severe external instability and heavy damages to the global economy and financial system. The worst may not be over. A careful look at the causes and lessons is most needed to inform decisions to cope with the current crisis and reduce the risk of such crisis in the future. As the G20 Summit last November reached initial consensus on the causes of the crisis it is proper that the Fund focuses on lessons.

The Causes and Lessons of the Crisis

First and for most, the crisis reflects the unsustainability of the growth mode in the United States characterized by low savings and over consumption. An adjustment to a more sustainable mode will depend on its own efforts. Second, the improper macroeconomic policies in some developed countries resulted in excessive global liquidity and over leveraging by financial institutions as well as housing and equity bubbles.

From the fiscal policy aspect, the deficits and large tax cuts by the U.S. government in recent years contributed to the over consumption of households. Public and household dissaving inevitably exacerbated its current account deficits. The deficits in boom cycle have reduced the space for stimulation in the current contraction and undermined the credibility of an exit in the medium term.

From the monetary policy aspect, the long period of low policy rates after the burst of the IT bubble in some developed countries caused excessive liquidity in the international financial markets for an extended time and encouraged large scale carry trade, and thus volatile short term flows. The low interest rates also encouraged high leverage of households, firms, and financial institutions and the expansion of assets bubbles. When managing aggregate demands, the central banks in some developed countries focused only on short term growth and neglected the systemic risks associated with asset bubbles. They also failed to adopt timely remedial measures.

Third, the severity of the crisis and its spillover reflects deficiency in the international financial architecture. The distorted Fund quota structure resulted in the misfocus of Fund surveillance leaving the major share-holders largely outside its focus. This stood out especially at the time of high sub-prime risk in 2007 when the Fund's main focus was still on the emerging market economies, especially on their exchange rate policies. The misfocused surveillance exercise miscommunicates real systemic risks to the market, as well as policy makers in both developing and advanced economies.

The current crisis also reflects the inherent vulnerabilities in the international monetary system with a national currency as reserve currency. Reserve currency issuing countries are constantly confronted with the dilemma between achieving their domestic monetary policy goals and meeting the demand for reserve currencies from other countries. The Triffin Dilemma, the conflict between maintaining the value of a reserve currency and providing liquidity to the world still wants a solution. From a global perspective, an international monetary system with national currencies as reserve currencies without adequate surveillance and discipline has inherent systemic vulnerabilities. The reliance on a few countries to issue reserve currencies may either overburden them with the need to meet the fast growing demand of the global economy, or create excessive liquidity in the global markets by their overly stimulated domestic demand. The increasing frequency and intensity of the financial crises following the collapse of the Bretton Woods system suggests that the current system is becoming increasingly unsustainable. The price is becoming increasingly higher, not only for the users, but also for the issuers of the reserve currencies.

Fourth, the lack of proper financial regulation and supervision, and market failure were the immediate causes of the financial crisis. Financial supervisors in some developed countries relied too much on the capacity of the markets to adjust on their own.

The failure of market discipline was reflected in many aspects. The distorted incentives and governance structure of financial institutions led to their excessive business expansion to pursue short-term profits. Accounting and law firms and credit rating agencies also lack self-discipline and the conflicts of interest led to distorted risk information and assets pricing. The inadequate risk control over financial innovations resulted in the surge in financial derivatives.

Solutions and Next Steps

First, crisis resolution requires concerted efforts by the international community to stimulate demand, stave off trade and financial protectionism, and restore the functioning of the financial system. Given the unprecedented monetary and fiscal stimulus, firm and credible commitment to medium and long-term sustainability is critical. Orderly exit strategy should also be an important part of crisis resolution.

Second, the current crisis has provided a rare window of opportunity for accelerating the reform of the international financial system. The current priority is to follow up with action on the consensus reached at the G20 Summit, particularly the reform of the Fund to the following three aspects: 1) Set up a timetable for launching the new quota and voice reform to increase the representation of developing countries and enhancing their role in maintaining global and regional financial stability. In the long run, an automatic quota adjustment mechanism so that Fund quota will not only reflect the changing economic landscape, but also meet the resource need of global trade and economic growth, as well as financial stability; 2) Reform the Fund surveillance process with greater focus on reserve currency issuing countries. The Fund should avoid making the same mistakes by focusing surveillance excessively on emerging economies and too narrowly on certain policies (for example, exchange rate policy); 3) The Fund should continue its reform of lending instruments and conditionalities to better meet member country's needs.

Third, the existing system requires a full-fledged reform to remove various restrictions on the role of the SDR, and diversification of international reserve currencies. Efforts should be made to push forward a SDR allocation sufficient to satisfy global liquidity needs in a timely manner and to broaden the use of SDR as a reserve currency

Fourth, it is important to strengthen cooperation in financial supervision. Financial authorities should enhance information exchange, enlarge supervisory perimeters to allow adequate coverage of global capital flows and financial institutions, set up an effective early warning system, refine effective financial supervisory standards, and improve accounting standards and capital adequacy requirements.

Mr. Daïri and Mr. Rouai submitted the following statement:

We commend staff for the concise, yet comprehensive, set of papers. The current crisis will certainly leave behind it a rich body of analyses of what went wrong and lessons for the future. The staff papers are part of this undertaking, providing useful analysis, conclusions, and policy recommendations, which will enrich the ongoing policy debate. Other lessons can be expected to be drawn by the economic profession, market participants, and policy makers in areas such as asset bubbles, market failure, and the risks of unfettered financial globalization. Current shortcomings of the International Monetary System, including the role of capital movements, need to be carefully assessed. It is to be hoped that the confluence of wisdom from all these sources will help reduce the frequency and severity of future crises, as we agree that crises will recur.

At the outset, we would like to make a few general comments. First, while we appreciate this early stock taking exercise, we continue to believe that the Fund's immediate priority should be the resolution of the current crisis in mature markets and the containment of its spillover effects on developing countries. This is all the more important since the crisis is still unfolding. Second, we have some difficulties with the scope of the paper, which covers areas of Fund governance and the global architecture that do not lend themselves to drawing lessons from the crisis. While there are overlaps in many areas, we believe that issues of governance should not be discussed through the back door of this paper, which should primarily aim at plugging the holes in surveillance, regulation and supervision of financial systems, and international coordination. Moreover, as also highlighted by Mr. Shaalan and Ms. Abdelati, there is no clear evidence that the current governance structure has hindered early detection of the crisis or its mitigation. Third, the ongoing crisis has exposed some of the Fund's limitations in carrying out its mandate. While legitimacy and relevance have been identified as the main drivers for reform under the Medium-Term Strategy, the arguments and emphasis were centered, at that time, on emerging markets economies. The current crisis has exposed the issue of the Fund's relevance to advanced countries and its lack of leverage on their policies. In addition, it has confirmed the inadequacy of Fund resources, facilities, and policies in dealing with modern financial crises, and we look forward to early completion of ongoing work in these areas. This being said, we broadly agree with staff analysis and recommendations and will make the following comments.

In the area of macroeconomic management, staff point to the limited emphasis given by central banks to macro-financial stability during the pre-crisis period. In this regard, we are pleased that the paper clearly repudiates the views—echoed by the Fund in the past—that asset prices bubbles are difficult to spot, that monetary policy should be mainly concerned with consumer price inflation, and that asset price busts can be cleaned up at lower cost. We agree with the paper's conclusion that central banks should use both prudential measures and monetary policy to respond to asset price bubbles.

The review of failures of Fund surveillance in Supplement 1 is refreshingly candid, and we commend staff for pointing to the many shortcomings that led to underestimating major risks and conveying muted warnings. We welcome the many valid points highlighted in Boxes 1 and 2, including the recognition that independent and reputable economists warned about the imminent risks, with Nouriel Roubini coming "the closest to seeing the form the crisis would take." Why were these commentators more prescient than Fund staff, and were the tools and information they used to arrive at their conclusions available to Fund staff? Another important issue is that crises do not follow the same pattern, and it is important to think out of the box, instead of relying only on past experience.

We welcome the recognition that Fund surveillance and assessment of vulnerabilities were heavily focused on emerging economies and less so on advanced economies (paragraph 5). Equally important is the tendency of major advanced economies not to heed Fund policy advice, and the paper could usefully explain the reasons: was it because of major disagreement in assessment or because of the lack of Fund leverage? This is all the more disturbing in view of staff recognition that the "message tended to become more muted rather than louder" (Paragraph 4).

Multilateral consultations were largely focused on global imbalances and were not effectively used as a channel of communication of the major risks that were building up in the financial sectors of advanced economies. We note the indication that the warnings about global imbalances "were taken seriously by policy makers." Maybe Fund warnings with regard to financial stability risks would have been equally well received had they been covered by such consultations. Staff comments will be useful.

Staff propose (Paragraph 8 of the main paper) that consideration should be given to discouraging mega-institutions and recommend increases in capital and leverage ratios, as well as intensification of their prudential oversight. These recommendations are in the right direction, but their application will take time. We would have preferred a more proactive and timely stance by staff in advising against recent actions in the area of banking consolidation and takeover. Recent experience indicate that consolidation between strong and weak banks before the restructuring of the latter often leads to a bigger, but weaker bank, and to the concentration of risks and fragilities in "too big to fail" institutions. The problem is even more severe when such consolidations are promoted, and indeed financed, by the public sector.

We agree that the shape and operation of financial markets will be different after the crisis, given the magnitude of the deleveraging underway and the massive losses and reduction of exposure to counterparty risks (SM/09/33). A key element, however, will be the nature of the policy response to deal with weak financial institutions through recapitalization, restructuring, or government intervention, including takeover of large, insolvent institutions. The paper seems conspicuously silent on this issue.

The absence of rules governing cross border resolution and burden sharing and the unfortunate prevalence of narrowly defined national interests deserve immediate attention. As pointed out by staff, because of the regulatory void and lack of ex ante cooperation frameworks, many supervisors minimized liabilities to nonresidents and maximized control of assets, sometimes invoking non-prudential measures. Still in the financial sector, the various pledges for additional deposit insurance and other commitments to guarantee assets losses of financial institutions, while necessary for crisis mitigation, are contributing to development of unfair competition among countries and banks. Similar distortions are also being introduced in the real sector through the promotion of domestic industries and sectors, leading to an increase in protectionism and beggar-thy-neighbor policies. We urge the Fund to take a strong stance against such developments and policies, which could trigger retaliatory measures and undermine recent progress in market liberalization.

Many of the lessons of the crisis identified by staff will require close cooperation with other institutions. Here again, the proposed solutions are sensible and deserve careful attention by relevant authorities. Among these reforms, we would like to highlight those designed to improve the coverage of the regulatory framework for financial markets, instruments, and products, to enhance market discipline and reduce conflicts of interest in the rating agencies, and to integrate compensation with corporate governance and risk management.

The proposed reforms on the global architecture and Fund governance have been debated for some time without the emergence of a clear support among the membership. Our Chair is willing to contribute to the debate on a number of these issues provided that such debate is inclusive of all Fund members and not limited to a grouping of the membership. Our preference, however, is to take up these issues separately in a dedicated paper and not as part of a broad stocktaking exercise. Among the ideas advanced by staff, we note the proposal to give "IMFC ministers and governors a high profile forum for focused discussions and decisions" indicating that "such a group should be neither too formal nor too large". Is staff considering a new framework other than the IMFC and the Council since both are formal and replicate the Board in their size and composition? Staff clarification will be welcome.

Mr. Kotegawa and Mr. Kihara submitted the following statement:

We appreciate the staff's work in preparing these four papers. They cover a diverse set of issues, in fact, there could be even too many issues for one Board discussion. Some of the issues would merit further consideration before the Fund reaches a definitive view. With this understanding, we would offer our initial response to the presented papers.

Financial Regulation

We agree that the basic causes of the current crisis are in financial regulation. Many points raised in the paper, such as the extension of regulations and supervision perimeters, changes in prudential regimes, and information gaps, are issues that all need to be addressed.

As staff indicate in the Staff Paper, "for every regulation there will be an innovation." Nonetheless, authorities are expected to minimize the gaps between regulatory frameworks and reality so as to avoid increasing systemic risks. We always see pendulum swings between market discipline and governmental regulations. At this juncture, it would be more reasonable to shift toward regulatory frameworks, while paying due attention to the development of the financial sector.

One of the new challenges we face under the current crisis is how to deal with large financial institutions that have cross-border operations. This could lead to a situation where those institutions are too large to be rescued by single country. Another aspect is that a rescue package for such institutions would require international coordination. In this respect, the suggestions expressed in paragraph 38 of the paper on "Lessons of the Financial Crisis for

Future Regulation of Financial Institutions and Markets and for Liquidity Management" touch upon several important issues. In reality, cross-border coordination, in terms of regulation and crisis resolution, are very challenging issues. We must recognize that each country's regulatory framework presents a long history and its own cultural background. Thus, applying a uniform approach across countries would not work. At this stage, establishing a binding code of conduct or international charter for banks still seems to be a highly ambitious agenda. Nonetheless, it would be helpful to start discussions on what might be feasible in this area.

Macroeconomic Policies

Many discussions have been held in terms of to what extent macro-economic policies should take into consideration asset prices. This is an issue that requires detailed and balanced consideration. Each circumstance will require a different policy mix.

In this respect, we support the staff's emphasis that what may matter is "who holds the assets, and how an eventual bust may affect financial institutions." The macroeconomic effects of an asset bubble could be very different, depending on how those rapid price increases are financed. The existence of a high-leverage, reliance on short-term or foreign-currency dominated debt would heighten the risks of asset price volatility. The Fund's surveillance has made good progress in these areas, and we encourage staff to make further progress.

We are somewhat puzzled by the part of the main paper on "Global Imbalances" (paragraphs 20 and 21 of SM/09/37). As described in the paper on "Lessons of the Global Crisis for Macroeconomic Policy" (SM09/37, Supplement 2), the main culprit of the current crisis "must be seen as deficient regulation." We see discrepancies in the tone of this point between the main paper and the supplement, and suggest that the text in the main paper be revised. While we do not necessarily agree with the point that capital flows (or current account imbalances) could be problematic since regulation could always remain imperfect, we welcome the staff's approach to the topic of capital flows. Indeed, highly volatile capital flows have made it extremely difficult for many countries, particularly emerging countries, to maintain a sound and stable macroeconomic framework. This is the area where many Fund members request valuable advice from the Fund.

Global Architecture

We agree with the surveillance part of this section indicating that expertise in the financial sector has been scattered across institutions. While this is inevitable due to the required level of expertise for standard setters, achieving more coordination among different institutions, and emphasizing a macro-economic perspective would help specify the financial sector's underlying risks. Proposed Early Warning Exercise is one way to promote such collaboration.

We also welcome that the staff makes a reference to financing in this section. Urgent action will be necessary to make progress our discussion on crisis prevention instrument. The needs to enhance the Fund's lending capacity is clear, and we look forward to other countries' concrete actions.

Policy coordination is an important, but difficult, agenda. The Fund has been vocal in calling for fiscal stimulus. We cannot stress enough, at this juncture, the importance to send cautions against protectionism, as well. Our view is that the most important way to increase the traction of the Fund's advice is to enhance the quality of Fund analysis. As more information becomes public and each country's capacity increases, it has become even more challenging for the Fund to present truly eye-opening and innovative research and advice. Further enhancement in multilateral surveillance and cross-country analysis could show value-added of the Fund analysis.

The paper mentions various governance issues, and there is no doubt that the Fund's governance reform is a highly important issue. We look forward to another occasion to have focused discussion on this topic.

Ms. Lundsager, Mr. Kaplan, and Mr. Wood submitted the following statement:

We welcome this opportunity to consider the staff's input to the international dialogue on lessons to be drawn from the financial crisis. We are pleased that the papers focus on recommended objectives rather than on how specifically to achieve them. It is important to understand that, in many cases, development of specific policy responses will be informed by the work of standard-setting bodies as well as technical working groups in the G-20 process. However, at this early stage and with little time for review, we would stress that the conclusions drawn in these papers should be described as those of the staff and not necessarily those of the Board.

Financial Regulation and Supervision

We appreciate the staff's insightful discussion of problems that contributed to the financial crisis, and we find much of merit in the proposed solutions. It is important, however, to consider costs and unintended consequences of those solutions. Appropriately, the paper assesses whether and how the perimeter of financial sector surveillance should be expanded to more institutions and markets. We believe, however, that this consideration must also take into account the costs of new regulation, and whether it creates new arbitrage opportunities or increases moral hazard.

The paper discusses prospects for aligning systemically important non-bank financial institutions' reporting standards with that of banks. Analysis of regulatory differences in the financial service sectors will help to identify any areas in which greater harmonization may lead to more effective supervision, especially in the context of large, complex financial institutions. However, it is critical to preserve practices and approaches of the individual sectors that are specifically designed for those sectors and which properly reflect the risks they are intended to address.

On the issue of procyclicality, it is important to characterize correctly the emerging consensus among market participants and regulators. Although the paper suggests that agreement has emerged that current loan loss provisioning rules and practices are problematic, we believe that the consensus generally reflects a need for standard setters to study the issue.

The staff recommends structural changes to regulatory capital requirements and loss provisioning guidelines to help institutions weather economic downturns. Financial institutions manage risk through the business cycle and naturally accept more risk during good economic times when credit defaults and losses are low. We believe the staff also should consider the scope for strengthening supervisory standards for sound credit and liquidity risk management through the business cycle.

Regarding the scope to improve cross-border failure resolutions, the staff suggests establishing an international banking charter accompanied by a set of common supervisory standards and international supervision. While this could help harmonize systems and ex ante rule development, it introduces the risk of arbitrage between domestic and international regulators. Has the staff considered how objectives could be achieved by applying the same standards across all charter types, allowing for flexibility in application based on materiality? Related to this point, in considering a potential role for a college of supervisors for more than information exchange, the staff should acknowledge the challenges since each jurisdiction must act in accordance with its own law.

The staff does not differentiate the tasks of harmonizing the legal and regulatory frameworks for information sharing from those for resolutions, though each poses quite different hurdles. Any future discussion of these issues would need to consider practical matters such as the budgetary treatment of insurance schemes across countries, resources for closing and insurance determinations, and timing of resolutions.

The paper recommends ex ante loss sharing arrangements between countries hosting cross-border financial institutions as one way to avoid “ring-fencing” of bank assets by host countries. Any additional consideration of a potential role for such arrangements should be informed by further study by the IMF, Senior Supervisors Group, and others of their feasibility and potential enforceability.

Macroeconomic Policies

This supplement has a useful discussion of whether monetary policy has a role in responding to asset price booms. The paper lays out a convincing argument that booms with a high degree of leverage have a greater potential for systemic risk, and the paper rightly emphasizes the primacy of financial supervision and regulation in preventing excessive leverage. However, as the staff notes, the ability of existing empirical models to distinguish between “good” and “bad” booms is low. That limitation, along with the inability to identify asset bubbles in a timely manner, argues against directing monetary policy toward leaning against asset price movements. In addition, monetary policy is a blunt instrument for dealing with a speculative boom, and the inclusion of asset prices as a target may lead to a less credible commitment to inflation fighting. In the end, we believe that monetary policy is best served by considering asset price movements to the extent that they affect the outlook for inflation and output.

We have some concerns about the discussion of tax issues. Although we agree that "in most countries, the tax system is biased towards debt financing", we disagree with the conclusion that the bias toward debt is unintended and easily addressed. Rather, the deductibility of expenses—including interest—that are related to earning income is a key feature of an income tax. One can choose to deny deductions for those expenses or to not tax equity returns, but that usually means changing from an income tax to a consumption tax. Pretending that such fundamental changes are easy or common does little to advance discussion.

Global Architecture and the IMF

Similar to our reactions on the other areas, we take the background supplement on the global architecture and the IMF as very interesting staff reflections, but not appropriate as a basis for assessing a view of the Board. We agree with some of the staff's conclusions but could argue against others. Recommendations for the way forward, in particular, are the subject of the Board's current work program and cannot be prejudged on the basis of this paper. Although we are not opposed to publication, we wonder how this supplement aids Fund communications on complex and consequential issues still under discussion by the membership. There are a number of issues where greater reflection would be warranted. We mention just a few.

The jury is still out on whether the spread of the crisis was worse because inadequately designed loans of insignificant size were available from the official sector for liquidity and adjustment. Early unconditional financing to Iceland, for example, would not likely have prevented that country's collapse.

As we have noted on other occasions, we are not convinced that modular FSAPs and risk-based ROSCs are appropriate.

The staff discusses new perspectives on existing concerns, such as those coming from large current account deficits and corresponding capital inflows. We would be interested in additional insight on what the staff has in mind.

The suggestion of a gradual drift to the G7, which is attributed to the purely advisory nature of the IMFC (and, presumably, the Interim Committee) in our view, is inaccurate. We look forward to discussion of the Fund's governance, including whether the Board is representative. We should say, incidentally, that although our view on European consolidation within a smaller Board is well known, we have not been as clear as the staff that a more representative Board should exclude small advanced countries.

Going forward, we have yet to hold the discussion on the size of IMF lending to countries, on repayment terms, and on a strategic view for whether IMF financing can effectively take the place of private financing over the medium term during this period of global deleveraging.

Mr. Moser, Mr. Weber, and Ms. Tartari submitted the following statement:

Staff attempts no less than staking out the path for a post-crisis macroeconomic, regulatory, and governance framework for the global financial system. This is a hugely ambitious undertaking at a moment in time when the upheavals in financial markets have not yet been overcome and a substantial contraction of economic activity is still in store. While we appreciate the concise presentation of the issues, the solutions suggested by staff will have to be reviewed further for their viability and effectiveness. At the same time, we will need to gain clarity about who is best placed to pursue those suggestions that find broad support.

We note significant differences as to the level of detail and analysis in the three background papers. Less breath and more depth may be fruitful for informing concrete follow-up. Most notably, we consider the staff's analysis and lessons with regard to the global architecture and the IMF as unconvincing and premature. While such discussions on governance and Fund policies are not without merit, their prescriptive detail seems to be misplaced in these papers. We do not endorse the relevant conclusions.

The fundamental question remains, why the systemic vulnerabilities that were seen to build-up were not addressed. We strongly doubt that a lack of information, missing processes, or inadequate institutional structures were at the root of the perceived lack of "traction" of Fund policy advice and the elusiveness of coordinated action at the international level. It is not because surveillance was fragmented that risks could not be effectively communicated; it is because there was no agreement about the extent of these risks or because political pressure prevented their discussion. Despite manifold warnings by the Fund and others, members have not been ready to adjust policies and remain fundamentally reluctant to surrender authority to international bodies. It may thus be overly optimistic to believe that a more centralized global policy surveillance could resolve this.

We therefore dispute staff's assertion that institutional reforms will be the "silver bullet" to overcome coordination and collective action problems. The solutions put forward on governance disregard that the Board has delegated decision-making authority and do not substantiate why a high profile forum with limited membership should be superior. Broadest possible representation (i.e., via constituencies) and a rules-based system, which is in the particular interest of—and therefore mostly championed by—smaller members, remain crucial for legitimate decision-making.

Staff should have been more assertive about the role and the merits of surveillance as the Fund's key crisis prevention tool. At the same time, it is essential that the bilateral and multilateral instruments in place produce candid and evenhanded assessments, that issues of treatment of confidential information are addressed, and that shortcomings in the scope and coverage of surveillance are being remedied. We underscore in particular the value of the integration of financial sector analysis into Article IV consultations and of FSAPs. The Fund's surveillance mechanism can be enhanced by the planned Early Warning Exercise that pools crucial expertise.

Beyond that, however, we should allow for a plurality of views among institutions on the global economic and financial outlook, rather than attempt to coordinate their conclusions. Policy debate dispersed in a number of fora is likely to provide a useful range of opinions. In the longer run, competition of views reduces the probability of overlooking risky evolutions; it remains less prone to mistakes than a monolithic view.

Financial Regulation and Supervision (Supplement 3)

We consider the case for a strengthening and refinement of regulation, including on cross-border arrangements, most compelling, since substantial work at the international level in this area has been ongoing since early 2008. There is thus sufficient diagnosis—but also debate among policy makers on costs and benefits—to establish a sensible reform agenda. Unfortunately, the paper leaves aside the financial industry's responsibilities and whether the interaction with supervisory authorities can be improved. To complete the picture, one should further explore questions related to moral suasion and enforcement. For example, it would be useful to consider how the leverage of supervision can be enhanced during boom periods.

The background paper lacks a clear position on whether market competition combined with appropriate regulation or direct state involvement make a financial system less crisis prone. One pertinent question is whether the Fund's recommendations should differ between private and publicly controlled banks. Clearly, the phasing-out of public crisis containment measures for banks is an important medium-term challenge. We could see a prominent role for the Fund in calling for and facilitating such a coordinated exit effort.

The shadow banking system is, indeed, lightly regulated, and significant improvements are needed. This crisis has highlighted the role of regulated large banks in fueling such high-risk activities and we must therefore proceed with caution. Problems in hedge funds, for example, pose a limited risk to the financial system as long as banks as primary brokers act prudently. In order to reduce future systemic stress, a strengthening of capital and liquidity buffers in financial institutions is highly pertinent.

Staff's assessment that professional investors relied too much on credit ratings should be qualified. Adequate ratings condense valuable information and significantly increase efficiency. Regulators and supervisors should ensure that ratings are used correctly and that the rating agencies properly adapt their methodologies to different entities or assets. We would see merit in fostering regulators' understanding of rating metrics and would welcome further work on this. Given that conflicts of interests of credit rating agencies are a problematic aspect in the current financial system, initiatives to eliminate such conflicts should be pursued, including setting up alternative financing schemes (i.e., exploring ideas such as a funding pool or mechanisms that shift financing to the user of the ratings).

Macroeconomic Policies (Supplement 2)

The conclusions drawn on macroeconomic policies are plausible, if not entirely novel. Monetary policy might have to take greater account of asset price movements. But we concur with staff that it is definitely too blunt a tool to deal effectively with excessive asset price movements. Regulation is the better instrument to deal with emerging financial vulnerabilities. Improving financial regulation and supervision is therefore of paramount importance, in particular where it has failed blatantly. Better regulation does nevertheless not necessarily mean more regulation.

Fiscal policy should aim at achieving surpluses in periods of high growth in order to be able to run deficits as the economic cycle turns, thus dampening economic fluctuation and at the same time keeping the public debt stable over the business cycle. Therefore, rules-based fiscal policy (such as Switzerland's debt-brake rule) should be promoted and refined as needed. Such a rule must effectively and credibly restrict expenditure growth in good times so as to allow for structurally sound public finances.

We share staff's view that the bias in many tax systems towards debt financing may skew an optimal allocation of capital. But, when comparing different ways of financing and their impact on incentives, it is important to consider all aspects of the tax system. In this regard, we would appreciate staff's comment on the tax treatment of funded pension schemes and their possible contribution to excess liquidity in the run-up to the crisis. Moreover, could the staff elaborate on the role that progressive vs. flat tax rates might have played in risk taking by firms and households?

Global Financial Architecture (Supplement 1)

Many of the conclusions under this heading are not based on rigorous analysis, and they mix problems that are not related. The background paper unduly combines preventive type measures (surveillance, cross-border regulation) that respond to weaknesses identified in the current crisis context with broader institutional and policy issues (governance, lending). The broader Fund governance issues merit a discussion on their own but are not directly related to the current crisis. Moreover, voice and representation should always be discussed in the context of the mandate of the Fund, since it is the latter that provides the criteria for the former.

The analysis of the failure of Fund surveillance and its lessons is incomplete and overly simplistic, and the suggested solutions contradict the staff's own findings. For instance, the Multilateral Consultations on global imbalances, which were undertaken with a high-level "effective forum where relevant policy makers could engage," without a role for the Executive Board, were hardly more successful than the bilateral or multilateral surveillance undertaken by the Board.

An issue not discussed is the increasing tendency of staff and management to dispense with the peer review role of the Executive Board and to directly go public to influence policy makers. It would be interesting to know whether this has indeed increased the persuasive power of Fund recommendations, or whether it is not rather the reason behind the staff's finding that the Fund's surveillance output before the crisis suffered from overly optimistic bottom-line assessments and hedged messages. Full and frank information of the Executive Board, which can channel information confidentially to the policy makers in all member countries, might be more effective.

We concur that this crisis, on account of its sheer size, offers an opportunity for the Fund to overcome barriers to coordination. But we need to deal carefully with this opportunity for change, which must aim to preserve those instruments and practices on which the Fund's credibility has been built and that remain well suited to fulfill its mandate. While more policy coordination is warranted in times of crisis, this is less so in tranquil times. Since the staff papers aim to look beyond the current crisis, they should have stressed more members' obligation to maintain a sound policy framework at home. Prudent domestic policies and well-tailored prudential supervision will go a long way in defusing the next crisis. After all, the ultimate cause of the current crisis has been a failure of national regulation and supervision, not a failure of multilateralism.

Mr. Fayolle submitted the following statement:

We thank staff for an interesting set of papers drawing initial lessons of the ongoing crisis. They provide a broadly adequate answer to the IMFC and G-20 call to the IMF to draw such lessons. At the outset, we wish to underline that notwithstanding the analytical value of the staff's work, the breakdown into four documents may not be the most efficient way to communicate. If such breakdown were to be maintained, we would suggest that the "chapeau" paper be focused on prioritizing the recommendations of the three other papers rather than simply compiling them.

We share many findings and recommendations made by staff, and would like to comment on the following issues of importance.

Lessons for Financial Regulation

We have long stressed the inadequacy of the perimeter of regulation and welcome staff's recommendations in this regard. Clearly, the perimeter is too narrow in its coverage of activities and institutions. To avoid the building-up of systemic risks, we agree that any entity that may induce systemic risks should be regulated accordingly. Hedge-Funds should be no exception and should disclose their exposures to supervisors to let them assess their potential systemic impact. A mechanism of sanctions for uncooperative jurisdictions or tax heavens should also be considered.

We also agree with the staff's assessment regarding policies to mitigate procyclicality effects stemming from existing rules. In particular, we wish to stress two recommendations. First, the backward-looking nature of loan loss provisioning rules and practices have proven to be part of the problem by allowing excessive risk-taken during upswings. The "dynamic provisioning" approach, by allowing a more forward-looking assessments of provisions needed, seems to be a avenue worth exploring in depth. To achieve this, prudential and accounting rules will have to converge. Second, there is also a case for a more limited use of the "fair value accounting" (FVA). We share the views that FVA should only be used for assets in the trading book.

Last, the crisis has highlighted the shortcomings in the rating agencies' business model and we strongly support that they adequately increase transparency on the methodologies they use to assess risks and rate assets, including by introducing new rankings for structured products.

Lessons for the Global Architecture and the IMF

At the current juncture, the urgency for the Fund is to reform its instruments and policies, along with an increase of its resources, to ensure that it fulfills its core mandate of crisis prevention and resolution. We see the ongoing reform of the Fund's lending role as promising, and we wish to stress a few points of importance to reinforce surveillance to better allow it to be a key tool for crisis prevention:

- The Early Warning Exercise, by connecting the dots between issues too often viewed in isolation, focusing on spillovers, exploring "tail risks" and drawing on various building blocks of quantitative analysis, should be able to reach the outcome of adequate policy measure advice to member countries' authorities to correct vulnerabilities or lower risks.

- The need to better integrate financial sector policies surveillance and FSAPs in Article IVs. We also share the views that FSAPs should be mandatory for all systemic countries.

Although we acknowledge the importance of governance issues, we stress that in the current context, it is clearly a medium-term issue compared to the previous ones we just highlighted. This said, we should stand ready to address this important issue in due time, taking into consideration that it is a wide area covering many different topics. We look forward to the agenda that will be set by G-20 leaders in this regard.

Lessons for Macroeconomic Policy

We agree with staff's analysis of the macroeconomic costs associated with combined credit and asset price booms, as well as of the respective roles of monetary and regulatory policies in mitigating them. One lesson of the crisis is undoubtedly that new macro-prudential policies, that will aim at preserving the stability of the financial system as a whole and not only of individual institutions, are clearly called for and have to be designed to prevent the next credit boom and bust to occur. However, this claim is different from staff's prescription according to which the mandate of monetary policy should be enlarged to include a macro-financial stability objective. Such a conclusion seems overstretched.

While macro-financial stability must clearly rank high among the concerns of central banks (which are notably in charge of the smooth functioning of the payment system and care in practice for the stability of the monetary market), this should not be considered as an independent objective for monetary policy as such. For reasons detailed in the paper (pages 11-13), regulatory and prudential policies are indeed better indicated to "lean against the wind" of growing financial imbalances and unsustainable risk-taking in the financial sphere than is monetary policy with its sole policy rate. Long debated issues like dynamic provisioning should thus be considered as a serious alternative to this proposal and may be as a building block of a future macro-prudential framework.

Staff implicitly identifies as one key problem the insufficient consideration paid to credit and asset price developments in what could be described as standard inflation targeting policies. It is true that the canonical New Keynesian model that underpins the logic of inflation targeting ignores in its simplest form all kinds of financial frictions that are crucial in explaining macroeconomic fluctuations in the real world. This however does not imply that we should expect benefits from the addition of a macro-financial stability goal assigned to monetary policy, besides its traditional commitment to price stability. Simply, this underlines the urgent need for more research in order to improve the integration of financial behaviors in the models used by central banks for monetary policy purpose.

For the time being, the Euro system's two-pillar strategy appears as the best possible answer to such analytical challenge. The Euro system has always expressed reservation about strict inflation targeting policies, and has based its assessment of risks to medium-term price stability on a wide range of indicators, including money, credit and asset prices,.

We agree with the lessons put forward by staff regarding fiscal policy, except the recommendation on removing the bias in tax system created by interest deductibility. We lack clear evidence of the role of the tax system in the crisis.

We welcome staff's analysis of the role of global imbalances in the crisis. Even though they are not at the root of the crisis, they have favored a benign environment that have encouraged risk-taking in the search for yield, thus making the global economy more vulnerable. Excessive consumption propensity and lax lending practices in the U.S., and excess savings in other areas of the globe are intertwined issues that should not be disentangled. These imbalances still call for structural policies aiming at bolstering savings in deficit countries, and for macroeconomic policies aiming at rebalancing growth towards consumption in surplus countries.

Mr. Guzmán and Ms. Valle submitted the following statement:

We thank staff for a very candid and systematic set of documents that covers the relevant lessons and outlines an appropriate response to prevent future crises from occurring. Inasmuch as it suggests measures stemming from the diagnosis and offer solutions to the relevant challenges, this excellent set of documents takes a further step and, in that sense, provides a useful guide for future debates in the appropriate fora, debates that will certainly contemplate many other alternative solutions.

We welcome the self-criticism and recognition of the institution's past mistakes. The IMF proves it is aware of the gravity of the crisis and the risks to its reputation. If anything we would point to the fact that such frankness is not as evident when the documents deal with the rest of the actors in the international financial system, a system admittedly plagued by fragmentation and lack of coordination in the regulatory, macro-prudential and global architecture dimensions. In general we concur with staff's analysis of the causes of the crisis, which are presented in a very clear manner as the combination of market, regulatory and oversight failures in the context of low interest rates.

We will divide our comments into the three dimensions the documents differentiate

Financial Regulation and Supervision

We commend staff for the document on "Lessons for future regulation of financial institutions and markets and for liquidity management". While keeping a broad perspective, it focuses on the areas in which deficiencies have been identified and helps define priorities for action in each of these areas. It is a commendable exercise that proves, once again, the usefulness of having the IMF working on these issues.

This crisis asks for a fundamental change in the functioning of the financial markets and in their supervision and regulation with a view of strengthening systemic stability. However, it is still not clear what the appropriate shape of the post-crisis financial system will be and we share the view that the challenge now is to ensure that measures are designed in a manner that support rather than hinder the needed restructuring. In this sense the document rightly mentions that decisions taken in the heat of a crisis need to avoid overreacting in a "rush to regulate". Others may argue that inaction, due perhaps to a sense of vertigo or to inertial thinking, could be just as regretful if we fail to take advantage of the crisis to introduce needed reforms.

On the areas identified, we have the following comments:

On the need to rethink the regulatory perimeter, we share the view that it needs to be expanded to include all markets, institutions and products. The idea of the flexibility of the perimeter is, in principle, an attractive one. However, we feel that it might be difficult to implement as it affects the predictability of the regulation. The notion of gradual regulatory requirements based on the "risk of the underlying activity" might lead to even more regulatory arbitrage if the estimation of such risks is not homogeneous across regional or national borders.

On market discipline we share the idea that due diligence in assessing counterparty and collateral risks has failed in the run-up to the crisis. Investors relied too much on credit agencies that, on their part, had growing conflicts of interests that lead to a poor risk evaluation. The document, appropriately, contains some of the measures that have been suggested to prevent these behaviors in the future. However, we note that bolder options have been put on the table regarding rating agencies. In particular, we see the need for a regulatory intervention to require the registration of rating agencies, of an external surveillance regime, and of rules addressing transparency, conflicts of interest and the quality of the ratings methodology.

On procyclicality, we share the staff's views and suggestions. In particular, we regard as particularly important the following elements:

- Rules-based dynamic provisioning and counter - cyclical capital buffers should be made an integral part of global prudential standards in order to dampen the excessive procyclicality of financial institutions' behavior.

- Accounting standard setters should refine the application of rules to financial instruments and loans, in order to better reflect risks and uncertainties in valuations. We also welcome the clear stance on the need to refrain from questioning the fair value accounting system.

- Compensation schemes for executives and highly paid employees of financial firms should not induce undue, short-term risk taking and should contribute to strengthening bank's risk management practices.

As a way to mitigate liquidity risks, the documents consider the introduction of an incentive risk mechanism, based on regulatory charges, disregarding the alternative of holding high-quality liquid assets as a buffer. It is true that the latter imposes costs on financial institutions. However, this buffer also offers some advantages not mentioned in the paper, such as allowing the institution to meet its obligations in times of stress and thus, giving a positive signal to the market. It also allows the institution to "buy time" to identify the root of the problem and to react in an appropriate way. On the other hand capital requirements do not deliver necessarily a more appropriate solution for liquidity problems.

On information gaps, we share the view that public authorities must have all relevant information about all significant institutions, markets and infrastructures in the financial system.

On, systemic liquidity management, staff makes the useful point of the need to orderly exit from the ad hoc innovations, -rightly introduced to avert the worse of the crisis-, while retaining those that are deemed useful in the future. In particular we have repeatedly pointed our concern on the quality of the balance sheet of central banks and the need to reverse several of the quasi-fiscal activities in which they have had to embark.

On the particular issue of the effectiveness of term lending and interbank guarantees versus asset swaps, staff tends to favor the later. We do not feel that one system is superior to the other since, as staff also recognizes it is not clear either that asset swaps have promoted the reestablishment of a normal lending channel. We would appreciate if staff could elaborate.

Macroeconomic Policies

On monetary policy, we share the view that central banks should adopt a broader macro-financial view, in order to appropriately monitor financial stability risks and their links with the real economy. However, the establishment of multiple targets for a central bank would require specific instruments. It is not obvious if the restrictions under which monetary policy is managed in an open economy allow central banks to effectively bust bubbles without negative externalities. Regulatory and prudential tools are certainly more appropriate, but perhaps not enough. In the end these issues go back to the discussion of the role of the Central Bank or other regulatory bodies in the oversight of the financial system. Should such oversight always reside at the Central Bank and be inextricably connected to the conduct of macro financial and systemic liquidity management?.

On fiscal policy, the two lessons of the crisis are clear and we share the views expressed by staff. We understand that the analysis could take advantage of the excellent work of previous staff documents and include medium term considerations that are essential to ensure the effectiveness and credibility of fiscal packages, when needed.

Global Architecture and the IMF

International financial institutions need urgent change to foster their effectiveness in fighting this crisis and also in helping to prevent future crises. This should be part of a leap forward in their adaptation to a more complex and interconnected world which badly demands new global public goods to promote macroeconomic and monetary stability as well as development. The document contains the main elements in this respect.

We have offered our comments on the issues covered under this dimension in other occasions and, thus, we will not repeat them here. We will just highlight the importance of four issues:

- We support the assessment by staff regarding multilateralism, and specially its position on IMF's governance, which is balanced and pointed. As we have stated in the past, the IMF's governance structure should be strengthened in order to facilitate international cooperation, information sharing and the exercise of peer pressure. We also understand the spirit of the specific proposals, except for the one consistent on creating a new central body to respond to systemic risks in the global economy. Could staff elaborate on this proposal?

- On financial regulation, there is indeed a need for further coordination and enhanced information, both in time of crisis and in normal times.

- While in the short-term the use of bilateral loans is appropriate, on a more permanent basis, the IMF's own resources (i.e. quotas) should be strengthened in order to protect its role as a lender of last resort.

- The Fund should also update its set of lending tools, particularly to strengthen its crisis prevention capabilities. In particular, we welcome the staff 's attention to the need of a high access precautionary line of credit and to improved conditionality.

Mr. Stein and Mr. Denk submitted the following statement:

We thank the staff for a candid and very insightful set of papers. They offer a concise yet fairly comprehensive analysis of the crisis and a host of proposals for solutions. A single Board meeting can hardly do justice to the broad range of issues, particularly given the short circulation period for the two supplements. We therefore see this Board meeting as an initial discussion, to be continued in greater detail on other occasions here at the Board and also in other fora. Accordingly, we will be selective in our statement and should caution that silence on a particular subject cannot be interpreted as agreement with the staff. In our view, the Summing Up should therefore be rather general in nature, sketching the landscape of where initial lessons of crisis lie and where future work is needed.

With regard to the roots of the current crisis, we agree that the massive market failure was facilitated by significant policy failures. Comprehensive financial regulation was lacking. Supervision on a national level was weak, fragmented, or insufficient—both where toxic assets have been created and where they have ended up. Global surveillance did not produce timely, specific, and actionable warnings. In short, this was a failure on many levels. Action will also be needed on many levels.

The Fund has an important role to play in making the world safe for sustainable economic growth. Identifying systemic vulnerabilities, giving policy advice, and monitoring progress are key instruments for that mission, and so is emergency lending for balance of payments purposes. Other players, both national and international, will be equally important for a resilient global economy, and we encourage the staff to cooperate closely with them.

Lessons for Regulation and Liquidity Management

We concur that far-reaching changes to the shape and functioning of financial markets are necessary. We need less leverage and more sensitivity to systemic risk. Much thought will have to be given to creating incentives that diminish—rather than increase—systemic risk, be it through capital adequacy requirements or compensation systems.

Expanding the perimeter of regulation and surveillance will be essential. Financial market activities should be regulated according to their economic substance rather than their legal form or geographic location, and focus should be on instruments and markets that, individually or jointly, pose significant risk to financial stability. Ultimately, all financial markets, products, and participants must be subject to appropriate oversight or regulation, without exception and regardless of their country of domicile. This is especially true for those private pools of capital, including hedge funds, that may present a systemic risk. Therefore, we call for appropriate oversight or regulation of these sectors in order to prevent excessive risk-taking. We also believe that credit rating agencies should be subject to mandatory registration and oversight.

We also strongly agree with the need to set up a solid information base to identify systemic risk. Presently, too many systemically relevant exposures remain invisible. This includes, for example, cross-border links between large, complex financial institutions and the whereabouts of credit default swaps, collateralized debt obligations, and other asset-backed securities. Compiling this essential data and presenting it in a compelling way, e.g. in the form of a "global risk map", could go a long way in identifying future threats to global financial stability. The Fund could take a lead role in such an undertaking.

On systemic liquidity management, the staff's call for more flexibility appears to be somewhat exaggerated. Central banks around the globe have shown an unprecedented level of cooperation and flexibility in dealing with the financial crisis. They have made a decisive contribution to the management of the crisis, providing liquidity in seemingly unlimited amounts not only in their own, but also in foreign currencies. Whilst central banks should further examine the appropriateness of their framework, we would caution against steps that may contribute to moral hazard in the future. This relates for example to the proposal to allow systemically important non-banks regular access to central bank facilities. First, appropriate oversight of systemically relevant market players needs to be established; access to central bank facilities can be no substitute to a comprehensive prudential framework. In the same vein, asset swaps proved useful in this current crisis where opaque securitizations play a prominent role. However, the most recent experience does not necessarily support the case for incorporating asset swaps into the standard monetary policy toolbox.

Finally, the Fund is well placed to contribute to the formulation of priorities as well as to assist in implementation, given its unique mandate and its near universal membership. However, as the report rightly points out, it is the responsibility of national regulators and international standard setters to define the specifics of various policy measures. Consequently, the degree of improvement in future regulation and liquidity management will hinge on the ability of the various parties involved to avoid turf battles and to effectively interlock the Fund's financial sector surveillance with regulation—on a national as well as an international level. We therefore encourage the staff to focus its contribution on its core competencies—e.g. with respect to macro financial linkages—while encouraging its members to adhere to internationally agreed standards for financial sector regulation.

Lessons for Macroeconomic Policy

The overall lessons for macroeconomic policy are well taken and we look forward to future work along the avenues presented.

However, a more balanced description seems warranted regarding the roots of global imbalances. The short analysis (para 7) only focuses on high savings rates in Asia and in oil exporting countries as well as investment preferences in favor of U.S. assets. It does not address the other side of the equation, namely low (or even negative) savings rates in the U.S. during a period of debt-fueled over-consumption.

On monetary policy, we agree that the paradigm of "benign neglect" regarding asset prices was flawed. The clean up after the bust of the housing bubble turned out to be unacceptably costly. We therefore agree that the "asymmetrical approach" has failed, even if monetary policy remains a blunt tool to contain dangerous asset price bubbles. A more symmetrical monetary policy seems thus warranted, which would not consider the boom-bust phases in financial markets as isolated events, but would try to look through the financial cycle. Thereby, central banks would rather take a longer-term perspective and include the future consequences of unfavorable trends in its financial market analysis.

In this regard, the staff's analysis may also be taken as an encouragement for the Euro system's two-pillar strategy. With the broad-based monetary analysis, which constitutes the second pillar, the Euro system already has a valuable analytical tool for the medium to long-term perspective. This tool extends the analytical horizon beyond the usual time span of two years and includes the low-frequency movements of monetary and credit aggregates in the decision-making process. Hence, the Euro system already has an important stabilizing element that enables it to counteract procyclical trends in monetary decision-making.

However, overloading the central bank with too many different mandates must be avoided. Central banks might be tempted to overemphasize output stabilization as a result of conflicts of interests among its mandates. In this context, it might also be noteworthy that the independence of central banks is a prerequisite for their ability to conduct an effective monetary policy.

As for fiscal policy, we concur with staff that fiscal buffers should be established in good times which might help to mitigate demand pressures in times of stress. In particular, asset price increases can mask a less robust underlying fiscal position by temporarily boosting tax revenues. We also agree that that taxation might have created dangerous incentives to build up leverage. We note that interest payments on mortgages are not tax deductible in Germany if the owner resides in the property, thus removing an incentive to maximize mortgage debt to create a tax shield. We look forward to further work on this important, yet politically difficult, subject.

Global Financial Architecture

It is important that clear responsibilities are assigned to the international institutions and fora that constitute the global financial architecture. We agree that the four main fields of the global architecture are correctly identified, namely (i) cross-border arrangements in the context of financial supervision and regulation, (ii) surveillance of systemic risks, (iii) international co-ordination of policy responses, and (iv) financial assistance. The Fund is a key actor in some of these areas. In other areas, different institutions take the lead and, again, good cooperation is key.

We broadly agree with the staff's conclusions regarding surveillance. We appreciate the candid assessment of what the Fund and others missed in the run-up of the financial crisis. We also strongly support the three priorities for action highlighted by the staff: (i) early warning exercise, (ii) systemic risk assessment from all quarters, including advanced economies, and (iii) better integration of financial analysis and macroeconomic work.

On cross-border arrangements for financial regulation, we differ with the staff's view on the following points: First, calling colleges of supervisors "fragile" seems a bit unfair, given that they are still in their infancy. We find their creation rather promising and hope that other highly integrated parts of the world outside Europe will develop similar approaches. Second, while we agree that international cooperation among regulators and supervisors needs to be strengthened considerably, we are cautious about too detailed rules for crisis resolution. In particular, we remain skeptical on ex-ante burden sharing arrangements. They are hard to predefine and risk setting the wrong incentives and creating moral hazard.

Reforming the Fund’s governance is important. But it is clearly not the most urgent task at hand. By contrast, overcoming the biggest global economic crisis in eighty years is extremely urgent and extremely important. Engaging in an intense, inward looking debate on internal IMF reform at a time of global economic crisis would be very hard to explain both to senior policy makers and the public at large.

Mr. Nogueira Batista and Mr. Estrella submitted the following statement:

We thank the staff for the interesting set of documents for tomorrow’s discussion.

IMF Governance

We are in partial agreement with paragraph 26 of the paper “Initial Lessons from the Crisis”. If the Fund is to be at the center of global policy, it will need to address its underlying deficits in ownership and legitimacy. This requires a rebalancing of quota and voting shares, sooner than the gradual process envisaged at the last quota review in April 2008. We are of the opinion that the next step should be more meaningful than the last review in terms of recognizing changing weights in the world economy and giving greater voice and representation to developing countries. We also agree with staff that we have to move to a more representative Board and IMFC, and that we should advance to a truly open system for selecting Fund management. Of course, this goes hand in hand with the selection of World Bank management. The next Managing Director of the IMF and the next President of the World Bank should be selected through a merit-based process, irrespective of nationality or any geographical preference. This depends on the abandonment of the unwritten rule that allocates these positions to European and American nationals.

We agree with Mr. Shaalan and Ms. Abdelati, however, that staff’s proposal to give IMFC ministers and governors a higher profile is unclear and may open the way for misleading assertions and harmful reform proposals.

IMF Surveillance

One of the main lessons of the crisis is the need to strengthen surveillance of advanced economies and major financial centers. The Fund should be able to identify, in bilateral and multilateral surveillance, imbalances in these economies that may have repercussions in other member countries. A rebalancing of voting power and representation in the institution would of course help achieve this goal.

Another area where improvements are necessary is the treatment of large cross-border flows in surveillance activities. The ongoing crisis has shown that there is a need to revise analysis as well as policy prescriptions in this crucial area. Member countries have faced large inflows of foreign capital with strong effects on their domestic fundamentals, leading in most cases to an increase in their vulnerability to reversals. A group of countries currently under Fund programs experienced a boom-bust pattern similar to the one seen in previous financial crises.

The Fund seems to have attributed previous financial crises mainly or exclusively to domestic problems or policy failures in emerging market countries. Policies adopted by developed countries were more or less automatically presented as "best practices". There seems also to have been an underlying belief in the inherent wisdom and efficiency of financial markets. Therefore, IMF staff was insufficiently critical of the imbalances that were building up in the advanced countries. Surveillance of major financial centers and of advanced countries was deficient, to say the least. On the other hand a crisis on this scale is part of a wider development and it would be wildly unrealistic to expect the Fund to have been able to prevent it.

Macroeconomic Policies

In October 2008, the financial market stress intensified—the breakdown of Lehman Brothers was undoubtedly the turning point to a more severe financial crisis. There is broad agreement that one of the main causes of the crisis was a long period of strong credit growth to non-creditworthy economic agents, combined with very low interest rates and excessive rises in equity and especially housing prices.

The staff have emphasized that the pre-crisis period was characterized by the increasing popularity of inflation targeting. Some central banks geared monetary policy almost exclusively toward stabilizing inflation, but only a few put sufficient attention to risks coming from asset price increases, especially in the more advanced economies. The monetary and financial authorities and international institutions underestimated the build up of systemic risks associated with the asset price boom. Now, it is being proposed that central banks should take more account of asset price movements, credit booms, leverage, and the build up of systemic risk.

We agree that an important lesson from this crisis is that monetary policy should pay more attention to asset prices—especially in advanced capital markets. However, the role of asset prices in monetary decisions is still under discussion. Some economists argue that interest rate policy should not react to asset prices and credit expansion if there is no inflation risk. Others argue that it is difficult to assess at what level interest rates should be set to correct a potential asset price imbalance. Overall, there seems to be a tendency to believe that central banks should be able to increase interest rates at an early stage of the cycle, i.e., before asset prices and credit start to accelerate dangerously. Of course, the opposite is also true: monetary policy should be able to adapt to substantial declines of assets prices.

Future Regulation of Financial Institutions and Markets and for Liquidity Management

The financial crisis has highlighted the weaknesses of current regulatory frameworks—especially in some advanced economies. Therefore, there is an urgent need to strengthen supervision and regulation. Investment banks, mortgage brokers, hedge funds, securitization vehicles and other private asset pools must be better regulated and supervised prudentially. The crisis showed us how market discipline failed, and how banks evaded capital requirements by transferring risk to affiliated entities which were subjected to little or no regulation and supervision. Special emphasis should be given to reducing conflicts of interest at the rating agencies. We agree with staff that credit rating agencies should be prohibited from giving advice on products they rate.

Overall, structural policies should be implemented to ensure the efficient functioning of financial systems. Increasing transparency is fundamental in order to remove uncertainty and limit moral hazard problems—by ensuring the assessment of credit risk and transparency in financial reporting. International cooperation among regulators and supervisors is extremely important in a globalized financial system. Governments, central banks and supervisory institutions need to work jointly to improve world standards for prudential supervision and the regulation of financial institutions. As we all know, this is more easily said than done. However, the severity of the current crisis may open the way for overcoming national resistances to international cooperation in this area.

Mr. Lushin submitted the following statement:

We thank the staff for a set of interesting documents. Below we offer our comments on each of the three "lessons" papers.

The Global Architecture and the IMF

Surveillance

The believe that the current crisis has revealed two large gaps in Fund surveillance: a failure to detect vulnerabilities in advanced economies and neglect of potential risks stemming from large capital inflows and outflows. With regard to advanced economies (especially the U.S. and the U.K.), the Fund acted on a premise that "the Caesar's wife is above suspicion" and did not perform a formal vulnerability exercise for them. As a result, a lot of resources have been used to erect defences around emerging market countries while the crisis has stricken from a completely unexpected direction. Of course, now this is about to change, but, alas, when it is already too late.

Concerning large capital flows, the Fund's standard prescription of greater exchange rate flexibility falls far short of being an adequate tool to address the risks. Many countries would simply not survive the exchange rate volatility that could be associated with this strategy. Therefore, the attitude towards measures of capital controls, especially of prudential nature, could be revisited. For example, limits could be established for borrowing in foreign currencies by households and businesses. Moreover, it is already clear by now that boom and bust cycles in global capital movements is a systemic problem that requires an internationally coordinated solution.

Better integration of Fund financial analysis with its macroeconomic work has already become a mantra with regard to surveillance, and, like many others, we support it. We doubt, however, that FSAPs could be a useful tool to achieve this. This formalized and excessively rigid exercise has been of limited use so far and its future usefulness is not evident, even after the suggested "sharpening". In our view, it would be better to use the limited MCM resources directly in the context of bilateral surveillance and producing more informative Article IV reports.

Policy Coordination and Fund Governance

The lack of policy coordination was an important feature of developments in the run-up to the crisis. However, better policy coordination is easier said than done, and the problem here is not only the absence of effective fora for policy discussions[1]. There is a fundamental contradiction between the global character of trade/capital flows and regulation/policy making at the national level. Even if the need for coordination is well understood, embarking on effective coordination would require some curtailment of national decision-making powers, which may be very difficult (or even impossible) for some countries. Something, however, has to give in: we would either have an orderly, regulated globalization with some decision-making at the international level, or the (continuation of) unrestricted national sovereignty in conducting economic policies with globalization in reverse.

This said, we believe that the Fund is better placed than any other group to be a vehicle of multilateral policy discussions and/or decision-making. For this to happen, the Fund's legitimacy should be enhanced, since right now it is a club of advanced countries (not only in regards to quota and voice representation, but the structure of staff and management as well) with emerging market and developing countries being the observers at best. Therefore, we cannot agree more with the proposals in the staff paper to rebalance quota shares and move to a more representative Board and the IMFC, as well as to create a truly transparent, open and merit-based system for selecting Fund management. However, if "giving IMFC ministers and governors a high profile forum" means establishing a ministerial Council, we would be prepared to consider this proposal only after representation issues mentioned above have been resolved. We see little merit in a Council that is not representative of Fund membership.

Cross-Border Financial Regulation

The problems revealed in this area are extremely complex while the proposed solutions look very much like piecemeal compromises that would not necessarily be effective. Although the staff is skeptical about creating "a binding code of conduct across nations" because of the associated political problems, we think that nothing short of that would be capable to effectively resolve the cross border regulation problems. What we have here is another manifestation of a fundamental contradiction between the global character of capital flows and regulation and policy making at the national level.

[1] Even if we had an effective and representative group of top policy makers that according to the staff maintains is necessary, it is unclear how the decisions adopted by this group would get traction in individual countries.

Facilities and Resources

We will have a separate discussion on precautionary facilities and conditionality. Concerning the amount of Fund resources, practically everyone agrees now that at least on a temporary basis they should be doubled. The tricky question is where the money will arrive from (apart from Japan). Needless to say, the biased structure of members' representation in the Fund does not help to solve this issue.

As to whether the increase in Fund resources should be made temporary or permanent, we think this depends on whether we see the current global deleveraging (that can also be called financial de-globalization) as temporary or permanent as well. If we believe that after the crisis cross-border capital flows will return to their mid-2000s levels, a general quota increase will be absolutely necessary.

Macroeconomic Policy

Macro-Financial Conditions Before the Crisis

We very much agree with paragraphs 10-11 pointing to the dangers associated with large capital inflows. At the same time, we have got a feeling from the staff paper that since global imbalances have not triggered the crisis, the staff tends to treat them as being less risky than before. We think that exactly the opposite is true, because (i) imbalances are going to increase owing to massive expansion of the U.S. fiscal deficit, (ii) expansionary stabilization measures being undertaken in the U.S. can hardly be characterized as building confidence in the dollar. Therefore, the risk of a run on dollar assets continue to hang over the global economy as the sword of Damocles.

Asset Price Booms

We read with interest staff's thoughts about "good" and "bad" credit booms. The striking conclusion is that, as with early warning indicators, we are unable to distinguish one from another. Given the ruinous consequences of "bad" booms, wouldn't be prudent for policy makers to consider all large and protracted booms as "bad" ones?

Turning to the recent boom, we wonder if the exponential rise in U.S. house prices together with a sharp increase in household debt could have been used as clear indicators that something was going terribly wrong. It has long become apparent to many that the U.S. housing market became a giant Ponzi scheme working on a premise that house prices will grow indefinitely. Why then nothing has been done? Our explanation is that simply too many people, including quite influential ones, had been profiting handsomely from the boom to be disturbed by the appeals to reason. This, however, was a typical feature of all previous financial manias as well.

Monetary Policy

The current crisis should have finally undermined the approach based on “benign neglect” to dealing with asset price bubbles. If it has not, we wonder what more evidence is needed. The tricky question, however, is how to address asset price booms with policy measures. We have long argued that monetary policy cannot ignore the dynamics of asset price. We therefore, are gratified that the staff has eventually admitted that “there may be long term benefits for growth and inflation form ‘leaning against the wind’ during time of asset price exuberance” (paragraph 31). This said, we accept the limitations of monetary policy as an “anti-bubble” tool described by the staff in paragraphs 32-34. The complexity of the situation, however, should not serve as justification for denial of the problem and consequent inaction. The fact that in small open economies capital account openness limit the effectiveness of monetary policy (paragraph 34) begs a question whether such countries can afford to have their own currencies going forward.

Future Regulation of Financial Institutions and Markets and Liquidity Management

This paper highlights policy priorities for the FSF, national authorities and international standard setters. We broadly agree with this list as summarized in paragraph 7. We believe that the proposals to focus on expanding the perimeter of financial sector surveillance, addressing procyclicality and information gaps, mitigating the risks of regulatory arbitrage are in line with discussions in other fora.

While the issues raised in the report call for action mostly by the authorities in advanced economies, slow progress in this area may have major negative consequences for all Fund members. Indeed, current intensification of financial market turbulence, especially in Eastern Europe, is a reminder of the urgency and magnitude of the tasks. Given the Fund’s role as a guardian of stability in the international financial system, it is the Fund’s responsibility to express clearly its opinion on the preferred course of action. In this respect, it is essential to find the right balance between confidential discussions with national and international bodies, on the one hand, and public statements, on the other.

Mr. Henriksson, Mr. Hukka, and Ms. Mogensen submitted the following statement:

We welcome the initiative to draw initial lessons from the current crisis, though it is still too early to draw firm conclusions on many of the issues involved. We do not yet have the full picture, as the crisis is still unfolding and effects of spillovers are still materializing. Elaborate academic studies will be needed, just as the lessons from the Great Depression is still a matter of debate. Consequently, our views are tentative.

As a general point, we would emphasize financial regulation and oversight when considering policies that could have prevented or mitigated the current crisis.

Financial Regulation and Supervision

Market Discipline and Rethinking the Perimeter of Financial Regulation

As documented by staff, the regulatory practices in many countries proved inadequate to compensate for the failure of market participants' own due diligence. In addition to the myopic nature of corporate compensation schemes and conflicts of interest in Credit Rating Agencies, staff points to the moral hazard created by the "too-big-to-fail" financial institutions. The challenges inherent to the effective supervision of cross-border mega-institutions certainly give reason to consider stricter regulation. We therefore would have appreciated a more extensive treatment of this issue given that the lessons and challenges in this area have been among the most pertinent.

We agree that the perimeter of financial regulation should be extended. Importantly, to mitigate re-emerging regulatory loopholes in the future, regulation should aim to be consistent across different sections of financial markets. The proposed graduated functional approach based on systemic risks is a promising start.

In order to avoid the concern of a "rush to regulation", the need to regulate should in each case be considered. To the extent possible, the assessment should always be based on comparisons of costs and benefits of regulation. The ongoing crisis has certainly put the past decade's efficiency benefits from financial innovation in different perspective and poses several questions. We wonder if the Fund, with its comparative advantage in cross-country analysis, would be well positioned to take up a role in leading the work in this area. We would be interested to learn whether the Fund has already been involved in such work and what scope staff sees for the Fund in digging deeper into this area.

On Policies to Mitigate Procyclicality

We agree that a modification of prudential rules to reduce undue procyclicality warrants consideration. That said, we should be mindful of the financial stability objective of prudential regulation. Other aims, such as securing the smooth development of the macro-economy, are best promoted through other means. Moreover, as noted by staff, the aim of reducing procyclicality needs to be carefully balanced with the need for the prudential rules to adequately reflect current risks. By definition, risks increase in an economic downturn and reducing the ratio of capital versus risks would diminish banks' resilience. In fact, during the current crisis, investors and other market agents have raised their assessments on what constitutes a reasonable level of capital in banks.

Regarding mitigation of liquidity risks, we are somewhat skeptical about the proposal to link capital charges to the amount of liquidity in banks. These are very different issues and banks should not be able to "buy" themselves lower liquidity.

Other Priorities for Action

Perhaps the most pertinent lesson of the crisis has been the criticality of timely information of sufficient quality and coverage. We fully endorse staff's approach to addressing information gaps in financial markets. We would note, however, that a general problem in information is the time lag. Even relatively short time lags of one to three months are too long since markets change very quickly. Staff also correctly highlights the importance of international coordination to enhance transparency of institutions operating across borders.

We support staff's proposal to further develop the guidelines for cross-border regulation and supervisions and describing best practices. Crisis exercises also have a lot of merit. In particular, the crisis has shown the need for increased cross-border harmonization of depositor protection schemes, for instance on coverage, funding and access to a credible credit line if needed.

The IFIs could play a role by assessing the adherence to such guidelines, as they do for other global standards.

Once the acute phase of the crisis is over, an important task is to identify a timely exit strategy for the authorities' liquidity support to financial institutions. The strategy must allow for a gradual and smooth transition and should involve proper incentives.

Macroeconomic Policies

The key lesson for macroeconomic policies is in our view to ensure sufficient fiscal consolidation during good times. First of all, it helps ensuring the fiscal space to absorb economic shocks. Second, as staff notes, it can also help mitigating the booms.

We are of lesser agreement with staff on their recommendations regarding the role of asset prices in monetary policy. As long as the primary objective of monetary policy is stable inflation, the evolution of asset prices only matters for monetary policy via their effect on inflation and the real economy. The interest rate instrument should not be overburdened, and it would be too blunt an instrument to, for instance, prevent a housing boom. We do not agree with staff that this has been proven wrong. In the somewhat more balanced presentation in the supplementary paper, staff rightly points to some caveats of their recommendation, such as a less credible commitment to inflation fighting and the lack of effectiveness in some instances with open capital accounts.

The Global Architecture

We shall focus our comments on the impact of surveillance on policy decisions and governance, as the focus of surveillance, including the use of FSAPs, an early warning system as well as the adequacy and use of the Fund's resources have been taken up in separate discussions.

The proposed solutions do not directly match the problems at hand. The Multilateral Consultation is a prime example. Several discussions were held at a high policy making level, without any Board involvement, but the results did not meet the expectations. It is logical to ask what the reasons behind this failure were. It is unfortunate that staff does not analyze this more deeply as this would have helped us more thoroughly understand the issues we are discussing now.

A key challenge for the Fund is to deliver a clear message that will induce policy makers to act. It is clear from staff's presentation that the Fund has failed in terms of discerning the specific vulnerabilities and proposing concrete policy solutions, but also in terms of communication. As Mr. Shaalan and Ms. Abdelati rightly notes, these failures impede by themselves the potential for an effective discussion of policy responses, rather than the Fund's governance. We also echo their reference to the normal fora for discussions with relevant officials who have authority and legitimacy to respond.

As also noted by Ms. Lundsager, Mr. Kaplan and Mr. Wood, the conclusions drawn in the paper are not necessarily representative of those of the Board, in particular those on governance, and they should not prejudge the future work program.

Mr. Majoro submitted the following statement:

We have read with interest the staff papers and agree that they broadly shed light on the causes of the financial and economic crisis and provide useful guidelines for future reform of the financial landscape. We limit our comments to five areas, namely on the initial rethink of financial regulation including cross-border and cross-functional regulation; addressing information gaps; systemic liquidity management in future; appropriate macroeconomic policies, and the IMF in the new global architecture.

Rethinking Financial Regulation

The idea that markets work better left alone has been proven false. Without regulation, compensation structures created incentives for short-term gains and dulled sensitivity to risks. The so-called financial innovation created complexities that finally undermined due diligence on counterparty risks. The endless pursuit of yield, including in non-traditional markets created financial institutions many times larger in size than the underlying real economy. The pursuit of profit created securitized 'assets' many times in size than the underlying real assets and without regard to their quality, and across different markets, without full appreciation of the attendant risks by the various regulators.

While we note that over-regulation should be resisted, one wonders whether the cost to over-regulation could have been as high as under the current crisis. We feel that regulation must be equally innovative and extend appropriately to a wider perimeter, unlimited by traditional definitions and targeting all systemic activity regardless of institution.

As crises will always occur, we agree that procyclical behavior should be checked, even on the upswings. An appropriately restructured regulatory and supervisory architecture, with suitable cyclical metrics and practices, will have an important role to play in this area.

We have noted the difficulties confronting cross border and cross-functional regulation and the suggestions for improvement. We agree that national fervor during crises is paramount and at the expense of better resolution methods. Equally, institutional turf may undermine efforts at cross-functional regulation. Accordingly, we go along with staff's suggestion that pre-existing arrangements will provide the needed fillip to cooperative crisis resolution.

Addressing Information Gaps

The opacity in financial transactions arose from off-balance sheet activity that was subsequently not reported routinely; complex structured credit products left largely unregulated; and over the counter derivatives that masked information about the underlying assets. Consequently, the associated risks remained largely unappreciated by markets and regulators. Going forward, we support the proposal of a multi-lateral information gathering and dissemination processes with full coverage of all key data not only for judging risks, but also for early warning.

Systemic Liquidity Support

Despite various efforts at injecting liquidity by central banks and fiscal authorities, credit markets remain largely frozen. The diagnosis pointing to inadequate liquidity as the ill has turned out to be inadequate. The prescription, costing billions of dollars, has elicited no response from the patient. The paper offers no more light than the what we know to have not worked. Therefore, the work of restarting credit functioning lies ahead.

Macroeconomic Policies

We note staff's extension of the objective of monetary policy to macro-financial stability and agree that the cost of policy inaction can be substantial as in the current crisis has demonstrated. Moreover, we support a more balanced evolution of economic variables and see an important role for monetary policy in smoothing boom tendencies in some markets, notwithstanding its ineffectiveness in some instances.

While we note the important role strong fiscal buffers could have played in coining larger fiscal stimulus, we are concerned that so far there has been little effect, with damage to world economies continuing unabated. In some cases where buffers are not large, debt financing has had to be large, with long term implications for taxation and demand compression and a slow and gradual global recovery.

Global Architecture and the IMF

We have already commented about the need for revamping financial regulation. We wish to add a point on the role of the Fund in crisis prevention and resolution.

The Fund was established to prevent the sort of crisis now obtaining. Regrettably, the Fund neither had adequate expertise, nor raised the alarm more effectively where in-house expertise permitted. This has led to accusations of un-evenhandedness in relations with its members.

That said, the recent work to explain the evolution of the crisis and review lending facilities and adequacy of its lending capacity has re-established the Fund as a key global institution in crisis resolution. We have previously supported an increase in IMF lending resources including through quota increase in the medium term and borrowing in the near term. We support further its continuing to work with other near universal membership institutions at developing new tools to address the crisis. Furthermore, the Fund should extend its work on reviewing lending facilities and adequacy of resources to low income countries.

The Chairman made the following statement:

We have a very important discussion this morning. Directors will recall that during the Annual Meetings the IMFC asked the IMF to draw preliminary lessons from the crisis, and this demand has been reiterated by the G-20 Leaders on November 15 here in Washington, D.C.

The fact that the Fund has been asked to undertake this task is significant. I have said and you also have repeatedly indicated during the last year that the Fund has a unique position to be able to analyze the relationship between the financial sector and the real economy. This request by the IMFC and by the G-20 leaders reflects not only the confidence they may have in the Fund, but also the acknowledgment that the Fund has a unique position in macro-financial analysis.

In my view, the paper does an excellent job drawing some preliminary lessons, and I had very good feedback during the past week when I met with many national authorities. The problem is that we are still in the middle of the crisis so it is even more than preliminary—it is just temporary lessons. Many things may happen in the coming months which may make this paper totally outdated, we do not know. Nevertheless, we have been asked to do this and I think it is useful to do it.

The paper touches on a number of very difficult and controversial questions and so it is not surprising that views may differ. Many of you have concerns about various parts of the paper, which is absolutely normal. That is why it is essential for us to have a kind of independent view from staff, because all individual views on questions like this may differ, which could lead to an endless discussion.

Some of you have asked why we have this discussion so much in advance of the Spring Meetings. As you know, there will be two very important meetings in March of the Finance Ministers and in the beginning of April in London, and I thought it was important for the Board to have an early opportunity to express its views. Also, it would be somewhat surprising if we let these two meetings go without a Fund paper and just prepare the paper for the last minute at the Spring Meetings, which takes place only at the end of April. It is better for the Board to be able to express its view on this matter relatively early.

The paper does not deal with crisis response, and some of the grays emphasized this point. That is correct; crisis response is not the aim of this paper. The paper is trying to draw some kind of lessons and the entire institution is now engaging in responding to the crisis, putting in place programs, and discussing policy responses with the authorities. So, crisis response is happening on a daily basis in the institution, and it would have been a different paper if at the same time it would have tried to draw lessons on this and give policy advice.

Now, let us discuss this paper. I intend to send the paper to all Governors next week so that they may have an opportunity to read it, and to make it part of the ongoing discussion.

Mr. Kishore made the following statement:

> May I suggest a procedural change? This set of papers is very important, instructive, and useful, which has touched upon three major set of issues including macroeconomic, financial regulation and supervision, and financial architecture, including reforms. All of these issues are so important that they would require focused and detailed and adequate attention by the Board.
>
> May I suggest that we take up today in this session the first two issues and slot very early, according to the convenience of management and the Board, the discussion on the third aspect on architecture reform to be taken up separately as these are so important that they would require a very detailed discussion. While we, in our observations and discussions, touch upon these aspects, the details of it deserves a separate and detailed focused attention later.

Mr. Shaalan reiterated his concern about the messages in some sections of the papers and noted that many Directors had questioned some of the reasoning and proposals put forth by the staff. Sharing Ms. Lundsager's concern that publication of the paper risked giving the wrong impression that the views in the paper were broadly shared and endorsed by the Board, he preferred to modify the paper in light of the current discussion and remove or temper proposals that did not have the general support of the Board. If such an approach was not feasible, the summing up of the discussion should be attached to the main paper in order to reflect the views expressed by the Board on the staff proposals.

The Chairman made the following statement:

> I can understand both concerns because, we are addressing very difficult questions and there are many different views on this.
>
> On the first point raised by Mr. Kishore, he is right that the governance question and architecture questions are very important. My concern is that some have raised questions indicating that even the Board should not discuss this question because of conflict of interest. I think that is the wrong idea; it will be incredible that the Board would be the only body not discussing governance, but the problem of conflict of interest is still there. So, we will have an extensive discussion on this point. That is one of the reasons why you remember a few months ago I said I will ask that the Trevor Manuel Report be discussed by the Board. My understanding is that this report is going to be ready at the beginning of March, and we could have at that time possibly, if he agrees, the presence of Chairman himself. We also have this group we decided

to establish with Mr. Moser. We need a significant discussion on all these governance questions.

On the other hand, it seems difficult not to have this comprehensive paper which has been asked by the IMFC and to send it to Governors. So, if it is only a question of the length of the discussion, we will see how much time it takes. I understand that there are many different views on this point, and this leads us to Mr. Shaalan's point. We can see the meeting of today as input to this paper written by the staff, and certainly many of the remarks made by Executive Directors would be useful to improve this document. I have read the grays and I have seen many remarks that are sensible and which could improve the document.

It is very difficult, almost impossible, on questions like this to have everyone agree on everything. On the other hand, it is not like something where we have to make a decision, where the question of voting is at stake because other decisions are made or not made. I see no real way to say a kind of majority will decide. Perhaps a possibility is to have a discussion by the Board on different points, improve the paper as much as possible and leave it as it is, namely a paper prepared by the staff, circulate it as a paper prepared by the staff possibly, as Mr. Shaalan said, with some short comments of those of you who would like to have their comments attached. There is no problem with that. I agree that it is difficult to give this idea that the whole Board will agree with all the points.

Perhaps we can consider the paper as it is, namely an independent assessment by the staff, introduce comments which will improve the paper and the nuances which probably are useful, and maybe some kind of hierarchy of arguments, but it remains a staff paper. It does not jeopardize the big discussion on the question of governance, as Mr. Kishore asked, that we can have rather rapidly. I think it is better when we have the Manuel Report. If not, we will have a second one.

Mr. Shaalan welcomed the Chairman's flexibility in agreeing to include the comments of Directors. However, even though the paper could clearly indicate that it was a paper of the staff, the header at the top would read "International Monetary Fund", making it difficult for the reader to assess whether it was a Board paper or a staff report. Inevitably, it was a report by the Fund.

The Chairman acknowledged Mr. Shaalan's point and suggested that the summing up be attached to the paper. In the of fall 2008, when the IMFC had asked the Fund to draw lessons, everybody was pleased that such a mission had been given to the Fund and not to somebody else. So, it was important to produce the paper, but with the precautions requested by Mr. Shaalan.

Mr. Nogueira Batista expressed support for Mr. Shaalan's concerns and Mr. Kishore's suggestion. The issues of governance and the global architecture were sufficiently important to be discussed in a separate session. That said, the Chairman's comment about conflict of interest and not allowing the Board to discuss governance issues was somewhat perplexing. If that reasoning had held true, it would also imply that management nor the staff could discuss governance, because there were conflicts of interest there as well.

The Chairman agreed with the point about management's involvement with governance question, which was why during the last months he had not expressed opinions on the governance and the architecture questions outside of private discussions. By definition, if there were a new architecture, it might change the relationship between the Governors, the Executive Board, and management, and so the conflict of interest was the same. Staff was somewhat different because it was supposed to produce independent assessments.

Mr. Daïri said that he agreed with Mr. Shaalan, Mr. Kishore, and Mr. Nogueira Batista. The problem was that, some proposals in the paper, such as the Council, were not substantiated. There were only a few sentences introducing the topic without a full discussion of the issue, notably without reference to the first attempt to activate the Council in 1999 and the discussion that occurred at that time, and without a discussion of the advantages and disadvantages of the proposal. It was inappropriate in the staff paper to address an issue of such importance without giving it due attention and candor. Any discussions on such topics should be deferred until there was a paper that gave sufficient attention and candidness in addressing the issue.

Mr. Pereira concurred with Mr. Kishore's proposal to hold a separate discussion on the international architecture. The issue was not limited to governance, as the staff had identified four different dimensions that involved surveillance and also macro-prudential coordination that warranted discussion. One of the main lessons of the crisis was the exposure of a fundamental flaw in the global governance, which was recognized in the paper in terms of fragmentation. Although in broad agreement with the staff analysis, he remained open to the idea of this to be presented as an initial input in the international discussions.

Mr. Lushin also supported Mr. Kishore's proposal, noting that on a procedural level there were challenges in taking on some broad and complicated issues in one meeting. Discussing such important issues at the same time could make the discussion less productive, and it was left to the Chairman to structure the discussion in a way that could make it more efficient. To do justice to the staff's efforts and in order to have a productive discussion, the meeting should be structured to separate the issues, with subsequent meetings if needed.

Mr. He shared Mr. Shaalan's concerns and supported Mr. Kishore's suggestion. While noting that the staff's papers had been presented together based on the reason that they are all connected to the causes and lessons of the crisis, some of the issues stood alone as very important issues, and deserved greater attention and a separate discussion.

Mr. Henriksson agreed with Mr. Shaalan's point on the problems of sending mixed messages, and underscored that the Fund should be sending just one message. On the governance issue, there was a relevant example: the paper indicated that one of the initial lessons of the crisis was that small advanced countries were one of the reasons for the crisis, which went too far.

The Chairman made the following statement:

> It appears that we are all in agreement with Mr. Shaalan. So, there is no problem to clearly establish that, whatever the content of the paper, it has to be seen as a staff report, and that any kind of summing up should be added for everybody to understand that there has been a discussion but we are far from having agreement by everybody on everything. All of you who have expressed a view are in agreement. So, there is no problem at all.
>
> The other point is how long are we going to discuss each question. Frankly, I understand that the Council issue is so important for the Board even if the word "Council" does not appear in the document, but I would not like people outside to think that, when the Board of the IMF is discussing the lessons of the crisis, the questions of regulation and macroeconomic implications are considered less important than the organization of the Board and the Council. We are all aware that the real question is how we get out of the crisis, what are the rules of the crisis in terms of regulation, in terms of macroeconomic policy, and the question of architecture is, of course, something in which we are all very much interested.
>
> I think Mr. Lushin is right. There are three topics, because we identified three big fields. There is some relation between the three topics, but they are different topics. We are going t o discuss, if you agree, one topic after another. First, on the discussion on regulatory questions, we will not find total agreement, but probably there may be some convergence. Then we will discuss, if you agree, the macroeconomic questions, and then we will discuss the third point. If we do not have enough time this morning to open the third point, we can have a meeting this afternoon or tomorrow morning to continue

> the discussion. But I agree with Mr. Kishore's point, which has been repeated by some others, that it is better to split the different discussions, not to mix everything.
>
> So, we are going to have this discussion one after another one. Let us start with the first one, say what we have to say on regulation. Please refrain yourself. You are asking that so really follow what you ask. Speak only about regulation in the first intervention. Then when we consider that we did enough, we will discuss the macroeconomic consequences and I will ask you to focus on this, not to go back on regulation, not to anticipate on the third part. Then we will open the third part. If we do not have enough time, we will follow with a second session.

Mr. He wondered, if the discussion of the three topics was strictly separated, at what point would Directors have an opportunity to raise questions that were not captured in those three areas.

The Chairman asked Directors to decide how they wished to proceed. If at the end it appeared that some questions required an umbrella discussion, that would be arranged.

Mr. Pereira agreed with Mr. He and sought clarification on the approach to the discussion. Mr. Kishore's proposal was to hold a separate discussion on the international architecture; there had been no reference to restricting Directors' comments to the three dimensions that the staff had proposed, which could be counterproductive if it prevented Directors from making all of their comments.

Mr. Stein remarked that his understanding, based on the Chairman's opening statement, was that the staff paper was comprehensive, but very preliminary providing an overview of all of the issues facing the institution. Each of the issues either had been discussed separately, such as the lending framework, or would be discussed separately at a later time. Directors should look at the overview without delving into the detail of the various issues because they would be taken in separate discussions. It would beneficial to quickly go through the issues and essentially provide political guidance to staff.

Mr. He indicated that his understanding of Mr. Kishore's suggestion was not a division of attention, but greater attention for certain separate issues.

Mr. Nogueira Batista appealed to Mr. He and Mr. Pereira to accept Mr. Kishore's suggestions as interpreted by Mr. Lushin and by the Chairman so that the discussion could begin.

The Chairman indicated that for the logic of the discussion perhaps it was useful for Directors to focus separately on the three main areas of the paper. However, Directors were free to make interventions as they saw fit. Thereafter, the staff would provide answers separately on each set of issues. Given that it might not be possible to cover all topics during the morning session, the discussion could continue into the afternoon. Moreover, a special session on the Trevor Manuel paper would be scheduled once it was received.

Mr. Kiekens made the following statement:

> I will cover the three topics, but I will give some comments on procedures.
>
> The staff has produced a set of concise papers. They were produced in response to a request from the IMFC that the Fund—I stress the Fund—take the lead in drawing the policy lessons from the current crisis, and takes the lead in recommending actions to restore confidence and stability. If we in the Board want to follow-up on the IMFC's call, I stress that the Board should come to conclusions because the call is for the Fund and the Fund is the Board. This is a critical responsibility for the Board to which we should give our fullest attention.
>
> Like many other Directors, I believe that this first meeting will not enable us to come to a set of well-articulated lessons, policies, and recommendations. Of course, the Board should strive for such an outcome as soon as possible with, at a minimum, a preliminary Board report, not staff report, by the Spring IMFC Meeting, if not earlier.
>
> I would have preferred papers with more analytical content and better statistical documentation about developments identified as critical in the build-up of distortions, vulnerabilities, and the collapse of confidence. Two of the four papers were circulated only in the middle of last week, leaving only a very short period of time for Directors to prepare for today's meeting. Thus, it was not surprising that almost all written statements became available only after the prevailing circulation deadline, around 6:00 last night. This is another reason why it will be difficult to conclude our discussion today.
>
> The papers for today's discussion cover a wide spectrum of topics, and rightly so. Each of them would have justified a separate Board discussion, but we should have prepared separately for each of the discussions. I prepared myself now for the first preliminary, exploratory discussion. I would like to start with what I consider the most important one, which is macroeconomic policies and what went wrong there.

The current crisis was driven not just by failures in regulatory policies and supervisory practices, but by weaknesses in macroeconomic policy regimes. The causes of the crisis indeed also lie in monetary arrangements, in fiscal policy, and in the failure to internalize macro-prudential risks. The interaction between monetary policy, liquidity creation, asset price developments, risk-taking by private agencies and financial institutions, and overall financial stability was not analyzed adequately by the IMF and widely neglected by policymakers. For an extended period of time, monetary policy was very loose in major parts of the world. Japan addressed its problems of the 1990s through expansionary monetary policy rather than real sector restructuring and financial sector restructuring, thereby stimulating large volumes of so-called carry trade.

For different short-term reasons, the United States has deferred monetary tightening. The most fundamental reason was that, in the absence of consumer price inflation, low interest rates would help avoid a significant slowdown in the United States and the rest of the world. Lax U.S. monetary policy was amplified by key emerging market countries, particularly China, which pegged their currency to the dollar at overly depreciated levels. In the run up to the financial crisis, the world had become awash with policy-driven primary liquidity, driving a strong asset price inflation with eventually spillovers in commodity price inflation.

Fiscal policy also contributed to a booming economy and soaring asset prices. In many instances, fiscal policy was in fact procyclical to a larger degree than was estimated in conventional analysis, mainly because of the buoyancy of tax revenues related to soaring asset prices. I conclude that the inconsistent macroeconomic policies created an environment in which a search for yield through financial innovation and rapidly increasing financial leverage created a lethal cocktail for the world financial markets.

Important lessons can be drawn from this analysis about the critical need to improve global macroeconomic policy consistency and coordination so as to avoid financial bubbles, excessive external imbalances, and inappropriate exchange rates.

The current crisis shows that monetary policy should not focus solely on price stability, but should also pursue the goal of macro financial stability. I agree with the staff that the monetary policy stance should pay proper attention to the asset price boom supported by leverage financing. However, since the interest rate policy is not sufficient to contain the risks related to the adverse asset price developments, these developments should also be accompanied by prudent regulatory and supervisory frameworks.

On fiscal policy, I repeat what is so long already well-known: Staff rightly reminds policymakers about the virtue of building surpluses in good times, thereby creating buffers for bad times. This is only a very preliminary comment, but it is a very critical analysis that we have to make and for which the Fund has the primary responsibility.

Let me now comment very succinctly on financial regulation and supervision. The other major causes of the financial crisis on which most of the analyses so far have concentrated are shortcomings in financial regulation and supervision. Indeed, financial innovation was creating massive market-generated liquidity, thereby supercharging the primary liquidity created by central banks. Regulatory shortcomings failed to rein in the excesses in the credit markets, particularly in the United States, but also elsewhere.

We now understand what went wrong with the complexities of financial innovation, but how can we explain the striking shortcomings in risk management and prudential oversight? An often heard observation is that, in good times, risk managers tend to become complacent, and this is certainly true. Moreover, with the growing complexity of financial transactions and structures, there was a tendency to overlook even the most basic rules of sound banking.

I would like to remind what I have said before that four such basic rules were disregarded. These were, first, and the most basic of all, do not give credit if the borrower is most likely unable to repay. It does not require much comment, but this most basic rule was not observed in many instances. Second, do not finance long-term credit with highly unstable short-term financing. Of course, there are maturity mismatches, the business of banking, but we went clearly too far in this maturity mismatching. Third, and this is a very important conclusion, do not circumvent basic rules of prudential regulation, such as capital adequacy requirements. As we now all understand, the phenomenon of securitization of loans and warehousing of those assets in the so-called conduits proved largely to be a fictitious moving of assets outside of the balance sheets. The credit lines from the originating banks generating the rollover of short-term financing was nothing else but a line to tie the securitized loans to the balance sheets, and I will come back to that phenomenon of circumvention of basic rules.

Fourth, and I believe a basic lesson that we draw from the failures in risk management, do not consider the risks of a portfolio of mortgage loans—or loans in general—to be similar to the risks of a more traditional portfolio of life insurance or fire insurance. The correlation of casualties in the traditional insurance business is almost nonexistent, whereas the losses on mortgage loans may be highly correlated during the downturn in a business cycle, as we all now observe. There was a collective failure to appreciate the extent of leverage taken on a wide range of institutions. The transfer of risks outside the balance sheets of banks was overestimated. In sum, private sector risk management disclosure and financial sector supervision and regulation all lagged behind the rapid innovation and shifts in business models.

What was most critically a failure was that innovation was not understood as being by and large the fact of regulatory arbitrage and the fact that the so-called financial innovation was often driven mainly—if not solely—by savings generated by regulatory arbitrage. If we would have understood that, I think we would have avoided of a lot of what went wrong.

A few comments on another complex topic—complex for political reasons, not for analytical reasons—which is the status of systemically-important banks that operate on a broad international scale. I have an extreme view. Ideally, such banks should be regulated by a set of international rules and supervised by an international authority. Such banks would have access to the liquidity support of the major central banks in which currencies they operate. The coverage by, and funding of, a deposit guarantee scheme and the resolution of solvency problems should be addressed under a set of international rules with a binding fiscal burdensharing according to the location of assets and liabilities, and governed by an international authority. Obviously, these topics merit in-depth analysis, and that is why I believe we cannot exhaust the agenda in one short, simple Board meeting.

I support the proposed shift in the paradigm of regulatory frameworks from an institution-based to an underlying activity-based framework. It is crucial that the modified framework covers all relevant segments of the financial system that are systemically important. And because of the evolving structures of financial institutions and the process of financial innovation, the perimeter of regulation and supervision should be adapted flexibly. Of course, the existing conflict of interest in rating agencies and the flawed incentives in the governance of financial institutions need to be addressed urgently, and other bodies are making good work on that.

A few comments on global architecture and the IMF. I agree with other Directors that many conclusions on this topic in the staff paper are not based on rigorous analysis and mix problems that are not related. The topic of governance of the Fund merits a separate discussion, and Mr. Kishore is entirely right, not that it is the most important one; I think the macroeconomic and regulatory failures are the most important and most pressing, but we should, for the order and the sake of good discussion, separate them from each other.

The first and most important aspect is that this discussion needs to address to what extent the identified shortcomings in the Fund's analysis and policy recommendations—and we can now identify them—can be explained. How it can be explained is a question mark; it is not a statement—it can be explained by flaws in the governance structure of the Fund, including the required independence of staff and management from political interference by member states. Whether the shortcomings in prudential regulation and supervision, as we have outlined, can be explained by shortcomings in the governance of the FSF also merit candid review.

As discussed several times in the past few years, including very recently by the Board here, financial sector issues should be better integrated in Fund surveillance. The major problem we have here is one of implementation, not of agreeing that it should be done.

In a few days we will discuss in a separate meeting how the Fund's lending facilities can best assist countries with balance of payments needs, including those resulting from the ongoing global deleveraging process. I will refrain from saying anything more than what I have said already, which is very short. I have consistently argued that Stand-By Arrangements offer sufficient flexibility to tailor financial assistance according to each country's specific merits and needs. I think that says it all, as far as I am concerned. I agree that the Fund should seek a doubling of its resources for its lending activities, and I call on members to be responsive to the Fund's needs on a broad collaborative basis.

In closing this statement, I would like to urge the staff and the Board to avoid simplistic conclusions on the interaction between the issue of quota distribution and the effectiveness of Fund surveillance. I stress that the most critical contribution of the Fund to coherent global policymaking is convincing and rigorous analysis. The Fund as an institution has little or no decision-making power with respect to countries' policies, a topic that Mr. Lushin very adequately addressed in his excellent statement. The prospect for transfers of sovereignty in this respect to an international authority is close to nil. We know that we have jurisdiction over exchange rate manipulation, which is the only, in my sense, real power we have.

In the same vein, the effectiveness of the discussion in the Board and the IMFC and in other groupings does not depend on the legal decision-making power of these bodies, but on the willingness of sovereign nations to cooperate and to internalize in their national decisions a broader international context. This is not an ideal setting. We should go in a globalized world to a supranational and international authority with transfer of sovereignty of the kind that we were able to reach in 1945 when countries agreed that they could no longer change the exchange rate unless the Fund agreed.

That is the past. In the 15 years I have been working in the Fund, not any decision could be reached in which there was transfer of sovereignty from sovereign nations to this institution, whether that was jurisdiction over capital account transactions, an orderly debt restructuring mechanism, whether that was even by interpretation agreeing that the Fund should exercise in-depth surveillance over financial systems in countries since we—except one Director—at that time all agreed that FSAPs are not part of surveillance but technical assistance and should be conducted on a voluntary basis.

In the present setting, I stress that the effectiveness of the Fund's surveillance does not depend on a decision-making power in a legal sense of the Board, the IMFC, a Council, or whatever groupings. It is the spirit of multilateral cooperation in which countries, according to the existing framework, are willing to take decisions in their national sovereignty. This cooperation is essentially a political process, but it is critical that the debate is documented by objective, authoritative analysis done by an independent authority, such as the staff of the IMF, and that is the added value that we can give.

We should all be aware of the sociopolitical constraints that policymakers face and this is a shortcoming in the staff papers. The technical analysis in the staff report, which I have by and large supported, should not prevent us from concluding that the most fundamental cause of the disaster we face today is a political one. One of the constraints of these political problems, probably one of the most important, was the inability of the political decision-making to contain the level of subsidy for the American consumer.

The American consumer is probably the most subsidized in the entire world. Borrowing for housing and for consumption is fiscally stimulated, as in few other countries. Public policies instructed and condoned Fannie Mae and Freddie Mac to give ever more risky subsidized credits to the common households at terms unsustainable for the borrower and at risk for the public finance. The subprime loans were the political response to make ever more expensive housing still affordable for the common citizen with stagnating labor income in an integrated globalized world, at least so it was seen at the time.

In this respect, the financial crisis in the United States today is very similar to the crises we have seen in many developing and emerging market countries. That the crisis in the United States affects so much more the rest of the world is because the creditor countries, including many banks in creditor countries, have been willing to extend credit for unprecedented amounts to the U.S. economy beyond prudent levels, because this country and the financial assets it was supplying to the financial markets worldwide were seen among the most creditworthy on earth.

We are learning many costly lessons, but the most fundamental one that I would like to report as a member of the Board to the IMFC is the need for governments all over the world to promote long-term objectives over short-term palliatives. Helping countries in achieving this for their own benefit and that of all other countries who participate in today's world economy is, in my opinion, the raison d'être of the Fund.

Mr. Rutayisire made the following statement:

The debate this morning was on whether regulation should start, macroeconomic policies, and financial architecture. Drawing from what I have seen in the staff reports, the starting point is that the flawed model of financial regulation and supervision is the most critical factor that has led us to where we are today. Starting from there, I thought I could establish a basis from which one could visualize what kind of macroeconomic policies could create the needed environment and the architecture that could also be desirable. So, I will confine myself to financial regulation and supervision.

In the staff report it describes a model in which at one end they describe as loan brokers and originators who had little incentive to screen risk that they sold on. This is a description of the asset securitization model. At the other end, the report describes investors who rely on optimistic statistical analysis by credit rating agencies. I would like to argue that this is not a linear model, and there are a number of nonlinearities in this kind of set-up and this would have an implication for design. The kind of model that one could try to describe is starting from both extremes. One could see many institutions that have developed like a spoke of a bicycle, if one could look at a bicycle tire. Originators create special purpose vehicles, either they can create them, which raises the issue of independence between special purpose vehicles and the originators themselves, or the special purpose vehicles could be independent. What I want to stress here is that the issue of independence in this model is something that emerges as a critical phenomenon. It could be a challenge to independence of conflict of interest, but at the same time it is also for the convenience of the industry itself. One cannot imagine a special purpose vehicle that would securitize pools of assets for which that vehicle has no knowledge about.

Supposedly, the vehicle should also have some relationship with the originator to know the character of the originator himself. The special purpose vehicle should then rearrange the pools of cash flows and redesign them in a manner that reflects the preferences of various investors. The vehicle must also design supportive credibility enhancements, and in this exercise we see that other institutions have come in, institutions that have no relationship with the banks by nature of the statutes that created them. We have insurance companies; we have rating agencies. They are created by separate statutes and have to respond to different authority. In this kind of arrangement now, they are involved in the securitization process.

Now, once the vehicle has sold assets to investors, it is not the vehicle that collects the cash flows, nor is it the originator that collects the cash flows, but another set of institutions emerged to collect the cash flows. It appears that for these institutions to be able to collect the cash flows, at least they need to know the nature of the originator. At times, the collectors of cash flows have also not been independent from the originators as much as they could also be independent. So, in this case, we see that conflict of interest could be by design, as a result of the industry, or it could be perverse because of ill intentions.

When it comes to paying investors, it is not the special purpose vehicle that pays investors. The collector pays the special purpose vehicle, but another set of institutions emerges to collect cash from the special purpose vehicle and remits it to investors. This is a cluster of lawyers and trustees; they are established by different statutes and they have different capital requirements.

There is a question of deciding on where the perimeter is going to be established. We have multiple jurisdictions that are involved. Mr. Kiekens pointed out certain jurisdictions not wanting to cede their authority. It is not that we would have it between nations, but also within a country who has multiple jurisdictions that would not want to cede their regulatory authority to others. So, when we talk about a unified regulatory authority, this raises a number of issues about how that could be done. Perhaps we are talking of an attempt to harmonize regulations or regulatory roles across different regulators. Otherwise, we have to be convinced on how one single regulatory authority could take over the responsibilities of regulation. Some domains are also highly specific that perhaps the competencies of one single regulator might not be available.

Furthermore, staff makes certain corrective proposals. They say differentiated layers of oversight should stress incentives, e.g. long-term horizons in decisions. This could be a constraint on the current model. I have said that the special purpose vehicle has to redesign the pools of assets to suit different investors. If we impose a certain investment strategy orientation, this is not going to give the special purpose vehicle enough latitude to respond to different investment requirements, and that could constrain the existing model and make it perhaps inoperational. I did not know if our objective is to move from the current model which had advanced to a certain stage and go back to the classical commercial banking, central banking relationship. I think that would not work, neither would the world allow us to go back that way. So, we would have to think of regulation in the context where we are at the moment.

The report says that regulatory standards should be based on the risk of the underlying activity rather than on the type of institution undertaking it. I think this dichotomy is restrictive. One cannot evaluate the risks pertaining to cash flows without assessing the risks of the institution itself. If the institution does not obey its governance rules, does not respect the ethics of business, it does not matter whether the cash flows will continue to trickle in, but eventually that kind of institution will undermine the quality of the cash flows.

Finally, another correction the staff provides is that the perimeter should be flexible. Again, this can have an inherent problem. Markets operate on reporting. I thought if the perimeter keeps on changing, then we are going to be bound to change reporting requirements. This is going to be a burden to investors who would not know what kind of reporting to expect, and it is also going to be a burden to those who would have to be constantly redesigning what to report. This is one correction that could have been looked at. I think it could be feasible that this would have implications on how the design can be set.

Mr. Lee made the following statement:

To begin with, I would like to support Mr. Kishore's and Mr. Shaalan's proposal regarding the procedural matter, where it would be very helpful to get a better understanding of the crisis lessons. I would like to thank staff for their timely, comprehensive, and well-balanced papers. This work responds to the call from the IMFC and G-20 for the Fund to take a leading role in drawing policy lessons from the crisis.

We circulated a detailed gray prior to today's meeting, so I will contain my comments to three overall issues. The first comment is related to so-called financial protectionism. While we agree that it is the right time to draw policy lessons, it is also important to recognize that the crisis is still unfolding, so we need to be careful not to be overly definitive or prescriptive in our policy recommendations. For example, the crisis is only just beginning to shift to a new phase where it is now threatening to cut off capital flows to emerging market economies. We will need to be more conscious of what additional policy lessons can be drawn from this latest stage of the crisis.

I would like to emphasize the need for the Fund to take a leading role in developing a coordinated multilateral strategy to avert an excessive withdrawal of capital from emerging economies. Perhaps this will need to include consideration of using moral suasion on key capital market players.

My second comment is related to the limitation of the central bank's role in dealing with financial crises. On the lessons for macroeconomic policy, we would argue that many central banks were aware of the build-up of systemic risk and they tried to respond to it by issuing various warnings. However, in hindsight, they appear to have misjudged the risk/reward trade-off in choosing not to use monetary policy more directly to deal with the problem. As such, we surely cannot avoid another look at the long-standing question of how monetary policy should respond to credit and asset price booms.

We also need to acknowledge that this is a very difficult issue that needs a thorough consideration of the trade-offs involved, including the possibility of undermining the effectiveness of inflation targeting, as well as the practical difficulties of identifying speculative booms. Given the numerous challenges and risks involved in using monetary policy in this way, we would emphasize that the burden to curb unsustainable credit booms should, first, be on enhanced prudential and supervision policies.

Lastly, I would like to touch upon the governance issue. I want to underscore my support for the proposals to reform the Fund's governance, including the enhancement of the voice and representation of emerging and developing countries. A great deal of work is already underway in various fora, including the IMFC, G-20 working groups, and the committee headed by Trevor Manuel. But given the need to achieve swift consensus on these issues, I would urge close collaboration between these various groups, particularly in the areas where there is direct overlap.

Mr. Guzmán made the following statement:

I will comment on the three areas. At the outset, let me thank the staff for an excellent set of papers. If we restrict ourselves to general terms and general propositions, we are in broad agreement. The problem, of course, is that there are two fields, the financial regulation field and the dimension on financial architecture, where the devil is in the details. The fact that the Fund suggests certain courses of actions forces us to have an opinion on those suggestions, and probably it is impossible to reach an agreement, not in one session, but in 30 sessions that we would hold on those issues. But, in general, if we stick to the essentials, the lessons of the crisis are right now far better distilled, and I enjoyed thoroughly reading all the papers.

I will make only two general comments. I particularly enjoyed the broad diagnosis. I can understand that there must have been some debate among departments and among staff, but I disagree with Mr. Kiekens, and I tend to share the general perspective in the papers. The regulatory and oversight failure by far has a central role in this crisis. Of course, nothing could have taken place without certain monetary conditions, and monetary policy needs to rethink its tools and its targets. But with the limitations in instruments, information, and the effectiveness of interest rate movements or monetary quantities, one could have expected that monetary policy was responsible for this in the context of open economies and with free capital movements. Good regulation and good oversight could have prevented this. I do not think that every context of low interest rates and abundant liquidity is bound to generate a crisis as the one we are experiencing today.

This brings me to the second general comment which goes to the recommendations with regard in particular to financial regulations but also, in a sense, to macroeconomic policy design and management. What I see here is not a total disconnect, but a partial shyness; the Fund is being timid in addressing all the regulatory solutions and at least proposing or forwarding to the international arena all the regulatory solutions. Why do I say this? In several areas: rating agencies, remuneration of compensation of managers, and especially the one that surprised me most, this concept of the flexible perimeter of regulation and a gradual regulation or regulatory charges defined in terms or in relation to, as a financial institution, your contribution to systemic risk.

This concept of flexibility or lack of, and aggressiveness of the regulatory stance comes from the fact that we all fear an overreaction and a rush to regulation. This is well understood, but in the current circumstances we fear that there is a risk on our part not to force change. There is going to be a strong reaction and resistance against certain regulations and certain changes. Now, one would think that the International Monetary Fund and/or other international institutions should rather take the position of pushing for reform and expect a dilution of several proposals to come from other instances, national governments and institutions that would have to apply those regulations. That is my personal perception.

The general skepticism is in these documents explicitly says that we do not trust that regulation can prevent all future crises. Nobody trusts that we are going to prevent a hundred percent of each crisis. But if you admit from the start that the reason of the crisis is poor regulation, please do not recommend inaction in the field of regulation. We should push ambitiously for all necessary reforms, and that is the single thing where I sometimes feel uncomfortable in reading these documents.

The same is true for monetary policy. The right conclusions are extracted for monetary policy, but then the difficulty is in what do we do with monetary policy and how we implement the changes. I could not find agreement within my constituency on how this could be implemented. One reasonable conclusion, which I did not see in the paper, is the fact that oversight and financial regulation needs to have a strong implication of the monetary authority. If the monetary authority is not involved in oversight and financial regulation, the institutional model to control financial markets might be weakened. I understand that it is very complex and it affects the institutional model.

On the international financial architecture, there is a question in our gray on a certain proposition that is there that we do not understand, and Mr. Shaalan also asked the question. I would be glad to have a session specific on financial architecture, or if it has to be debated here, I will also join the debate.

Mr. Pereira made the following statement:

I am not going to confine my comments to your suggestion and structure on the three dimensions. I just would like to start by commending the staff for a very good set of papers. We not only enjoyed them but we found them very useful as input for our initial discussions and for the mandate of our membership to draw lessons, and it would also be very useful in our discussions.

I would like to make three comments regarding areas that deserve more attention. First, this crisis reflects both market and policy failures. In that regard, I welcome the staff's recognition that perhaps we put too much attention on the traction power of monetary policy to conduct the business cycle. In fact, it is asserted that the popularity of the inflation targeting scheme could be one of the reasons in which we do not foresee the asset bubbles and macroeconomic implications.

The other element that the staff put forward is also the global imbalances, and that this is an area of critical importance. What I missed in the staff paper regarding global imbalances is the role of fiscal policy, so I would like to endorse the comment of Mr. Kishore, Mr. He, Mr. Kiekens and others, that it is subject to challenge to assert that the role of fiscal policy has a negligible impact on global imbalances, and this had to do with the expansionary stance of fiscal policy, particularly in advanced countries. We discussed this in our constituency, and personally I believe that the U.S. fiscal deficit has a great deal to do with the imbalances and that we could face a completely different picture rather than saying that, because developing countries have excess savings, there was a context of excess liquidity turning to the yield search and, therefore, with lack of regulation, this turned out to be a global financial crisis.

In our view—and we expressed this before—there was little comfort in asserting that the global imbalances were sustainable, because there was a huge change in its composition. In the 1990s, the current account deficit of the U.S. was targeted to investment while in recent years it was more toward consumption and fiscal policy. In particular, I cannot but name things directly in terms of military expenses that create and promote particularly the context for the U.S. economy.

The fact that the interest rate and standards were kept lower is an area that deserves more careful consideration in the staff paper. It is fiscal policy and particularly the expansionary stance in some advanced economies that are related to this crisis. I wished that the staff could put some more emphasis and analysis on this. While in the vast majority of the countries the advice was to fiscal rules, and even developing countries faced some problems in terms of procyclical fiscal and monetary policies in the context of free capital inflows, that was not the case for some advanced economies. So, my point here is first to ask the staff to address this issue more carefully.

Secondly, another lesson that is missing in today's discussion is the inherent instability in the monetary international system based on one currency, and this is something that Mr. He and others put very clearly. We have to also study the configuration of the international monetary system. There was not a single reference in the staff report on this. I know that this is a very complicated and perhaps a medium-term issue. Again, the root of this crisis is the stability of the international monetary system based on the currency of one country as an international reserve currency. How are we going to work in a more stable and equitable international system, knowing that this crisis will particularly target those countries at the bottom and will exacerbate inequalities in income and wealth distribution.

My third point is regarding the question that we put in our gray and that Mr. Warjiyo and others also pointed out on how these lessons will be integrated into Fund surveillance and policy dialogue with members. There is a recognition that perhaps we failed in terms of putting too much emphasis on monetary policy and the way to conduct this business cycle and how that will permeate into the data with countries. We still need to discuss these issues. That is why in the very beginning I supported Mr. Kishore on the proposal of having a very specific discussion on the global architecture, which involves for the Fund discussing our mandate in terms of both supervision, surveillance, and lending.

It seems that, rather than reforming the IMF, we are actually trying to impose most obligations to the members, and that seems to be a huge mistake. There is recognition that we failed in some of our policy advice, but at the same time, when we go to surveillance, we are placing the emphasis on obligations of members rather than revisiting our own mandate. I am concerned about that.

The staff paper put forward some proposals, such as the mandatory FSAP and other elements, the reference to joint responsibilities, and this still deserves more consideration. We would rather have a concrete proposal on how we are going to change the surveillance to our members rather than again make a reference. I would like to read one comment that captures exactly what

I am trying to say. It says that we cannot expect to make much progress on IMF surveillance until it is clear what obligations and rules of the game a country is being monitored against. That is exactly what we need to discuss and that is why I believe that having a separate discussion will be very important.

Finally, I would like to reinforce one of the questions in our gray. When the staff called for a group of policymakers with the ability and mandate to take leadership in responding to systemic concerns about the international economy should be formed, my concern is in the context of surveillance, in terms of coordination of policy actions, it seems to be like a reference that we need to create a new "G." What is exactly the proposal behind that, coming from an institution that asserts that one of our main advantages is the near universality of our membership? I would like to get some clarification on this point today.

Mr. Moser made the following statement:

First, on regulation, we all are aware of the fact that, however broad we make the perimeter for regulation, banks will do everything they can to find the loopholes in the regulation and to circumvent that, because it is clearly in their interest to reduce costs that come along with regulations and increase profits. So, one question which would go beyond this paper is whether we should not or cannot find a way to directly get at the incentives of the banks. Most clearly it would be an incentive for banks to be systemic. One lesson may be for banks coming out of this crisis is it pays off to be systemic because that is when you get bailed out.

Has the staff thought about or discussed issues like having banks that are systemic, or especially banks that are "too big to fail" to pay a risk premium to taxpayers so that, in case they have to be bailed out, that there are funds. But, then also maybe that it works on the incentives, that it increases the costs for banks to be big, that increases the costs for being systemic? Is there a discussion going on about issues like this?

A question for SPR, one thing that comes clearly out of the papers is that safety buffers have to be built up, that they were not sufficient and they have to be built up during good times, and that is true for the banking sector and also true in the area of macroeconomic policies, in particular fiscal policies. So, one question would be, should we not then intensify surveillance exactly during good times? The tendency for us is actually to go the other way around, and the example is Iceland. We were all very comfortable with putting

Iceland on a 24-month surveillance cycle because everything was going so well there. They were booming and everyone said, well, they are booming, so there is no problem there. But that is actually when we have to put the restrictions on. Is this maybe an issue to look at, intensifying surveillance during boom times?

Third, for Mr. Blanchard, I noticed in the paper on the lessons for liquidity management that there was an issue brought up that central banks might have to change their operational frameworks for liquidity provision during times of crisis. My sense is that it would be much better if the operational framework for monetary policy could be maintained during both times of crisis and during other times. This would be a good opportunity for the staff to look at the operational framework of monetary policy in general, to look at actually how monetary policy is implemented. Really, it is clear that central banks, at very different degrees, had to make these adjustments. My guess would be that the more modern the operational framework of a central bank was, the less adjustment was needed. So, I think this is an area that the staff could certainly take a look at.

By the way, in that paper also on liquidity management, just a small point. It only talks about dollar swap agreements. It was not just dollars swap agreements, but there were also Euro and Swiss franc swap agreements introduced.

Mr. Kotegawa made the following statement:

We issued a gray, so I just have one small question that I intentionally did not include in my gray, and that is a question to Mr. Caruana. This has some relevance with the issue raised by Mr. Moser and also Mr. Kiekens, especially when Mr. Kiekens touched upon the issue of regulation, its sociopolitical consequence, or some kind of importance.

I will miss Mr. Caruana, first of all as a good friend, and, second, as an expert in this area, but most importantly as a witness of history, where he worked as the Chairman of the Basel Committee which came up to Basel II.

The purpose of this intervention is not any kind of judgment, but rather to share just the facts with my colleagues here in the Board. The issue is, when you worked on that issue of Basel II, I understand that there was an attempt, at least at the level of the Secretariat, to bringing the off-balance sheet assets onto the on-balance sheets in the course of the negotiations, but you encountered very strong resistance or opposition from the industry involved and perhaps even from the authorities who were in charge of those issues. I would just like to ask you if that was true, because that would be a very valuable historical fact to share.

Mr. Kishore made the following statement:

We found the set of staff papers to be very interesting and useful. They are, on occasions, marked by a certain degree of unusual candor. This is welcome, and I hope this tendency will be further strengthened in the days to come. As Mr. Kiekens pointed out, and as the staff paper is captioned as "Initial Lessons" we are looking forward to the discussions and the recommendations of the IMF at every level of its consideration and decision-making to be crystallized, and then it would be requested to you that we have a roadmap for further developments and further modalities for implementation thereof.

We have issued a gray and I will not repeat the main points there, but a couple of points in addition and for reiteration.

In all crises, after they are over or during the crisis, there is a tendency which evolves inevitably toward the deterioration of the narrative and the argument into some kind of a blame game. This present crisis is indeed a global one; it is upon us all. Therefore, I think we would be doing better to focus on the big picture.

The staff very appropriately has talked about the objective of stability so as to encompass both price and financial stability. Fiscal policies have been underscored in terms of surveillance looking very critically and scrutinizing the policy interventions for the asset prices, also. Recent experience has shown that monetary and fiscal policies can at best be the first line of defense in shielding the real economy from the financial shock.

There are very clear limits which have been exposed to monetary and fiscal policies. Interest rates would have a zero nominal bound; liquidity injections are futile in a crisis of confidence. Quantitative easing could not stave off, as we know, a most remarkable, productive, and efficient economy in Japan from losing nearly a decade. The fiscal stimulus takes time; by the very nature of its operation, it takes time, and then perhaps how much time would be taken by which economy. Sometimes the case has become too little and too late. In this perspective, it appears that the second line of defense is sound and prudent financial regulation and supervision.

This crisis has also thrown up some stark lessons. My short point is that it is not nearly lax supervision which led to the crisis. The burden of my argument is that supervision is deficient; the structure, the regime is deficient and incapable of delivering what we require and, therefore, the question of its lax or smart implementation would be secondary. We have to address the question of this structure, mechanism, the regime of this supervision itself and, therefore, deficiency has to be addressed.

This also shows that the Basel processes are inadequate, somewhat a straightjacket, and even inducing riskiness. Mr. Kotegawa, asked the question; I am very interested in looking forward to getting the clarification on how do we look at the Basel processes, but today they appear to be somewhat inadequate.

As far as further mechanisms, improved systems are required. We will have to have a supervisory system and a regulatory regime which are not only sound and all encompassing, but where all booms and slumps are captured and then subjected to analysis and, therefore, there are no good booms and bad booms; all booms and slumps must be captured by our system. Mr. Moser was absolutely on the spot when he said that this would need to be re-engineered once again.

Both at the national and the international levels, the systems and processes have to be placed in position, because the question of intervention or not making any intervention would, as I said, become secondary. First of all, we must have the toolkit and instruments to be able to use them if we decide to do so and the situation demands. This brings me to a short point of the necessity for equipping both national and international authorities with adequate human, technical, and fiduciary resources to be able to cope with the innovations of the financial markets and intermediation.

The last point is the question regarding the issue of national responsibility. There is no doubt that we are together in this crisis and its solution because it is global. If we are extolling the virtues of globalization, the negativities which have fallen unintended out of it will have to be faced. The short point is that the responsibility finally today rests with national authorities and the costs are finally to be borne by the nations themselves. The multilateral, the international architecture can only help each other, but ultimately the costs of market failure will have to devolve upon the sovereign only.

In this context, just touching upon the question of international reserves, there is an understandable—I am not saying desirable or undesirable—tendency on the part of sovereign nations to accumulate their international reserves. If there is no effective, efficient, and fully-equipped international framework and regime for supervision and regulation, the tendency for nations to accumulate reserves will continue unabated. What will happen? You can say that any nation is free to do so, but it is an impossibility for every nation to develop resources of that kind and, therefore, some kind of a regulatory system will have to be required as the third line of defense.

This will take me in transition to the question regarding the overall financial architecture and global reform on which I refrained from commenting today as I have requested for a discussion on the matter. I close with a request that, at the end of the second session, where financial architecture and reforms, etc., have been discussed, to work out a roadmap for moving forward. How do we crystallize our recommendations; when and who do we remit it to in order that they, at appropriate levels and fora, get translated and implemented; and what kind of a feedback do we get with a view to getting the implementation monitored in terms of—and with reference to—our recommendations.

Mr. Kiekens made the following statement:

The second most important result of the IMFC meeting of last October was the mandate for the Fund to take the lead in making a study on the lessons of the crisis. I am very ambitious on that and I hope my colleagues will join me. If six months from now the reference analysis of the crisis is one produced by a single professor from a single university or a set of professors, or if it is produced by another international financial institution somewhere else across the Atlantic, we will have failed. This is a golden opportunity to show that the Fund is indeed at the center of the analysis, and we must deliver. I am very glad that the Director of the External Relations Department is present today. This is a very important communication tool, not only to the IMFC but to all the world, and we need to deliver.

I do not want to censure the Fund staff, not at all. Their input is critical; without them, we, the Board, will not be able to deliver a report. But I am not fully satisfied with the papers produced so far because, as such, they are inept to be the communication tool that I want to see for our policymakers and for the public opinion at large. It is a good start, but they should rework the papers. They should give very precise analysis, where possible. Concise, of course; it should not be a volume of ten books. It should be documented by statistical data that proves, that documents the developments that are identified in the papers as leading to the distortions and to the wrong incentives.

What is the role of the Board? I would like to see this a report of the Board, if possible, but that does not mean that the Board needs to unanimously agree on everything. Of course not. The report should be based on the staff and then it should identify, where that is necessary, where Directors have a dissenting or concurring opinion. I believe, Mr. Chairman, that is your challenge, and the challenge of the Board. Of course, it will be a major task for the staff to help us produce such an authoritative analysis that becomes indeed the reference for understanding what happened, why it happened, and how we will act to prevent it.

You may have been suspicious and asked what was the single or the first important conclusion of the IMFC. It was something entirely different. The first lesson drawn from the crisis was a lesson not mentioned in the staff report, at least not as such. It was repeating and strongly endorsing a conclusion already taken by the G-7. We met and "agreed the following plan of action. We will take decisive action and use all available tools to support systemically important financial institutions and prevent their failure." Mr. Chairman, that was concluding that the collapse of Lehman Brothers was a big mistake. I have not seen that in the staff papers sharply analyzed as such. Of course, this decision, this announcement made by the international community has huge consequences, and we should, of course, analyze them, too. But, first of all, it was a lesson, the first lesson up front in the first sentence of the IMFC communiqué, and I am somewhat surprised that it was not taken over in this staff paper.

But that is not the most important one. The most important is that we have now a golden opportunity to show that indeed the Fund is the leading analyst of the crisis, and we should be honest and candid.

Mr. He made the following statement:

I want to join others in thanking the staff for presenting a set of very good and very useful papers. I found them to be much more frank than the papers on the lessons we have seen before, but there are still many areas or important issues that need more candor. Knowing that we will continue to have other discussions, this is only the initial understanding of the lessons, as the crisis is still unfolding and differences will always be there.

I think the purpose of doing this exercise is to seize the opportunity to pull ourselves up the learning curve. Usually, the learning curve is very flat, but this is an opportunity that we could take a step, a giant step forward if we have the correct attitude. It is very important to be intellectually honest rather than politically consistent.

One related issue that is puzzling me is a very old issue. I think it has been on your mind constantly probably, but not mentioned in the staff papers. Why has the Fund or the international community been less sensitive to risks, and the receiving end has also been less receptive to the warnings? I think there is the question of transparency and candidness, and also the trade-off for the Fund to play more of an advisory role or police role.

The incorrect handling of this balance probably has some effect on the delivery of the warning or forming of the warning, and receiving of the warning. Just to give one analogy, there are HIV clinics. If the patients know in advance that the doctor will publish the diagnosis, then probably the patients will work with those who keep their file private.

There is also a balance to be struck with the Fund's communication to the outside and to the authorities. The staff reports, the policy papers or Article IV reports target the two at the same time, one-size-fits-both, to the authorities and to the outside. As a result, the Fund compromises on the candidness if the report is expected to be released to the outside. In that case, it would also compromise the discussion between the staff and the authorities, because the authorities know in advance that the report will be published to the outside and they will be less candid.

Maybe staff can give us some comments on how and whether it is feasible to have a better target with two kinds of messages, one to the authorities and the other to the outside rather than just allowing a few deletions of a few sensitive sentences. I think that we should come back and reconsider the Transparency Policy.

Another point I want to make is also on the role of fiscal policy in the run-up to the current crisis. I found it very puzzling that staff came to the conclusion that it has not played a major role in the run-up to the crisis. I agree with Mr. Stein, Mr. Pereira, and Mr. Kishore that the low savings rate in the United States, especially the large fiscal deficit, has played a very important role in the first place also in causing the global imbalance. I see an inconsistency here. Fund advice has always been fiscal consolidation is important, but in giving this particular advice to the U.S., the message is that in the bust cycle you have to expand and to take care of growth and financial stability, but in the boom cycle you have to save.

If you look back at the records of the Article IVs, Multilateral Consultation advice, or U.S. commitments, the advice during the boom cycle is to consolidate over the medium term. If the boom-and-bust cycle is a way of life, then that would be equal to saying that you should tighten at the bust cycle because it is medium term. We are saying in the boom cycle you should tighten over the medium term, and the medium-term translates to the bust cycle. I wonder why the advice has always been that way and why this fact is not analyzed or missing in the papers before us.

Mr. Fayolle made the following statement:

I would like to start by congratulating staff for this paper. Whatever we do on this issue, people will find that this is too short, this is too long, this is too broad, and this is too narrow, so I would not pay too much attention to that. I would pay more attention to what is missing in the paper, which for me is prioritization; what is the most important and what is less important? To put everything basically at the same level is probably not what is the most useful to give the advice of the Fund, and here I think it is not only the staff and management, but also the Board to this request from the IMFC.

I can be extremely short. I have just three things to say on what, in my view, the Fund needs to be. One, the Fund needs to be ambitious in its recommendation to enlarge the perimeter of financial regulation, because this is one of the key reasons why we are where we are. We have long called for its expansion to any activity and any institution carrying potential systemic risks, and it implies that the Fund works on issues, such as hedge funds, uncooperative jurisdictions, rating agencies, etc., where strong and decisive actions need to be taken shortly.

Second, the Fund needs to be relevant in its response to its membership during the crisis, and this is also urgent and very much needed. I think the urgency is to reform quickly its instruments and policies along with an increase in its resources. This is where we can be the most useful in the crisis.

Finally, the Fund needs to avoid to giving the perception that we are being very inward-looking. We have been very good at being inward-looking over the last years. It is absolutely clear that governance issues are extremely important and are also extremely complex. If they are extremely important, I missed something, which is why only 20 percent of those countries that are eligible to a quota increase have taken the needed legal actions to get to this quota increase. I think this is a very important issue that needs to be looked at in the medium term, and probably less urgent than some others we are dealing with today.

Mr. Sadun made the following statement:

I will try to inject a certain degree of discipline in the discussion, not too much but just a tiny bit. I will not comment in detail on the issue of governance and on the issue of macro policy, with the understanding that we will have the opportunity to discuss these other issues on another occasion. I will just focus on a very few remarks on the first topic, which is the regulation of the financial markets.

I do not have to be encouraged to stress the importance of this aspect. My authorities are very keen on this issue. At the recent G-7 meetings and on other occasions, they went so far as to propose what they call a legal standard as a reference to a replacement of the traditional gold standard as the foundation for the new economic system.

Besides the word play, the message that my authorities want to convey is the absolute critical importance to come up with an appropriate regulatory environment for the financial system, because that is what is needed by the global economy right now.

There are a number of very good points which have been highlighted by the staff analysis and I just wanted to pick up two or three of these points. The first one is that it is absolutely correct that, as Mr. Fayolle has just mentioned now, the perimeter of the regulation has to be appropriately developed. Some segments of the markets have been allowed to operate outside such a perimeter. Some jurisdictions are operating outside proper supervision.

These are crucial steps that we have to take, and this is even before we start to discuss the appropriate measures. In other words, we might come up with the best possible fiscal regulatory system, but if we allow the important components of the financial system to operate outside the perimeter of the regulation, we will not have achieved much progress.

The second topic is on risk. It is clear that among the key reasons for this crisis has been the inadequacy of the risk models, and I am referring both to the internal system to assess appropriately risk by the financial institutions and also the failure of outside institutions, like the rating agencies, to provide a suitable framework to help assess this risk. The failure of handling correctly these risk issues must be a central part of what we should improve.

Finally, there is the point of cross-border cooperation. It should be obvious but, nevertheless, I think it is appropriate to stress that point again. The nature of the crisis is such that without a proper system to handle the cross-border implications, we would not go very far. There has to be an effective regulation of cross-border institutions.

Finally, and perhaps even more relevant, since we are analyzing a crisis which is still going on, there has to be the proper harmonization of the remedial actions. It is not only that harmonizing the action increases the effectiveness, but also avoids unintended consequences on a national level.

I promised at the beginning not to deal with the other issues, but I just wanted to make a very brief reference to something else. It seems to me that discussion of what went wrong with the macro policy is at the essence of what we have been asked to produce. I do not subscribe to the notion that the failure of the regulatory system is the only or the main culprit of the crisis. I think that the failure of macroeconomic policy has at least provided conditions for the crisis to explode.

Finally, I am very much in agreement with what Mr. Fayolle said—it is important that we discuss governance, but considering the situation where we are now, I think that a discussion of governance should be limited to the functionality of the discussion to handling the crisis. In other words, I would be very, very disappointed if a discussion on governance will distract us from the most important and pressing issues.

Mr. Nogueira Batista made the following statement:

Let me say, first of all, that I think this meeting is not one of our best. The first reason for this is that I think there was an error on your part to bring these three papers together in a joint session. Mr. Kishore tried to suggest a way, Mr. Lushin amended it, and I supported it, but nobody is following the suggestions made by Mr. Kishore and Mr. Lushin. I would rather just confine myself to the first paper.

I will try to be brief. First, on the paper on regulation, I think there is a problem here in the way that all of the papers are written. They are written mainly with the advanced countries in mind, which is understandable because the crisis has its epicenter in the advanced economies, mainly in the United States and Europe, but this is rarely made explicit.

We are talking about the financial system, the international economy, and mostly what we have implicitly are lessons from the experience of the advanced economies. Since there is an intention of publishing it, I would suggest that staff look carefully at this, because most of what is written is relevant to the advanced countries and not to the rest of the world.

In the paper on regulation, in the first paragraph, there is the assertion that this is to help inform us on our surveillance. There are concerns which our chair has expressed repeatedly and which I feel is missing. First is the recognition that our surveillance was deficient mainly with advanced countries and major financial centers. There must be an explicit recognition that that was a major gap and failure in the Fund surveillance in recent years. I think this is something that, if we want to be candid and honest, we need to say this expressly.

Second, a concern that I have is that we do not draw an implication which I think is very important from the lack of regulation, which is the lack of regulation of cross-border flows and the implications of large and unstable capital flows, especially for developing countries. I feel that there is an absence of this consideration here, possibly because it is less relevant for advanced countries than it is for emerging market countries, which are not at the center of the crisis.

Second, on the paper on macro, here I missed one macro lesson from the crisis which again is relevant mostly for developing countries and maybe that is the reason why it is not highlighted here, which is the insufficient concern with external vulnerability of countries; by that I mean insufficient concern with high current account deficits, concentrated debt, and external debt profiles which lead to large gross financing requirements. We have seen that in several countries that have come to the Fund.

This is one major reason for the balance of payments crisis—the openness of capital accounts, the lack of adequate regulation of cross-border flows, and an inadequate level of reserves, and other issues that, taken together, make a country vulnerable. If you look at these variables, you will find probably that countries are coming to the Fund in the crisis so far are those that were weak on these counts mostly, and those that are not coming to the Fund are those that have strengthened these points or most of these points at least.

Finally, on governance, Mr. Fayolle is always lamenting—he has done it again—that we should not concentrate excessively on governance issues. Let me say something there. I would be glad to take his place in the Steering Committee on Governance, because I am much more concerned with governance issues than Mr. Fayolle apparently is. That Steering Committee is dominated by Francophone countries, so I think a Latin American there would be quite adequate.

But coming to the point of governance, I would like to draw my colleagues' attention to the Chapeau Paper, paragraph 26, and, complementing that, the third paper on governance, on global architecture in the IMF, on pages 8 and 9, paragraph 8, the final part of paragraph 8. I would like to make that the focus of my comments

I am largely in agreement. For instance, I noticed that when you speak of the rebalancing of quota shares, in the third paper you do not have an important thing which you have in the Chapeau Paper on paragraph 26, which is rebalancing quota shares and sooner than the gradual process envisaged at the last quota review. I think this is an important point that should be present also in the paper, maybe a bit expanded on, because this is really what we need. We need to accelerate the process that we initially thought was adequate in the April reform.

I agree to move to a more representative Board in the IMFC. I wonder if on page 9 the small advanced countries are not being singled out unfairly. I am open to discuss that. I look at Mr. Moser, Mr. Bakker, Mr. Kiekens, all valuable Board members, and I wonder if the mention of these particularly small countries on page 9 is really fair. I am open to discuss that, but I will leave it for the future.

On page 9, the next point is giving IMFC Ministers and Governors a high-profile forum. I wonder what that means. I would like staff to clarify that. If that is a nod to the Council, then we have here a big debate before us. If it is something else, I would like to know what it is.

I think we can solve this problem of having higher level of Governor involvement in our work, which I think is something that we can pursue if management, staff, and the Board are willing to rethink the IMFC process, which has ossified into a very formalistic and bureaucratic process, which reduces the level of Ministers' engagement. Let me give you a few examples.

First Mr. Shaalan's minister is now the Head of the IMFC. We should have the drafting of the communiqué not done simultaneously with the Plenary but in the Deputies Meeting that occurs a few weeks before. That is where the drafting session of the communiqué should at least begin. That is a basic question of order.

Second, we should not submit Ministers and Governors to having to listen to a speech by the OECD, a speech by the WTO, a speech by the World Bank. We should have an interactive session where the focus is the interaction between you, the Managing Director, the Head of the IMFC, and the Governors. That should be the focus.

For instance, when we last discussed the IMFC agenda, I was strongly opposed to bringing in very secondary issues, like the Sovereign Wealth Funds, as a topic of the agenda. Let the Ministers and Governors be heard and have the opportunity to interact among themselves with you, with the IMFC Chair, on the central issues of the day in an informal way, not a multilateral monologue where everybody reads out of pre-written statements, but an interaction.

I am quite confident that, if we do this, we do not need to change any legislation in the Fund and will not need to create a Council. We can improve enormously the involvement of Governors and Ministers in the work of the institution by rethinking the IMFC process in a different way.

Mr. Kiekens made the following statement:

I want to react to the intervention of Mr. Nogueira Batista. He has said many issues with which I agree, foremost with the fact that the fallout from the crisis for emerging market countries needs to be properly analyzed. I think that is a very important lesson, and policy recommendations we need to examine.

But then Mr. Nogueira Batista observed that maybe the less attention given to that topic in the papers is because it is less relevant for advanced economies. That might be the case for some, but it is certainly not the case for others. It is suffice to look at the exposure of advanced countries' banking systems to emerging market countries, and you can see indeed that the claims of American banks on emerging markets is a tiny percent of GDP, but that for the smaller economies, their banking systems, be them Dutch, Swiss, Belgian, Austrian, the exposure is very, very important as a percentage of GDP. If I take only two countries in my constituency, Austria and Belgium, together their exposure on emerging market countries is larger in absolute terms than any other G-7 country.

That is why I think it is very relevant also for us advanced countries to discuss that. It is very important that the financing role of the Fund is adequate and that we are very supportive. That is also why we think we deserve a seat at this table, because we have a huge stake in the functioning of the international financial system.

I want to observe that these aspects of countries' involvement in the international financial system are not at all recognized in the quota system. We can discuss that later. This is only in reaction to very adequate comments by Mr. Nogueira Batista.

Mr. Horgan made the following statement:

Let me join with others in thanking the staff for what are very good and interesting papers, and a real sound basis for discussion. I also liked actually some of the frankness in the papers about some of the previous failings of the IMF. I think that wins a great deal of credibility to some of the analysis.

Let me just first talk about regulation. I guess one point I would make is that national sovereignty is a reality; it is not going away. The most fundamental point then is that good regulation actually begins at home. I am not arguing against better international cooperation and better attention to cross-border issues, or international standards with respect to these things, but the fundamental fact is that the fundamental failures were failures of domestic regulation, and that is something that I think probably deserves more emphasis.

My second point, on the regulatory side, is that with many financial institutions there is a real principal-agent problem, and that is addressed in your paper. That is one of the most important issues that, with a lot of the banks and financial institutions, it is not the shareholders who are running those organizations; it is the managers of the organizations who have a completely different incentive structure than the shareholders. I think it is going to be really important to pay attention to the incentives that are provided to managers, particularly in widely-held financial institutions, and the kinds of compensation schemes that these people are subject to.

The third thing I wanted to say is that I agree with the comments in the papers on the need for sort of ex ante rules on resolving banks' and financial institution failures. I have seen some comments by analysts suggesting that banks or systemically important financial institutions should be required to develop their own resolution plans and have them pre-approved by regulators in advance. I am just wondering what the view would be on that, and is that a lesson that we could take out of this, and indeed extending that, you know, internationally pre-agreed burden sharing agreements which you do touch on in the paper. I just question whether that could be beefed up a bit.

Turning to the macroeconomic side, I guess I would put myself in the camp of those who think that macroeconomic fundamentals are an important dimension of the problem as it has developed. It is not just a regulatory issue or primarily a regulatory issue. The regulatory issue is extremely important, but I think there are some macro fundamentals which are also at the heart of the problem that we are facing.

I guess the second point I would just make, and it is a minor point, is I am not sure I agree that inflation targeting per se is the source of the problem. I think there are examples of countries that have had inflation targeting but have not succumbed to the kind of financial crisis. I take it that there are issues associated with that, but I am not sure inflation targeting per se is the source of problem. Inflation targeting has to be supplemented by sound regulation, and central banks have to be involved in macro prudential aspects of regulation, but I am not sure that inflation targeting per se is the issue.

A final point I would like to make on the macroeconomic side is I wonder whether—and I do not know if this is a lesson from the crisis or part of the research program for the IMF—I wonder whether in certain circumstances we have to take a look at the issue of capital controls and under what circumstances capital controls may be an important tool in the toolkit to deal with particular crises. We have seen it in Iceland. I wonder whether there is a kind of research program there that is required on the part of the IMF. I am not in favor of general capital controls. I had a professor from Latin America in the early 1990s so I am interested in this issue.

On governance, I will save my comments on governance for later, other than to say that we are in favor of bringing forward the time period for the review of voice and quota. We think that is something that could be usefully done.

Finally, I have a point on communications. I agree with Mr. Kiekens that this document as it goes out is going to be a really important communications tool. I would err on the side of the documents being actually very hard-hitting in terms of the analysis and in terms of just the way it is constructed and the language that is used.

I think that is going to probably require some forbearance on the part of myself and colleagues in terms of the hard-hittingness, and really some prevention of self-censorship on the part of the staff. I think this is an important tool, and it is better to err on the side of being hard-hitting than erring on the side of being mushy and say, well, there is this and that.

Finally, I come to agree with Mr. Fayolle. I think part of that is actually a better sense in the paper or papers on what are priorities and what are not, what are the most important things and what are some things that are perhaps of lesser importance that are important to talk about, but a better sense of prioritization would be helpful.

Mr. Lushin made the following statement:

I must observe with regret that the proposal to split the discussion is not working. To be credible, I will observe this proposal and will try to limit myself to comments on regulation mostly, and reserve the right for later intervention on other issues.

On regulation, I have just two points. A lot of work has been done with regard to how regulation should be enhanced in order to address the gaps that led to the crisis. This work is undoubtedly very good. One issue missing here is not only that we should have a sound set of rules and regulations, but also the way that these regulations are enforced.

I am saying this because there is a lot of anecdotal evidence that in the boom cycles, when bubbles are growing and when regulation is at the most critical point to interfere, there is some difficulty for regulators to enforce regulations. There is obvious resistance on behalf of market players to being deprived of certain potential income. I am just wondering if this aspect of the problem has been looked at and what could be possible approaches to address this problem, which is the tendency for regulation enforcement to become more complicated on the upswing.

Second, a large issue in regulation is regulation of cross-border financial institutions. I agree with Mr. Sadun that first steps are now being made on this and much more needs to be done. It seems to me that large cross-border financial institutions and the associated problems are just one of the aspects of financial globalization.

Another issue is that some countries are too small to live in this environment of huge capital inflows and outflows. We are not very vocal at advising small, open economies how to live in this new world of huge capital mobility. We advise them to be flexible and to open capital accounts, but what happens in the end we can very well see in Iceland, for example.

The problem is not only with regard to large cross-border private financial institutions, but the problem is that some countries need some kind of framework to survive in this volatile environment of global inflows and outflows.

Finally, let me make a comment on Mr. Kiekens's proposal that our presentation of lessons from the crisis should be much more elaborate based on a larger volume of research, statistical data, and to be more profound. Well, I totally agree with you. The only difficulty I see is that we are not at the end but are at the midst of the crisis. For this reason, the final lessons are still unclear.

For me, it is without question that the Fund would need to have a big say on the reasons and lessons, but I am not sure that right now, given the huge uncertainty we are facing, we are in the best time spot to produce such comprehensive research.

Ms. Lundsager made the following statement:

I will pick up on several of Mr. Lushin's comments. Just briefly on the regulation side, I am sure the staff has looked at our preliminary statement. One of the things that strikes me, first of all, is Mr. Lushin's very good comment on the enforcement side. One can have all sorts of wonderful regulations. If they are not enforced, there is not much utility, so I totally agree on that. I agree there have been failures of enforcement not just in the United States but in other countries as well.

But coming back to Mr. Sadun's position on the cross-border issues and how difficult that is, it comes back to the point Mr. Horgan made that we still have national sovereignty and all our regulators are still subject to their national laws and national regulations. We must find a way to have good national regulation, but also find a way that the implications for other countries are clear and there is coordination among us.

One perfect example of this was deposit insurance within the European Union and what happened when some countries changed their policies. Of course, deposit insurance is very important for sound national banking systems, but it does have an implication on the cross-border movement of capital. Of course, there has to be coordination there.

It would be interesting to see the report released today, the de Larosière Report, in terms of how the European Union will coordinate the extent to which there will be changes in terms of international cross-border agreements, in terms of how all this is going to work. That would be very helpful for the rest of us to see.

On the macroeconomic side—I will continue with that because everybody else is—Mr. Horgan's preliminary statement mentioned the point on exchange rates and excessive accumulation of reserves. I would totally agree with what you said that that was a key part of the adjustment, not just the fiscal deficit in the United States. This brings me back to this perennial point of the relationship between fiscal positions and external accounts, which I continue to find a little bit puzzling because we do not really have a direct relationship.

We have seen in Japan for many years their very high fiscal deficits, very large accumulation of public debt, and yet there were large current account surpluses at the same time. In the United States, we have had fiscal deficits decreasing while our current account deficit was increasing. Now we are going to see a huge increase in our fiscal deficit, as you have all seen reading the papers every day, but our current account deficit has been declining. There is not this one-to-one linkage so I do not think we can blame the whole global crisis on U.S. fiscal deficits, which relative to GDP were much smaller than in many of the countries you all represent around the table. I do think there has to be a much broader analysis, and that is why I come back to the point Mr. Horgan made that exchange rates and foreign exchange reserve accumulation are very key to that.

What is going on here is our real economies are adjusting to what started in the financial sector. A lot of what happens there is determined by what is going on in all our economies, why we are focused on the economic stimulus right now, getting monetary and fiscal policy right.

The reality is that the United States is going to be consuming less than it was in the past, and that is the real adjustment for which all your countries have to prepare and how can domestic demand be strengthened in many other countries to compensate for that, not just to help the United States to recover through more exports.

I realize we are not looking to export-led recovery here, given what is going on in the rest of the world, but clearly in other countries there is going to have to be more focus on domestic demand and not just on export-led. I think those are very key issues going forward on which I am sure the Research Department will continue to focus.

Finally, on the overall package of papers and the prioritization, I would love it if we could have a clear list of priorities, what are the most important areas we should blame and what are the most important areas to fix. I think that is very difficult to do right now, and I do not blame the staff for not being able to come up with a clear list of what are the most important things to do today versus tomorrow, versus next month, versus next year. I think that is very difficult to know.

As Mr. Lushin said, we are in the midst of the crisis right now. The final lessons are unclear. I think it is very difficult to say immediately what the most important priorities are and what the second ones are. I think it is something with which all our countries are grappling and trying to come up with an approach and not leave anything undone that needs to be fixed.

I just think it is very difficult for the staff to say. If it puts something out, there would be many who would disagree. I do not think that is really a fair criticism, but I do thank the staff for laying it out. As we do not agree on this, from the discussion you have heard this morning, we must be careful that this is characterized as the staff's thoughts on this. These issues are still under active consideration across countries, across institutions, not just the IMF, and that there will be much further work to do.

Mr. Majoro made the following statement:

One, the idea that markets work best when totally left alone seems to have become a problem and seems the role of risk analysis and risk mitigation should not have been devolved in this way.

Second, it begs the question as to why the fiscal injections and the monetary injections by the central banks have not actually given the response that was needed from the patient. The patient has hitherto not responded to the fiscal and monetary injections. Is it because the injections are not adequate? Is it because they are not timely? Is it because the persistence of the crisis is a reflection of the confidence that could be undermining the recovery? Can we draw lessons from the persistence of the crisis for the future in times of restoring confidence? Is the problem not that of confidence rather than that of regulation or even failures in macroeconomic policy?

We observed that monetary easing so far does not seem to have helped a lot even when interest rates have hit the 0.2 percent levels. The large fiscal injections also imply that the day will come and we will need to drain that excess liquidity from the system. It is clear we have got to do our primary role of containing inflation and anchoring its expectations. We still have to come back and drain out that liquidity if again we have got to refocus ourselves to the primary target of inflation.

In this type of crisis, I also think that the linkages between the real economy and the financial sector could have broken and that would mean that the staff will need to do more policy and empirical work on the transmission channels of monetary policy and also its effectiveness.

I want to raise another issue to do with policy asymmetry. How do you respond to this crisis as advanced economies are different from emerging economies and different from Sub-Saharan Africa, for instance? Can we talk of policy symmetry in treatment? Does one size really fit all, or do we need to have groups arranged differently and also prescriptions or lessons learned from those particular groups again addressed and drawn out?

Mr. Bakker made the followings statement:

I think these are fine papers, and I would like to complement staff also for the cooperation between the departments. These are frank and open papers, as Mr. He said. It is clear it is work in progress, but I think we need to get out with these papers. It would be good to take a few of the comments on board as far as they are improvements. Let me try to add two or three comments which I think might be added.

I think the main purpose of the papers would be also to position the Fund well. In that respect, first, on the analysis, I listened very carefully to

Mr. Kishore, Mr. He, and some other colleagues. I feel in the analysis we could pay more attention to the use of leverage to finance asset booms in advanced countries. This is an unprecedented crisis which started in advanced countries and which quickly became a global crisis, and I think that aspect needs more consideration.

Frankly speaking, loose macroeconomic policies have played a role and I think that might be stressed. It might also make the analysis more acceptable to colleagues, so I would support such changes in the text.

I think one practical conclusion from that as well is that we see an unprecedented drop in world trade. We have never seen that before. Our national central planning agency—the Netherlands is a very open economy so they are very close on this—is now predicting for this year -10 percent.

We should support more visibly initiatives of the World Bank and other institutions on trade credit. We should speak more loudly on the risk of protectionism, especially financial protectionism. That message should come out more clearly.

Second, it is clear that what we have learned from this crisis is that failures of supervision in large countries, be it the United States or elsewhere, have very important repercussions on other countries. I think that is a major lesson and we need to draw conclusions from that for the IMF. I am not advocating that the IMF becomes the world regulator, but it may become the supervisor of supervisors. We need to look at Article IVs and the way supervision is dealt with in the Article IVs, because we are all seeing the impact.

On the way the Fund is approaching the crisis, I feel that the case-by-case basis we are following has its limitations. We were spot-on when we said that government interventions in the financial sector need to be coordinated, and it seemed that it was a very useful message.

When we deal with countries in difficulties, I believe we face the same issue here, and especially in Eastern and Central Europe, where the case-by-case approach may be not sufficient. I believe that we should be more proactive in seeking regional solutions. In Europe, we need to do more and to actively engage European partners to look for a comprehensive solution or a master plan here. We could also be more proactive in supporting Asian regional initiatives.

Finally, I think multilateral coordination needs to be improved. What I found lacking is that the need for quota reform is very much underlined in the papers, but then it is merely linked to voice and representation. It is an important issue and, like Mr. Horgan, we advocate bringing the quota increase forward, and that needs to be promoted in a more concrete way.

It is not because of lack of governance that systemically large important countries have not followed up Fund advice. On multilateral coordination we need to seek ways to have more traction, to have clearer follow-up. It would also improve the perception that the IMF is more evenhanded in its advice and not solely focusing on emerging economies.

Having said that, I think these are fine papers that are important and we me must get them out with good communication, so that we can profit also from international discussions from academics and policymakers. Of course we can improve this product, but sometimes the better is the enemy of the good.

Mr. Kiekens made the following statement:

I am glad that I can speak after Mr. Bakker. I am sure you listened carefully, as always, and heard his call for the Fund to collaborate better with the European Union entities in addressing the problems in Europe, and that I support fully. I will do my best on my part to have the European countries working well with the Fund and in helping the IMF have the resources we need to do our job. I think we need to have it both sides.

I wanted to react to what Mr. Horgan said that national legislation is here to stay and the critical issue is to have good national regulation, as Ms. Lundsager says. But I would like to stress that the key issue is for regulation to offer a level playing field across the globe. If national regulation, good as it is, has major differences, we will see emerging distortions and arbitrage between regulations that exists nationally. We should not underplay that and we should stress the major problem of coordination and level playing field.

This brings me to another statement made by Mr. Lushin, who said the implementation even of broadly similar regulation is also an issue. He went on to say that there might be a tendency in countries to become complacent on the implementation of regulation in the boom periods, because regulators are reluctant to enforce regulation that could reduce profit chances for banks, but I would document the Board with complaints I heard from bankers about the reluctance of regulators to toughen the stance.

Regulation in essence is a limitation on competition among banks between boundaries that are safe and sound. Banks may be very unhappy to see that the regulator is too lax because it forces them, if they do not want to be priced out of the market, to do the broadly similar, unhealthy, dangerous business than their competitors.

I can assure you there are banks that are well aware of the risks and that feel like a prisoner of the fact that the regulator is not willing to tighten the stance and to avoid or to prohibit the irresponsible banks from going too far. I think regulation has a lot to do with limiting competition. This is my suspicion. It is indeed a fact that some national regulators were reluctant to do that, not so much probably because it would forgo profit for some individual banks but because there were no banks of that country at all operating in that country; it was foreign banks. The regulator may conclude that if banks take excessive risks it will be the home-country regulator's problem, not the host country's problem. That is an issue of international coordination.

The representative from the European Central Bank (Mr. Pineau) made the following statement:

I will just comment on monetary policy and liquidity management. On the issue of inflation targeting, early inflation targetters have recognized over time that there are some limitations to the framework in terms of time horizons and analytical underpinnings. We tend to agree with the staff that even a flexible version of inflation targeting might still need to be revisited when it comes to these two elements, policy horizons and analytical frameworks.

One lesson of the crisis is that a medium-term policy horizon like the one that we adopted from the start of the ECB is better suited to take account of relevant trends that typically evolve more slowly than monetary variables. One might think of asset or commodity prices, as well as credit developments or issues relating to global imbalances, as examples of such longer-term trends that need to be taken into account by monetary policy.

Second, on the analytical framework, in our case monetary analysis, along with the standard economic assessment, has enabled us to consider financial credit and monetary developments when assessing risks to price stability. You may remember that back in December 2005 this monetary analysis played a role in us deciding that upside risks to price stability relating to excess liquidity and to a low-risk premia needed to be translated into policy action.

We agree with staff that there are major difficulties in identifying asset price bubbles, and we agree also that one should not react mechanistically to rapid credit growth. Likewise, it is clear that monetary policy can be assigned only one objective, i.e. price stability. However, the ongoing crisis invites us to revisit the feasibility of "leaning against the wind" in certain exceptional circumstances. In such circumstances like the one we are in at the moment, monetary policy and financial stability assessments, if not objectives, would need to be closely integrated.

This leads me to my second point on monetary policy, and that is this link between monetary policy and financial stability. One of the staff papers examines the quality of the warnings expressed by institutions other than the IMF in the run-up to the crisis. In that context, we find it a bit untoward that staff did not review the relevance of the ECB's communication, particularly through its Financial Stability Reviews since 2004, along with the BIS and FSF.

More fundamentally, we consider that the crisis has shown the need for central bank involvement in financial stability to go beyond flag-raising through monitoring and analysis that are mainly carried out through Financial Stability Reviews. An upgrading of central bank contribution to financial stability would imply greater responsibility for macro prudential supervision, and this would include developing Early Warning Systems, conducting macro stress testing, and advising on financial regulation and supervision from a financial stability perspective.

Some of the proposals included in the report by Mr. de Larosiere issued today tried to assess this gap in current supervisory arrangements. Likewise, the role of the Fed in macro prudential supervision is currently under review in the U.S.

I turn quickly to liquidity management, and here I would like to stress, because it is not totally clear in the paper by the staff, that the implementation of nonconventional measures should not be predicated on the level of policy rates. Such measures may be taken well before the room for lowering policy rates at the zero lower bound has been exhausted. This is in line with our separation principle, but it is also consistent with steps taken by the Fed between September and December of last year. Indeed, nonconventional measures were developed both by the Fed and the ECB after September 2008. Prior to that date, exceptional liquidity management measures by both central banks were reflected in the composition but not the size of their balance sheets.

After September 2008—that is, the failure of Lehman Brothers—the Fed's balance sheet has roughly doubled in size while the ECB has expanded by two thirds, roughly speaking, though the size of the balance sheet of the ECB is still bigger in absolute terms than the one of the Fed. In contrast to the Fed, it is true that the ECB has limited its nonconventional liquidity measures to the banking sector. We thus share the concerns expressed by the staff regarding the quasi-fiscal nature of nonstandard measures that aim at influencing prices and/or quantities in selected segments of the nonbanking financial sector. The characteristics of national financial systems could make such measures less effective. In addition, the lasting impact on the central bank balance sheets would need to be considered. However, we cannot exclude resorting to such nonconventional measures going beyond the banking sector in the Euro Area if the situation would warrant.

I have just a few more technical comments on other aspects of the staff paper on liquidity management, but I will pass these comments directly to the staff.

The Financial Counsellor (Mr. Caruana) made the following statement:

I will follow the order of the three sections of the Initial Lessons paper. The order, to some extent, reflects the notion that responses in the financial regulation and supervision area is one of the key elements in responding to the crisis or preventing the next crisis. We have all emphasized the importance of the other sections, so just regulation alone will not be enough and lessons have been drawn in all the three areas.

Let me start by thanking you for these comments and questions that will help to refine a little bit our explanations in the document. I will try to group the answers to your questions around the basic topics that are presented in the area of regulation and finance, and I would like to start with a very general comment.

Some have asked about missing elements or elements that perhaps we were not giving enough emphasis. Some have compared this paper with our April paper that was presented to the IMFC, and realized that some areas were more highlighted there, for example risk management, or financial industry responsibilities or even rating agencies. We can bring a little bit of that here, but really we were not trying to repeat that document. We were trying to build on that document and go to the basic substantive issues in terms of regulation, and that is again from the prevention point of view. As you know, we have been working on this issue since the beginning of the crisis, and this has been presented in this document that was to the IMFC, but also in the GFSR. There is plenty of work where more answer analytical work has been done.

This document tries not to be very prescriptive because, as many of you mentioned, the crisis is still unfolding, and because regulatory reforms should be flexible in the way that it is presented and approached in different countries. I will come back to this issue of flexibility and uniformity of supervision and regulation at the end of the comments, because there were some questions.

We will try to refine a little bit from the discussion. We would like perhaps to put it a little bit more into context. If it is agreed, I would like to add a box on the work that others are doing in the Financial Stability Forum. That may help to give a little bit of context to that, and that would be distributed before publication. Let me go to the main questions and main comments that you have made.

First, extending the perimeter of regulation is one of the key messages that should come out. There seems to be basic agreement but some word of caution, and at the same time some people saying that we have to be ambitious in how to approach that. We tried the approach that we have presented in different groups, which is an approach that extending the perimeter of regulation should not be an open-ended extension. Someone was saying that it should not be a continuously moving target and it should not be continuously expanding. I think this is absolutely right. That is why the two-tier approach that we are suggesting is a good beginning.

We need a better definition of what is systemically important, and two of the chapters of the next GFSR will deal more analytically with some of the aspects of that. We defend the idea that regulation should be functional, that it should not be based that much on the legal structure of the institutions but on the functions that they perform and, therefore, these two tiers—one basically extending the information that is required, and the other more narrow one on the prudential perimeter—are the right approach.

There were questions about examples. Let me give you an example. The first perimeter is where we ask supervisors for information, under this functional principle of big funds, perhaps with a threshold. It will be obviously banks. It could be all what is included in the shadow bank. They all would have some disclosure requirements. The disclosure requirements will provide enough information for the supervisors to determine which institutions are systemically important and, therefore, which institutions should be upgraded to the second level, which is where prudential regulations will be required. By "prudential regulations" I mean capital and I mean liquidity; it may be the case one of the three or perhaps the three—and a special regime for winding down if there is a problem. This is what we mean by "prudential." It is the right approach to keep it contained, but at the same time to respond to the crisis.

The prudential regulations that we have talked about should differ among the different institutions, so we are not asking for exactly the same regulation for the same institutions but just similar capital regulation could be applied. Let me give you a second example. If one institution, whatever is the legal nature of the institution, is selling protection heavily in the market and, is creating a lot of counterparty risk and becoming an important network of risk, it should have capital requirements for this activity, whether it is a bank or not.

We are trying to capture AIG-kind of approaches. It could be a hedge fund or it could be an insurance company. If they are in this situation of interconnectedness and creating this kind of risks, there should be some kind of regulation. This is what we are proposing.

There was a question about how to deal with the notion of banks too big to fail; is it necessary to put attach some kind of insurance premium? We have not dealt with that in detail. We have prepared one of the few papers that mentioned this issue, at least for consideration. The approach that, in principle, we think is sensible to take is that it has to be recognized that the surveillance and the prudential requirements may be strengthened if the supervisor thinks that the size of the institution adds risks to this institution and in that way you could require additional prudential requirements to that institution.

The second big element that we introduced, and there were some questions about it, was the procyclicality or trying to address procyclicality in the financial system and in the present regulations. The key notion that we are trying to present here is that it would be better if this is kind of rule-based, it is ex ante, it is preestablished and not something that the regulator has to decide in the middle of the situation, but the rules are known before. That is good for the regulator and also for the banks that have to make the plan for their capital. There is more transparency. Of course, these do not rule out the fact that there could be additional measures that, on a discretionary basis, have to be taken by regulators when it is required.

On the leverage ratio, some concern was expressed. We present it as a supplementary; it is not the key element but is a useful supplementary and in our view, is a lower hierarchy from the risk-weighted kind of ratios, but it is a useful ratio.

On procyclicality, let me mention that we always tend to talk about capital, but we should talk about other elements, and we talk in the paper about other elements such as accounting, etc., that has also the capacity to influence the procyclicality. We also present the approach.

Finally, we agree that the transition to a higher level of standard of capital should be gradual and it should take into account the necessary graduality that is required to get out of this present situation. We are not dealing with how to get out of the present situation. We are thinking of the endgame of the future. Standards have to be improved, and there is a huge amount of work needed on that.

There was a very direct question about the Basel process. There were in some grays mentioned of Basel II problems, etc. I would like to say that this crisis is not a test for Basel II. It is a test for Basel I. Basel II was not even implemented in the United States, and in most countries it was in the transition phase, so this is not a test of Basel II.

But there are plenty of lessons to derive from this crisis for Basel II, and this has been taken into account—they are being taken into account, the procyclicality that I mentioned and some reinforcement of the structural programs, the trading book. I mean, there are plenty of lessons to learn in all areas.

There was a question on the discussion about consolidation. First, when I was there, these had already been discussed so I was not in that discussion. In any case, the consolidation of off-balance sheets in the banking group is also an issue that is related to accounting, and I think it was on the accounting where the clarity was not that clear. I think there was room for supervisors to do it properly, but it was not that clear. Now accountants are moving toward better and clearer frameworks for consolidation of the off-balance sheet exposures into the banking groups and that would be an improvement, and this is work going on.

There was a very specific question about prudential approaches and capital controls. Let me say that, to the extent that it is possible, I think prudential approaches, especially when the prudential has been taken years before and it has been working through the years, are a much better approach. On some occasions, it may be necessary to think about capital controls in these cases. I think it is important to recognize that these measures do have tremendously high costs. The effectiveness tends to diminish with time. Therefore, if there is an extreme situation where these have to be implemented, it should be to buy time to prepare a real package of additional measures and real measures that would address the problem that we are trying to solve.

There was a question on the role of the IMF in this area of regulation. I think the IMF has an important role, has had already an important role in different areas. It is not a standard setter, but it can contribute to the debate of the standards. It can contribute to find gaps. I remember when I was on the regulatory side, the Gaps paper that was produced here was a very effective paper and a very useful paper.

Of course, there is the area of surveillance and helping implementation and monitoring implementation. This is the core of our business and extremely important, along with paying attention to the macro financial and the cross-country, as we have repeated many times.

There was a very direct question to what extent there was evidence of relaxation of lending in other countries in addition to the United States. There is some evidence of relaxation in other countries. I do not think that we are in a situation as severe as the subprime mortgage market here in the United States, but there was relaxation, for example, in terms of the high loan-to-value ratios that have been used in some of these countries, after a long period of optimism. Supervisors should be aware of that.

There was another question about one comment that we made about the cross-border liquidity provision—and I am moving now to the liquidity part—to what extent there was a better mechanism, we mentioned these words, and this has raised the question what is this better mechanism. Basically, it was in relation to swaps between central banks. These swaps worked very well, so we were very supportive of the action that was taken.

The issue here is more that, in some countries, the proportion of the swaps in relation to the problem of the difficulties of liquidity in foreign currency calls for some ex ante standing arrangements that could be set up between countries, especially when there is a banking relationship that could lead to this kind of liquidity issues. That is what we tried to say with this comment. Again, understanding how you read our comments, we can modify slightly the language, not to change the meaning but just to explain it better.

There were some comments about what we said on lending based on collateral. The concept that we wanted to say was very simple. We thought that the primary factor of lending should not be collateral but should be based on the capacity of the borrower. Of course, good collateral is important. It was not much more than that.

There was a question trying to compare why we said that asset swaps are better than term lending or interbank guarantees. Again, we are not talking of facilities or instruments or tools in normal times. We are talking about tools in crisis management toolbox. It was in that context that we were discussing that.

We tend to think that interbank guarantees have proved to be complex, because of the coordination and because of differences on how this had been implemented among countries. Term lending has been okay in the sense that it has worked well, but none of the instruments have been able to reignite some of the markets that need to work. This is not a criticism. These asset swaps were needed in our view, and tend to be a little bit better from that perspective and seemed to have worked rapidly and better. That, again, is not talking about normal circumstances; it is talking about crisis situations and not talking about permanent tools.

My last comment would be on coordination with other bodies. There was a question to what extent the implementation group under the Basel Committee creates some issues with the work that we are doing. It is just the opposite. I think it is a welcome development. The fact that the AIG changed its name and changes a little bit in nature and extends their scope of activity is welcome. We have been working very well with them. Our approach to that is our pilot exercises to Basel II and to other activities, and it will be even better to have an interaction with this group and it will continue to be helpful in our relations with them. We are not overlapping with them. They are doing different things than what we are doing. We will be able also to profit from the discussions that they have not just on Basel II implementation but in other areas. That is a positive element.

On coordination between central banks and supervisors, we think that one of the key lessons is that central banks have a very important role in systemic stability in different countries, and that includes accessing all the necessary information, even the supervisory information of individual banks. That has been stressed since the beginning and we said that a long time ago, independent of how the different countries are structured in terms of who is in charge of prudential supervision and who is not. Central banks have an important role, and this should be recognized. I think the trend goes in that direction.

Finally, my last comment would be on this issue of flexibility in the implementation of regulation and harmonization. On harmonization, we use sometimes binding codes, international charters, and these have raised some concerns from some people. The two main points that we want to make here is that we have to be flexible and we have to understand that countries are different and that national responsibility is the key element. There is no doubt about that. I think this is a question of balance and we are way out of where we should be. We can make the consistence and the convergence of practices much better than it is at this very moment. I think the Fund has to go in that direction. In the area of early intervention, in the area of crisis resolution, we have to do better.

Most importantly, we have been always talking about how to improve coordination. The second idea that is in the paper is that, if we do not get some additional improvements in other areas which usually are not in the supervisory purview of supervisors and some legal frameworks for resolution, the coordination among supervisors moving forward on that frontier is going to be extremely difficult. These are the two main elements that we want to promote.

We will take on board your comments. We would like to make some minor changes and, if that is acceptable, we would like to put an additional table to put that into context which will explain the work that is being done in the FSF and the G-20 so that our work is put into this context. This will be distributed to you.

Mr. Kotegawa recalled that the investment banking industry had opposed efforts of the BIS Secretariat to mandate that the off-balance sheet activities should be on the balance sheet. Furthermore, when listing standards on the New York Stock Exchange were strengthened in the aftermath of scandals related to Enron and WorldCom, there was a widespread argument that New York lost competitiveness to London.

Mr. Gibbs made the following statement:

> I wanted to thank Mr. Caruana for clear and helpful answers, and also to join those colleagues this morning who thanked staff for an excellent set of papers that cover a very broad range of issues. Notably these issues are covered in a relatively lightweight packet, given the substance that is covered, so I would like to congratulate staff.
>
> I said in my gray on this section that I agree with the key headline messages from this paper, so I do not have much more to add. I welcome Mr. Caruana's proposal to supplement the paper with a box detailing the work with other institutions. I would not say it is a lesson from the crisis, but it is a lesson that I am learning over time that the Fund's work can be strengthened by collaborative work with other bodies and other institutions.
>
> We all know that this poses organizational challenges, poses challenges at many different levels. The FSF certainly needs to expand and we are arguing for that elsewhere, but I think there have been great steps forward in terms of collaborative work with the FSF. There may be further to go, but I think it is important to recognize the progress made so far. I am grateful for the many benefits that are showing through in this work.

Mr. Daïri urged staff to investigate further issues related to foreign involvement and investment in domestic financial systems and the long-term effects, drawing conclusions from the current the current crisis.

The Financial Counsellor (Mr. Caruana) replied that off-balance sheet accounting issues remain very important and staff will continue to analyze the implications. Generally speaking, current reform efforts are in the right direction.

The Economic Counsellor and Director of the Research Department (Mr. Blanchard), in response to comments and questions from Executive Directors, made the following statement:

> I am going to try to answer the main questions raised in the grays and then some of the questions which came up this morning. The first point is a general point, which is that from 2001-07 there was high growth and for the most part that growth was actually healthy growth; with productivity growth with low inflation. That is an important point to make.

However, at the same time, as in any sustained growth period, there were imbalances problems. Some countries had deficits which were too large. There were current account imbalances. I think there was a great temptation, in looking back, to look to things that each of these factors was actually responsible for the crisis. That is a temptation we have to resist. These may well have been the effects that we have to repair now or later, but it does not follow that they were actually responsible for the crisis, and I think part of the difficulty of drawing lessons actually comes from there, so let me make a few points along these lines.

The second point is on global imbalances. Global imbalances are not a cause but an outcome. One has to look behind and decide where it came from, and I think there is general agreement that it came from the geographic distribution of saving, high saving in a part of the world and low saving in another part, and then from the fact that for various reasons, which actually change with time, there was a strong preference for U.S. assets on the part of foreign investors. The result of this was that basically there were these large capital flows largely to the United States, and there were low world real interest rates, which corresponded basically to what Mr. Bernanke has called the "savings drought."

By itself this is not a catastrophe and this is a fairly pleasant environment. Low real rates mean that there are all kinds of projects which are worth financing and it is something that we should basically like. What we have learned is that this is an environment in which over optimism becomes prevalent, and the statement of risk becomes prevalent. People want more return for their money, because they are not getting much for the riskier assets. There are people on the other side who are more than willing to invent things which look like they have high return.

In principle, regulation stops that kind of behavior from actually taking place. I think that regulation failed. In the end, I do not think global imbalances contributed in a major way to the crisis. The main culprit was deficient regulation unable to stem these dangers.

This being said, it is not because they are not the cause of the crisis that we should not draw some lessons from global imbalances from high capital flows. I think that the lesson from this crisis, as with many other crises, is that we have to be very wary of very large capital inflows both on the way up and when they are on the way down. They create over optimism, they create distortions, and we have to be careful. In that context, the notion that we might want to revisit and consider capital controls is a reasonable thing.

By capital controls, this may stem from limits on foreign currency exposure of domestic borrowers to more dramatic measures, but I think this crisis really forces us to think about this.

The third point, on U.S. fiscal deficits, I think there is no question that U.S. budget deficits were too large. It is clearly constraining the ability of the current administration to do more. Were they a major contributor to the crisis? Again, I think the answer is no, it is not where the crisis came from. It does not mean that we should not do something, but I do not think they were a major contributor to the crisis.

The fourth point, on monetary policy, is that the fashion for the last ten years has been to agree that inflation targeting was really the way to run monetary policy. If you thought that one should worry about asset price booms or credit booms, the burden of proof was on you to prove that it was actually essential. I think what this crisis has shown is that the burden of proof should be on the other side. What we have learned is that when these disequilibria happen, they are extremely hard to correct, and the notion that when things turn around you will be able to stop them by lowering interest rates has proven not to work. There is a very strong asymmetry in the build-up then and the sharp decrease thereafter.

In the Chapeau Paper and the background paper we emphasize that not all asset booms or credit booms are alike; some are more dangerous than others. We suggest constructing measures of systemic risk which would allow us to distinguish between the two. Some booms are more dangerous, some would lead to an increase in systemic risk, and others would lead to less of an increase. There is a lot of work to be done here by basically constructing these measures and monitoring how they evolve over time, and this will be an important instrument for central banks to have.

The second point we make here is that once the central banks have constructed these measures, then they may have to pay attention and react when these measures indicate that the risk is really high. This is very hard to do. There is collateral damage in the sense that you do things to the rest of the economy and not just to the market that you tried to dampen. That should be the last line of defense. Regulation and surveillance is really the way to go about it.

These are the major points that I wanted to make in answer mostly to the grays. There are three smaller points that I will take. First, there was a question on taxes and tax deductibility of interest payments. Eliminating tax deductibility of interest payments both for households and for firms would lead to a level playing field between equity and debt finance, and that was the point we were making in the document. One of the grays mentioned that we should go further and think about not taxing savings and moving to a consumption tax. This would clearly have desirable implications. It would not deal directly with the leverage issue, which is what we were focusing on, but it is clearly something which should be considered, despite the political problems associated with it.

Let me repeat the second of the small points Mr. Caruana has already actually addressed. We say at some point that collateralized lending may be dangerous. This is clearly in the context of asset bubbles. Good collateral is a good thing and we surely are not against lending against good collateral, but when the type of collateral that is used is easily subject to bubbles, then the cocktail basically becomes dangerous and that is what we were pointing to, not that we are against using collateral in lending.

The last point raised this morning was on liquidity provision. What has happened since the beginning of the crisis is that central banks have extended liquidity provision by basically accepting a much larger range of collateral. I think the issue there is whether this should be something which is done only in times of crisis or whether we have learned something about actually allowing for fairly large liquidity provision even in normal times as a way of preventing some of the problems that cropped up during this crisis.

I think this is very much an open issue. My sense is that one of the lessons will be that larger liquidity provision against a larger array of assets with the proper haircut is properly one of the directions that we will want to take.

Mr. Henriksson made the following statement:

I have a question, and that is in the Chapeau Paper on Bullet Point 17. I listened carefully to what you said, but I read the Chapeau Paper the following way: It says that some central banks saw monetary policy as too blunt an instrument to counteract asset price booms, and I agree with that. Then you say that this assumption has been proven wrong, and I do not agree with that. I do not think you agree, either, because you have written the report like this: “Some central banks saw monetary policy as too blunt an instrument to counteract asset price booms”. Then you say that this assumption has been proven wrong. I do not agree with that, and I do not think that you do as well. So I would review the language there.

My experience is that economic policy is very much like fighting. We spend all the political capital trying to fix the problems behind us. This is like conducting economic policy by driving a car by only looking in the rearview mirror. Let us say we have had this big crisis and now we are going to do things to prevent what happened before. The question is what is the next crisis we are expecting? Could the next crisis come from reacting too fast when asset prices go up?

If the stock markets and housing prices go up, one response would be to immediately raise interest rates dramatically. Will that create an environment with low long-term growth? I do not know. I am asking you to consider that. It may seem strange to talk about overregulation, but that might happen. Please provide your views on both issues, and tell me if I have the wrong impression.

Mr. Sadun made the following statement:

I want to thank Mr. Blanchard for his very clear and lucid comments, but I would beg to differ with his remarks on a couple of key points.

I believe it was Oscar Wilde who said that the only way to deal with temptation is to succumb to it, and I am going to take that advice. I am going to succumb to the temptation to find something wrong with so-called 'excessive' growth and the notion that policy did not matter. Policy did have a crucial role in, if not triggering the crisis, at least in creating the conditions for the crisis to explode.

It might sound ungenerous from my part to label the very rapid growth that the world economy has enjoyed for several years as excessive. At the risk of using that unfavorable label, I have come to the conclusion that there was something wrong with the type of growth that we experienced just before the crisis. My assessment is that part of the growth was a direct result of unsustainable policy, excessive financial leverage, excessive consumption, and excessive utilization of fiscal instruments to artificially push growth to an unsustainable level. I am very much convinced in that regard.

This brings me to the second point: that policy matters. As I said, it is unavoidable that policymakers should take responsibility for contributing to, at least, creating the conditions that led to the crisis. I am very keen on that not only because I do strongly believe that is the case, but also I believe it is extremely important that this aspect be underscored by the Fund.

If you want to draw any meaningful conclusion from the crisis, we also have to include in our analysis the fact that, if the crisis exploded, it was certainly because finance regulation was insufficient, but also because there have been a number of policy failures. I think that is a very important lesson that we should underscore, simply because we do not want, once the acute phases of the crisis are over, to recreate the conditions to face another crisis a few years down the road. I think it is very important that the IMF does not miss the opportunity to send that message loud and clear.

Mr. Stein made the following statement:

I would like to thank staff for these papers, which I found very comprehensive and insightful.

I would like to support what Mr. Henriksson said that we need to avoid trying to win the last war, rather we also need to look forward. I think it is not only discovering what the next crisis would look like; even before that you have to think about what the world will look like after this crisis. In this regard, I have my doubts that we will be able to return to the same growth rates that we had in recent years. The consequences of that fact have to be point analyzed. This is missing in these papers, but I would not request that it should be there because it is still too early to come to conclusions.

The second point I would like to make is that I venture to disagree with the picture that Mr. Blanchard has just painted. I think it is too mono-causal. My question is basically: would the crisis have happened without the imbalances, or would the crisis have happened without weak regulation? I would say to both that the answer is no. The imbalances exist, and without the imbalances we would not have all this capital that had flowed into one country to allow for this increase in leverage. Had we not had these capital inflows, I believe it would not have made a difference whether we have regulation or not because there would not have the means to create these bubbles. Therefore, I believe we cannot say one is the reason and the other one is not. I believe we are in a multi-causal world and that is why we have to also look at solving the problems in a multi-causal way.

Mr. Rutayisire made the following statement:

I have two issues of concern. One concerns cross-border capital flows and restraining domestic borrowers from foreign currency borrowing. It seems to me like this could affect low-income countries, especially if we do not take into account the players that are behind these capital flows. For instance, if I imagine of a subsidiary of a big coffee company based in Geneva lending money to a subsidiary in my country, I know some will say that this subsidiary is producing for export, but we cannot ignore that some subsidiaries that are producing for domestic markets are also as important as those which are exporting, especially in terms of employment. If we impose restrictions on where these subsidiaries can source their financing, this could discourage foreign direct investment to these countries. So, one needs to take into account the different players that could be behind the capital flows.

Second, when we started these informal and formal discussions about the current crisis, I remember the Chairman saying that monetary policy is going to be looked at in a comprehensive perspective, especially considering that we are dealing with situations in which we have generalized market disruptions. When I look at the macroeconomic paper, I see an approach that tends to narrow the focus rather than maintaining a comprehensive outlook. For instance, if I look at the current situation, I would imagine that monetary policy that is going to have an impact on interest rates could have conflicting impacts on market players. For example, those who are buying credit default swaps are better off if interest rates remain high or if they go higher, because their premium is going to be based on the value of underlying assets, which is low. If I look at the other side, those who are providing credit default swaps would be worse off if interest rates go down, because the value of the assets that they have undertaken to indemnify is going to be priced higher and they have to higher liabilities. So, I could see those players having a tendency to oppose interest rates moving in either direction. That could affect the trend that we would want to see in terms of an accommodative monetary policy through the lowering of interest rates. Could one not say that monetary policy is going to be effective if it is accompanied by a quick cleaning up of toxic assets and liabilities than relying on standard monetary policy alone?

Mr. Moser wondered if staff looked at both the range of collateral allowed as well as the operational target for the interest rate when assessing the operational framework for liquidity management

Mr. Yakusha made the following statement:

Let me start with this issue of collapsing trade flows. We have heard the numbers: Chinese imports down by 46 percent; Japanese exports by 30-something percent; and U.S. trade down by almost 20 percent. Several countries are already feeling quite a lot of pain as a result. Given that the lessons paper does not address this trade collapse, the paper is basically is not following the requirements of our Articles of Agreement, which charges us to promote international trade by maintaining financial stability through payment systems free of restrictions. Of course, the logic of Mr. Blanchard argument that global imbalances have nothing to do with what is happening and it is more or less about basically regulatory failure is one of the plausible examples why trade is collapsing now, because we see the growing unavailability of trade financing insurance. On the other hand, I am afraid that I am more in the camp of Messrs. Sadun and Stein in questioning the sustainability of the overall growth model this trade expansion was based on.

Frankly speaking, if you think of this being a problem of the major economies in the world, then we did quite a good job on the Asian growth model based on high savings and heavy exchange rate management. If you look at the counterpart of the Asian growth model, you will see an unsustainable growth model based on consumption which, in turn, is based not on real income growth but on virtual income growth. We are not just talking about the United States, but also many emerging market economies, which also basically show a lot of global demand based on unsustainable credit booms fueled by the same capital inflows. If you look at the United States—because macro economically the United States is obviously more relevant—again, if those numbers are correct, in 2006 U.S. households took almost $1 trillion in mortgage equity, and this incidentally is very similar, in terms of numbers, to the U.S. current account deficit.

Looking back at trade developments, which grew strongly from 2005-07, and then suddenly collapsed, you may think that this trade growth was based on something that was not, from the very beginning, very sustainable. I am very much in agreement with Mr. Stein that we may not see the resumption of high trade flows and growth indicators in many countries until we address all those inconsistencies in the policy mix. Here, I am talking not only those inconsistencies we have been discussing with respect to emerging market countries, but also inconsistencies in the policy mix of industrialized countries, especially those countries where growth was clearly based on housing and other asset price booms.

Mr. Kotegawa made the following statement:

I was just inspired by Mr. Yakusha's intervention, so I would like to just make an observation regarding Japan's exports.

Japan's exports to the USA consist of relatively expensive items, and we have observed a much larger decline of exports to the USA compared with other markets. This comes from a shift of U.S. consumers from the high end to the low end goods. This also reveals how dependent Japanese manufacturers were on the world market despite the fact that they have already established many factories abroad. As Ms. Lundsager rightly pointed out this morning—and I also made the same point in an intervention last year—the world might have put too much burden on the U.S. as a global locomotive of growth. As a result of the decline of the major advanced economies, we have observed the squeeze of our economies all over the world.

I would just like to add that, until November, the major part of the decline in exports was explained by the decline of exports to the USA, while starting in December our exports to other countries, such as Asian countries, started to decline, which is the second-round effect. Having said that, I would like to ask Mr. Blanchard, whether economic imbalances have been frequently observed in the past. For example, in the 1970s we have observed imbalances as a result of the two-time oil shocks. Then in the 1980s we had mainly a big trade imbalance between Japan and the USA. More recently, there has been a big trade imbalance between China and the USA. Also, when we talk about the bigger crises, there were lots of crises: the 1980s in Latin America, the 1990s in Japan, the late 1990s in Asia, 1998 in Russia, and now again.

In the case of the imbalance between Japan and the USA in the 1980s, we tried to remedy this imbalance by artificially realigning our exchange rates, which at that time we thought was the right way to do. There is an argument that this actually triggered the big crisis in Japan.

When we look at the big crisis in Japan or Asian countries, this crisis took place on the side of the surplus countries, but this time it is completely opposite. So, while I appreciate your focus on the capital flows and your finding that the major culprit of this crisis is regulation, I am also personally very much interested in looking at those other previous imbalances.

Mr. Kiekens made the following statement:

Mr. Chairman, following up on what Mr. Kotegawa said, I think this crisis is in many respects similar to previous crises, and we should outline that it is not that this is unprecedented. Of course, there are unique features, especially that this is now a truly global crisis due to the integration of financial markets.

I broadly agree with what Mr. Blanchard said, and I am grateful for his clear exposé, but I believe that we need to nuance somewhat his assertion that macroeconomic policy is not the main culprit of the problems. I think there is a more balanced picture, which is that there is an intimate interaction between failures at both the macro policy level and the regulatory level. The failures at the macro level are very clear—inconsistent monetary policies and inconsistent exchange rate policies, which led to the creation of huge policy-driven primary liquidity. This later supercharged by financial sector-driven liquidity, which brings the regulatory aspect into consideration. We have discussed the global imbalances for years now, which we have always characterized as a result of failures in macroeconomic policies, and I think global imbalances are a major part of the build-up of the crisis. The very low savings of households in the U.S. were a result or an outcome of both, in my opinion, macro policies and deficient prudential policies. Thus, we should identify both causes of the crisis: excessively low saving by U.S. households; and, the mirror image of that, excessive leverage and indebtedness.

What are the macroeconomic sources of this savings behavior of households? First, tax incentives in favor of borrowing for housing and consumption are a major factor behind the current account deficit in the U.S.

The second cause, certainly for macroeconomic policy at the global level, is the overvaluation of the dollar and the undervaluation of exporting countries. It is a huge incentive for a consumer to buy consumer goods at an overvalued currency? Or is it a huge subsidy for countries that accept an undervalued currency to sell their consumption goods at an undervalued currency? Both contribute, but there was an inconsistent exchange rate policy at the global level, as we have pointed out for many, many years.

Third, the willingness of surplus countries to lend in order to finance these deficits at prevailing exchange rates certainly provided the possibilities, by and large, for deficit countries to finance their excessive consumption.

That said, there are also micro-level regulatory deficiencies, most obviously the lack of adequate supervision of mortgage markets and mortgage lending in the U.S.

What is missing in the analysis is that we should analyze in detail why these deficiencies were allowed to occur and to continue, which is a socio-political phenomenon. I think we need to examine more in-depth the effects of globalization on labor income, and the effects of low interest rates on housing and asset prices and housing costs. This conundrum that housing has become unaffordable unless it is financed at highly subsidized rates is something that we need to analyze. It is a major cause of the crisis and it would not be correct to overlook all these factors.

For many years, the Fund has identified the global imbalances, but we missed clearly one point. We were warning of a disorderly unwinding of these global imbalances because we feared that it would lead to a disorderly devaluation of the dollar. This did not happen fully. What we missed was that a deficit is always, or at least to a large extent—and this was certainly the case in the U.S.—covered by borrowing. We failed to examine in-depth whether the borrowing entities in the economy and in the U.S.—i.e. mainly households—was able to sustain this level of indebtedness. We have asked repeatedly whether the debt sustainability of households was an issue for concern. The staff examined the matter, and I think we made mistakes in that regard. Whether or not we were confronted with an unsustainable bubble or not lies in analyzing the sustainability of debt. If you are not convinced that those economic agents that are contracting debt will be able to repay on reasonable assumptions of future income and reasonable assumptions on asset price developments, we are in trouble. The most fundamental rule of banking needs to be observed: give credit only if you are reasonably assured that the debtor will be able to repay. We overlooked that at the micro level and we overlooked that at the macro level.

Mr. Lushin made the following statement:

It is a very interesting discussion, and I would like to add my voice in favor of the position first presented by Messrs. Sadun and Stein, which argues that there is a link between global imbalances and the current crisis. Mr. Stein is absolutely right that, without global imbalances, the deficiencies in regulation alone would not have given rise to this crisis.

The financial crisis and global imbalances have one element in common, and this element is the huge accumulation of private household debt in some deficit countries, most importantly in the U.S. The incentives behind this are numerous and could be discussed, but the basic risk is clear: household debt in many deficit countries went beyond the levels that could be judged as sustainable. The manifestation of this came not through the disorderly unraveling of global imbalances, but rather through the financial crisis in the form that we see today.

Let me make two observations in this context. The fact that we did not witness the resolution of tensions in the global economy through the way that we have anticipated previously—that is, the unwinding of global imbalances—does not mean that this threat disappears. It stays with us, and I think it is becoming even more dangerous. Certainly, investors had a strong preference for U.S. assets, but this strong preference cannot go on indefinitely. At some point, even the most trustworthy assets, if they are expanding at a high pace, may come under risk. The point is that the risk of global imbalances has not disappeared. If global imbalances unravel it could well be the end of the world as we know it.

The current crisis and the global imbalances are closely linked with the overall framework of the international monetary system as it existed over the last decade, i.e. a system where the U.S. dollar served as a de facto global reserve currency. I very much agree with Mr. He on the risks associated with a national currency also serving as an international reserve currency. In essence, that country has the privilege of borrowing without concern for any budget constraint, and this is a very dangerous situation. On the one hand, international investors crave dollars because they need hard assets in which to invest. Only dollars can fill this role, which is a problem, because it gives rise to disturbances and disequilibria in the global economy that cannot be sustained indefinitely. As such, I very much support the proposal in Mr. He's statement that we will need to think about the global architecture in general, including possibly on scenarios for the diversification of reserves or to create a reserve currency or reserve asset that is not linked to a national currency.

Mr. He made the following statement:

I found the comments of the previous speakers very inspiring, so I cannot resist the temptation to elaborate on some of the points.

First, I believe Mr. Kotegawa's comment was very enlightening. Looking at the exchange rate movements during the last few months, it is notable how stable these have been compared to previous episodes of financial instability. At the same time, trade flows have been very volatile. I think that the underlying driving force is this deleveraging in the U.S., which could also be termed as a rise in U.S. saving. This is being driven by demand rather than the exchange rate, which confirms again that the exchange rate does not matter much in determining the current account.

On Mr. Kiekens's comment, I found it very interesting and difficult to explain that, in spite of the surpluses flowing from the Asian and Middle Eastern countries, the impact of this crisis, which originated in the U.S., has been most severe in Europe rather than in Asia. It is possible that Asian and

Middle Eastern investors are very naive investors, so they just buy U.S. Treasuries. At the same time, the sophisticated investors in Europe, especially Western Europe, invested relatively heavily in the subprime sector. Based on the overall aggregates, it is not easy to see the true picture; so, we have to look in depth into the underlying factors that are driving the trend.

Mr. Kiekens made the following statement:

I would like to respond to Mr. He. It is absolutely correct that an aggregate current account surplus does not imply being trapped in the American subprime crisis. Indeed, European banks were naively misled into investing in these assets. One of the reasons is clearly that these financial institutions did not do their due diligence. One big surprise for many European investors concerned a one-way bet that exists in the U.S. mortgage market that does not exist in Europe. If you are indebted under a mortgage loan and you give up the collateralized real estate, there is no recourse to financial or other assets, nor to current or future labor income, which is a huge incentive for households in the U.S. take a one-way bet. In other words: You buy a house, you know you cannot repay the loan, but you hope—naively or not—that the value of your house will go up. If it goes down, then it is not a big deal. You give up your house and you did not lose more than maybe the equity you were able to build up. We should probably examine whether this provided an excessive incentive, or perhaps served as a means of subsidizing the American consumer into excessive indebtedness.

Another aspect that we did not examine is that, for a reserve currency-issuing country like the U.S., disciplining force of the market on external debt is much less effective than for other countries. A country that needs to finance its external debt in foreign currencies cannot default by devaluation. The U.S., in my analysis, can run away, at least in part, from its external indebtedness simply by devaluing or allowing its exchange rate to depreciate. This also needs to be pointed out as one of the possible causes. However, the responsibility does not solely rest with the debtor country; it rests also with the creditors. It takes two to tango, and as I said once many years ago, these global imbalances will only stop when creditors are more cautious in giving credit to those that need to finance their excessive consumption.

Mr. Daïri agreed with the points made by several Directors on the role of macroeconomic policy, global imbalances, and the quality of economic growth from 2002-07. He noted that successive World Economic Outlooks had clearly attributed high U.S. economic growth to rising private consumption from borrowing backed by asset price increases which, in the context of negative savings, made growth extremely sensitive to a decline in asset prices, with direct implications on the financial system.

Mr. He noted Mr. Kiekens' comment that it takes two to tango, but pointed out that sometimes a single dancer could also tango. If the U.S. were subject to market forces, then interest rates would likely need to rise in order to finance the fiscal deficit.

Mr. Lee recalled the objective of the meeting was to ascertain some lessons from the crisis in order to avoid its recurrence. He reiterated that emerging markets were expected to bear the brunt of the next stage of the crisis, because capital inflows from advanced countries to the emerging markets were drying up, which created a risk of sharp depreciations and a sharp drop in equities. He asked staff what measures might prevent the onset of the next stage of the crisis, and what would be the appropriate role for the IMF in this regard.

The Economic Counselor and Director of the Research Department (Mr. Blanchard), in response to comments and questions by Executive Directors, made the following statement:

> These are difficult issues, and there is clearly room for disagreement. Indeed, there seems to be some disagreement between the staff and at least some of the Board members, and perhaps even among Board members. Again, these are only initial lessons and we will have to revisit these later.
>
> Let me start with the easy stuff and then finish with global imbalances, which was at the center of so many of the questions.
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> On the easy stuff, I noted a point of agreement with Mr. Kiekens on fiscal policy. It is clear that we have a fiscal framework that is providing incentives to firms and households to take on fairly high leverage. Although I do not think it has played a central role in triggering the crisis, it is now coming back to haunt us. Indeed, we are now entering a phase where the high leverage of households and corporations may well become a major issue.
>
> The second point of agreement is with Mr. Henriksson. We read the paragraph he mentioned and I think that he is right. The third assumption on monetary policy being too blunt a tool to be used to address asset price developments is a matter of opinion. The statement is too strong and we will correct it. The other point of agreement is about fighting the last war. Indeed, this is what we are good at. If there is another subprime crisis in the U.S., I think we will be ready for that one. The hope is that we will be ready for more. It could well be that the next shocks come from outside the financial sector, in which case this will be a different game.

If the next shock does in fact come from the financial sector, I think that one of the lessons of this crisis which will be useful is this notion of systemic risk. We are going to construct measures that are going to be better than what existed and we are going to monitor them. Will these be perfect? Surely not. Nevertheless, I think there will be a major improvement upon what we have used in the past. Even if the next crisis does not manifest exactly in the same form, it could come from somewhere in the financial sector, and in that case we might be able to detect it earlier than we have so far.

There were some other questions to which I am not going to do justice. Was world growth excessive or not? I think we can debate this. This is a question of how much of the X percent increase in world GDP between 2001-07 was healthy, and how much was not. None of us at this stage can give an answer. My believe that most of it was probably healthy, and then some of it was due to the imbalances.

On global imbalances, let me just state my views beyond the paper itself, which I hope will clarify the way I think about this issues. The question is not whether global imbalances were healthy or not. I think there is general agreement that they are not healthy. These arise from a number of distortions. On the one hand, these are low private saving in the U.S. due to some tax distortions and large deficits. On the other, Asian saving is largely—especially in the recent past—reserve accumulation, which is an incredibly inefficient way of insuring against shocks. There is a need for better arrangements, such as credit lines. So, there is no question that what is behind global imbalances is partly distortions and that we should correct them.

Is there a sense that these imbalances are dangerous for the world? Yes, I think the worry that the Fund had that the dollar could basically depreciate suddenly when investors had a change in heart was not an unreasonable worry, and it is something we should worry about in the future. We have to work on policies that enable these imbalances to be gradually unwound over time. That is not at issue. What is concerns whether these imbalances contributed to the crisis as a first-order factor. In that regard, I think the argument is much weaker.

I want you to think about the following conceptual experiment: Suppose that the multilateral discussions had been successful and we had been able to decrease Chinese saving and increase the U.S. saving in such a way as to keep global saving the same and, as a result, eliminate capital flows from China to the U.S. This would have been a world without global imbalances.

Assume also that monetary policy had enabled maintaining output at the same level. In that world, the interest rate would have been the same by construction. While there would have been no Asian investors wanting to invest in the U.S, the slack would have been taken up by U.S. households wanting to invest in the U.S. exactly in the same amount as the Asian foreign investors did.

Would they have made very same choices as to what kind of assets they wanted? They would have been in a world in which the interest rate on riskier assets was very low, so they might have been very tempted to also go for the stuff that in hindsight we know was in fact too risky, and the outcome would have been nearly the same. That said, it would have been different in some ways; there would have been less leverage of households which, again, I do not think was a trigger for the crisis, but may now be relevant. Otherwise, the differences would have been very small.

I think we have to be careful with our assumptions about global imbalances and in terms of drawing conclusions on whether these were a factor. I do not think it is central to this crisis. This does not mean that we should not deal with it; we should deal with the underlying factors, and I will stand my ground on this.

The Chairman noted that the third paper tackled the lessons of the crisis vis-à-vis issues of international governance, and recalled that a discussion would soon take place on a report by the committee led by Trevor Manuel.

The Director of the Strategy, Policy, and Review Department (Mr. Moghadam), in response to comments and questions by Executive Directors, made the following statement:

There were a lot of comments and a few questions raised on the third paper, particularly about governance, so let me start from there.

Let me start by clearing up some of the misconceptions. We are not advocating a new "G," and we are not advocating a Council; in fact, the word "Council" does not appear in the paper. The staff paper aims to highlight the issue of engagement by policymakers with a view to increasing the traction of Fund advice with policymakers. The paper notes that, over time, we have seen the policy debate moving out of the IMF and into various other fora, such as the "Gs," which appear to enjoy the engagement of policymakers. I think what is at the back of the staff's mind and I am sure of everyone in this room is how we might regain the interest of policymakers and how can we make the Fund the center of policy dialogue and international cooperation. What the paper puts forward is a modest proposal for trying to engage policymakers in a more effective way than is presently the case. At the same time, achieving engagement also means addressing representation issues and, therefore, the paper touches on these two topics. I realize that the way we put it might not have been as clear as we had intended, but we are happy to clarify these issues in the paper. The Council is one of the possible approached, but it is not the only one, and we have heard other ideas this morning.

The second topic on which there were a number of questions was surveillance. A number of Directors wondered what would change to make surveillance more effective, and asked whether we are doing enough to address the shortcomings that the paper highlights. Broadly speaking, work is already under way to address some of the shortcomings. For example, we have had a discussion of the Triennial Surveillance Review, and a number of issues are highlighted there. We also recently had a discussion of how to better incorporate financial sector issues into surveillance. There are lessons for the way the staff works in that regard, and a couple of specific issues were mentioned today, e.g. to be more specific in our recommendations. An issue which some of you have highlighted, for example, was the use of special investment vehicles in the U.S., and whether we should have delved more into the issues—e.g. off-balance sheet risks and the need for capital—rather than more generally talking about financial sector risks.

Directors also talked today about linkages. For example, when we focused on global imbalances, we focused on what would happen if there was a run on the dollar. However, we did not look at what would happen in terms of deleveraging if there was a collapse in U.S. assets. So, there are lessons in terms of specificity and on pursuing linkages, but there are also new mechanisms that need to be put in place. Some of you highlighted the fact that the staff vulnerability analysis only focused on emerging markets, so that new mechanism is being extended to the advanced economies.

Importantly, we had not put enough emphasis on analysis of tail risks. The new Early Warning Exercise does exactly that, addressing the question which Mr. Moser raised this morning, by looking at these issues during good times, and not simply at times like this. Perhaps some of the issues on fragmentation could also be addressed in that context. For example, as you know, it is not uncontroversial, but the fact that the Fund will work with the Financial Stability Forum addresses some of the fragmentation of surveillance issue.

> There were questions raised this morning about Transparency Policy. We are actually planning a review of Transparency Policy, including Deletion Policy. I do agree there are some rigidities there at the moment that would need to be addressed.
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> Mr. He asked if there are vehicles to be more candid with the authorities than with the public. Many of you have commended more candid staff reports, and noted that it is good to be candid in public. There are other vehicles that, if necessary, one could use for more candid interaction with the authorities. The final statement, for example, which is produced by the staff in the field, can be candid, and it is the authorities' decision to publish it or not.
>
> Finally, Mr. Lee asked about crisis management. I underline what the Managing Director mentioned this morning. The whole institution right now is engaged in crisis management. The paper here touches on resources. We have had some success. Since the paper was published, we have been actively in dialogue with countries looking for financial assistance and some who are not looking for financial assistance. Also, there has been a lot of engagement on technical assistance, particularly in the financial sector. Of course, we are looking at the broad policies related to crisis management and we will have a discussion concerning facilities on Friday. So, there is a lot of work on the way in terms of crisis management by the institution.

Mr. Daïri noted that the staff report states that its proposed body of Ministers should be neither too formal nor too large. Did that imply doing away with the 24-chair structure?

Mr. Spadafora agreed with Mr. Moghadam that there are vehicles already available for being more candid with the authorities. In that light, he wondered what was the underlying motive for a review of transparency policy.

Mr. Gibbs agreed that increasing the engagement of Ministers and the traction of the Fund's policy advice were key challenges. He felt that giving Ministers a role in setting the Fund's Statement of Surveillance Priorities could be an important vehicle for engagement. The IMF would report to Ministers on how it carried out its surveillance priorities in the previous period, thereby encouraging active engagement and discussion about the priorities for the period ahead.

Mr. Lushin made the following statement:

> I have a question that I reflected in my statement not as a question but as an assertion, and that is a question about the need for stronger global policy coordination. I agree with this need, but I think the problem is that all of us

understand policy coordination differently. If policy coordination implies more fruitful, productive, and informed discussions between Ministers and Governors, it can only be welcomed, and it is achievable in rather different ways. If policy coordination means surrendering national sovereignty to some supranational body to take the sort of decisions covering not a single country but a number of countries, I do not see in the present political context the possibility of easily obtaining such an outcome.

As I mentioned earlier, even if there is a body of policymakers small enough to be effective, yet with sufficiently broad representation to be legitimate, and even if this body takes decisions not of a general nature but of a nature pertaining to individual countries, how could these decisions get traction? Multilateral consultations are illustrative in this respect; good discussions were held and recommendations adopted, but the traction was minimal.

My basic question asks: what type of policy coordination are we looking for? The problem is that, most likely, we are going to obtain policy coordination for more informed and productive discussions, but not to the extent that these lead to real coordination that would impact national policies. I am afraid that it is the latter that is most required in this context of a globalized economy and financial markets. Actual policy changes, and not just discussions and consultations, are needed to make globalization sustainable.

Mr. Vogel noted that the Economic Policy Institute had recently advocated the Employee Free Choice Act, which would restore some balance to labor markets. Given that the IMF may have overemphasized labor market flexibility in the past, he wondered whether a revision of the Fund's policy advice on labor markets might be included as part of the lessons learned from this crisis.

The Director of the Strategy, Policy, and Review Department (Mr. Moghadam) welcomed Mr. Gibbs' suggestion on using the statement of surveillance priorities as a tool of engagement. In response to Mr. Lushin's question on how to foster collaboration in a way that enables policy traction, he noted that one potential avenue could be a discussion of the results of the Early Warning Exercise.

The Chairman made the following statement:

Well, this point on coordination is an interesting one, because it is true to say that, from a political point of view, it is presently not very easy to organize more political coordination. On the other hand, if new rules appear in the financial sector, they probably will be implemented everywhere, which is a kind of policy coordination; even if it is not macroeconomic policy. At the same time, what the Fed has been asking for the last year—namely, some stimulus where it is possible—has been finally done, more or less. I do not know where this coordination was finally agreed, but what I am sure that everybody finally came to this idea because it was just the right idea. So, I am not so pessimistic on the possibility for more policy coordination, especially given the situation over the next year or so, which will be very difficult times and the need for coordination will be so strong.

The most difficult question was about the 24 chairs. I see no problem in that regard. Everybody knows that some members of this Board are arguing that the Board should not stay at 24 and should be reduced. So, the paper just wanted to raise the different possibilities. As on all questions on governance, I was very keen to ask staff to leave things open and just reflect the ideas that are floating around without making choices. This is certainly true for the question of the Council as well as other questions, because we have to discuss these point more. At the same time, as I said this morning, there is a question of mixing roles if we argue too much about the organization of our own Board in the Board.

It is well-known that some want to reduce the number of members. The United States, for instance, has been arguing that they accept staying at 24, but that it could not be considered as a permanent situation, even if it has lasted for some time. So, this is one of the ideas out there and there is no reason to act if these ideas do not exist. That does not mean that staff will take any position in favor or against. It is an open question that may be discussed in the coming weeks or months if the question of governance is discussed by the IMFC, the G-20, or other bodies.

Mr. Daïri still thought it was dangerous to hint at proposals on which there had been no open discussion. He noted that the drafting of the report gave the impression that the Fund was trying to delink the composition of a ministerial body from the size of the Board. Furthermore, while a Council was not being named explicitly, the report made reference to a body with decision-making authority, which could only be a Council.

The Chairman remarked that the recently released de Larosiere Report included a full chapter on the Council and naming it as such. In that light, the Board would be the only body acting as if the question was not on the table. While some might agree and some might disagree with the proposal, that was beside the point. The paper aimed to avoid taking any decision, because that was not staff's role. The question would be discussed by many bodies and thus it would be better to address the matter directly. It was for that reason that he had supported Mr. Kishore's proposal, which was endorsed by many Directors, to engage in a real discussion. It was also why he had initially suggested that a better forum for the discussion might be the report by Mr. Manuel. If the latter was the case, he offered to invite Mr. Manuel to meet with the Board to take up the issue of governance.

Mr. Daïri strongly encouraged redrafting the relevant section of staff paper prior to its publication to eliminate any underlying assumptions. While the idea to increase efficiency and traction through a Ministerial Committee might be a good one, being able to infer such through the drafting and publishing of the document would be putting the cart before the horse.

The Chairman recalled that the paper would clearly indicate that it reflected the views of staff and not those of the Board, as earlier requested by Mr. Shaalan.

Mr. Kiekens made the following statement:

> The Chairman's reply to the question by Mr. Daïri about the number of Executive Directors is for me perfectly acceptable; that is good news. But there is an underlying assumption in the staff paper, not about the number of Executive Directors, but the kind of countries that some chairs may represent. That underlying assumption is that the provision in the Articles of Agreement that countries are free to elect their Executive Director would not be applied. Nobody so far has ever suggested that we should revisit that rule, and I wonder why the staff is venturing into that without a preliminary discussion.
>
> Second, I would recommend not to publish staff's paper. As I said at the outset of my intervention this morning, the IMFC called on the Fund to make a report on the lessons and the relevant recommendations and, as I have always understood, the Fund involves the Board. I am not willing to censure the views of the staff, but my ambition is to see a report by the Board on the basis of a staff report, and we should discuss whether that is feasible or not.
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> On publication, I think it is too early to publish, certainly the part on governance. This debate is far from over. I would like to listen to your reaction on that matter, mainly because I think the Board should make a report to the IMFC.

The Chairman made the following statement:

> Well, there are three points. The first point is that you agree with me about the number of seats, so I have no further comments in that regard.

The second point that you are referring to is not in the chapeau paper, as far as I know, and I think you are right. As such, it is something which has to be written in a different way.

On the third point, I am not sure I agree, for two reasons—one formal and one more political. Let us start with the more political one: we are expected to say things, and the situation is very dynamic and things are going very rapidly. The IMFC Meeting is on April 25th. Until then, a lot of things will happen. If we enter into the game too late, then the game will be already over. We have to produce something for the IMFC, so we could wait for April to have this discussion. However, we all know that decisions are likely to be taken in the coming weeks on all the topics we discussed today—not only on this one, but on all the topics—and that probably it will not be good for us to be absent in this discussion.

The other point, which is a more formal point, is that, as far as I understand—but I want to speak under the control of people here who know the rules better than I—when we have a staff paper, this paper is not likely to be changed a lot but for factual things or small corrections as we discussed today. If there is some dissent from the Board endorsing or not endorsing the paper, that is a separate declaration. I can understand that the Board will not endorse many parts of the document, but I see no way that we could hope to have, even in two weeks or three weeks, a document on which the whole Board will agree, because there are some very different positions on key questions. In the end, the question is easy: either we do nothing, or we just say what has been proposed by Mr. Shaalan which, from my view, is acceptable. I will note in my summing up that, especially on this last part on architecture, there are many very different views from many Directors. Moreover, most of the background papers have already been circulated, so it is a bit unusual to have the background papers circulating and not the chapeau paper, which is in fact less detailed and, in my view, less problematic than the background papers themselves.

What we can do is wait a little. As I told you, Mr. de Larosiere's report was released today. As a courtesy to one of my predecessors, I think we should wait a little and not to pre-empt any kind of press comment that will inevitably appear if we release the paper at the same time. We could wait for a week or so, which will make it easier to take into account some of the comments Directors have made. That said, it would be rather difficult to keep this staff report a secret. Again, I want to ask more of the people knowing better than I do the rules of the institution.

Let the discussion move forward. As I said this morning, I have heard some concerns on a potential conflict of interest. I think it would be unusual for so many bodies to be discussing the future of the IMF, but not us. It would be strange for us not to have a paper on this discussion, or choose not to participate in this open discussion. Clearly, the Board is not being committed to this paper. If at the end the G-20 Ministerial in mid-March chooses to discuss this question; if the Trevor Manuel paper is discussed not only here but somewhere else; or if the Heads of State meeting at the beginning of April take a decision, and then we can come back later in the IMFC to reach some conclusions, it would be ridiculous for us to be absent from the process, so we really need to move now. It is a pity in some respects, because we did not choose the calendar, so we are a bit constrained, but it is difficult to avoid.

Mr. Daïri reiterated that the his problem was that there were hints and suggestions in the staff paper, but these were not based on any substantive discussion of the issues. If there were a full-fledged, dedicated paper to the issue discussing all aspects, including the pros and cons of various approaches, it would be acceptable to publish the report. However, the report at hand might give the impression that the Board was leaning toward some proposals without a substantiated discussion of the issues.

The Chairman made the following statement:

Mr. Daïri, if we had a long paper on this, it will be very difficult to reach a consensus in the Board. Moreover, I would fear some comments from outside saying the Board of the IMF is spending a lot of time working on its own problems while we are in the midst of the biggest crisis in recent memory. We cannot give the impression that staff is working days and nights on describing the pros and cons of different proposals for institutional reform. Really, I think it would look bad. That is the rationale behind offering some ideas and not making any decisions, because this is the only way we can deal with these difficult questions.

There is no good answer. I am on your side from this perspective. There is no comfortable situation for us when Governors, journalists, academics, and others are talking about our institution. We are in the middle of that conversation. Moreover, the Board does not really agree on a specific solution. So, I think the only way to avoid problems is not to appear as if we are evading the issue or precise proposals. I know some of your authorities favor a Council and some others are not at all in favor the Council, and so there is no way to find a common view from the Board.

Mr. Daïri replied that he understood the Chair's position, but the Council issue had been discussed by some chairs for some time, while for others it was still new. During meetings he recently held with his constituency, he had been unable to give any sense of the pros or cons of a Council because lacked a paper reviewing the issues.

The Chairman noted Mr. Daïri's suggestion for a paper on the pro and cons of a Council.

Mr. Kishore made the following statement:

> Mr. Chairman, I am extremely grateful to you for accommodating our views and showing this amount of flexibility, but I request for a reconsideration by you on a point which has its roots in my first observation at the opening of the discussion. Mr. Chairman, I, for one, am prepared to sit throughout the night to discuss the third aspect of the paper. Having said that, we must be sensitive to what Mr. Daïri's intent is. It is not, I can assure you, merely a question of this Council. We could have a three-hour discussion on that point alone. There are also issues on surveillance, on the composition of the Executive Board, on representation, management selection, and inter-institutional coordination as part of the global architecture. There are a host of issues that would seek and need your indulgence for a full session, if not for a full day. I would submit, sir, that everybody is free to express their views. Staff is completely free to put its views. If they want to put it in the public domain, why not? But I would very humbly submit that it should not go through the conduit of the Board, because the Board, simply put, has not discussed them in detail. Therefore, while you may like to put them in the public domain, there should be a clear disclaimer that the Board has not discussed them at all. There are very contentious, long term issues, and I would strongly urge that you put on the agenda very quickly a whole session for discussing these aspects and then go to the public domain, because sanitizing merely a few lines and expressions here and there would be most inadequate.
>
> Mr. Chairman, I see your point that we should not be lagging behind, but there is a classic dilemma. When things are fine, what is wrong with the IMF; this is not the time to discuss the problems of the IMF. When things are going wrong, let us address these questions of what is going wrong; this is not the time to discuss the IMF. When is the time to discuss the IMF? To cut a long story short, is please slot a whole discussion on this, take everybody's view on board, and then, of course, the consensus and majority view will prevail and that can go legitimately in the name of the Executive Board's stand, but as of today,

The Chairman made the following statement:

Well, Mr. Kishore, I do not know what the Board thinks because one hour ago, when I asked the Board to take the floor on this question, nobody wanted to take the floor. I am prepared, as you said, to have this long session to know better what the Board thinks. That said, this question of reforming our governance is, in my view, not really at the root of this paper. This paper is on lessons of the crisis. I do not know if there are many links between the global imbalances and the crisis, but I am sure that there are not that many links on the way we choose the Managing Director and the crisis. To make this the main question to be discussed before we offer some initial lessons from the crisis is maybe a little too much. I propose that we now sum up this meeting, and I will convey the message that the Board did not make a decision on the issues related to governance. We can try to clean up the paper to avoid any kind of problem. Again, I think it would be very bad for us to be the institution not having proposed some kind of lessons from the crisis before the major upcoming meetings, starting with the Heads of State and Government in the European Union in two days, then the question of the G-20 Finance Ministers in two weeks, and then in London in one month. All this process take place before our IMFC. Again, I am sorry about that. I would have preferred it the other way around, but that is the way it is.

We really need to be present in this discussion, so I will take into account your concerns. We will have a long discussion at a later date, and at that time we will be able to see if there is a possibility for the Board to have a consensus. To avoid any kind of confusion in the paper, precisely to avoid any kind of problem like the one Mr. Daïri just noticed, the paper will be reexamined. Finally, in the summing up, we will echo Mr. Shaalan's request that Directors want to talk more on governance and that this discussion today cannot be viewed as any kind of conclusion.

The Chairman made the following summing up:

Today's discussion has provided a timely and important opportunity to try to draw initial lessons from the ongoing crisis. Executive Directors considered these staff reflections concise, yet comprehensive, with a host of stimulating, and at times controversial, recommendations. Directors stressed that the Fund, given its mandate, has a singular responsibility to analyze the crisis and to work closely with other players—both national and international—to help restore global financial stability and economic growth. However, Directors stressed that, given the broad range and complexity of the issues under consideration and the still unfolding crisis, today's discussion will necessarily be preliminary. Continued debate in greater detail will be required in subsequent Board meetings before we can reach a definitive view. Today's discussion nevertheless provides a very useful sketching of the landscape, particularly in areas where future work is needed.

The seeds of the crisis were sown during the years of high growth and low interest rates that bred excessive optimism and risk-taking and spawned a broad range of failures—in market discipline, financial regulation, macroeconomic policies, and global oversight. While Directors' views differed on the relative importance of each, Directors saw need for remedial actions across a broad front and at many levels, implying an ambitious agenda for policymakers and the need for coordinated action.

Financial Regulation and Supervision

The current financial crisis has its roots in the failure of market discipline in systemically important advanced countries, as misaligned incentives led to excessive leverage and risk-taking, new and complex financial instruments that were poorly understood, liquidity mismanagement, and, ultimately, increased systemic risk. Regulation and supervision failed to stem this excessive risk-taking, in part because of inadequate assessments of inter-linkages between regulated and non-regulated institutions and markets. When the crisis ensued, policy responses were hampered by fragmented regulatory structures, inadequate disclosures of risks, and weaknesses in crisis management and bank resolution frameworks, especially in dealing with cross border stress.

Directors suggested that a range of reform priorities could be usefully considered. First, the perimeter of regulation should be expanded to include a wider range of institutions and markets, and be underpinned by more effective cross-functional regulation and cooperation. Second, existing regulatory and institutional practices should be re-examined with a view to reducing procyclicality. Third, liquidity management practices and regulatory policies must also change to ensure that financial institutions maintain larger liquidity buffers. Fourth, strengthened public disclosure practices for systemically important financial institutions and markets should be a priority. Policymakers need to take the lead in translating disclosures into effective assessments of institutional and systemic risk, and incorporating this information into early warning frameworks and the formulation of macro-prudential policies. Fifth, cross-border and cross-functional regulation and cooperation should be improved and promote level playing fields across markets. Finally, national liquidity frameworks need to be strengthened, and, at the international level, enhanced mechanisms for providing cross-border liquidity are vital.

Macroeconomic Policies

Directors noted that an important lesson from the crisis is that not all asset booms are alike, and that their effect on systemic risk depends on the involvement and exposure of the financial sector. In that context, many Directors saw merit in expanding the mandate of monetary policy to explicitly include macro-financial stability, rather than just price stability. A number of other Directors, however, were of the view that monetary policy is too blunt an instrument to deal with asset-price and credit booms, and that overloading one instrument with too many different objectives must be avoided. Directors agreed that prudential regulation should play a central role in addressing credit booms. More generally, Directors recognized the merits of authorities adopting a broader macro-prudential view, and assigning a clear institutional mandate for macro-financial stability.

Directors generally considered that fiscal policy did not play a direct role in the run up to the crisis. Nevertheless, many Directors observed that, in many countries, budget deficits had not been reduced sufficiently during the boom years when revenues were high, and that consequently the available fiscal space to fight the crisis is more limited. Further, in several countries, the structure of taxation promoted leverage and debt financing—a bias that increases the vulnerability of the private sector to shocks. In that context, Directors looked forward to further work on this important, yet politically difficult, subject.

A number of Directors observed that global imbalances have played a role in the build-up of systemic risk, while a few Directors disagreed. Although financial integration has helped transmit these risks, the lesson is not that capital flows should be sharply curtailed. Rather, most Directors saw a need to revisit macroeconomic and structural policy responses to large imbalances, stressing consideration of financial and real spillovers, and to examine the scope for prudential measures to reduce systemic risk associated with capital flows.

Global Architecture and the IMF

A key failure in the architecture is inadequate warnings prior to the crisis, including, albeit not only, by the Fund, especially in the surveillance of systemically important advanced countries. Even where risks were identified, too often they were expressed vaguely or were too muted to gain traction with policymakers. Directors generally considered that the Fund should have been more effective in identifying, communicating, and promoting coordinated responses to systemic risks to the global economy.

Accordingly, efforts to strengthen surveillance must intensify, with emphasis on covering all sources of systemic risk in an integrated manner, and further analysis of poorly understood issues. The tacit presumption that risks lie mainly in less mature markets should give way to surveillance of all types of systemic risk, in advanced and emerging market countries alike. In this connection, most Directors welcomed work under way toward a joint early warning exercise with the Financial Stability Forum. Many Directors also underscored the importance of, for the Fund, sharpening the FSAP—although some attached greater priority to more generally strengthening financial sector analysis in the context of bilateral surveillance. Greater attention should also be paid to large cross-border flows in surveillance activities. The importance of candid and independent staff analysis and recommendations for effective surveillance was underscored.

During the crisis, poorly defined rules or collaboration agreements among financial regulators on resolution and burden sharing led to fragmented policy responses and spillovers when institutions failed. While broadly agreeing that this problem should be addressed, Directors noted there are no easy solutions, given the need to share fiscal costs. Possible areas for improvement include: a renewed supervisory focus on globally active and systemically important financial institutions and markets; developing compatible bank resolution and information-sharing frameworks; and agreeing on minimum supervisory practices for the oversight of cross border firms.

A fourth fault line in the global architecture has been inadequate liquidity support and financing and insurance facilities to help countries weather the turbulence in global capital markets. While Directors noted that resolving this problem cannot be the responsibility of the Fund alone, efforts under way to double the Fund's lending capacity should go a long way toward providing a solution. Reforms of Fund lending instruments, conditionality, surcharges and commitment fees, and Fund governance are each also important issues in their own right. We have had separate Board discussions already on some of these topics and, for others, discussions will take place in the near future.

Many Directors stressed that the conclusions drawn about IMF governance in these papers should be recognized as the staff's views and not necessarily those of the Executive Board. They did not consider that the IMF's internal governance structure had prevented early detection of the crisis or its mitigation. Nevertheless, Directors believed that IMF governance reform is an important issue in its own right. In this context, they noted the importance of resuming work on quota and voice reform, although some Directors underscored that crisis-response work should remain the Fund's immediate priority. Directors looked forward to the opportunity to discuss the forthcoming report by the Trevor Manuel Committee.

In sum, today's preliminary discussion has given us much food for thought and further reflection. These lessons and staff recommendations for their implementation will both need to be followed up in various international fora, including most importantly at the Fund Board. Given the importance of achieving broad agreement on this wide range of issues, close collaboration with other concerned fora and intense dialogue among ourselves will be crucial in the period ahead.

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Acting Secretary