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The Nordic-Baltic Office
International Monetary Fund

Report 2007/1

Recent Policy Developments in the International Monetary Fund

CONTENTS

I. INTRODUCTION

This report is prepared by the Nordic-Baltic Office (NBO), representing Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden in the Fund's Executive Board

The report concentrates the principal topics dealt with by the Executive Board and the International Monetary and Financial Committee (IMFC) since the last IMFC-meeting in September 2006. The report covers the principal *policy* issues discussed by the Executive Board and the IMFC with references to the positions taken by the Nordic-Baltic chairs. Concerning the results of the Fund's bilateral economic surveillance, Article IV-consultations, with countries in the Nordic-Baltic Constituency, the reader is referred either to the Fund's general website (www.imf.org) or the websites of each of our countries' authorities where staff reports, press information notices etc. are published.

The work on implementation of the Fund's Medium-Term Strategy (MTS) continues to dominate the Fund's agenda. The outline of the Medium-Term Strategy was first presented to and endorsed by the IMFC at the Annual Meetings in September 2005. In the last six months, the agreement from the 2006 Annual Meetings in Singapore has been implemented and work has been ongoing to further refine and specify the strategy. The strategy aims at implementing reforms to make the Fund meet the challenges of the twenty-first century in all its business areas. During the last half year work has, in particular, concentrated on the issues of quotas and voice, surveillance, Fund finances, Fund engagement in low-income countries (LICs) and a new liquidity instrument for market access countries.

In January, the membership of the IMF was expanded, when the Republic of Montenegro became the 185th member. Within Management, Mr. Murilo Portugal was appointed Deputy Managing Director in October 2006, succeeding Mr. Agustin Carstens who returned to Mexico to serve the incoming government. Mr. Simon Johnson was appointed to the position of Economic Counsellor and Director of the Research Department at the IMF in March, succeeding Mr. Raghuram Rajan who returned to academia in January 2007.

As of January 1, 2007, Finland handed over the EU Presidency to Germany. The EU Presidency plays a central role in coordinating cooperation among the representatives of EU countries in the Fund and, in some cases, also represents the EU's views in the Executive Board. The work of the NBO during the last part of 2006 was directed not only towards representing the views of the Nordic-Baltic Constituency within the Fund, but also towards advancing the coordination of the EU chairs.

II. QUOTAS AND VOICE IN THE FUND

One of the more important, yet difficult, areas of the Fund's Medium-Term Strategy (MTS) is the change in the Fund's quotas to better reflect the weight and role of member countries in the world economy. At the Annual Meetings in Singapore, in September 2006, The Fund's Board of Governors approved a Resolution on Quota and Voice Reform[1]. In addition to an immediate first ad hoc quota increase to China, Korea, Mexico and Turkey, the Resolution prescribes a change in the Fund's Articles of Agreement to provide at least a doubling of the basic votes that each IMF member possesses, aiming specifically at protecting the relative voting power of low-income countries. In an initial discussion on a revision of the Articles of Agreement the Executive Board agreed that the work on basic votes should continue in parallel to the work on a new quota formula.

The Resolution also calls on the Executive Board to allow for an increase of the staffing resources available to those Executive Directors that are elected by a large number of members, specifically the two African.

The Nordic-Baltic chair has strongly supported the objective of enhancing the voice and participation of low-income countries in the Fund through at a least doubling the basic votes. Our chair has supported introducing a mechanism to safeguard the share of basic votes in total voting power, as well as other options such as the increase in staffing resources, particularly for the two African chairs.

A. A New Quota Formula

The Resolution also stipulates that the Executive Board shall reach an agreement no later than by the Annual Meetings in 2008 on a new quota formula (a mathematical formula linking a member's economic size to its quota share) to guide the future development of members' quotas. The Executive Board has so far had informal discussions on the revision of the quota formula. There is broad agreement on a set of underlying principles for a new quota formula, namely that it should be simple and transparent, consistent with the multiple roles of quotas, and properly capture the members' relative positions. In view of this, it will be important that the new formula results in higher shares for dynamic economies, while the voice of low-income countries is increased. Nonetheless, there is still further work needed before the Executive Board will be able to agree on a new formula.

The Nordic-Baltic chair has supported the Managing Director in his approach to the quota reform, that is making the formula credible, but simpler and more transparent, as well as relevant to stand the test of time. Our chair has indicated its willingness to approach the quota discussion constructively, while emphasizing that an agreement before long on the reform is essential for the Fund's legitimacy.

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[1] Press Release No. 06/189, September 1, 2006

The Nordic-Baltic chair has emphasized that GDP and external openness, including financial openness, should be the main variables in the new quota formula, while a less prominent role should be assigned to the variability of trade and capital flows and to the size of foreign exchange reserves. To facilitate convergence of views in the Executive Board, the set of variables should not be expanded beyond these four. Our chair has also supported a non-linearity in the formula to achieve a rules-based distribution of quotas that is regarded as fair and acceptable by the broad membership. Moreover, the Nordic-Baltic chair has indicated in earlier discussions that once the new formula is in place, our chair will support a second round of limited quota increases as part of the reform package.

III. SURVEILLANCE

The umbrella of surveillance reform covers three policy initiatives. The revision of the 1977 Surveillance Decision and the Multilateral Consultations were part of the MTS from the outset, while the third element, the Remit, was introduced by the IMFC in its 2006 spring meeting. Work has also been ongoing on the coverage of financial sector issues in surveillance.

A. The 1977 Decision on Surveillance over Exchange Rate Policies

The Medium-Term Strategy envisages more emphasis on the original goals of surveillance, that is promoting a stable system of exchange rates and avoiding manipulation of exchange rates and the financial system. This broad foundation of the Fund's surveillance over exchange rate policies is laid out in Article IV of the Fund's Articles of Agreement, and further specified in the 1977 Decision on Surveillance over Exchange Rate Policies of the Executive Board. There is a view that the 1977 Decision is only partially relevant to surveillance as it is carried out today and should be updated. However, an agreement covering all areas has yet to be reached, and work on finding a broadly accepted framework continues.

It is proposed that the organizing principle for surveillance would be external stability. In this regard, not only exchange rate policies, but also monetary, fiscal, and financial sector policies – which have a direct link to external stability - would be the subject of surveillance, whereas other policies should be covered only to the extent that they are relevant to the promotion of external stability. It is agreed that the revision of the 1977 Decision should be guided by three principles: (i) a revised Decision should not introduce new obligations, and should enshrine dialogue and persuasion as key pillars of effective surveillance; (ii) the Decision should pay due regard to country circumstances, and emphasize the need for evenhandedness; and (iii) a revised Decision should retain flexibility to allow surveillance to continue evolving. The above principles were endorsed by the IMFC in its 2007 Spring Meeting. The IMFC called for continuing work on updating the Decision, while underscoring that the goal should be to improve the quality of surveillance, its focus, candor, and evenhandedness.

The Nordic-Baltic chair broadly supports the revision of the 1977 Decision as proposed. By clarifying the scope and modalities of surveillance and the members' commitments, the revised Decision would facilitate the members' engagement with the Fund, and provide greater transparency and accountability in surveillance. Our chair has emphasized that, in order to usefully guide the Fund's surveillance, the revised Decision needs to be built on a broad consensus among the membership. It needs to be clear that the Decision does not impose new obligations on the members, that would go beyond the scope of the surveillance mandate defined in the Articles of Agreement. The Decision should underline the principles of focus, equal treatment, candidness, and independence of Fund advice. The members' policies should be assessed in terms of their (i) internal consistency, (ii) consistency with external stability, and (iii) consistency with other countries' policies. While the choice of an exchange rate regime is up to each country, the Fund has a central role to play in assessing the consistency of domestic policies with the chosen exchange rate regime and the impact of that regime on other members and the global economy.

B. Multilateral Consultations

The introduction of the multilateral consultations provided a new forum for debate and action on common issues. The objective of the first multilateral consultations was to discuss the policies necessary to address global imbalances while maintaining robust economic growth. The first dialogue involved five members or groups of members – Saudi Arabia, China, Japan, the Euro area and the United States. In a report to the IMFC Spring 2007 meeting, the participants of the consultations and the Fund staff agreed that reducing global imbalances while sustaining global growth is a shared responsibility and discussed future policy plans and ways to contribute to the goals of the consultations. The rebalancing of domestic demand growth across economies was considered key for reducing global imbalances.

The IMFC welcomed the report and noted that the policy plans set out by the participating countries represent further important progress. The IMFC will look forward to the Executive Board's review of the consultations experience and the lessons for the future. The Fund will continue to follow developments in global imbalances through its regular multilateral and bilateral surveillance procedures, and may call for renewed consultations if developments so warrant. Future multilateral consultations are likely to include groups of countries relevant to the specific issues to be addressed.

The Nordic-Baltic chair has been supportive to the Fund's initiatives related to the multilateral consultations. The consultations, which form a part of the Fund's multilateral surveillance responsibilities, are an important forum for debate among parties on a common economic issue.

C. Remit

Establishing a Remit was proposed in the IMFC Spring 2006 Communiqué, which stated: "The IMFC should set a new annual remit for both bilateral and multilateral surveillance through which the Managing Director, the Executive Board and the staff are accountable for the quality of surveillance." Although the Board's views have been divided on the value added of a remit, discussions have provided a basis for moving forward. The format of a remit will also be dependent on the progress in reshaping the overall surveillance framework, especially the revision of the 1977 Decision.

In principle, a Remit would set, in a compact form, time-bound priorities and operational objectives for the Fund's surveillance. Hence, a remit would give the Executive Board an opportunity to provide more explicit guidance on surveillance, and also provide a well-defined benchmark for assessing the outcomes. Although similar processes already exist, mainly in the form of Triennial Surveillance Reviews, the value added of the Remit would be in formalizing the process and raising the profile of surveillance priorities. There is a consensus that a Remit is to be set by the Executive Board, while the IMFC could play an important role in increasing awareness, among the membership and general public, of the Fund's surveillance priorities.

The Nordic-Baltic chair sees a potential for the Remit to become a useful element in the Fund's surveillance toolbox. The Remit could be devised to serve several purposes. First, and obviously, it would constitute a compact statement of the priorities that guide the Fund's surveillance activities. As such it could enhance accountability by providing a clear basis for an assessment of the effectiveness of Fund surveillance. Second, it could be a useful tool for communicating with external stakeholders, enhancing the visibility and political legitimacy of the Fund's surveillance. Finally, an endorsement by the IMFC of the surveillance objectives would serve as a commitment from the side of the membership to work with the Fund in achieving those objectives. Nevertheless, attaining the multiple objectives of a Remit requires striking a careful balance regarding the optimal degree of detail involved. Care should be taken to prevent periodic Remit reviews from becoming too resource intensive.

D. Financial Sector Issues in Surveillance

The Medium-Term Strategy established a task to develop an analytical framework for addressing financial sector issues in Article IV reports, aiming to enhance financial sector coverage in macroeconomic analysis. The Taskforce on integrating financial sector issues into Article IV-surveillance was created for this purpose and prepared a report. The Executive Board was briefed about the conclusions and recommendations of the Taskforce in an informal seminar. The report emphasized the need for a broader multilateral perspective, more focus on the financial sector's impact on growth and the economy and for thorough assessments of risks. The area departments and the recently established Monetary and Capital Markets Department have already begun the implementation of relevant proposals.

The Nordic-Baltic chair has supported improved integration of financial sector surveillance into Article IV-surveillance and welcomed the Taskforce's recommendations. The Nordic-Baltic chair is looking forward to the implementation of the recommendations and to the new generation of Article IV-reports.

IV. Crisis Prevention

In view of a call on further work from the IMFC in Singapore, in September 2006, the Executive Board has continued its discussions on the establishment of a new liquidity instrument, a so called Reserve Augmentation Line (RAL), for emerging market countries with access to financial markets. Moreover, steps to strengthen the Fund's engagement with emerging markets are also an important area of the Medium-Term Strategy. The purpose of introducing a new instrument would be to reduce the likelihood of crises by making highly liquid resources available to potential users, in the case of rising market pressures, in exchange for commitments of strong policies. However, at the same time the Fund's resources must be protected and moral hazard minimized.

A. A new Liquidity instrument

In the initial proposal from last August the qualifications for support would be determined on the basis of an ex-ante assessment. There would be no explicit conditionality, but the member's performance and implementation of policies would be monitored regularly during the course of the arrangement. Moreover, if a member was to face the need for a drawing, an upfront access in the range of 300 to 500 percent of quota should be made available. The Executive Board focused further on the design of the RAL in its latest discussion in March, namely on a strong qualification framework so that use of the RAL would be limited to members with sound policies, and on the length of the arrangement and the monitoring structure. Furthermore, the Executive Board discussed whether the RAL should be established under the Supplement Reserve Facility (SRF), as the RAL would commit resources on a precautionary basis for the same type of balance-of-payments needs that the SRF addresses. Discussions in the Executive Board will continue with the view of finding a consensus on a new instrument.

While the Nordic-Baltic chair has traditionally had reservations regarding the need for the Fund to offer such an insurance-type instrument, such as the RAL, it acknowledges that developments in the global financial markets and the evolving needs of the emerging market economies have changed the situation. Our chair now considers that, with proper fine tuning of some design elements, an instrument like the proposed RAL could be a valuable addition to the Fund's toolkit.

V. The Fund's Role in Low-Income Countries

According to the Medium-Term Strategy, the Fund should seek a more focused role in its relations with Low-Income Countries (LICs), with more flexibility and less procedure, and with more emphasis on the Millennium Development Goals. Several discussions related to the Fund's role in LICs have taken place recently, with an underlying theme to refine the Fund's policy advice to LICs on promoting sustainable growth and on macro-critical areas. The Review of Bank-Fund Collaboration, requested by the Managing Director, was finalized in February. Furthermore, the Independent Evaluation Office completed a report on the Fund's engagement in Sub-Saharan African countries, and the Executive Board also had a thorough discussion on the 2007 Global Monitoring Report.

A. Cooperation with the World Bank

The Report of the External Review Committee on Bank-Fund Collaboration, commonly named the Malan report after the Chairman of the committee, was published in February. The report was first discussed in a joint informal briefing by the Executive Boards of the World

Bank and the IMF on February 27, and later by the IMF Executive Directors in an informal seminar. The report pointed to the increasing integration of economies which created a need for a culture of cooperation and trust between the two institutions. At the same time, communication was deemed to be poor in several areas, which limited the effective coordination of work strategies. For example, there was no robust dialogue between the Fund and the Bank on their future strategies and their implications for collaboration. Among a wide range of issues covered by the Committee, one of the most prominent was the Fund's role in LICs. The report suggested that the Fund needed to clarify its role in LICs in relation to its core mandate and avoid overlaps with the Bank, but noted that it should not reduce its engagement with LICs. The committee suggested that the Fund should reconsider its role in long-term financing for LICs, partly to ensure a more even focus on short-term balance-of-payments support. On a positive note, the committee commended the Bank-Fund collaboration in areas such as the Initiative for the Heavily Indebted Poor Countries (HIPC), financial sector issues, and the Reports on the Observation of Standards and Codes (ROSCs).

The Nordic-Baltic chair supported exploring the option of creating a standing Bank-Fund working group to promote and monitor collaboration, and recognized the need to strengthen the dialogue between Management and senior staff in the two institutions. It also expressed support for continued Fund engagement in LICs and the continuation of the Poverty Reduction and Growth Facility (PRGF), but emphasized the need for careful coordination with the Bank on debt sustainability and fiscal issues in particular.

B. IEO Evaluation of the IMF and Aid to Sub-Saharan Africa

In March, the Executive Board discussed the findings of the Independent Evaluation Office (IEO) regarding the Fund's aid-related involvement in Sub-Saharan Africa (SSA). The IEO report was based on evidence from PRGF programs in 29 SSA countries between 1999 and 2005, and focused on an apparent disconnect in external perceptions between the Fund's rhetoric and actual results. The IEO found that Board-approved policies on saving versus spending of aid inflows had been consistently applied, but the recommendation to save aid to increase reserves or limit inflation in a number of countries could explain why the Fund was often perceived as blocking the use of aid. In light of this, the IEO recommended clarifying the policies and guidelines to Fund staff and the donor community. The report also pointed out that program design and staff analysis had only to a limited extent been accommodative of increased aid. Furthermore, IMF communications had been perceived as committing the Fund to engage more in aid mobilization efforts and poverty-reduction analysis than what was actually feasible within the programs. The IEO also found collaboration with the World Bank inefficient, resulting i.a. in PRGF-program design failing to utilize Bank-specific knowledge on infrastructure development. Finally, the IEO recommended increased ground-level communication of Fund policies by improving the interactions of resident representatives and mission chiefs with local donor groups and civil society.

The Nordic-Baltic chair emphasized the importance of clear communication on the nature and limits of the Fund's role in LICs. Our chair acknowledged the challenge with the perception of the Fund as blocking the use of available aid, but did not consider the PRGF-benchmarks as being too restrictive. Our chair argued that the Fund had gradually adapted to increasing aid flows, and emphasized that the inherent volatility of aid flows should be smoothed by creating a prudent spending path combined with an increase in reserves. Our chair was also of the view that the shortcomings of the communication at the country level should be addressed, but within the current budget envelope. Finally, our chair emphasized that the Fund's core competence is in macroeconomic advice and warned against mission creep. While issues such as mobilization of aid and promotion of the Millennium Development Goals are crucial, there are other institutions that have the mandate and better expertise to take responsibility over them. The Fund should play a supporting role strictly within its own area of competence.

C. The Global Monitoring Report

The joint Bank-Fund 2007 Global Monitoring Report on the Millennium Development Goals (MDGs) showed that real progress is being made on the MDG agenda in several areas. The report highlighted gender equality and empowerment of women and the special problems of fragile states as key areas to facilitate further progress towards the MDGs going forward The report stated that strong economic growth had reduced the overall level of poverty, but the results were uneven across countries. Gender equality was described as a necessity to make economic growth benefit all, while also being helpful in achieving the other development goals, including education, nutrition, and reducing child mortality. Measures for improvement in this area include better monitoring and mainstreaming of women's empowerment and equality into policy formulation and donor programs. Regarding fragile states, the report noted that while only 9 percent of developing countries' population lived in such states, they encompassed over one-fourth of the extreme poor globally, and that they were failing to keep up with economic progress elsewhere. Efforts to support their transition from fragility should include improving response time to crises, increasing field presence, and better interagency collaboration. To move forward in both areas and to secure further progress towards the MDGs, increased efforts to scale up aid will be needed for country programs. The report was discussed by the Executive Board in March.

The Nordic-Baltic chair welcomed the report, but noted the lack of focus and clear policy messages in the report in relation to core Fund activities. In this regard our chair saw an important role for the Fund in supporting further efforts to improve macroeconomic management, financial infrastructure, investment climate and governance, possibly reinforced by HIPC or PRGF programs, which will be necessary to achieve sustained growth. On the scaling up of aid in general, the Nordic-Baltic chair stressed the importance of donor harmonization and the realization of existing commitments made by the G8 countries. Technical assistance and capacity building were considered the central objectives for the Fund's engagement in fragile states. The Nordic-Baltic chair emphasized that efforts to achieve higher growth rates should not lose sight of environmental costs, and suggested a focus on the economics of environmental sustainability in the 2008 report.

VI. THE FUND'S FINANCIAL SITUATION

A part of the MTS is to enhance efficiency and deliver key output against tightening budget constraints. The last years' rapid decrease in outstanding credit to member countries from a high of 76.8 billion SDR by end-September 2003 to 11.8 billion SDR by end-March 2007 has drastically reduced the revenue from the Fund's lending operations. Hence, the current model for financing the Fund's budget has come under pressure, and has led to discussions on how to improve long-term predictability of revenues.

A. The Budget and the Medium-Term Situation

The mid-year review of the Fund's income position for the financial year 2007 in January showed that the income shortfall increased 10 million SDR, compared to previous expectations, to about SDR 70 million due to advance repayments during fiscal year 2007 by Indonesia, Serbia, and Uruguay[2]. Although the repayments have not fundamentally changed the medium-term outlook, the projected income shortfall is increasing towards about 245 million SDR in fiscal year 2010[3]. The Fund maintains precautionary balances to provide protection against the risk of an income shortfall and losses of a capital or general nature which amounted to SDR 7.6 billion by mid-year. As a response to the deteriorating income situation, the Executive Board has put in place a medium-term program of expenditure constraint, reducing the Fund's real expenditures by two percent each year.

The Nordic-Baltic chair found that the steep decline in outstanding Fund credit in recent years is clearly a welcome development as it testifies to the strength of the global economy, but that it necessitates a reform of the Fund's income mechanism. Our chair has also emphasized that an important contribution to closing the income shortfall must come from reducing the Fund's expenditures, guided by clear strategic priorities.

B. The Fund's Long-Term Finances

As part of the Medium-Term Strategy, the Managing Director had in May 2006 appointed a Committee of Eminent Persons to give recommendations on the Fund's long-term financial situation. The resulting report was presented to the Executive Board and the public on January 31. The report recommends several revisions to the current income model in order to reduce the financial reliance on the margin charged on lending activities. The key recommendations were to expand the Fund's investment operations by broadening its investment mandate and investing part of the quota resources, creating an endowment by a limited sale of the Fund's gold holdings, and charging for some services to member countries (mainly technical assistance). These findings were also discussed by the IMFC in its 2007 Spring Meetings. Further proposals will be presented to the Executive Board in the coming months.

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[2] After the review, the Philippines announced that it will fully repay its outstanding of SDR 146 million. This does not have a significant impact on the income projections.

[3] The Fund's Income Position for FY2007 – Midyear Review, December 7, 2006

The Nordic-Baltic chair found that the proposals by the Committee to study sustainable long-term financing of the Fund provide a sound basis for further work. The Committee's recommendations to create an endowment from limited gold sales and to explore further a prudent relaxation of the Fund's investment guidelines were supported. However, more analysis will be needed on the implications of the option of investing the Fund's quota based resources.

Although the Nordic-Baltic chair saw a clear need for measures to better ensure value for money in the Fund's provision of bilateral services, our chair was not convinced by the feasibility of charging for those services. Thus, the viability of charging non-low-income Fund members for bilateral services, and other means of making the prices of these services more transparent, deserve to be assessed further.

VII. STAFF OF THE NORDIC-BALTIC IMF OFFICE

as of April, 2007

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