

**INTERNATIONAL MONETARY FUND
WORLD BANK GROUP**

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY

J

Press Release No. 39

October 6 - 8, 1998

Statement by the Hon. GERRIT ZALM ,
Governor of the Bank for the NETHERLANDS,
at the Joint Annual Discussion

Mr. Gerrit Zalm, Minister of Finance

The Netherlands

Mr Chairman,

Ladies and Gentlemen,

[1] The policy response of IMF and World Bank

As we all know, the world economy is currently experiencing serious financial instability. In this difficult situation the IMF's response has generally been adequate and continues to be supported by the Netherlands. Also, we support the Bank's efforts to assist countries in implementing the necessary structural reforms in the financial and the corporate sector and to alleviate the effects of the crisis on the poorest and most vulnerable. In a number of Asian countries recovery is now under way. However, in other cases, efforts to restore confidence have not yet brought about the desired result. This warrants a careful evaluation of the policies of the countries concerned and of the response of the international community. In this respect, both sufficient availability of funding and appropriate burden sharing between public and private actors are essential.

[2] Financial sector management

In the meantime, it is possible to formulate a number of preliminary lessons to be learned from the crisis and the international response to it. A core lesson for IMF and Bank members is that sound macro-economic monetary and budgetary policy are a necessary, but not a sufficient condition for financial stability. A healthy financial sector safeguarded by adequate and effective supervision is similarly important. We welcome the initiatives that have been taken in response to the Asian financial crisis by the Bretton Woods institutions and by other international organizations to enhance and monitor standards in financial sector supervision. Further technical assistance by the international community to help emerging markets in establishing sound financial sectors is urgently needed. For this, we do not need to create a new international organization. That would only divert attention from the urgent real issues.

We have already assigned to the IMF the task of monitoring the implementation and observance of the Basle Core Principles. This monitoring should preferably form a regular element in Article IV consultations. In our view, Fund resources should be redirected to this end. In addition, the World Bank should further increase its capacity to assist countries, also pro-actively, in strengthening their financial sectors. I do think that these efforts need to be further stepped-up and coordinated where necessary.

[3] Hedge Funds

Particularly in periods of financial distress, sizeable bank losses resulting from excessive risk taking may lead to a rapid loss of confidence in financial markets, seriously increasing systemic risk. In recent weeks, we have seen the near collapse of a hedge fund. The lessons to be drawn from this event are twofold. Firstly, transparency of hedge funds should be improved, so that all parties associated with hedge funds are aware of the risks they run. Secondly, the sheer size of banks' exposure to these funds is worrying. In our view, the Basle Committee should take the lead in examining these issues further.

[4] Capital controls

A number of emerging markets have responded to the financial instability by unilaterally introducing controls on capital *outflows*. Indeed, the destructive forces of large scale inflows followed by massive outflows has given rise to a debate about the desirability of international capital mobility. It also delayed progress on a proposed amendment of the Fund's Articles of Agreement to extend the Fund's mandate to overseeing the orderly liberalization of international capital flows. However, we should not lose sight of the fact that the free flow of international capital has made a significant contribution to economic development over the past decades. The recent crisis has made clear once more that in liberalizing capital flows, appropriate sequencing is crucial. Liberalization should start by opening up an emerging market for foreign direct investment; more volatile flows of capital can be liberalized only

after a stable financial sector, with adequate supervision, has been established. As a transitory measure market-oriented controls on short term inflows, as successfully implemented in some emerging economies, can be helpful in securing that foreign capital is used for productive investment and genuine trade financing. The final objective should not be to abandon international capital mobility, but rather to create a stable and transparent framework for international capital flows, both in terms of sound macro-economic fundamentals and of sound financial sector supervision. We expect the Fund to continue to take the lead in the current debate.

It is important to note that restrictions on short-term capital flows cannot be a long term substitute for sound macro-economic and regulatory policies. In those extreme cases where temporary restrictions could help to create breathing space to implement the necessary adjustments they should be applied in the context of an IMF-supported adjustment program.

[5] Burden sharing public-private sector

Another core lesson to be learned is that the sums involved in IMF-led rescue programs are nearing a level that is undesirable in view of the moral hazard implications for the private sector. In a global economy with huge and ever increasing private capital flows, public money simply cannot provide full rescue whenever private creditors panic en masse. Large scale efforts may seem an energetic response to crises and hence carry some public appeal, but they raise unwarranted expectations. It is of paramount importance that private investors are involved in rescue operations at an earlier stage. The importance of private sector involvement is reinforced by the difficulty of activating second lines of defense in bringing about financial support.

In my opinion, the Fund should play a more active intermediary role in bringing about a contribution by private creditors and Fund support should be made conditional on their contributions. Efforts should be made to establish more structural contact with creditor groups, such as the Institute of International Finance.

[6] Rethinking the architecture of the international monetary system

We strongly believe that the IMF is the proper place to decide on the future of the international monetary system. The key is to strengthen its capability to prevent and withstand financial instability. Our Interim Committee should remain the core forum for these discussions. If the present arrangements for its meetings do not cater enough to having effective discussions, we should focus on creating the opportunity for that.

[7] Fund-Bank collaboration

In responding to the international financial crisis, we should ensure that Fund and Bank do not duplicate, but remain complementary. They should continue to focus on their primary responsibilities. The Fund should continue to be focussed on macro-economic stability and restoring confidence in times of crisis. Medium and long term structural policies are primarily the responsibility of the Bank. In this respect, we welcome the attention paid by the Bank to the social consequences of crises. In cases of overlap such as the efforts to strengthen the financial sector in emerging markets, the need for good co-operation is evident. We welcome the improved Bank-Fund co-operation in specific pilot cases as a follow-up of the ESAF evaluation. The Bank should not engage in large scale balance of payments financing for the crisis countries, an activity for which it lacks the mandate and the instruments.

[8] IBRD Net Income

Apart from the mandate issue, the provision of large scale balance of payments support puts undue pressure on the financial capacity of the Bank and shifts that burden onto the

borrowers. A more equitable burden sharing could very well involve a capital increase. Declining net income cannot adequately provide sufficient funding for reserves and for the other purposes which shareholders want the Bank to finance. We must be aware that there is a limit to what we can ask the Bank to do. We would therefore urge shareholders to live up to their responsibilities and contribute adequately to HIPC and IDA.

Mr Chairman,

The international financial institutions cannot continue to respond to international crises by supplying ever larger rescue packages. All actors, including the countries concerned and the private sector should strengthen their efforts to avoid further turmoil. Fund and Bank should be provided with the necessary means to continue to play their role. In this context, I am glad to be able to announce today that the IMF quota increase has been approved by Dutch parliament.