



**Financial Sector Surveillance:  
What have we learned.**

by

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First, let me thank the Independent Evaluation Office of the IMF for inviting me to speak today on strengthening IMF surveillance. We, at the Bank of Thailand, have been a keen supporter of the Independent Evaluation Office ever since its inception in 2000. In particular, efforts on the Fund's advice on capital flows management as well as its recent review of FSAP, have been useful for us in shaping our own policies. I wanted to mention this at the outset, as a way of registering our support and appreciation.

My task today is to speak on the financial sector dimension of surveillance. Given time limitations, I want to cover just two issues. The first is to comment on the new direction of Fund surveillance on financial sector, as embedded in its medium-term strategy, particularly on the issue whether the new direction is adequate vis-à-vis what remains to be done in crisis prevention. And the second is to comment on a few additional areas that should be emphasized going forward in the context of surveillance for emerging markets.

But before doing that, let me start first with the key issue of this seminar---that is the lessons learned.

The Asian financial crisis of the 1990's has been described by some as being the most severe in its depth and regional coverage. Looking back, I think three important lessons clearly stand out.

The first is the risk associated with liberalizing capital flows without adequate safeguards and proper policy framework. Important in this context is the need for greater policy and economic flexibilities to help manage the effects on macroeconomic stability from persistent capital inflows and possible subsequent reversals. Also important is the need to have in place a credible crisis prevention mechanism that will allow timely liquidity support to be mobilized.

As for the financial sector, the lesson learned is that a resilient and robust financial sector is key to avoiding crisis. The foundations for a resilient and robust financial sector are in the strong framework for prudential regulation and supervision, greater transparency and good governance, as well as a balanced financial sector. This last point applies particularly to well developed capital markets that can allow financial risks in the economy to be spread out, shared, and more efficiently managed.

And the third lesson is the need to have in place an effective mechanism of economic and financial surveillance to identify potential

risks, especially those relating to financial sector and capital flows issues, which are the two most important risks for emerging markets.

All three lessons are now well known. And we have seen conscious efforts by national governments and IFI's such as the IMF to take heed of these lessons.

In Asia, at the national level, we see a region-wide move toward a more flexible exchange rate regime, with a disciplined framework in the conduct of monetary and fiscal policies. As for the financial sector, after the initial restructuring and consolidation, the framework of policy has moved towards risk-based supervision, to an adherence to international standards, and to the undertakings of formal financial sector assessments either under FSAP or within the country's own financial stability evaluation framework.

At the international level, the IMF has also come up with many new and important initiatives. As for the financial sector, its financial surveillance process has been deepened with the introduction of FSAP and the surveillance of international capital markets under the Financial Stability Forum, and the publication of the Global Financial Stability Report.

More importantly, the recent initiatives on the new direction of financial sector surveillance is another important step in understanding the linkages between macroeconomic stability and financial vulnerabilities. The new direction aims to integrate financial sector analysis and issues with the Article IV process, and then to link the bilateral surveillance with multilateral surveillance. In our view, this is an ambitious undertaking, but is a move in the right direction.

The challenge, as we see it, will come from the implementation process, especially on the issue of what should be the adequate scope in terms of issues to be covered, choice of countries, and the analytical approach to be used. These are important questions that will need to be worked out, taking into account resources at the Fund. Our view is that the initial move on the new direction should not be overly ambitious. It is better for the process to move forward gradually, focusing first on the most systemically important economies.

But as far as emerging markets economies are concerned, if surveillance is to be effective in pre-empting crisis, then I think one question that can be asked is whether the improvements that we are now seeing, as well as the new direction to be taken, are adequate or credible as a mechanism of crisis prevention.

This is an important question for policy and I have given this question a lot of thought. My view is that the new direction does fill important gaps in the current surveillance process. And if the new direction is meaningfully implemented, it will go a long way in strengthening surveillance and contribute to a resilient and robust financial sector.

Nonetheless, one must not lose sight of the fact that a resilient and robust financial sector is only a necessary condition for avoiding crisis, not a sufficient one. As recent research has shown, key pressure points that can lead to difficulties for emerging markets are more likely to be externally-induced. A case in point is the difficult environment associated with sudden changes in global financial conditions that result in a rise in global real interest rates and more volatile capital flows. Such developments can create difficulties for emerging markets through spillover effects, large and persistent capital inflows, and the risk of sudden stop and capital reversals. So, it is in this context that IMF surveillance on emerging markets, in addition to the new directions that we have discussed, should pay attention to the sources of the externally-induced risk and vulnerabilities, and to assist members, through Fund policy advice, on how best to prepare.

To help emerging market members become better prepared for these risks, I have a few suggestions to make on the Fund's current efforts.

First, for the new direction on financial sector surveillance to be relevant for crisis prevention, it is important that the key systemically important economies participate. As with FSAP, this is an area that is likely to be a challenge. Ideally, most systemically important economies and those with potential financial vulnerabilities should participate if the new direction were to have a strong relevance to the global surveillance objectives.

The second suggestion is in financial markets surveillance. Again, if surveillance is to have a strong relevance for emerging markets, we will need to have a more policy-oriented surveillance of the global financial markets, focusing on the key financial flows, and on keeping members informed of what the Fund sees as the current trends and risks in the global financial markets. Also, it would be useful if the Fund could develop its own in-house view of a benchmark risk scenario which then can be used, or shared with members, in stress-testing the vulnerabilities of their economies and financial sectors.

I probably have used up my allocated time. I hope my remarks have been useful. Again, I would like to thank the Independent Evaluation Office for the invitation. Thank you.