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Financial Stability in the World of Global Finance

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To reduce their vulnerability to national and international financial crises, countries must address the weaknesses in their financial systems.

Since the mid-1990s, financial crises have erupted in half a dozen developing and emerging market countries in Asia and Latin America as well as in Russia. The costs for the countries affected have been heavy, with the crises leading to bank failures, corporate bankruptcies, job losses, increased fiscal burdens, depletion of foreign exchange reserves, depressed economic activity, and even, in a few cases, political and social turbulence.

Initial research on the causes of the crises highlighted weaknesses in the afflicted countries' economic fundamentals, excessive short-term foreign borrowing by governments and private sector entities, and volatile short-term capital flows. Recent studies, however, increasingly point to the important role of weaknesses in national financial systems in triggering or exacerbating crises. For this reason, the international community has been stepping up its assistance in strengthening banks and other financial institutions. After all, the whole—the international financial system—cannot be healthy if its parts are not.

Why are countries vulnerable?

With the globalization of finance, firms and sovereign borrowers in countries around the world have increasingly obtained financing in the international financial markets. Between 1970 and 2000, cross-border capital flows increased from less than 3 percent of GDP to 17 percent for advanced economies and from virtually nothing to about 5 percent of GDP for developing economies.

The fundamental benefits of financial globalization are well known—by channeling funds to their most productive uses, it can help

developed and developing countries alike achieve higher standards of living. But sudden reversals of capital flows—which may occur because investors have doubts about the viability of domestic policies or financial institutions, are retrenching in response to crises in another part of the world, or are shunning countries with similarities to a country in crisis—can threaten national and international financial stability. Banks with substantial net foreign exchange liabilities or outstanding foreign-currency loans to domestic companies with revenues in local currency may be hit especially hard if the currency depreciates, as the Thai baht did in 1997, or if interbank credit lines are withdrawn.

Recent research suggests that the chances of a country experiencing a financial crisis may have increased with globalization, possibly because technological advances enable funds to move into and out of countries more rapidly. A study carried out by Barry Eichengreen and Michael Bordo in 2001 reveals that the probability of a randomly selected country experiencing a crisis has doubled since 1973. In addition, currency crises became much more frequent in the final quarter of the twentieth century, both alone and in conjunction with banking crises. Also, financial instability in a single country can threaten the stability of the entire international financial system, as was the case in 1998 when Russia defaulted on its debt and devalued the ruble. Investors around the world incurred large losses and stock markets tumbled in both emerging markets and industrial countries.

To achieve financial stability, countries need financial systems that are deep, broad, and resilient; they must address the weaknesses that make their systems vulnerable to shocks. To help countries strengthen their financial sectors and to preserve the stability of the international financial system, the IMF—as part of an international effort—has intensified its work on financial sector issues.

The IMF's role

The IMF has adopted a three-pronged approach: (1) helping member countries carry out comprehensive assessments of financial sector vulnerabilities and developmental needs; (2) strengthening the monitoring and analysis of financial sectors, developing guidelines, and promoting transparency and integrity; and (3) helping countries build strong institutions.

Assessment of financial sector vulnerabilities. The centerpiece of the IMF's efforts is the Financial Sector Assessment Program (FSAP), launched jointly with the World Bank in 1999. The FSAP—essentially a health checkup of a country's financial system—is designed to help policymakers identify strengths and vulnerabilities and devise measures to reduce the potential for crisis (Box 1).

Box 1

What are FSAPs?

FSAPs typically include appraisals of the relative importance of the various financial institutions in the system; the sensitivity of the financial system to shocks under alternative scenarios; and financial soundness indicators, such as capital-adequacy ratios, extent of nonperforming loans in banks' portfolios, and earnings trends. They also include assessments of liquidity developments and policies; the crisis-management framework; the regulation and supervision of the financial sector, including adherence to internationally accepted financial sector standards and codes; and the requirements for further financial sector development.

The analytical work focuses on developments both in the aggregated measures that are useful indicators of the soundness of financial institutions and in other indicators of the financial health of the main nonfinancial counterparties (households and corporations) of financial institutions, as well as on the behavior of the macroeconomic variables that are closely associated with the performance of the financial system, such as interest and exchange rates. In addition, the impact of macroeconomic and other shocks on the profitability and solvency of financial institutions is subjected to sensitivity and scenario analysis—stress testing, which is undertaken in cooperation with officials in the country and often proves helpful in building risk-management capacity. The implications of weaknesses in the financial sector for macroeconomic stability are also considered.

Assessments of the extent to which financial sector standards and codes are observed make it possible to identify gaps in regulation and transparency, evaluate the overall stability of the financial system, and measure a country's practices against international benchmarks. Among the standards covered are the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies; the Basel Core Principles for Effective Banking Supervision; the Core Principles for Systemically Important Payment Systems; the International Organization of Securities Commission's Objectives and Principles of Securities Regulation; and the International Association of Insurance Supervisors' Insurance Supervisory Principles. (When relevant, observance of standards and best practices in other areas—for example, corporate governance and insolvency and bankruptcy regimes—is also assessed.)

More recently, as part of the international community's effort to promote the integrity of financial systems and prevent their abuse, FSAPs have also begun to systematically cover provisions for combating money laundering and the legal and institutional aspects of financing terrorism.

A collaborative effort involving experts from the IMF, the World Bank, and various national agencies and standard-setting bodies, an FSAP involves the assessment of a wide range of financial institutions (such as banks, mutual funds, and insurance companies); the financial markets themselves (securities, foreign exchange, and money markets); payment systems; and regulatory, supervisory, and legal frameworks. While the IMF tends to focus on issues concerning systemic financial sector risks and vulnerabilities, particularly as they

relate to macroeconomic stability, the World Bank focuses on issues related to development and poverty reduction.

The team carrying out an FSAP discusses its findings with the national authorities during the IMF's Article IV consultations (regular—typically annual—reviews of a country's economy). The IMF then prepares a Financial System Stability Assessment (FSSA) for its Executive Board. The FSSA, which draws on the FSAP findings as well as discussions during Article IV consultations, is focused on issues of macroeconomic stability related to developments in the financial sector. The FSSA also includes a Report on the Observance of Standards and Codes (ROSC).

By the end of 2001, more than one-third of the IMF's 183 members had participated in the FSAP or volunteered to do so in the future. Financial sector assessments had been completed for 25 countries, 20 were under way, and 23 countries and the East Caribbean Central Bank area had formally committed to one in the future. These countries represent a broad cross-section of the IMF's membership, geographically and in terms of stage of development.

During its last review of the FSAP in November 2000, the IMF's Executive Board agreed that, in any one year, somewhat greater priority should be given to systemically important countries—that is, countries whose economic troubles could have repercussions in other countries. In that regard, the finance ministers and central bank governors of the G-20 countries (many of which are considered systemically important) agreed at their inaugural meeting in June 1999 that they should participate in the program. More than half of them have already done so or are formally committed to doing so. Indeed, the FSAPs already completed span a broad spectrum of countries with different institutional and market structures, including Canada, the Czech Republic, Hungary, Ireland, Japan, Korea, Kazakhstan, Poland, Slovenia, South Africa, Sweden, Uganda, the United Kingdom, and Yemen.

Monitoring, analysis, transparency, and integrity. Health checkups and risk profiles are only as good as the intelligence available, so the IMF is pushing for better, more extensive, and timelier information to enable it to carry out deeper, more thorough, and more accurate analyses. In this context, it is strengthening its own information base for frequent monitoring of financial sector developments and refining its stress-testing methodologies and its analysis of the links between the financial sector and macroeconomic performance. It is also encouraging countries to improve the transparency and integrity of their financial systems. Efforts in these areas are concentrated on the following main activities:

- *Developing and fostering standards.* The IMF's Code of Good Practices on Transparency in Monetary and Financial Policies seeks to make more information available to market

participants so that they can make better informed decisions. The IMF is also working with other standard-setting bodies.

- *Developing early warning systems.* From its Washington headquarters, the IMF is monitoring the financial sectors of individual countries—particularly when there is a risk of systemic instability stemming from the financial sector—so that potential problems can be identified early on and steps taken to avert or mitigate a crisis.

- *Developing financial soundness indicators and methods of macroprudential analysis.* The financial soundness indicators include a core set of aggregated prudential indicators of the banking sector and a broader set of indicators that cover the financial health of the nonbank financial, corporate, and household sectors and real estate markets. The IMF is also developing readily applicable stress-testing methodologies for off-site analysis of vulnerabilities.

- *Developing guidelines, in collaboration with the World Bank, for the management of debt and foreign exchange reserves.* The guidelines are based on best practices worldwide. The two institutions are also helping countries build the necessary institutional infrastructure.

- *Developing guidelines for sequenced and coordinated capital account liberalization.* Many of the countries in which crises erupted had rapidly eliminated controls on capital inflows. However, capital account liberalization needs to be carried out carefully, in conjunction with the development and strengthening of the domestic financial system. The IMF is therefore working to formulate some general principles for the orderly liberalization of capital flows.

- *Promoting the integrity of financial systems.* The IMF has developed a methodology enabling national and international authorities to assess the adequacy of a country's apparatus for preventing money laundering and is also collaborating with the Financial Action Task Force to expand the methodology to encompass the arrangements for combating financing of terrorism.

Institution building. Many countries lack the institutional capacity to supervise and regulate their financial sectors or to gather the data they need to obtain an accurate picture of the health of their financial institutions. The IMF is working with the World Bank and other donors in coordinating *technical assistance* for institution building.

The IMF also provides technical assistance aimed at eliminating deficiencies identified during assessments of *offshore financial*

centers (*OFCs*)—that is, the operations conducted abroad by a country's domestically registered financial institutions. Activities of offshore entities have not been subject to the same prudential standards and scrutiny as those of onshore financial institutions, which may make it possible for unscrupulous firms and individuals to hide sizable transactions and exposures not permitted by onshore supervisors. If exposed, such activities could severely damage the reputation of the country and impair the ability of its onshore institutions to conduct normal business with firms abroad.

Looking forward

Two years after this major push on the financial front, what is the verdict?

Our experience to date suggests that the integrated approach of FSAPs is helpful in identifying key financial sector vulnerabilities, issues, and development needs (Box 2). Participating countries acknowledge the value of an objective and comprehensive assessment as well as of the peer review aspect of the program. However, they also say that there is scope for further refinements and extended coverage in such areas as stress testing, informal markets, legal frameworks and enforcement capacity, and consistency in the analysis of issues across countries. The IMF's efforts to strengthen the information, analysis, and monitoring of financial sector risks and institution building will, by their very nature, take longer to bear fruit.

Box 2

Sample country FSAPs

FSAPs have been undertaken in a broad range of countries, helping to identify key vulnerabilities in the financial system. Even where there were no immediate risks, medium-term vulnerabilities were brought to the attention of the authorities. The following three examples represent countries at different stages of development and experiencing different types of financial sector weaknesses.

Lebanon. The FSAP for Lebanon, carried out in 1999, included stress testing of the portfolios of individual banks, using parameters derived from macroeconomic vulnerabilities. In addition to deficiencies in the observance of certain standards and other institutional weaknesses, the FSAP highlighted the financial system's vulnerabilities to credit, liquidity, and interest rate risks. It recommended actions that could be taken to strengthen the liquidity-management infrastructure and the supervisory framework. Following the FSAP, observance of the Basel Core Principles for Effective Banking Supervision improved considerably.

Mexico. The actions Mexico took after the crisis of 1994-95—including implementing sound macroeconomic policies, restructuring and consolidating banks, and strengthening its links to the U.S. economy—yielded positive results. When its financial system was

assessed in 2001, it was found to be more resilient to shocks and well placed to contribute to economic growth and development, but Mexico was advised to address problems in such areas as the operations of development banks, the framework for housing finance, and the lack of clear rules to prevent a troubled institution from having continued access, without proper guarantees, to liquidity from the Bank of Mexico. The FSAP included recommendations for institutional capacity building in these areas.

Finland. Although an FSAP carried out in 2001 found that Finland had a very sound financial system that was quite resilient in the face of fluctuations in asset prices, deficiencies were identified in the observance of banking supervision and securities standards. The FSAP also pointed out that crisis-management arrangements posed a challenge in light of the highly concentrated financial system and the dominance of complex financial conglomerates.

Countries need to pursue sound policies, improve transparency, adhere to international standards and best practices, and address possible imbalances that could trigger crises. They also need to build adequate institutional and regulatory capacity while ensuring that their financial development is consistent with the level of their economic development and to put in place the mechanisms that will enable them to manage and quickly resolve crises. The costs of a financial crisis depend on its depth as well as the speed of recovery, which, in turn, may depend on the effectiveness of the institutional structures—such as deposit insurance and lender-of-last-resort arrangements—that are in place. It is also critical that countries strengthen their laws, institutions, and mechanisms for combating money laundering and the financing of terrorism while ensuring that supervisory weaknesses do not allow the operations of offshore financial centers to compromise the integrity of domestic financial systems.

It is as yet too early to judge the effectiveness of the IMF's efforts in this area. A market-based financial system that allows the transfer of risks from those who do not wish to bear them to those who do is bound to experience some failures. While it is impossible—and even undesirable—to have a foolproof system that eliminates all risk taking, a sound financial system would strengthen the capacity of countries to cope with difficulties when they arise. The success of the IMF's efforts will be judged by the extent to which such capacity is enhanced and by the frequency and severity of future systemic financial crises. Beyond this, it will be reflected in the financial system's enhanced depth and breadth and its contribution to economic growth.

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