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The Nordic-Baltic Office
International Monetary Fund

Report 2005/1

Recent Policy Developments in the International Monetary Fund

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CONTENT

LIST OF ACRONYMS

ERM	Exchange Rate Mechanism
EU	European Union
EURIMF EU	Countries Group of IMF Executive Board Representatives
FSAP	Financial Sector Assessment Program
FY	Fiscal Year
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
GNI	Gross National Income
GRA	General Resource Account
HIPC	Heavily Indebted Poor Countries
IEO	Independent Evaluation Office
IFI	International Financial Institution
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
LIC	Low-Income Country
MDG	Millennium Development Goal
NBC	Nordic-Baltic Constituency
NBO	Nordic-Baltic Office
ODA	Official Development Assistance
PA	Precautionary Arrangement
PCC	Post Conflict Country
PRGF	Poverty Reduction and Growth Facility
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
SCIMF	EU Sub-Committee on IMF Matters
SDR	Special Drawing Right
USD	United States Dollar
WEO	World Economic Outlook
WTO	World Trade Organization

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INTRODUCTION

This report is prepared by the staff of the *Nordic-Baltic Office* (NBO) at the International Monetary Fund in preparation for the Spring Meeting of the Fund's *International Monetary and Financial Committee* (IMFC) on April 16, 2005. The report is published at websites of finance ministries and central banks of the Nordic-Baltic countries.

The report covers the period since the IMFC Meeting in Washington D.C. in October 2004 to April 14, 2005. It centers on the following key areas:

- Discussions on the Fund's medium-term strategy;
- The global economy and financial markets;
- Selected country cases. This includes the Fund's main debtor countries, the Fund's response to the Tsunami disaster, and a summary of the Executive Board discussions on Nordic-Baltic countries that have taken place during this period;
- The Fund's support for low income countries, including the ongoing consideration on possible further debt relief and financing issues;
- Reviews of key Fund policies and other issues.

In the various sections of the report, special reference is made to key views presented by the *Nordic-Baltic chair* at Executive Board meetings on behalf of the *Nordic-Baltic Constituency* (NBC). Main sources used for the preparation of the report include the *World Economic Outlook* (WEO), the *Global Financial Stability Report* (GFSR), and the report of the Managing Director to the IMFC on the IMF's Policy Agenda. These reports, along with the Fund's Annual Reports, country reports, and other policy subject reports, as well as Press Information Notices summarizing discussions in the Executive Board, are available on the Fund's website *www.imf.org*.

The Nordic-Baltic Constituency consists of eight countries: Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. The NBC has 3.52 percent of the total votes at the Fund's Executive Board that consists of 24 chairs representing the 184 member countries. The Managing Director, or one of the three deputies, chairs the Board meetings. The *Nordic-Baltic Office* currently has eleven staff members: An Executive Director, an Alternate Executive Director, three Senior Advisors, four Advisors and two permanent Administrative Assistants. A rotation scheme has been approved ensuring that all eight countries in the *Constituency* are represented in professional positions in the office.

Through the Executive Director, the NBO contributes to the policy formulation and decision-making of the Fund. The NBO serves the interests of the *Nordic-Baltic Constituency* by promoting its views and enhancing its role within the Fund. The NBO cooperates with national authorities by receiving guidance, exchanging views and providing information on discussions and developments within the Fund. The NBO has prepared an internal Business Plan covering the Fund's fiscal year (May-April), which sets out a Mission Statement for the office and a strategic approach to the NBO's resource management. Information related to the NBO and its work is available on an in-house website.

The NBO participates in various Committees of the Executive Board. The Nordic-Baltic Executive Director chairs the Committee on Executive Board Administrative Matters and is a member of the Committee on the Budget, the Committee on Interpretation and the Ethics Committee. Moreover, the Nordic-Baltic Executive Director is member of the Task Force on Publication of Fund Documents in Languages other than English.

The six NBO representatives from EU countries participate in the informal cooperation between EU countries' representatives in the Fund (EURIMF). This cooperation has been further developed during recent years, following the agreement at the EU Summit in Vienna, Austria in December 1998 that the EU should play its full role in international monetary and economic policy cooperation within international fora, including the Fund.

The cooperation within the EURIMF is focused on broad Fund strategic policy issues as well as on countries of systemic importance, including emerging market countries with large Fund financial programs. In addition, upcoming *Article IV* consultations involving EU countries are discussed in the EURIMF. The EURIMF also meets with the Fund's staff and management with a view to contribute to the work program of the Fund and to push forward EU ideas and positions. The EURIMF interacts with and receives guidance from the EU subcommittee on Fund issues (SCIMF) established under the EU *Economic and Financial Committee*. SCIMF is composed of representatives of finance ministries and central banks of the EU countries. With a quarter of EU member countries in the *Nordic-Baltic Constituency*, the informal EU cooperation provides additional avenues for the NBC to strengthen its influence.

Two permanent committees guide the work of the NBC in Fund related issues. The *Nordic-Baltic Monetary and Financial Committee* (NBMFC) is composed of two high-level officials from each country, the State Secretary/Permanent Secretary from the relevant ministry (Ministry of Finance or Ministry of Economic Affairs) and a Deputy Governor/Member of the Board of Governors from the Central Banks. The *Group of Alternates* is composed of Heads of International Departments in the Central Banks and relevant ministries. The Alternate Committee meets twice a year to discuss Fund related issues and makes proposals to the NBMFC. The NBMFC is a decision making entity with regular meetings twice a year, but consults more often if necessary, e.g. in telephone conferences. The NBMFC also develops strategic positions on issues that are likely to be prominent on the international monetary arena.

For the individual countries in the *Nordic-Baltic Constituency*, their direct engagement with the Fund is now limited to surveillance in accordance with *Article IV* of the Fund's Articles of Agreement. Estonia, Finland, Latvia, Lithuania, Norway and Sweden are on a standard 12-month cycle, i.e. the Fund's staff visits these countries once a year to assess their economic policy and provide the authorities with policy advice. Denmark and Iceland are on an optional 24-month cycle. All the countries in the *Constituency*, except Denmark, have been assessed from a financial sector stability point of view within the framework of the *Financial Sector Assessment Program* (FSAP). Norway has just undergone an FSAP that will be discussed - together with the *Article IV* surveillance report - by the Executive Board in June. Denmark is expected to have an FSAP during FY 2006 (May 2005-April 2006). Countries in the *Constituency* are making the reports from the *Article IV* surveillance available on the websites of their ministries of finances and central banks, together with a summary of the views of the Executive Board. Those reports are also available on the Fund's website.

I. SHAPING THE FUND'S STRATEGIC DIRECTION

The Fund's Medium-Term Strategy

A major subject discussed in the Executive Board during the recent six-month period has been the ongoing review of the Fund's medium-term strategy. The review was initiated by the Managing Director, Rodrigo de Rato, in September 2004, and the Executive Board has discussed the issues during an informal recess of Executive Directors in early February, 2005, an informal Board seminar in February, and a regular Board meeting in March. Following discussions of the subject during the IMFC meeting, deliberations will continue at the Executive Board. The aim of the work is to reach a shared understanding of the Fund's work priorities in a vision of the institution's forward-looking strategy by the time of the 2005 Annual Meetings in September. The medium-term strategy, together with the results from the ongoing review of the Employment Framework, Compensation and Benefits, will be an essential input into the medium-term budgetary framework for FY 2007-2009.

As a guiding principle for the Fund's medium term strategy, special focus has been put on the need to help and encourage members to adopt sound policies and establish robust institutions, and to embed sound policies in institutional frameworks that reinforce them and make them more likely to be sustained in the future. The special emphasis on institutions reflects the growing evidence that policies conducive to stability and sustained growth cannot be implemented effectively without appropriate underlying institutions. This applies particularly to the adequacy of so-called "broad" economic and political institutions. Other essential parameters for the Fund's medium-term strategy are the influences that are expected to shape the global economy in the coming years, including that private international capital flows are likely to continue growing rapidly. Private capital flows are already far larger than official sources of financing. Other important issues are related to the Fund's collaboration with the World Bank and other international organizations, and the governance of the Fund. Issues regarding quotas, voice and participation of all members has a considerable bearing on the Fund's perceived legitimacy, and hence on its effectiveness. As an important element of the strategic review, the Fund's membership has to consider closely and in a cooperative manner how to make progress on these issues. To that end, the period of the 13th General Review of Quotas provides an important opportunity. In accordance with the Fund's Articles, this review will need to be completed by January 2008.

The discussions have shown a considerable degree of common understanding of the Fund's core mission. With this anchor, the Fund must continue to adapt to global economic developments, respond to the changing needs of its diverse membership, and learn the right lessons from its experience. There is broad agreement that policies conducive to stability and sustained growth cannot be implemented effectively without appropriate underlying institutions. While the Fund has built up considerable expertise regarding economic institutions responsible for the promotion of macroeconomic and financial stability, there is general agreement that the Fund should not have a direct role in building and developing "broader" institutions of importance. Such broad institutions include those that create effective property rights for broad sections of the society and govern contracts. Furthermore, there is general agreement on the need to increase the focus on issues that matter most for macroeconomic and financial stability and thereby growth in each country, while paying attention to the spillover effects of members' policies. Moreover, Directors have reconfirmed the importance of adequate voice and representation by all members, and a distribution of quotas that reflects developments in the world economy. The discussion has also touched upon a number of longer-term issues, such as the appropriate future scale and circumstances of Fund lending; its role regarding international capital movements; the possible need for additional mechanisms to facilitate the orderly resolution of sovereign debt problems; and possible changes in arrangements for financing the Fund's administrative budget.

The *Nordic-Baltic chair* welcomes the discussion of the role and rationale of the Fund. While our chair would have preferred a more comprehensive discussion of the strategic direction of the Fund in view of global economic trends, having discussions on prioritizations and policies linked to the budget will be of great benefit for Fund governance and transparency and our chair's underlying goal of keeping the Fund as a lean, effective and flexible institution. The *Nordic-Baltic chair* has invited Management to emphasize which tasks they regard of high priority and which are of less priority, and on the budgetary implications. More specifically, the *Nordic-Baltic chair* has emphasized that:

- The guiding principle of supporting members in designing and implementing sound economic policies and strong institutions is deeply rooted in the Fund's traditional emphasis on macroeconomic stability, international trade, and financial stability.

- "Broad" economic and political institutions are of major importance for stability and sustained growth. It seems relevant that the Fund obtains information on the quality of these institutions as part of its involvement with individual member countries. However, the Fund should concentrate its involvement with the "specific" institutions of macroeconomic and financial management. The Fund should not have a direct role in promoting the development of a broad group of institutions. Another question is how the Fund can encourage other bodies to invest in the cultivation of those "broad" institutions.

- The Fund should continue to improve the effectiveness of its surveillance. Enhanced transparency and access to economic and financial information are vital to macroeconomic and financial stability. Increasing interdependence and potential for spillover effects will also require development of more effective regional surveillance tools. Moreover, debt sustainability analysis is a central tool in crisis prevention and lies at the core of the Fund's responsibility, implying that such analysis should feature as an integral part of all country surveillance and program reports. While agreeing that increased selectivity of surveillance increases its effectiveness, it is clear that the emphasis on increased focus and selectivity requires an element of judgment also with respect to its political feasibility.

- The Fund has a key role in securing financial stability and this should be seen as a core activity. An important challenge will be to more effectively transfer lessons learned within the FSAP framework into regular surveillance.

- The Fund's financial support should be based on unambiguous rules founded on economic considerations and tailored to country-specific circumstances. Financial assistance should be more selective, supporting only robust and credible programs and should always include a clear exit strategy.

- A comprehensive review of the crisis resolution framework is overdue, including private sector involvement, the lending into arrears policy, and the rationale for a debt restructuring mechanism. One aspect that deserves to be addressed concerns the diminishing catalytic effect of Fund financing, and the implications this should have for the Fund's lending policy.

- The Fund has an important role in low-income countries, mainly in policy advice and capacity building in its core areas. Recently, increased focus has rightly been put on how the Fund can contribute to the universal endeavor of achieving the MDGs. *The Nordic-Baltic chair* strongly supports the work on improving the nationally owned PRS approaches and the Fund's continued efforts to streamline and sharpen the PRGF. *The Nordic-Baltic chair* has endorsed an advisory role for the Fund in helping countries to deal with aid flows, focusing on the macroeconomic aspects of potential capacity constraints. *The Nordic-Baltic chair* supported a further study of the factors behind the lack of growth in many LICs, including an examination of the balance between external adjustment and financing in Fund-supported programs that has turned out to be insufficient to stabilize debt ratios even after HIPC debt relief.

- The governance of the Fund should be examined to strengthen the legitimacy and effectiveness of the institution in the future. Moreover, while the Fund's internal management and governance have been significantly strengthened over the past few years, issues remain, including to further improving the budget process in the setting of priorities. It may also be useful to evaluate the effectiveness of the current organizational structure.

In connection with other discussions on quotas, voice and representation, the *Nordic-Baltic chair* has supported increasing the number of basic votes and letting these become a fixed percentage of the total number of votes. Changes in quota formulas could also be considered, letting countries, which are particularly underrepresented in relation to their calculated quota shares, get ad-hoc quota increases. However, the basic principle should be maintained, that it is the ability to contribute to the Fund's financing which should determine quota size and voting share. *The Nordic-Baltic chair* has also encouraged a further strengthening of the Fund's internal governance. Decision processes need to become fully transparent with timely involvement of the Executive Board, confirming its role as the central policy-making body.

Budget Issues and the Review of the Fund's Employment Framework, Compensation and Benefits

While considerable progress has been made in strengthening the budget process in recent years, further reforms of the budget process have been launched with the ultimate aim of establishing a medium-term output oriented budget. The strategic review will play an important role in setting priorities for the Fund's work program and medium-term budget framework.

Furthermore, the Fund is reviewing its overall employment framework, together with the system of compensation and benefits. The review will consider issues related to the Fund's staffing strategies, career management, and staff compensation and benefits. The review draws on external expertise and is expected to be finalized toward the end of 2005.

The *Nordic-Baltic chair* has supported these developments and stressed the desirability of adopting a more strategic and medium-term view of the budget process. On a number of occasions, the *Nordic-Baltic chair* has not been able to support Management's proposals for salary increases in recent years and, together with many other chairs, has requested a broad review of the compensation system. Therefore, the *Nordic-Baltic chair* has welcomed the comprehensive review of the Fund's compensation and benefits system and its terms of reference. In this review, the *Nordic-Baltic chair* has, *inter alia*, stressed the importance of increased flexibility in the system and maintaining an expatriate approach to the benefit system.

II. The Global Economy and Financial Markets

The Executive Board conducted its biannual assessments of the world economic outlook and global financial stability in March 2005.

World Economic Outlook

While global growth remains strong and the global economic environment relatively benign, higher oil prices and large global imbalances continue to pose challenges, and underlying vulnerabilities remain in many countries. Global growth is projected to be 4.3 percent in 2005, or above the long-term trend, despite a slowdown during the latter part of 2004, partly resulting from the impact of higher oil prices on consumer demand. Growth was exceptionally high in 2004, 5.1 percent. The global expansion continues to be underpinned by accommodative macroeconomic policies and favorable financial markets conditions, including continued low long-term interest rates. The Tsunamis that battered Indonesia and other Indian Ocean rim countries in December 2004 are not expected to have a substantial impact on regional growth, despite their appalling toll in human lives lost and property destroyed.

At the same time, global growth has become less balanced. Divergences in regional growth rates have widened and the significant global imbalances have further worsened. While forecasts have been revised upwards for the United States and China (where a soft landing is not assured) and for most emerging markets, forecasts for Europe and Japan have been marked down. On the positive side, inflation has generally remained subdued with limited second-round effects from higher oil prices. However, the global economy remains vulnerable to a number of medium-term risks, in particular the large global imbalances, difficult fiscal positions in many countries and structural weaknesses. Due to the importance of the developments of the oil market for the global economy, oil market developments were discussed in the Executive Board both at a separate meeting and in connection with the world economic outlook discussion in March.

At the Executive Board meeting, the *Nordic-Baltic chair* was in broad agreement with staff's assessment. *The Nordic-Baltic chair* stressed the importance of engineering an orderly rebalancing process. A key priority must be an ambitious fiscal consolidation in the US. Additional exchange rate flexibility coupled with financial market reform would promote a more balanced economic development in Asia. Further structural reforms in Europe and Japan remain crucial to stimulate growth. Positive growth prospects in Africa are welcome, but continued efforts to build strong institutions, together with sound economic policies and good governance, are needed to ensure lasting growth. The *Nordic-Baltic chair* also noted that the recurrent spikes in the oil price add urgency to the efforts to improve the working of the oil market, including promoting capacity expansions, enhancing data transparency and supporting measures to improve energy efficiency. A successful completion of the Doha Round is vital for making international trade a stronger stimulus for economic development in advanced and developing countries alike. Particular emphasis must be placed on achieving a genuine and lasting improvement for developing countries' market access. Concrete progress in the coming negotiations is the common responsibility of all countries.

Global Financial Stability

The global financial system has further strengthened in the past six months, supported by solid global economic growth and continued improvements in balance sheets of the corporate, financial, and household sectors in many countries. *The Global Financial Stability Report* (GFSR) acknowledges ongoing improvements in the fundamentals of many emerging market countries. Prospects for sustained financial stability are underpinned by still favorable outlook for the world economy and the growing spreading of risks in financial markets. Nonetheless, the currently low long-term interest rates and credit spreads may mask underlying vulnerabilities and pose risks of market reversals, especially for less credit-worthy sovereigns and corporations. While these risks are generally expected to be manageable given the strength of financial institutions, the GFSR stressed the need for continued vigilant monitoring and timely policy measures.

To mitigate risks, the GFSR emphasizes the need for a robust implementation of risk management practices. Central banks should continue to gradually raise interest rates in a way well anticipated by markets. More generally, the authorities should maintain market confidence through taking measures to facilitate orderly adjustment of global imbalances.

The GFSR follows up on analysis presented in the previous two issues of the reallocation of risk from the banking sector to other sectors, with the emphasis in the latest issue on the household sector. The conclusion drawn is that the households have been taking on more risks and have become, increasingly and more directly, the “shock absorber of last resort” in the financial system.

The *Nordic-Baltic chair* was in broad agreement with the analysis and findings of the GFSR. The resilience of global financial markets amidst the tightening monetary policy in a number of mature financial markets, spike in oil prices, and growing global imbalances has been remarkable so far. The global financial system seems to be able to deal with today’s uncertain position better than in the past. On the other hand, with the current trend of widening global imbalances that are neither sustainable nor easily reversed, uncertainty about their possible implications for financial stability will continue. Efforts by all major players to engineer an orderly rebalancing process and to sustain market confidence are called for. The *Nordic-Baltic chair* noted that the near-term risks appear to be contained. However, in light of the magnitude and uncertainty associated with medium-term risks, there is a need to be cautious. The focus on risk transfer to the household sector was appropriate. The *Nordic-Baltic chair* referred to the experience of countries in the constituency that shows that analysing developments across household groups contribute to the understanding of the financial robustness with regard to the household sector.

Selected Country Matters

Table 1: The Largest Borrowers under the GRA, Credit Outstanding (February, 28, 2005)

	Billions of SDRs		In percent of quota	Share of total GRA credit, percent
	Stock at February 28, 2005	Change from July 31, 2004		
Brazil	16.1	-1.1	531	31.0
Turkey	13.4	-1.4	1392	25.8
Argentina	8.8	-1.2	415	16.9
Indonesia	6.1	-0.5	295	11.7
Russia	0	-2.6	0	0
Uruguay	1.7	0.1	542	3.3
Sub-total	*46.1*	*-6.7*		*88.7*
Other GRA credit	5.9	-0.6		11.3
Total GRA	*52.0*	*-7.3*		*100*

The Fund's overall lending has continued to decline with the biggest impact over the last months coming from Russia's early repayment of its entire outstanding obligations to the Fund. The overall lending, however, remains concentrated in arrangements with a few large borrowers.

Argentina
A three-year *Stand-By Arrangement* for Argentina was approved on September 20, 2003, giving the country access to SDR 8.98 billion or USD 12.55 billion. The *Nordic-Baltic chair*, together with three other chairs, abstained from the Executive Board's decision. In the view of the *Nordic-Baltic chair*, the program did not deal in a satisfactory manner with the serious economic and political difficulties facing the country. It was, therefore, not in the best interest of Argentina, the region and the Fund. The *Nordic-Baltic chair*, together with several other chairs, also abstained on the decision to complete the first review of the program in January 2004. However, the *Nordic-Baltic chair* could go along with the completion of the second review in April 2004, given the fact that there was progress in some areas where the *Nordic-Baltic chair* had expressed concerns. The third review of the program was not completed during 2004. It was the understanding that program discussions between the Fund and the authorities would be resumed once the outcome of the debt restructuring and work on structural fiscal issues has been assessed.

Argentina's sovereign debt exchange offer formally ended on February 25, 2005. The Board was informed on March 3 about the results of the debt exchange. Bondholders representing an amount of USD 82 billion had been eligible for the offer. The global acceptance rate was 76.1 percent of eligible bonds, representing USD 62 billion worth of bonds tendered under the offer. Thus, holdouts represented about USD 20 billion.

The Fund is studying the outcome of the closure of the debt exchange, taking into account the Fund's lending into arrears (LIA) policy. The strategy towards the unrestructured debt will be discussed further, to ensure consistency with the LIA policy. In this context, an important next step is to discuss a new debt sustainability assessment in the context of the ongoing Article IV discussion. As stated by the Managing Director on April 1, it will be in the interest of Argentina as well as the international community for the Argentine authorities now to formulate a realistic strategy to address the issue of remaining arrears.

The *Nordic-Baltic chair* has emphasized that a possible new program relation should be based on a medium-term primary-surplus fiscal policy path reflecting the macroeconomic outlook and Argentina's future obligations to the Fund, as well as the outcome of the debt restructuring. The program should lead to a declining Fund exposure and thereby pave the way for a sustainable exit from Fund-supported programs. While recent macroeconomic developments have been positive, sustainable growth in Argentina will necessitate comprehensive structural reforms with prudent fiscal management, a banking reform and addressing remaining challenges in the utility sector. A new program would also have to be based on an updated debt sustainability analysis. This will also have to take into account what will happen to holdout creditors. The Argentinean authorities must develop a strategy on how it will treat the arrears owed to these bondholders. The *Nordic-Baltic chair* has underscored the necessity for the Fund to say "yes" to strong, coherent and sustainable programs with access commensurate with the balance of payments need and the strength of the underlying program, and "no" when policies are insufficient and inconsistent and the standards in Fund supported programs are not adhered to.

Brazil

The Ninth Review under the *Stand-By Arrangement* from 2003 was completed in December 2004, and the Tenth and last Review in March 2005. Brazil's performance under the arrangement, which has been treated as precautionary by the authorities, has been outstanding. The fiscal primary surplus has been higher than targeted and inflation has been brought within the target range, although high economic growth, in combination with higher oil prices has created some upward pressures. The external position has improved with rapid export growth. On March 28, the Brazilian government announced that it is not going to seek an extension of the current arrangement or a new arrangement with the Fund.

The *Nordic-Baltic chair* has commended the strong performance under the program, but has underlined the need for vigilance, as Brazil is still vulnerable to both a shift in market sentiment and external shocks. Aiming for a higher fiscal surplus than the 4.25 percent target would strengthen debt sustainability and better support monetary policy. Monetary policy, based on the inflation targeting framework, would benefit from an operationally autonomous central bank. The authorities were urged to continue steadfastly with structural reforms including investment in human capital, prudent resource management and environmental protection.

Turkey
During the last months of 2004 and the first part of 2005 negotiations between the Turkish authorities and Fund staff have continued on the elements of an economic program and a draft letter of intent that could be supported under a new three-year Stand-By Arrangement in the order of USD 10 billion. Understanding had been reached in December 2004 on the key elements of the economic program, including continued fiscal discipline, containing and reducing the social security deficit, tax policy reforms, banking sector reform and structural reforms. However, a number of policy steps was needed to be taken before the Executive Board could consider a program request. On April 12, the Fund's Resident Representative in Turkey announced that with these policy steps now close to completion, the authorities' letter of intent has been finalized. It is envisaged that a Board discussion on a new program can take place in the first half of May 2005.

Iraq
In September 2004, the Executive Board approved SDR 297.1 million in Emergency Post-Conflict Assistance to Iraq as support for Iraq's economic reconstruction efforts through 2005 and to help catalyze additional international support, including debt relief. The Fund has continued policy discussions with the Iraqi authorities and provided technical assistance, particularly in the area of institution building. After the elections in January 2005, policy discussion with the new government will continue. The discussions are expected to focus on the implementation of the emergency post-conflict program for 2005, and subsequently on the policy measures that could form the basis for the negotiation of a future stand-by arrangement

The Fund's Response to the Tsunami Disaster
Following the severe earthquake and associated tidal waves that hit Indian Ocean countries on December 26, 2004, the Fund has been engaged in assisting the authorities to cope with the aftermath of the disaster. The Fund focused its initial work on assessing the implications of the disaster for macroeconomic policy, including the impact on growth, as well as the fiscal and external positions. The Fund also moved ahead to initiate the provision of emergency financial assistance and longer-term financial aid, which the *Nordic-Baltic chair* has actively supported. The Board decided in January to set up an administered account to subsidize emergency assistance for natural disasters provided by the Fund to PRGF-eligible member countries. Total funds needed to make this initiative effective are estimated to be USD 70-100 million.

Two countries in the *Nordic-Baltic Constituency*, Norway and Sweden, have provided contributions to the administered account. Of total contributions of USD 26 million so far, Norway has contributed USD 1.6 million and Sweden USD 10 million. The Fund provided subsidized emergency assistance in early March 2005, to the Maldives and Sri Lanka.

Article IV Consultations with Nordic-Baltic Countries, September 2004 – April 2005
Finland. The 2004 *Article IV* consultation was completed on January 28, 2005. Executive Directors commended the authorities for the impressive strides made by the Finnish economy in recent years, aided by strong productivity gains and a stable macroeconomic policy

framework, with low inflation and sizeable fiscal surpluses. However, unemployment has remained stagnant, and Finland will face the challenge of population aging earlier than any other country in the European Union. Directors noted that while Finland's fiscal position remains comfortable from a comparative EU perspective, the general government surplus had eroded in recent years. They recommended that the planned cuts in income taxes be offset by a reduction in public spending, preferably through improved efficiency in the provision of social and welfare services. Directors called for comprehensive structural reforms to reduce the required fiscal adjustment to ensure fiscal sustainability when facing the challenge of aging. They called for initiatives to raise the employment rate at both ends of the age spectrum, steps to follow up the significant pension reform being phased in, and a further strengthening of competition in product markets.

Lithuania. The 2004 *Article IV* consultation was completed on March 22, 2005. The Executive Board complimented the Lithuanian authorities for the implementation of sound macroeconomic policies and structural reforms. Directors welcomed Lithuania's entry into ERM II and noted that the economy appears broadly on course to meet the Maastricht criteria and adopt the euro in early 2007. Directors cautioned, however, that challenges remain for both the near- and the long-term. The current account deficit has widened appreciably in 2004 and is forecasts to deteriorate further. Inflation, though low, has accelerated, and domestic bottlenecks and higher oil prices could raise the inflation rate temporarily above the Maastricht limit. With indicators suggesting that output will remain above potential in 2005, an expansionary fiscal stance could add to inflationary pressures and the current account deficit. Short-term stability requires a more cautious fiscal policy than that contemplated by the authorities to allow for automatic stabilizers to operate. Directors encouraged the authorities to build a safety margin to be used in the event of a slowdown. Directors welcomed the authorities' plan to lower the personal income tax rate to improve incentives to raise employment and productivity. They emphasized that tax cuts should be phased in together with complementary measures so as not to jeopardize fiscal consolidation. Directors encouraged the authorities to accelerate structural reforms to support increased productivity, competitiveness, and long-term growth.

Estonia. The Executive Board concluded the 2004 *Article IV* consultation on November 8, 2004. Estonia was commended for the successful nominal and real convergence with the EU, and Directors agreed that the economy is well placed to meet the challenges of adopting the euro. The good track record of cooperation between the Fund and the Estonian authorities was noted. On policy challenges, the continuing high current account deficits are a potential cause of concern and may not be sustainable over the medium-term. However, Estonia's external competitiveness remains strong. Maintaining a prudent fiscal policy stance is important to avoid exacerbating the current account imbalance and to minimize the risks under ERM II. The *Currency Board* arrangement remains credible, as indicated by Estonia's relatively high credit rating, and is a viable strategy in the run-up to euro adoption. The banking sector remains sound. The rapid credit growth could pose a risk to macroeconomic and financial stability. Estonia's labor market flexibility is vital for maintaining competitiveness, and moderation in public sector wage growth will be of crucial importance in light of its signaling effect on the private sector. A key longer-term challenge will be to address the needs of an aging population and increasing health care spending. Directors commended the completion of most large-scale privatizations and the progress made in restructuring and liberalizing the energy sector.

III. The Fund's Support for Low-Income Countries

A main objective of the Fund's work with low-income countries is deep and lasting poverty reduction, as elaborated in the United Nation's *Millennium Development Goals* (MDGs). Working closely with the World Bank, and in the context of the policy frameworks set out in the countries' own *Poverty Reduction Strategy Papers* (PRSPs), the Fund provides its low-income members with policy advice, technical assistance, and concessional loans under the *Poverty Reduction and Growth Facility* (PRGF), and provides debt relief under the *Heavily Indebted Poor Countries* (HIPC) Initiative.

The *Nordic-Baltic Constituency* is supporting this work while underlining the importance of the Fund's involvement being focused on the institution's core areas of expertise, *i.e.* macroeconomic policies and financial stability. The *Nordic-Baltic chair* has paid particular attention to developing countries where the members of the NBC have special engagement as major donors of aid. The *Nordic-Baltic chair* has encouraged the development aid ministries of our respective countries to provide first-hand information to enable as informed statements as possible when these countries are discussed in the Board. Low-income countries that have attained particular focus include Bolivia, Malawi, Mali, Mozambique, Nicaragua, Tanzania, Uganda and Zambia. As shown in the annex, the NBC is a substantial financial contributor to the Fund's work in low-income countries.

The Fund's Role in Low-Income Countries

The Fund's role in Low-Income Countries (LIC) was initiated as a special topic last year, and has been one of the key issues for recent IMFC meetings. The Fund is in a unique position to support the key pillars of the Monterrey Consensus: country-owned domestic frameworks and policies, and an enabling international environment. The Fund works with countries to design policies and build institutions that will help them grow out of poverty. Furthermore, the Fund is a strong advocate for more and better international support. The Fund is also collaborating closely with other development partners, including in preparation of the upcoming UN Summit Conference on Implementing the Millennium Declaration in September. This includes the Global Monitoring Report, which reports on progress toward the Millennium Development Goals, and further work on innovative sources of developing financing.

Discussions have covered four broad areas. First, the instruments the Fund should be equipped with in working with its low-income members, as well as the financing of these. Second, issues related to debt sustainability. Third, the collaboration between the Fund and the World Bank in these matters. Fourth, the design of programs for LICs. Moreover, a *Committee on Low-Income Country Work*, chaired by the First Deputy Managing Director, was established in 2004, with the objective of ensuring policy coherence across the Fund on issues related to LICs.

The *Nordic-Baltic chair* is actively involved in these discussions, noting that the Fund has an essential role to play in LICs. This role is derived from the Fund's core mandate of supporting institutions and policies necessary for macroeconomic stability, which is a precondition for economic growth and poverty reduction. Recognizing the progress made in recent years by the Fund in aligning support behind country owned PRSPs, the Fund should continue to refine both program and facility design to better meet the need of developing countries in their efforts to reduce poverty.

Debt Relief and Debt Sustainability for Low-Income Countries

In the international debate, the issue of possible further debt relief for low-income countries and the financing has been high on the agenda recently. At its meeting in September 2004, the IMFC called upon the Fund to consider further debt relief and its financing, and in February 2005, G7 Finance Ministers expressed their willingness to provide as much as 100 percent multilateral debt relief on a case-by-case basis.

The topic was discussed in the Executive Board in March. While further debt relief could ease concerns about debt sustainability and attracting additional financing to achieve the MDGs, significant drawbacks referred to in the discussion include that it could perpetuate moral hazard and raise issues of equity. The Fund's own potential role in relation to additional debt relief will in practice be limited since only a small part of the poor countries' debt to international financial institutions are owed to the Fund. During the discussion, Directors also emphasized that the Fund should engage in further debt relief only as part of a broader international initiative, and that the benefits of such an initiative would depend importantly on the donor community's willingness to increase the overall aid envelope to ensure additional net resource transfers to LICs. It was underscored that the Fund should not embark on an initiative for further debt relief without first ensuring adequate financing. Of the possible sources for financing, most Directors stressed that additional bilateral grant contributions would be the most desirable. Furthermore, Directors broadly opposed the use of existing PRGF resources, as this would reduce the Fund's future concessional lending capacity. On the potential use of the Fund's gold, it was agreed that it could not be allowed to compromise the Fund's financial strength and integrity. At this stage, it was also clear that there is far from the necessary support for any agreement on the use of the Fund's gold.

To preserve the potential benefits of debt relief, it will also be critical to help countries avoid excessive borrowing in the future. This is the purpose of a new debt sustainability framework for LICs. Key elements of such a framework were endorsed last year, and the Board had a further discussion of the debt sustainability framework in April 2005.

The *Nordic-Baltic chair* has expressed the view that the most credible, reliable and durable approach to finance the funding gap for the MDGs would be to make faster progress in increasing aid budgets and raising the ratio of Official Development Assistance (ODA) to 0.7

percent of GNI. More ambitious multilateral trade liberalizations would also be essential. Debt cancellation is not always considered the most effective and equitable way of supporting the efforts to achieve the MDGs. Debt cancellation would be most effective if directed at providing debt relief towards HIPC countries, if this is based on a debt sustainability framework, as well as a sufficient track record of reforms and sound policies. Debt relief based on debt sustainability considerations would contribute to broader efforts of poverty reduction, and would improve prospects for coping with exogenous shocks.

The *Nordic-Baltic chair* has been of the view that debt relief should not be allowed to compromise the IFIs capacity to lend to low-income countries that are dependent on concessional borrowing for their economic development. The Fund's role in additional debt relief should be contingent upon parallel actions by other creditors, recognizing that outstanding debt to the Fund is comparatively small. A common framework would be needed. Financing of the Fund's low-income facilities should be kept separate from the Fund's general resources. A self-sustained PRGF is preferable, supplemented with additional bilateral loans if needed. On the issue of finding the financing for the clearance of arrears for Liberia, Somalia and Sudan, the *Nordic-Baltic chair* underlined that once these countries qualify, the funds for their debt relief should be found, based on updated costing and examination of the available options.

The *Nordic-Baltic chair* remains skeptical to the use of the Fund's gold for debt relief. Gold is an important part of the Fund's financial solidity, and provides security for financial contributions that are necessary for the Fund's lending to low-income countries. Therefore, bilateral funding should be the main source of financing for the Fund's role in low-income countries and this should be the case also for additional debt relief. In the event that it would be determined that the Fund's gold should be used as part of debt relief financing, the *Nordic-Baltic chair* stressed the following conditions: an outright and open sale of gold in the market would be consistent with the letter and spirit of the *Articles of Agreement*; the gold sale should be limited (not be the main source); and the sale should be undertaken in coordination with the ongoing sale of central banks' gold. It should be noted that the use of central banks' assets for this purpose might require approval by national parliaments.

On the new debt sustainability framework, the *Nordic-Baltic chair* has welcomed the further progress made in making the framework operational, including agreement on indicative thresholds for the net present value of debt to exports, depending on the quality of a country's policies and institutions. The *Nordic-Baltic chair* has emphasized the importance that the World Bank and the Fund produce a joint framework in each country case. Debt sustainability analysis (DSA) should be incorporated into existing operational practices of both institutions. This implies that for the Fund, the DSA would normally be required in the context of the Article IV consultation or a PRGF-supported program review.

Further progress has been made in implementing the HIPC Initiative. Three more countries – Honduras, Rwanda, and Zambia – have reached the completion point, bringing the total to 18 countries.

IV. REVIEWS OF KEY POLICY AREAS AND ISSUES

Review of Conditionality

A country borrowing from the Fund will have to make commitments on economic and financial policies, a requirement known as conditionality. Conditionality links the approval or continuation of financing provided by the Fund to the implementation of specific elements of economic policy by the country receiving the financing. Thereby the conditionality provides safeguards to the Fund that its resources will be used to help countries solve their balance of payments problems and will be repaid. Conditionality provides at the same time assurances to the country that it will continue to receive the financing under the arrangement provided it continues to implement the policies envisaged under the program supported by the Fund. In recent years, the Fund has worked to focus and streamline conditionality in order to promote national ownership of strong and effective policies. Following up on these efforts, a broad ranging review of Fund supported programs is being undertaken, to better support country driven adjustment and reform efforts under a wide range of circumstances. In the review focus has been both on examining the initial experience with the application of the streamlined conditionality guidelines agreed in 2002, and on the design of Fund supported programs. The 2002 conditionality guidelines emphasize national ownership of policies, parsimony in conditions, tailoring of policies to member circumstances, coordination with other multilateral institutions, and clarity in the specification of conditions.

The Executive Board discussed the 2002 Conditionality Guidelines in March 2005. Directors agreed that the implementation of the new guidelines has delivered positive results overall. They recognized that this review has come at an early stage of experience with the new guidelines, and that further evidence, in particular on economic outcomes, will be needed before definitive conclusions can be drawn. Directors welcomed the streamlining of the breadth of coverage of structural conditionality, in line with the requirement that such conditions be deemed "critical" to the goals of Fund supported programs. They observed that structural conditionality has shifted away from non-core areas, which are less likely to be critical; that it tends to cover fewer areas than previously; and that it is more strongly linked to initial economic conditions. Directors considered that the next review should be based on a larger body of evidence, and in particular, it should take stock of economic outcomes. Accordingly, Directors agreed that the next review would be conducted at the latest in March 2008.

The *Nordic-Baltic chair* welcomed the progress made in the application of the new guidelines, but noted that more experience and evidence is needed before their effects can be fully assessed. There is room for further progress in streamlining and limiting conditionality to areas of critical importance for achieving the program objectives. Furthermore, strong and front-loaded structural conditionality remains important to address fundamental weaknesses in macro-critical areas, as demonstrated by a number of recent ex-post assessments of Fund supported programs and the evaluations undertaken by the Independent Evaluation Office. While extensive conditionality is not a substitute for poor ownership, the authorities should nevertheless be ready to prove their commitment to the Fund supported arrangement by adhering to robust and sufficient conditionality. Genuine ownership and strong conditionality are complements, not mutually excluding alternatives. Moreover, in case of repeated uneven performance, the Fund should progressively raise the bar for potential re-engagement. The *Nordic-Baltic chair* encouraged Fund staff to take a more active role and assist in the development of policy options for the country authorities.

Design of Fund Supported Programs

The Executive Board discussed experiences with the design of Fund supported programs in December 2004. With regard to the objectives and outcomes of Fund supported programs, it was underscored that external viability remains a core objective. The adjustment under regular Fund supported programs (based on the General Resources Account, GRA) has been broadly in line with medium-term debt sustainability, and Fund support seems to have mitigated the impact of adjustments on growth. However, in a number of programs, especially in cases of capital account crisis, the external adjustment has been sharper and larger than needed to stabilize external debt levels. Consequently, Directors encouraged Fund staff to undertake further analysis of the optimal mix between financing and adjustment as well as of the determinants of capital flows and of the so-called catalytic effects of Fund supported programs. For low- income countries (ESAF/PRGF supported programs), programmed improvements in current account balances have, on average, been smaller than those required to stabilize external debt ratios, even at the lower levels prevailing after debt relief under the HIPC Initiative. Furthermore, Directors recommended more emphasis on avoiding overoptimistic growth projections, which risks undermining the reliability of debt sustainability assessments and the credibility of programs. On policies, Directors emphasized that the Fund should avoid supporting policy mixes that do not sufficiently underpin the exchange rate regime and the need for greater focus on fiscal consolidation in program design, particularly high quality fiscal measures that are politically feasible and sustainable. It was noted that fiscal consolidation has generally contributed to improvements in the external current account, while not being associated with lower economic growth, suggesting that confidence effects play a significant role. Directors agreed that work on program design needs to continue in a number of areas and that both internal seminars and external outreach to stimulate a wider debate on some key issues are important.

The *Nordic-Baltic chair* broadly agreed with the main conclusions, particularly stressing the need for increased focus on a "no policy change" scenario in debt sustainability analyses. It is important that the debt sustainability analyses in connection with surveillance and Fund supported programs reports are realistic. Sustained output expansion in ESAF/PRGF countries was encouraging, but the current account deficits in these countries remain too large to reduce or stabilize external debt ratios, even after debt relief. It was also worrying that fiscal slippages appear to have become more of a rule than an exception in Fund supported programs. This problem needs to be addressed – including through reconsideration of the principles for granting waivers in connection with the Executive Board's discussion on program reviews – not least to foster ownership and to sustain the credibility of Fund supported programs. The systematic over-optimism in medium-term forecasts should also be addressed.

Review of FSAP

In March, the Executive Board reviewed experience with the *Financial Sector Assessment Program (FSAP).* The FSAP was introduced in May 1999 by the Fund and the World Bank to strengthen the monitoring of financial systems in the context of the Fund's bilateral surveillance and the World Bank's financial sector development work. The FSAP is designed to help countries enhance their resilience to crises and cross-border contagion, and to foster growth by promoting financial system soundness and financial sector diversity. The staff paper for the review describes the developments in the FSAP program since the previous review in March 2003, and proposes that the key features of the program - joint Bank-Fund nature and voluntary country participation - remain unchanged.

Directors, including the *Nordic-Baltic chair*, welcomed the progress that had been made since the last review. They observed that about 120 countries, two-thirds of the membership, have participated or requested participation in the program, and called for continued efforts to encourage systemically important countries to participate. In this context, as a way to increase awareness of the program, Directors supported instituting annual reporting to the Board on country participation in the FSAP. Directors were pleased that improved prioritization and streamlining have resulted in assessments that are better tailored to country circumstances and that the average cost per FSAP has decreased. Directors agreed to keep both the joint Bank-Fund nature of the program and the voluntary country participation unchanged. On FSAP updates, Directors agreed that while there should be flexibility, an update should comprise an assessment of financial sector developments and progress in implementing earlier FSAP recommendations. Directors agreed that an average frequency of FSAP updates of about five years seems reasonable. While a number of Directors supported a move to a policy of presumed publication of the Financial Sector Stability Assessments (FSSA) arising out of the FSAP, many other Directors noted that a move to presumed publication for the FSSA is not consistent with the voluntary nature of the program. So far, about two-thirds of countries have volunteered to publish the FSSA. Directors noted that further proposals might arise from the upcoming reviews of the program by the Fund's Independent Evaluation Office and the World Bank's Operations Evaluation Department.

The *Nordic-Baltic chair* underlined the importance of transferring the knowledge from FSAPs into regular surveillance, particularly as the frequency of future FSAP updates would be limited. In addition, financial sector technical assistance should be better linked to FSAP updates. A continued streamlining of the scope of the assessments, including the information requests, was needed. The *Nordic-Baltic chair* supported a general move towards stronger encouragement to participate in the FSAP and to publish the FSSA.

Seminar on: From Fixed to Floating Exchange Rates

In December 2004, the Executive Board considered a paper *From Fixed to Float: Operational Aspects of Moving toward Exchange Rate Flexibility,* which provides operational and technical guidance for countries that have decided to move toward a more flexible exchange rate regime. At the 2004 biennial review of surveillance, the Board stressed the need to assist countries that are contemplating a move toward greater exchange rate flexibility.

Directors reaffirmed that no single exchange rate regime is appropriate for all countries in all circumstances. They underscored that the paper should not be regarded as a prescription that floating is the preferred option, noting that the Executive Board has not asserted the superiority of any one exchange rate regime over another. They considered the seminar to be a useful step toward developing the practical advice that the Fund can offer to members who wish to undertake the transition toward more flexible exchange rate arrangements. Directors recognized that more can be done to support countries' efforts in a variety of circumstances and suggested follow up work in some areas, including in developing and refining the operational advice as to the speed and sequencing of the move toward floating.

The *Nordic-Baltic chair* underlined that fixed exchange rate regimes have worked well in many countries, particularly small open economies, but also for larger economies within the framework of regional monetary corporation. Overall consistency of policies rather than the exchange rate regime per se is what matters the most. The option of regional exchange rate arrangements and currency unions deserves to be underscored. Moreover, a simultaneous and coordinated action within a region could make any switch easier. As to the necessary policies for an efficient regime switch, the *Nordic-Baltic chair* underlined the importance of strong and consistent fiscal and structural policies for monetary stability. The emphasis in the Fund's policy advice should be on the importance of overall sound, consistent, and sustainable policies and technical advice in applying or moving to different monetary regimes. Appropriate and transparent goals, a set of sound principles of implementation, an independent central bank, smoothly functioning markets, and adequate risk control systems are generally essential for the success of every monetary regime.

Review of the Fund's Work on Trade

In February, the Executive Board discussed a review of the Fund's work on trade. It was noted that the Fund has responded to a number of recent challenges facing its members by stepping up its work on trade. The Fund has consistently advocated open trade regimes as a means to improve economic efficiency, combat rent seeking and corruption, promote economic growth, and as a result, provide a firm basis for poverty-reduction efforts. Moreover, it was noted that the Fund has pressed for an ambitious Doha Round and urged members to ensure that free trade initiatives are consistent with the multilateral system.

In the discussion, the *Nordic-Baltic chair* underscored that the Fund has an important role in advocating trade liberalization and assisting members to adjust to freer trade, given its unique position for surveillance at the multilateral level. The Fund should focus on its areas of comparative advantage, i.e. analyzing the impact of trade liberalization measures on economic growth, the exchange rate, the financial sector, fiscal revenues and evaluation of spillover effects. Continued collaboration between the Fund, the World Bank and the WTO is essential to promote the Doha Development Agenda. The *Nordic-Baltic chair* welcomed the reduced use of trade-related conditionality under Fund supported programs, in line with the aim of streamlining the Fund's conditionality. More coherent integration of trade liberalization strategies in the PRSPs was encouraged, since such efforts may enhance low income countries' ownership of trade liberalization polices. While regional trade agreements are second best to a multilateral framework, the *Nordic-Baltic chair* stressed that regional arrangements can be important building blocks towards and consistent with multilateral liberalization. In addition, the *Trade Integration Mechanism*, which provides additional support for program countries to mitigate short-term effect of trade reforms, could be used more actively. Only a limited number of countries had made use of this mechanism so far.

The Nordic countries have adopted an initiative called *the Nordic Africa Initiative (NAI).* This initiative aims at strengthening the dialogue on trade and development in Africa, and to increase the understanding of how African interests can be met through active and constructive participation by all WTO members.

Review of the Fund's Finances and Financial Structure

A review of the Fund's finances and financial structure has been initiated. At a Board Seminar in March 2005, Directors considered that the Fund's current financial structure has served the institution well and should be broadly maintained. However, a potential decline of the outstanding credit and continued low global interest rates would make it prudent to explore new ways to secure the Fund's income and to broaden the income base without undue increases in the rate of charge. Directors called for further work on options for broadening the Fund's income base, including through an investment account. A follow up discussion is planned to take place later this year.

The *Nordic-Baltic chair* agreed that no fundamental changes were needed, but underlined that the Fund should aim to simplify the income mechanism and make it more transparent. The *Nordic-Baltic chair* supported activating an investment account, but did not support a lowering of the interest rate paid to creditors for the use of their funds for the Fund's lending. The *Nordic-Baltic chair* underscored that a reduction in credit outstanding and less loan concentration should be seen as a sign of success for the Fund and not a cause for concern.

Review of the Fund's External Communications Strategy

In March 2005, the Executive Board discussed the paper *Integrating IMF Communications and Operations*, which had been prepared in response to the Board's request to regularly discuss the issue of external communications. Fund staff continues to organize a variety of outreach efforts, including briefings and seminars for parliamentarians, the private sector, trade unionists, journalists, and civil society organizations. The *Nordic-Baltic chair* has contributed to a number of such outreach efforts. The paper notes that the ongoing discussions on the Fund's medium-term strategy may also warrant a more fundamental discussion of the external communications strategy. It therefore makes some suggestions for improvements that can be accommodated within existing budget limits.

Directors agreed that the Fund pursues a reasonably balanced communications strategy and did not see a need, at present, to increase efforts significantly or to make a shift in the Fund's communications strategy. Directors supported better coordination and integration of communication activities with the Fund's operations, both in country work and in broader policy design and implementation.

The *Nordic-Baltic chair* stated that much has already been achieved in improving the dissemination of information. It is now equally important to further strengthen the two-way dialogue, ensuring a mutual understanding between all interested parties. The *Nordic-Baltic chair* welcomed additional emphasis on communication related to surveillance as well as increased outreach, particularly in program countries in order to clarify the role of the Fund. The *Nordic-Baltic chair* considered that resident representatives could play a strengthened role in communications, and that Executive Directors can play a useful role in communicating about the Fund's activities and policies.

V. Crisis Resolution Issues

Progress Report on Crisis Resolution

Over the past six months, there have been further developments in crisis resolution mechanisms under the existing legal framework. *Collective Action Clauses* (CAC) have become the market standard in New-York law governed sovereign bonds, with over 90 percent of all sovereign issues having included CACs during this period. The inclusion of CACs has not had any observable impact on pricing. Furthermore, efforts to improve engagement between creditors and debtors have been continuing in the context of the draft Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets ("Principles"). While supporting the drafting of such Principles, the Fund has left their specification to sovereign debtors and their creditors.

The Executive Board will shortly discuss the determinants of and prospects for market access by countries emerging from crises, including when this has involved a restructuring of sovereign debt.

The *Nordic-Baltic chair* has generally held the view that more needs to be done in terms of formulating a robust framework for the resolution of sovereign debt crises, and the *Nordic-Baltic chair* has requested a comprehensive review of the Fund's crisis resolution framework. While welcoming the increased use of CACs and the development of "Principles", the *Nordic-Baltic chair* has emphasized that it will be important for the Fund to study further how it can define its own role more precisely in relation to the Principles. Moreover, a thorough review of the lending into arrears policy is needed, not least a further clarification of the "good faith" criteria.

Review of Access Policy

In April 2005, the Board reviewed the Fund's access policy in the credit tranches, the Extended Fund Facility and the Poverty Reduction and Growth Facility, as well as the policy on exceptional access. The discussion included the standard limits on lending by the Fund

(100 percent of a member's quota on an annual basis and 300 percent of quota cumulatively), as well as the conditions and circumstances that may lead to lending beyond the limits, as set out in the framework for exceptional access. The Board also considered the policies for lending under the PRGF, under which the Fund makes concessional loans to its lower-income members.

Directors noted the broad principles underlying the Fund's access policy, which are to provide appropriate support to members undertaking adjustment measures to resolve their balance of payments problems; to treat members uniformly; and to safeguard the Fund's resources. They broadly concurred that the Fund's criteria for access in individual cases remain appropriate. Although access is determined in terms of the quotas of members, a number of Directors felt that quotas may not always faithfully reflect the size of an economy and accordingly should not be viewed as the best metric in all cases. Directors also generally considered that the existing access limits remain appropriate. As regards the exceptional access policy, Directors were of the view that the exceptional access framework approved in 2002 and 2003 remains broadly appropriate. Most Directors agreed that a discussion of exit strategies would help foster better communication with capital markets and facilitate earlier re-access.

The *Nordic-Baltic chair* agreed that the access framework remains appropriate. A strong and coherent access policy framework should continue to be a key feature of the Fund's crisis resolution toolkit, and it is necessary to apply the framework consistently. While underlining that the exceptional access criteria and procedures should not be changed at this stage, the *Nordic-Baltic chair* supported reinforcing the procedures by including in future considerations of requests for exceptional access a discussion of exit strategies and alternative forecast scenarios. Incentives and maturity considerations in exceptional excess cases should be revisited. While preferring a broader review of Fund facilities, the *Nordic-Baltic chair* looks forward to the upcoming review of charges and maturities, and continues to advocate the use of SRF terms in all exceptional access cases. The *Nordic-Baltic chair* also continues to have concerns about providing exceptional access in precautionary settings, being only willing to consider it as an exit strategy for countries with existing high access if overall exposure is brought down during the program period. In implementing the framework, strict adherence to the Fund's lending into arrears policy is important as well as ensuring private sector involvement in accordance with the Prague framework.

VI. Activities of the Independent Evaluation Office

The Executive Board established the Fund's Independent Evaluation Office (IEO) in 2001. The IEO provides objective and independent evaluation on issues related to the Fund. The Office operates independently of Fund Management and at arm's length from the Executive Board. It enhances the learning culture of the Fund, promotes understanding of the Fund's work, and supports the Executive Board in its governance and oversight. While only the evaluation of the Fund's Technical Assistance has been discussed by the Board since the last

IMFC meeting, work is well underway on the remaining items on the IEO's work program. This includes evaluations on the Fund's approach to capital account liberalization, Fund assistance to Jordan, the FSAP, and structural conditionality. IEO is also working on the terms of reference for an evaluation of the Fund's multilateral surveillance and an Issues Paper will be made available for public comments in the next few months.

Evaluation of Technical Assistance Provided by the Fund

The Fund is providing technical assistance to help member countries strengthen their capacity to design and implement effective policies. Technical assistance is offered in several areas, including fiscal policy, monetary and exchange rate policies, banking and financial system supervision and regulation and statistics. The Executive Board has had two discussions on the experiences of the provision of technical assistance (TA) to its members. One discussion was devoted to the *Independent Evaluation Office's (IEO) Evaluation of the Technical Assistance Provided by the Fund*, and the second reviewed the *Experience of Providing TA in the Fiscal and Monetary Areas to the Post-Conflict Countries.* While TA is an important task for the Fund, the Fund's role is limited to issues of relevance for the Fund's core areas of activities with regard to macroeconomic and financial stability.

The IEO evaluation emphasized the need to develop a medium-term country policy framework for setting TA priorities; to develop more systematic approaches to track progress on major TA activities; to promote greater involvement by the authorities and counterparts in the design of TA to enhance ownership and commitment; to strengthen efforts to identify options and discuss alternatives with local officials prior to drafting TA recommendations; to widen the program of *ex post* TA evaluations and establish more systematic procedures for disseminating TA. Directors agreed that the report provided a balanced assessment of the strengths and weaknesses of the Fund's TA, and considered it to represent a valuable input into the ongoing strategic review of the Fund. They agreed to the main recommendations of the IEO, and Fund management has appointed a task force to make concrete proposals on how to implement the recommendations.

The *Nordic-Baltic chair* generally supported the IEO's recommendations. It was noted that the Fund has an important role to play in providing TA, particularly within the institution's core areas and in promoting the recipient countries' own capacity for good governance. The TA priority-setting process needed to be enhanced, including an introduction of a medium-term perspective for setting the TA strategy and priorities. In this regard, the poverty reduction strategies and needs that emanate from country-centered policy frameworks are important in prioritizing demand. It was also important to strengthen the role of the Fund's area departments and increase involvement of country authorities to promote ownership and commitment to TA implementation. Recommendations should be implemented within the current resource envelope by gradually reallocating TA resources.

Regarding the second discussion, on post-conflict countries (PCC), the *Nordic-Baltic chair* generally found the approach of providing TA appropriate. A main conclusion of the discussion was a need for flexibility, while aligning the short-term TA exercises with long-term capacity building. It was agreed that the initial TA strategy should be limited to simplified procedures. In some cases, it might involve second-best policies, which should be superseded by more efficient alternatives as the local capacity develops. The Fund could take a leading role in coordinating TA in its core areas of expertise in PCCs. It was noted that the Fund should not always play a lead role, seeing the scope for other international institutions in this area. The *Nordic-Baltic chair* saw some merit in incorporating the key TA recommendations in program conditionality on a selective basis, and in line with the policy of streamlined conditionality.

ANNEX: NORDIC-BALTIC CONTRIBUTIONS TO THE FUND

Table 2. Selected Bilateral Contributions to the *PRGF and PRGF-HIPC Trusts*
(In millions of SDRs; as of end-February 2005)

	PRGF Trust	PRGF-HIPC Trust	
	Subsidy contributions	Loan commitments	Subsidies and grant contributions
Denmark	67.0	100	18.5
Estonia	--	--	0.5
Finland	42.2	--	8.0
Iceland	4.6	--	0.9
Latvia	--	--	1.0
Norway	45.6	150	18.5
Sweden	186.7	--	18.3
Total	346.0	250	65.7
Memorandum:			
Total all donors	3,490.7	15,722.7	1,561.6

Table 3. Contributions to Subsidize *Post-Conflict Emergency Assistance*
(In millions of SDRs, pledged as of end-February 2005)

	Contribution Pledged
Norway	3.0
Sweden	0.8
Total Nordic-Baltic contribution	3.8
Memorandum:	
Total pledges by all countries	11.2

Table 4. Contributions to Subsidization of the *Fund's Emergency Assistance for Natural Disasters to PRGF-Eligible Members* (In millions of SDRs, pledged as of March 1, 2005)

	Contribution Pledged
Norway	1.1
Sweden	6.5
Total Nordic-Baltic Contribution	7.6
Memorandum:	
Total pledges by all countries	17.6

Table 5. Contributions to Subsidization of the Various *Fund Technical Assistance Programs* (In millions of SDRs, pledged as of end February 2005)

Denmark	
Subaccount contributions	3.69
Afritac	0.31
Norway	
Subaccount contributions	0.37
Afritac	0.87
Sweden	
Subaccount contributions	0.73
Iraq subaccount	1.99
Afritac	0.15
Finland	
Afritac	0.31
Total Nordic-Baltic pledges	8.41
Memorandum:	
Estimated use of external financing for Fund TA in FY 2005	23.48

The subaccount contributions are sometimes earmarked to specific countries, while in the case of Norway they are given more broadly such as to "countries under stress". While donors sometimes prefer earmarking, the Fund prefers less restriction on the use of the donated funds. However, experience has shown that the Fund's instruments are very flexible and can be adapted to donor preferences. Japan is by far the largest single contributor to the Fund's technical assistance programs.