Commentary

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The IMF and World Bank Financial Sector Assessment Program

At the height of the global financial crisis we asked in *Après Dégringolade,* the October 2008 edition of *Commentary:* "Would the US dollar be able to maintain a significant role as a reserve currency? Would creditor nations continue to hold US debt securities? Would the balance sheet of the US Federal Government be impaired? Would the US Treasury be able to maintain its reputation as issuer of risk-free bills, notes and bonds? Would an inflationary scenario emerge in future for the US economy? Would the value of the US dollar decline in relation to other currencies? Would the International Monetary Fund (IMF) be called upon for advice and assistance to protect the global financial system?" The global financial crisis of 2008-2009 leaves no doubt that there are serious problems with both national and global financial sector structures and operations including systemic risk. Regulatory reforms and controls are widely recognized as being essential to the global economic recovery process. Resilient, well-regulated financial systems are critical for financial stability in a world of increased capital flows. Typically, the national financial sector will include banks, securities exchanges, pension funds, insurers, the central bank, and national regulators. These institutions constitute the framework for economic transactions and monetary policy. The soundness of a country's financial system is important for the domestic economy and for its trading partners and countries with which it maintains financial linkages.

The International Monetary Fund (IMF) and the World Bank operate a joint initiative to provide member countries with a comprehensive evaluation of their financial systems known as the Financial Sector Assessment Program (FSAP). The emphasis of any FSAP will be on prevention and mitigation of problems and instability rather than on crisis resolution. The FSAP involves the analysis of sectoral developments, risks and vulnerabilities, using a range of financial soundness indicators and macrofinancial stress tests. Also examined within the scope of the FSAP are structural underpinnings of financial stability and systemic liquidity arrangements, including the institutional and legal framework for crisis management and loan recovery, transparency, accountability, and governance. As a part of the process, the FSAP provides assessments of the extent of observance of various international financial sector standards.

The role of the IMF in the FSAP is to focus on the linkages between the soundness and operations of the financial sector and macroeconomic performance, and the support of policies that make financial systems more resilient to shocks or lessen the likelihood and severity of financial system crises. By contrast, the role of the World Bank in the FSAP is on strengthening the financial sector to promote economic development and reduce poverty. For major industrialized countries, the IMF is exclusively involved in the conduct of the FSAP, whereas the World Bank contributes to the work of the FSAP for developing countries. The FSAP aims to alert national authorities to probable vulnerabilities in their financial sectors, whether internal or external in origin, and to assist in the design of measures to reduce these vulnerabilities.

The current global financial crisis has served to underscore the linkage between financial system soundness and macroeconomic developments. Clearly, with the benefit of hindsight, inadequate bank regulation and supervision, weak or poorly-managed financial institutions, and lack of transparency, were at the heart of the crisis. In response to the global financial crisis, the IMF is increasing its efforts to help countries identify and implement policies that will result in sound financial systems. The IMF has four principal means for promoting financial system soundness; these are Bilateral Surveillance, Multilateral Surveillance, IMF-supported Programs, and Technical Assistance. Bilateral Surveillance is the process of regular dialog and policy advice that the IMF is mandated to provide to its members, covering macroeconomic and financial developments and policies in their countries. These efforts, including the FSAP, are intended to better identify financial system strengths and weaknesses, and thereby lessen the frequency and intensity of potential problems. Multilateral Surveillance introduces the concept of a regional or multi-country perspective to the surveillance process. As economies and financial systems are increasingly integrated across borders, many relevant issues span multiple jurisdictions. Spillovers from one country or financial systems occur more frequently as the recent financial contagion has demonstrated. IMF-supported Programs typically include measures to strengthen member countries' financial systems, provision of financial assistance, identification and diagnosis of problems, and design of systemic reforms and restructuring. IMF Technical Assistance includes training and advice on improving monetary and fiscal management, foreign exchange and capital market development, design of payment systems and deposit insurance arrangements. This advice and assistance may also extend to the development of the legal framework for banking, prudential regulations and supervisory capabilities, as well as strategies for systemic bank restructuring. Twelve months after *Dégringolade* we can begin to see the strategies of the IMF at work.

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