

Statement by Mr. Per-Kristian Foss, Minister of Finance, Norway, on behalf of the Nordic and Baltic countries i.e. Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden, to the IMFC Meeting in Washington D.C., October 2, 2004.

Main messages

- The conditions for a continuation of the global recovery are in place. Policy-makers must use this propitious environment to address global imbalances, move towards more sustainable fiscal positions and press ahead with structural reforms to sustain growth and employment at higher levels. Furthermore, they should prepare for an orderly transition towards higher interest rates.
- The effectiveness of Fund surveillance could be improved by increased focus on potentially vulnerable countries, systemically important countries, and regional and multilateral issues. In individual consultations, increased attention to country-specific areas of vulnerability is warranted.
- A general review of the crisis resolution framework and the Fund's lending facilities is needed.
- Adherence to the existing exceptional access framework will be crucial to secure orderly financial crisis management, foster market discipline, and to safeguard the Fund's resources. The handling of Argentina with exceptional access and a weak program has weakened the reputation of the Fund and undermined the institution's aim to catalyze private funding.
- Poverty reduction must remain at the top of the international agenda. The ongoing work to improve the effectiveness of the Fund's engagement in low-income countries is important for making progress towards the Millennium Development Goals.

Challenges ahead in the World Economy

Global economic growth continues to be strong despite the rise in commodity prices – notably oil – and geopolitical uncertainty. The recent moderation of growth in the US, Japan and China suggests that world growth will be slower compared to the first half of 2004, but a solid expansion is projected also for 2005.

The key downside risks looking some years ahead arise from regional balance of payments imbalances and high sensitivity to increased interest rates. Policy measures to cool down the Chinese economy have prompted fears of a hard landing that would have spillover effects across Asia – most clearly in Japan – but a slowdown in growth to a more sustainable pace remains the most likely outcome this year.

The present low level of interest rates is unlikely to be maintained when the upswing has become firm and more even. Managing the transition towards higher interest rates, while at the same time ensuring orderly adjustment in financial markets, will be an important task for policy-makers in the years to come. Fiscal vulnerabilities continue to be a key challenge both in industrial and emerging market countries. While the challenges in many industrial countries are related to reforms of pension and health systems, external vulnerabilities and poorly structured debt pose a more immediate

danger in emerging markets. Policy-makers need to take full advantage of the current recovery to make progress towards addressing these issues. Reducing energy intensity and shifting to renewable resources would address some of the challenges in global energy markets.

We welcome the recent agreement on a framework for further negotiations in the Doha Round and encourage all countries to engage dedicatedly in the more detailed negotiations on trade liberalization up to the Ministerial Conference in December 2005.

In **the euro area** the key challenge is an acceleration of structural reforms and fiscal consolidation without derailing the incipient recovery in domestic demand. Reforms should aim to improve the functioning of the labor and product markets and ensure long-term fiscal sustainability. A more decisive and coherent approach would be recognized as responsible measures to mitigate future challenges for welfare systems. A revised Lisbon strategy with a clearer focus and a greater political and public ownership would be an important step forward.

The growth prospects for the **new EU member states** are favorable. Nevertheless, many of these countries face important challenges. Also in view of their preparations for EMU participation, it is particularly important that these countries use the favorable economic conditions to make progress with fiscal consolidation.

The recovery in the **United States** seems to be broadly based. The main challenges remain to reverse the strong fiscal and monetary policy stimulus of recent years, while maintaining the growth momentum. Although growth may moderate more than envisaged, delaying necessary fiscal consolidation would put at risk the sustainability of the upswing. More ambitious and credible policy measures than currently planned are called for, not least to put public finances on a sounder track and bring about correction in external deficit. Clearly, this would also help to reduce the risk of an abrupt and disorderly correction in the US dollar and a sharp increase in long term interest rates.

In **Japan**, the recovery appears to be broadening and becoming more sustainable, but still too dependent on external demand. The risks of deflation are not yet eliminated. The current more favorable economic situation provides a good opportunity to intensify and broaden structural reforms in banking and corporate sectors. A credible strategy to consolidate public finances over the medium term is called for.

China's remarkable economic expansion continues, although policy measures geared towards cooling down the economy to a more sustainable pace appear to have had some effect. A consistent set of macroeconomic and structural policies accompanying the move towards greater exchange rate flexibility is necessary. In this context, fiscal policy will have to play an important role, not least in order to secure a soft landing.

The robust economic expansion in **other Asian economies** could be further nurtured by supporting domestic demand, as inflationary risks seem well contained and external constraints are not present. Emerging Asia would – through allowing real exchange rates better reflect their economic strength – need to shoulder a larger share of rebalancing global demand.

The upturn in **Latin America** provides favorable conditions for embarking on much needed consolidations of public finances. A key to a more stable macroeconomic environment is continuous work towards achieving a sustainable debt burden. To ensure that the current rebound in growth is sustained, progress in structural reforms has to be maintained, especially in the financial sector and the tax system.

The outlook for many **African** countries is better than it has been for some time, but strong efforts from the countries themselves, not least in containing conflicts and improving governance, are necessary to lay the foundations for sustained strong growth. The international community has an important role to play in Africa, most notably through debt relief, increased aid flows, and through improved trading opportunities.

The International Monetary Fund and Policy Matters

We welcome the initiative to discuss the strategic direction of the Fund over the longer term. The recent 60th anniversary and the appointment of a new Managing Director could provide an ideal opportunity for a deeper reflection on how the rationale for and the role of the Fund are affected by the evolving of the international economic and financial system. We look forward to continued discussion until and at the next IMFC meeting.

Surveillance and Crisis Prevention

Surveillance and crisis prevention are at the core of the Fund's activities. The Nordic-Baltic Constituency welcomes the significant progress that has been made in recent years in making surveillance more effective, and in improving the crisis prevention framework. Nevertheless, we believe there remains scope for further improvements.

In particular, the Fund's surveillance should be more focused on potentially vulnerable countries and systemically important countries. Regional and global spillovers should also receive greater attention. In individual Article IV consultations, greater selectivity of topics should be sought through increased focus on country-specific areas of vulnerability. Particular emphasis should be placed on candid discussions of exchange rate issues and debt sustainability assessments. The focus of Fund surveillance has to be on whether a country's policy mix is consistent with fundamentals, and whether it is conducive to medium-term sustainability.

The Nordic-Baltic Constituency would like to see continued focus on transparency issues, including on the experiences with the revised publication policy. Building on the positive experiences of the last few years, we believe the Fund should advance further towards mandatory publication of all surveillance and program reports.

Enhanced transparency and increased flexibility in the procedures for surveillance allow for a more effective signaling on the strength of a member's policies. We are, however, not convinced that the proposed new Policy Monitoring Arrangement would complement existing surveillance modalities and borrowing arrangements in providing additional signaling benefits. Rather, the Fund should strive for a more efficient use of the untapped potential inherent in the existing instruments. We believe low access precautionary arrangements have a valuable role to play in this regard. The experience

with such arrangements has been good, and their role in the Fund's crisis prevention tool kit should be strengthened.

We welcome the IMF's increased focus on governance issues. Strong institutions are of great importance in supporting and sustaining sound policies and in increasing program ownership. We would like to call for a more systematic analysis of these issues.

Crisis Resolution and Private Sector Involvement

It is important to bring clarity about the respective roles of the public and private sectors within the current international financial architecture. Therefore, the Fund should step up the work on an efficient framework for handling financial crises that can ensure more predictability. We are disappointed about the low priority given to improving the tools for crisis resolution and ensuring private sector involvement. The Nordic-Baltic Constituency strongly believes that a general review of the crisis resolution framework is called for, not least since recent country cases with exceptionally large and prolonged Fund lending have put into question the effectiveness of IMF programs in catalyzing private capital flows. Although we welcome the increased use of collective action clauses, we believe that additional measures are needed to ensure orderly sovereign debt restructuring processes and enhance private sector involvement.

Adherence to the existing exceptional access framework will be crucial in order to secure predictable financial crisis management, foster appropriate market discipline and safeguard the resources of the Fund. The handling of Argentina with exceptional access and a weak program is therefore an experience the Fund should draw lessons from. It has, in our opinion, weakened the reputation of the Fund and thereby undermined the institution's aim to catalyze private funding. Further efforts should be made to remedy this. In the future, the Fund must be prepared to say no when policies become inconsistent and vulnerabilities build up.

Lending Facilities

Although the Fund's goal for some time has been to rationalize the lending facility structure, it appears that the last few years' amendments have added new complications. The unresolved inconsistencies in the use of the Supplemental Reserve Facility are one example. We believe the Fund should aim for a much simpler lending system, not least for reasons of transparency and accountability. The goal should be a system with enough flexibility to accommodate solutions to different balance of payments problems. We do not see a need for changes in the current access limits, but believe the incentive structure should be streamlined to ensure that a member country's use of Fund resources is temporary. More specifically, we believe charges, as well as surcharges for exceptional financing, should be graduated with credit outstanding. In this regard, it could also be beneficial to consider whether the introduction of repurchase expectations has worked according to the intention.

Fund Governance

The paper by the Fund on Lessons from the Crisis in Argentina and the IEO-report on the Role of the Fund in Argentina have provided important lessons and recommendations with regard to Fund governance. The Nordic-Baltic Constituency

strongly supports the main message that internal Fund governance needs to be strengthened. In particular, we believe it is necessary to fully respect the role of the Executive Board as the main decision-making body of the institution.

Quotas, Voice and Representation

The Nordic-Baltic Constituency strongly supports efforts to enhance the voice and participation of developing countries in the decision-making of the Bretton Woods Institutions. Important progress has been made in some areas, which include strengthening the capacity of the offices for developing country constituencies at the Fund and the Bank and capacity building initiatives in developing countries, but more needs to be done. As an additional step, we support augmenting the voting power of developing countries through an increase in basic votes.

The Fund's Role in Low-Income Countries

The Monterrey Consensus establishes a partnership between developed and less developed countries and defines a set of targets and responsibilities for member countries. The intermediate targets set for development aid are far from reached and the Nordic-Baltic countries call again on developed countries to step up their efforts to better comply with the agreed targets. We hope the work underway, on how to better mobilize aid, will bring this issue forward.

Economic growth in developing countries falls substantially short of what is needed to achieve the Millennium Development Goals (MDGs). We hope that the newly found momentum in the Doha Round will be utilized to further trade liberalization contributing to economic growth. At the same time, growth-stimulating efforts combined with improved macroeconomic stabilization will be strongly needed. Low-income countries themselves should focus on institutional reforms, governance and infrastructure. Furthermore, ensuring better and equal access to basic services such as education and health care, reducing poverty and underpinning a more equal income distribution, would help to enhance and sustain growth. Therefore, we encourage further analysis of these issues. The Fund has an important role in providing advice within its area of competence. Close cooperation between the Fund and the World Bank will be important in order to find better ways to stimulate growth. Similarly, closer cooperation with the donor community and with the multilateral development banks will be needed.

Strong surveillance, technical assistance and effective Fund financial support through programs will all be essential elements in an enhanced strategy. We support the ongoing work to define more clearly the IMF's role in these respects. We welcome the proposed mission statement and work program presented by the Fund, and broadly agree with its content. The Fund especially needs to focus on how to handle exogenous shocks, with a reasonable combination of conditional and concessional lending.

Strengthening of the poverty reduction strategy approach and the framework for the poverty reduction and growth facility (PRGF), broadly in line with the recommendations from the IEO, will be needed to improve the effectiveness of the Fund's engagement in low-income countries. There should be more emphasis on improving the capability of countries to develop and implement policies supportive of

growth and poverty reduction, notably through a better alignment of both procedures and content of the PRGF to national policy priorities. We believe that the effectiveness of PRGF programs will be strengthened if a better understanding of key drivers of growth and poverty reduction could be established.

It is essential that the signaling function of the Fund be developed further with the aim of providing clear and calibrated signals on policy progress to donors and the public in general. The choice and design of the instruments will have to be related to the specific needs in each case.

As to the financing of the Fund's activities in low-income countries, the Nordic-Baltic constituency continues to support a self-sustained PRGF combined with additional bilateral loans. Separate financing is essential to preserve the monetary character of the Fund's quota-based resources. It is important to reach an early agreement on an equitable burden sharing between donors.

Considerable progress has taken place under the HIPC Initiative, but not all eligible countries have qualified for the initiative within the time limit set. Most of them are conflict affected countries having special problems. We welcome the recent Board decision of a two year extension of the initiative. To avoid problems with moral hazard, debt rescheduling and forgiveness can not and should not be permanent tools of aid to developing countries. It is therefore important to consider new ways to address long-term growth and debt sustainability in both HIPCs as well as other low-income countries. The proposed framework for debt sustainability provides a useful starting point for further deliberations. We stress the need for joint Fund/Bank debt sustainability analysis in order to provide coherent analysis and guidance to countries and development partners.