September 23, 2005

Biannual Report on Recent Policy Developments in the International Monetary Fund

Nordic-Baltic Office
International Monetary Fund
2005/2

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CONTENT

LIST OF ACRONYMS

CAC	Collective Action Clause
CFF	Compensatory Financing Facility
EFF	Extended Fund Facility
ERM	Exchange Rate Mechanism
EU	European Union
EURIMF EU	EU Countries' Group of IMF Executive Board Representatives
FSAP	Financial Sector Assessment Program
FY	Fiscal Year
GFSR	Global Financial Stability Report
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
LIA	Lending into Arrears
LIC	Low-Income Country
MDG	Millennium Development Goal
NBC	Nordic-Baltic Constituency
NBO	Nordic-Baltic Office
ODA	Official Development Assistance
PA	Precautionary Arrangement
PPP	Public Private Partnership
PRGF	Poverty Reduction and Growth Facility
PRS	Poverty Reduction Strategy
PRSP	Poverty Reduction Strategy Paper
PSI	Policy Support Instrument
RTAC	Regional Technical Assistance Center
SCIMF	EU Sub-Committee on IMF Matters
SDR	Special Drawing Right
SRF	Supplemental Reserve Facility
TA	Technical Assistance
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 Annual Meetings of the International Monetary Fund and the Fund's *International Monetary and Financial Committee* (IMFC) on September 24-25, 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. on April 16, 2005. The report centers on these key areas:

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

Special reference is made to key views presented by the *Nordic-Baltic chair* at Executive Board meetings under the heading ***The Nordic-Baltic Position***.

Main sources used for the preparation of the report include the World Economic Outlook (WEO), the Global Financial Stability Report (GFSR), and Press Information Notices (PINs) summarizing discussions in the Executive Board. These reports are available on the Fund's website www.imf.org along with the Fund's Annual Reports, country reports and other policy subject reports.

The *Nordic-Baltic Constituency* (NBC) 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 is guided by 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 is in line with the policy that EU should play its full role in international monetary and economic policy cooperation within international fora, including the Fund.

The cooperation within the EURIMF focuses 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. 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 and Sweden are on a standard 12-month cycle, i.e. the Fund's staff usually visits these countries once a year to assess their economic policy and provide the authorities with policy advice. Denmark, Iceland and Norway 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 was discussed - together with the *Article IV* surveillance report - by the Executive Board in June. Denmark is going 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 finance and central banks, together with a summary of the views of the Executive Board. Those reports are also available on the Fund's website.

In May, the Fund opened its second headquarter building in Washington, D.C., adjacent to the Fund's existing headquarter on 19th Street. The new building houses about 1,500 staff. With the move to the new offices, the Fund can accommodate its entire Washington-based staff in fully owned facilities for the first time since 1983, enabling it to relinquish leased space elsewhere in the downtown area. The new building was completed ahead of the original timetable and within the overall budget.

I. THE GLOBAL ECONOMY AND FINANCIAL MARKETS

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

World Economic Outlook

The global expansion remains broadly on track with global growth forecasts for 2005 and 2006 largely unchanged from the last World Economic Outlook. The balance of risks is slanted to the downside, including higher oil prices, increasing current account imbalances and geopolitical risks. Global current account imbalances – a key medium-term risk to the outlook – have increased yet again with the United States current account deficit now projected to reach about 6 percent of GDP in 2005. Global growth is projected to be 4.3 percent in both 2005 and 2006. Growth continues to be led by the U.S. and China, while forecasts for Europe have been marked down. Japan's economy is regaining momentum with stronger growth in 2005, while projections for emerging and developing countries have changed very little. The continued global expansion is underpinned by accommodative macroeconomic policies, benign financial markets conditions, including continued low long-term interest rates and solid corporate balance sheets. Inflation has generally remained subdued, and the second-round effects from higher oil prices have so far been limited.

The global economy remains vulnerable to a number of short- and medium-term risks. The main short-term risks are the high and volatile oil prices; rising protectionist sentiment driven by global imbalances and growing fears of emerging market competition; and significant tightening of financial market conditions in response to a jump in inflationary expectations, in particular affecting the housing market. In addition, the rise in oil prices will further complicate the resolution of global imbalances. The growth impact of recent oil price increases has so far been relatively modest, but a substantial further jump in prices could have more serious adverse effects on the global economy, especially in view of the disruption in the wake of Hurricane Katrina to the already strained refinery capacity in the United States. Medium-term risks include global imbalances, unsustainable fiscal positions and structural weaknesses in labor and product markets. A successful outcome of the Doha Round remains critical to support global growth in the medium-term.

The Nordic-Baltic Position

Compared to the temporary softness in the spring, the global expansion now appears firmer. Yet, medium-term vulnerabilities remain. Therefore, the key priorities are still continued fiscal consolidation in the U.S. to engineer a needed internal and external adjustment, further structural reforms in Europe and Japan to stimulate growth and additional exchange rate flexibility coupled with financial market reform in Asia to promote a more balanced economic development. The heightened probability of a more permanent shift in the oil price calls for greater attention to fiscal and regulatory measures to encourage energy efficiency and incentives for promoting energy saving technologies and alternative sources of energy. The low level of investment at the current stage of the business cycle is holding down real

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interest rates. This seems to contrast with high corporate profitability in a number of mature markets, partly reflecting a moderate wage growth following the entry into global economy by China, India and other labor-abundant emerging countries. It might be that the business sector's apparent reluctance to commit savings to real productive investments - which are truly long-term and more difficult to reverse - reflect an inherent heightened uncertainty about the long-term prospects for the global economy.

The threats of protectionism - with potentially harmful repercussions for international trade and global growth - necessitate a stronger focus on the WTO negotiations in the coming months. 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. Concrete progress in the coming negotiations is the common responsibility of all countries.

Global Financial Stability

The biannual Global Financial Stability Report (GFSR) assesses global financial market developments, including potential weaknesses in the global financial system. The August 2005 GFSR notes that the global financial system has yet again gathered strength and resilience. Against the backdrop of continued solid global economic growth and determined efforts to restructure and cut costs, balance sheets of many financial institutions and corporations have strengthened to the extent that the sectors can absorb a significant financial shock before coming under systemic stress.

The current configuration of generally solid growth and low inflation, as well as low bond yields, flat yield curves and compressed risk premia, provides the global financial system with a favorable environment for continued resilience. However, the GFSR also underscores that the same factors underlay a further increase in global imbalances and higher debt levels in many countries, particularly in the household sector. Thus, while recent economic developments have reduced near-term risks, medium-term vulnerabilities have increased. At the same time, the report recalls that at times of sharp asset price developments, countervailing forces tend to mitigate such developments before long.

Some of the topical issues addressed in the report include the increased indebtedness of household sectors in a number of countries. Low mortgage financing costs have induced substantial increases in household debt, particularly in the U.S. Relaxation in credit standards and products such as interest-only and negative amortization mortgages may be adding to risks in mortgage markets, allowing households to take on higher levels of debt and giving increased access to marginal borrowers.

While increasing growth and interest rate differentials in favor of the U. S. have ensured full financing of the growing current account deficit and supported the dollar, the potential for a sharp correction in financial markets in the medium-term have increased. As sharply falling dollar exchange rates and rising dollar interest rates could cause disorderly financial markets and depressing global growth, the GFSR emphasizes the importance of addressing global imbalances and containing other risk factors.

The report notes some trends that could help enhance financial stability over time, including protecting against the risk of abrupt changes in capital flows. One such trend is the ongoing demographic changes and ensuing pension reforms, which increases the size and importance of institutional investors such as pension funds and life insurance companies. Another important stabilizing trend is the much enhanced transparency and disclosure in financial markets, including on behalf of emerging market borrowers thereby containing the risk of unjustified contagion.

The Nordic-Baltic Position

It is encouraging to witness a continued highly resilient financial system with short-term risks on the downside. Indeed, the further improvement in the financial sector, healthy economic growth and still benign inflation outlook give ground for positive assessment of the near-term financial stability.

At the same time, medium- to long-term risks are considerable and may have increased lately. A large number of indicators are now simultaneously exhibiting marked deviations from historical norms, e.g. very low real short-term rates and nominal bond rates, low credit spreads and measures of market volatility, low household saving rates, high household debt and house price growth in many countries, a remarkably high investment to GDP-ratio in China and record external imbalances. Thus, the number of important indicators simultaneously displaying abnormal values, and the potential effects on economic and financial stability, imply a more cautionary risk outlook. Besides that, the still growing global imbalances and possible abrupt adjustments could have a significant impact on the exchange and interest rates, and the stock market valuations globally.

Selected Country Matters

The Largest Borrowers under the GRA, Credit Outstanding (August 30, 2005)

	Billion SDRs			
	Stock at Aug. 30, 2005	Change from Feb. 28, 2005	In percent of quota	Share of total GRA percent
Turkey	11.0	-2.4	1140	26.3
Brazil	10.8	-5.3	355	25.8
Argentina	7.5	-1.3	354	17.9
Indonesia	5.7	-0.4	276	13.6
Uruguay	1.7	0.0	544	4.1
Sub-total	*36.7*	*-9.4*		*87.8*
Other GRA credit	5.1	-0.8		12.2
Total GRA	*41.8*	*-10.2*		*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 lending remains concentrated in arrangements with a few large borrowers.

Argentina

Argentina's global debt exchange offer was launched in January 2005 and closed on February 25 with a 76 percent participation level. As a result of the debt restructuring, Argentina's debt burden has declined to 72 percent of GDP (from 147 percent of GDP in 2002) and the debt service profile has improved considerably. Nonetheless, approximately USD 20 billion in principal remains outstanding. The settlement of the debt exchange was not completed before June 2, 2005, due to a delay resulting from legal action by some nonparticipating creditors to attach the tendered bonds. The Argentinean authorities subsequently informed the Fund's management of their desire to start negotiations on a new economic program.

In June 2005, the Executive Board concluded the *Article IV* consultation with Argentina. Argentina's economy has rebounded from the financial crisis in late 2001. Reflecting buoyant domestic demand, real GDP grew close to 9 percent in both 2003 and 2004, bringing real output level back to the level achieved prior to the crisis. Further measures will be needed on the structural front, not least with respect to strengthening of the institutional fiscal framework.

The Nordic-Baltic Position

The *Nordic-Baltic chair* has emphasized that a possible new program relation should be based on a sufficiently strong 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 of the remaining challenges in the utility sector. The Argentinean authorities must develop a strategy on how it will treat the arrears owed to nonparticipating bondholders. The *Nordic-Baltic chair* has underscored that the Fund should say "yes" to strong, coherent and sustainable programs with access commensurate with the balance of payments need and the strength of the underlying program. However, the Fund should be prepared to say "no" when policies are insufficient and inconsistent, not adhering to the standards in Fund supported programs.

Brazil

In March 2005, the Brazilian government announced that it would not seek an extension of the Stand-By Arrangement or seek a new arrangement with the Fund. The Stand-By Arrangement expired at the end of March 2005. In July, Brazil made a voluntary advance repayment of its SDR 3.4 billion in Fund credit outstanding under the Supplemental Reserve Facility, reducing outstanding loans with the Fund to SDR 10.8 billion.

The Nordic-Baltic Position

The economic performance of Brazil has been impressive under the expired Stand-By Arrangement. Brazil is well prepared

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to graduate from Fund financial support. Vigilance is still needed, as the economy is vulnerable to changes in market sentiment and to external financial shocks. The best strategy to reduce remaining vulnerabilities is to continue on the road of firm fiscal and monetary policies and steadfast implementation of structural reforms.

Turkey

In May 2005, the Executive Board approved a three-year, USD 10 billion Stand-By Arrangement to support Turkey's economic and financial program through May 2008. Growth in Turkey has been strong in recent years, on average 8 percent over the last three years. At the same time, inflation has fallen to single digits, its lowest level in more than 30 years. The authorities' new program is designed to extend these gains and reduce Turkey's remaining vulnerabilities. The government's commitment to maintain the primary surplus target at 6.5 percent of GNP will steadily reduce the public debt and help contain the current account deficit. Continued independence of the central bank, together with next year's introduction of full inflation targeting, will help consolidate the reduction in inflation.

Turkey's economic and financial performance remains strong. Structural performance has also continued to be pursued by the authorities. However, one key component of the program's structural reform agenda - a pension reform law - could not be approved before Parliament recessed for the summer. As a result, consideration of completion of the first review has been postponed.

The Nordic-Baltic Position

The performance on the growth and inflation front has been commendable. The heavy debt burden and widening current account deficit underscore the significant remaining vulnerabilities. The new program appropriately aims for further fiscal consolidation, and achieving a primary surplus of 6.5 percent is a key component of this strategy.

Iraq

In September 2004, the Executive Board approved SDR 297.1 million in Emergency Post-Conflict Assistance (EPCA) as support for Iraq's economic reconstruction efforts through 2005, and to help catalyze additional international support, including debt relief. The Fund has also continued to provide technical assistance, particularly in the area of institution building. On August 1, 2005, the Executive Board concluded the first *Article IV* consultation with Iraq in 25 years. The authorities were commended for having established and maintained a degree of macroeconomic stability under extremely difficult circumstances, and for having initiated structural reforms. However, the economy remains fragile, and much work remains to be done to transform Iraq into a market economy, firmly based on a path of sustained growth. Putting in place a coherent fiscal strategy aimed at prioritizing the use of available resources is critical. In recognizing the difficult context, Directors urged the authorities to start phasing out the significant government subsidies on petroleum products as quickly as feasible. While the continuing security problems have contributed to delaying the reforms identified in the program supported by the 2004 EPCA, a well-focused reform agenda will be a key to creating the conditions for a sustainable, broad-based growth.

The Nordic-Baltic Position
Improving the budget management and fiscal data collection is critical for further progress in economic reform. The Iraqi authorities should also address the weaknesses in the fiscal and oil sectors, identified in the audit report by the *International Advisory and Monitoring Board* (set up in 2003 by the UN to oversee the proceeds from the *Development Fund for Iraq* and Iraqi oil sales). This includes improving the reporting of spending by the ministries, strengthening control over the use of oil revenues and providing complete accounting records of the *Development Fund for Iraq*. An international auditor should also be appointed for the central bank. To strengthen debt sustainability, the authorities should agree to debt rescheduling terms for the non-Paris Club and private creditors comparable to those agreed with the Paris Club in late 2004. On the Iraqi authorities' desire to enter into a Stand-By Arrangement with the Fund by the end of 2005, the *Nordic-Baltic chair* emphasized that a country needs adequate capacity for policy planning and execution to assume the obligations under upper credit trance conditionality.

***Article IV* Consultations with Nordic-Baltic Countries, April -September 2005**

Norway: In June, the Executive Board concluded the *Article IV* consultation with Norway. Directors commended Norway's strong fiscal and monetary policy framework and the success in avoiding any adverse effects of the oil wealth. Inflation has remained low, with core inflation well below the inflation target. The flexible inflation targeting regime, including last years refinement, has served Norway well. Slack in labor and product markets is diminishing and the structural factors holding prices down may be waning. The labor markets could become overheated in 2006, a year when two-year wage bargains would be concluded. Directors appreciated the authorities' efforts to contain the non-oil fiscal deficit by restraining spending growth. In this regard, they welcomed the revised 2005 budget, which will use extra oil revenues to reduce the non-oil deficit, thereby bringing forward the date when the fiscal guidelines are achieved to the year 2008. Further breaching of the fiscal rule might damage the credibility of fiscal policy. The authorities should take advantage of the current favorable economic climate to comply with the fiscal guidelines as quickly as possible. The 2005 tax reform eliminates some distortions and promotes employment. Further privatization would be beneficial.

Directors welcomed the conclusion of the Financial System Stability Assessment (FSSA) that the financial system is sound, competitive and well managed. The authorities were commended on the strong system of financial supervision, and on the close coordination of financial supervision among the Nordic countries in view of the important cross-border financial linkages. The authorities should implement the reforms laid out in the FSSA. Directors commended the generous level of Norway's development assistance, which is well above the UN target. They welcomed Norway's support for multilateral trade liberalization and its own generally low trade barriers, while encouraging reduction of still-high barriers to agricultural imports.

Latvia: In July, the Executive Board concluded the *Article IV* consultation with Latvia. Directors commended the strong performance of the economy, which had culminated in Latvia's admission to ERM2 earlier this year. Decisive and timely action to reduce inflation would be crucial to meeting the authorities' Euro adoption timetable and, more generally, to preserving external competitiveness. In view of the pegged exchange rate, fiscal policy is the primary tool for ensuring macroeconomic stability. Directors, viewing rapid credit growth as adding to demand pressures, commended Bank of Latvia's decision to raise interest rates and tighten reserve requirements over the past year. The options for additional tightening had diminished; therefore, other measures to moderate credit growth are called for. In this regard, closing capital gains tax loopholes that could be fuelling the mortgage boom were seen as a priority. Directors recommended enhanced supervision of banks with substantial nonresident deposits.

Sweden: The Executive Board discussed the 2005 *Article IV* report on Sweden in September 2005. Executive Directors commended Sweden's remarkable economic performance in recent years, underpinned by large productivity gains, persistently low inflation, and a comfortable external position. Much of this performance can be traced to a stable policy regime of fiscal discipline and credible inflation targeting. The authorities should build on their successes and pursue their structural reform agenda with renewed vigor in order to address the challenge of population aging and fully realize the benefits of global integration.

With inflation projected to be below target over the next two years, the Riksbank's decision to cut the policy rate by 50 basis points is appropriate. However, with the outlook for growth appearing to turn more favorable than perceived at the time of the decision, interest rates may need to be raised at some point to safeguard the inflation target. Directors commended the authorities' continued strong political commitment to sound public finances and their strong record in this respect. Nevertheless, the substantial fiscal stimulus planned for this year and next, in spite of the favorable economic outlook, was seen by many Directors as indicating a gradual shift away from the spirit of the fiscal framework. In particular, they pointed to the postponement of the goal of achieving the 2-percent surplus target beyond the medium-term policy horizon and the narrowing of the contingency margins under the expenditure ceilings for the central government.

Most Directors supported the view that clarifying the criteria for assessing compliance with the surplus target - by specifying the interpretation of "over the cycle" - would improve fiscal transparency and accountability, and avoid entrenching a pro-cyclical bias to fiscal policy. The authorities were encouraged to accelerate the pace of other structural reforms to enable Sweden to address long-term demographic challenges from a position of economic strength and reap the full benefits of enhanced global integration. There is a need to further raise competition in important sectors, including construction, pharmaceuticals, and retail trade. Directors praised Sweden's continued commitment to a liberal international trading system and its high level of development assistance.

II. Medium-Term Strategy

The Executive Board has continued the review of the Fund's objective and medium-term strategy. The Managing Director, Rodrigo de Rato, initiated the review in September 2004, and has put special emphasis on four themes: the value of multilateral cooperation, quality macroeconomic advice, temporary financial support and the resolution by member countries on issues that persist in the Fund's governance. Two areas underlying these central themes and deserving particular attention are the Fund's work in financial sectors and its role in capital account liberalization. The aim of the work is to reach a shared understanding of the Fund's work priorities in a 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.

While the Fund's work and adaptability have generally been positively assessed, some factors have prompted a desire for a critical reflection on the future direction of the Fund. This includes the question of whether the Fund is fully prepared to meet the macroeconomic challenges that lie ahead such as dealing with unprecedented global imbalances, responding to possible capital account crisis caused by abrupt shifts in global asset allocation, and helping all members, especially low-income countries, to grow by integrating into the world economy.

The Managing Director's report to the IMFC on the Fund's medium-term strategy underscores that if the Fund is to remain in step with a rapidly changing world, it has to identify an organizing principle that defines its mission, prioritizes its elements and suggests that globalization could serve this purpose. Thus, helping members reap the benefits and weather the difficulties associated with globalization could be considered the key task currently facing the Fund. The Fund should outline a strategy that explains how it might reorganize itself to meet its objectives with concrete actions and outcomes for the next 3-5 years, and do so in a way that addresses the concerns of the entire membership.

The outline of the Fund's medium-term strategy identifies nine key directions for future work:

1. More effective surveillance, with the accent on more focus and greater attention to context - including the global context, the political context, and the increasingly wide range of issues potentially affecting stability in members' economies.

2. In advanced countries, a stronger focus on global implications and on possible policy adaptations when Fund advice was not accepted.

3. In emerging markets, improving early warning systems, reviewing mechanisms for crisis resolution, and considering further the possible role of Fund financing commitments in crisis prevention.

4. Improving the Fund's ability to advise on how best to manage the process of capital account liberalization.

5. In low-income countries, sharpening the focus on the Fund's core areas of expertise, introducing greater flexibility in Fund instruments, assessing the achievability of the Millennium Development Goals, and streamlining procedures.

6. Improving the management of technical assistance (TA) notably by ensuring a central role for area departments in working with country authorities to develop TA strategies.

7. Reflecting the above priorities in a three-year budget framework, while considering means of broadening the Fund's income base.

8. Improving organization by modernizing the staff compensation system and the departmental structure, streamlining management and Board responsibilities, improving risk management, and seeking a clearer division of labor and more effective collaboration with the World Bank.

9. Ensuring that all members have an appropriate quota and voice in the institution.

The report suggests deeper analysis of financial markets and more integration of financial expertise into area department missions. During the last 15 years, the increasing importance of private capital flows and of a stable and well-functioning financial sector has led to greater emphasis on these factors in the Fund's work. Against this backdrop, a special external *Review Group on the Organization of Financial Sector and Capital Markets Work* was established in June 2005. The mandate is to provide the Fund with an independent perspective on how the Fund should organize its financial-sector analysis and surveillance activities. The Group, which is led by *U.S. Public Company Accounting Oversight Board* Chairman William J. McDonough, is expected to present a report to the Fund's management later in 2005.

The Nordic-Baltic Position

Viewing the Fund's future work in light of opportunities and challenges raised by globalization is a praiseworthy move, which helps identify the most likely impediments to growth and macroeconomic and financial stability across the membership in the years ahead. Moreover, it serves as a guideline for the Fund in order to move closer to its original mission and stay focused on core activities. Globalization brings large benefits, but adjustment costs and inherent risks cannot be ignored. This is a major development that should be given priority as a motive behind changes to the Fund's working methods.

An efficient division of labor and cooperation with other institutions such as the World Bank and the WTO is important. Fund staff and management should initiate a dialogue with the new World Bank counterparts on ways to rationalize the division of labor and strengthen the effectiveness of cooperation.

Surveillance should continue to be at the core of the Fund's activities, and should focus on macroeconomic issues from the point of view of stability and globalization and draw synergies from multilateral and regional surveillance. Exchange rate issues should remain central to the Fund's role. It is important to improve the integration of financial sector expertise into area department teams and missions to strengthen bilateral surveillance. In this respect, the Fund would benefit from a better understanding of capital account liberalization issues. To enhance the relevance of Fund policy advice in advanced countries, staff reports should clearly spell out regional and global implications of country policies and long-term trends. Another issue deserving more attention is how the Fund can promote a stable and open trading system and work to avoid increasing protectionism. In order to make surveillance more effective, a strong communications strategy is of essence, based on openness, transparency and a public debate.

The scale and scope of future Fund lending should be a natural part of a strategy discussion. In this context, it is important to continue the debate on crisis management. Management's intention to launch a review of the Fund's instruments in crisis resolution and Lending into Arrears (LIA) policy is welcome, and discussions on exit strategies are encouraged.

In general, initiatives to improve the Fund's work in Low Income Countries (LICs) are welcome. Low-income members are among those benefiting the most from the Fund's core competences. Given the strategic focus on globalization and current account issues, a key challenge of the Fund's role in LICs will be to assist in effectively managing incremental aid flows. Better tailoring of Fund support to the different needs of LICs will also be important.

The Fund should put more emphasis on the MDGs, including to report explicitly on the achievability of the MDGs under realistic financing scenarios. Country specific analysis and policy advice and realistic assumptions on each country's internal priorities and budgeting, are equally important.

Organizational reforms should make the Fund better able to stand up to the challenges envisioned. It is important that incentives are in place to collaborate effectively across the institution and to ensure the sharing of knowledge. A business plan for the Fund as a whole should be an important element in such endeavors. Particularly important for the governance of the Fund is to review the working methods of the Executive Board to create room for discussions on strategic issues.

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 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 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.

The Fund's role in LICs has been one of the key issues for recent IMFC meetings. The G8 proposal for debt cancellation has further added to the focus on the Fund's poorest member countries, making it a central theme for the Annual Meetings.

Discussions have covered five broad areas. First, the G8 proposal for further debt relief. Second, instruments the Fund should be equipped with in working with its low-income members, as well as the financing of these. Third, the design of programs for LICs. Fourth, a status on the implementation of the HIPC Initiative. Fifth, a review of the Poverty Reduction Strategy (PRS) approach. 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 Position

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.

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 *Constituency* have special engagement as major donors of aid. Development aid ministries of our respective countries have been encouraged 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 in recent discussions include Bangladesh, Bolivia, Ghana, Malawi, Mali, Mozambique, Nicaragua, Sri Lanka, Sudan, Tanzania, Uganda and Zambia.

The G8 Proposal for 100 Percent Debt Cancellation

The G8 Summit in Gleneagles in July 2005 proposed a 100 percent cancellation of HIPC countries' debt to the Fund, the World Bank and the African Development

Bank. For the Fund, the G8 supported to use existing internal resources to finance the debt cancellation. The proposal has subsequently been discussed in the Executive Board on a number of occasions. At an early stage in this internal process, the Nordic-Baltic Executive Director, together with Directors representing the Belgian, Dutch and Swiss constituencies, asked staff for further clarifications on some important issues, including in relation to conditionality and uniformity of treatment. In this communication, it was explicitly stated that this proposal for further elaboration by staff would not prejudge the position of these chairs in the subsequent discussions.

The Nordic-Baltic Position

The *Nordic-Baltic chair* strongly supports the international efforts to reach the Millennium Development Goals. Debt relief, enhanced aid and increased trade, as well as sound economic policies in the recipient countries, are all essential to achieve these goals. It is encouraging that the global fight against poverty is on top of the G8's agenda. The G8 debt cancellation proposal clearly demonstrates the political commitment to make further progress towards the MDGs, and it is important that a broad political agreement on the key elements of the proposal would be reached in connection with the Annual Meetings. It is essential that debt relief is additional as a contribution to the necessary firm and time-bound commitments to raise official development assistance towards the UN target of 0.7 percent of gross national income.

The G8 proposal rightly focuses on the inherent conditions in the HIPC framework as a means to ensure that debt cancellation is provided to countries with a track record of sound economic policies. Emphasis on good governance, accountability and transparency as crucial to releasing the benefits of debt cancellation is important. A proper balance should be ensured between making the debt cancellation "predictable", while not giving full debt cancellation to countries which performance have lapsed or are off track. Eligible countries should maintain a sound macroeconomic performance and good governance. There is merit in further discussing how an active Fund involvement could help ensure that debt cancellation will achieve its fullest potential. This includes elaborating on possible modalities of how to ensure that post-completion point countries without Fund programs still pursue sound policies.

Furthermore, it is essential that sufficient capacity for the PRGF is sustained even after debt cancellation has been provided. It is important to come to a conclusion with respect to the issue of equality of treatment, as some countries with an already high debt burden will not benefit from the proposal. A proper balance should be achieved between the principle of uniformity of treatment and the increase in costs that follows from an expansion in the number of countries that can qualify for debt cancellation. Fair burden sharing is essential. Moreover, the Fund's capacity to lend to the LICs must not be compromised by the proposal, and it is therefore important to secure the financing. The principle of additionality is in this context of utmost importance. The proposal entails using part of the resources in the PRGF subsidy account. The Nordic countries have provided a substantial share (in terms of quota) of these resources.

Policy Support Instrument and Shocks Facility

As part of the ongoing discussion on the Fund's role in LICs, staff has undertaken a survey of PRGF-eligible members and donors seeking their views on how the mechanisms of Fund support for LICs could be made more useful. A number of low-income countries might not need Fund financial support, but still want the Fund to support their program and endorse the quality of their policies. Moreover, donors often attach as condition for disbursement of budget support that the country is "on track" in its Fund arrangement, making Fund signaling important. The Executive Board has discussed a proposal to establish a *Policy Support Instrument* (PSI), which would not entail financing, but a Board endorsement of the country's policies. The Executive Board has also discussed the possibility of introducing a window under the PRGF, which could be used for LICs facing exogenous shocks.

The Nordic-Baltic Position

The *Nordic-Baltic chair* supports efforts to strengthen surveillance and signaling in low income countries. This could be achieved be using more efficiently the untapped potential in existing instruments in terms of surveillance and lending facilities. This includes low-access PRGFs and *Precautionary Arrangements* and enhanced surveillance/transparency - signaling's "closest relatives". However, in view of the broad support for an additional signaling instrument the suggested PSI is supported. Such an instrument could support countries in safeguarding sound policies and in ensuring debt sustainability without a formal financial arrangement.

In the discussions on a possible shocks-window in the PRGF, the *Nordic-Baltic chair* supported that the Fund establish a policy on how to assist LICs facing balance of payment problems as a result of sudden exogenous shocks, but was not convinced of the need for creating a new window. The objective could be met through amendments of the existing instruments. The *Nordic-Baltic chair* would have preferred further simplification and transparency in terms of the Fund's facility structure.

PRGF Program Design

In September 1999, the Fund established the *Poverty Reduction and Growth Facility* to make the objectives of poverty reduction and growth more central to lending operations in its poorest member countries. PRGF-supported programs are underpinned by comprehensive country-owned poverty reduction strategies (PRSP), prepared by the country with broad participation of key stakeholders.

Earlier reviews of the PRGF by Fund staff in 2002, and by the Independent Evaluation Office of the Fund in 2004 confirmed that the design of the programs supported by PRGF lending has become more accommodating to higher public expenditure, in particular pro-poor spending. With the marked reduction of macroeconomic imbalances and resumption of growth in an increasing number of low-income countries in recent years, the policy challenges that these countries face have evolved. Increasingly, countries are facing a range of viable policy options: should they use any fiscal space to cut excessive tax burdens or raise public spending to improve the provision of public services? Some of these issues are especially pertinent in light of the prospect of a significant scaling-up in foreign aid flows to the LICs in the years ahead.

Against this backdrop, the review discussed by the Executive Board in September focused on selected policy issues facing LICs that have achieved broad macroeconomic stability with particular emphasis on the role of institutions in economic growth, the macroeconomics of aid absorption, and the budgetary and monetary policies that will encourage growth and poverty reduction. Staff recommends that PRGF-programs in the future give increased weight to trade liberalization and measures to improve the business environment in program countries. Staff also recommends that the Fund's role should continue to focus on macroeconomic stability and achieving or maintaining debt sustainability.

The Fund has, and will also in the future, have a limited role in building so-called broad economic institutions even if it is recognized that such institutions are important for economic and political stability in a country. The challenge for PRGF-programs will be, therefore, to ensure that growth and poverty reduction is sustained despite that the PRGF-countries will continue to have rather weak institutions in a foreseeable future. Absorbing larger amounts of aid inflows is also likely to become a more important issue in the future. Avoiding that the exchange rate becomes overvalued and at the same time ensure that aid is used in a predictable and efficient manner will pose increasing challenges for PRGF program countries, and PRGF-programs will have to be adapted to address these new issues.

The Nordic-Baltic Position

The traditional focus in Fund-supported programs, including PRGFs, on maintaining broad macroeconomic stability, avoiding overvalued currencies, and pursuing trade openness, is essential to help countries sustain growth. There is not much evidence that any country has been able to sustain growth over extended periods of time when it suffered from severe macroeconomic imbalances. Looking ahead, there is a need for increased attention to debt sustainability in PRGF-programs. Increasing absorption capacity of countries is important and is likely to become even more important, in the near future, with the increase in aid in prospect.

There is a large potential for improving growth prospects through improving institutions that are generally still weak in many LICs relative to other country groups. Governments in LICs have the main responsibility for ensuring improved institutions in order to sustain a pattern of growth. Improved transparency, budgetary control and anti-corruption efforts could potentially reduce the volatility of aid flows as donors' confidence increases. The Fund's role in institution building lies primarily within the narrow concept of institutions. However, this represents important challenges ahead since such institutions are vital to induce macroeconomic stabilization through coherent policies, fiscal transparency and governance, structural reforms in selected areas and facilitating trade. Liberalization of trade regimes and private sector development can increase growth potential further when the institutional frameworks are sufficiently strong.

A topic of particular interest in the current PRGF review is how to manage incremental aid inflows as part of the MDG effort. A "spend and absorb" strategy at the outset is appropriate and this requires a close coordination of fiscal policy with exchange rate and monetary policy. Focus on the potential to create fiscal space through enhancing public sector efficiency as well as increasing taxation is important. Many LICs clearly operate on a sub-optimal tax rate and tax base, and streamlining in this regard is certainly a viable option to put the public sector on a sustainable track towards fulfilling important functions within the economy. One key element in achieving absorption capacity in the long-term is having the tradable goods sector growing during periods of incremental aid inflows and strong economic performance, to facilitate a balanced external position in the longer term.

HIPC Initiative – Status of Implementation

Further progress has been made in implementing the enhanced Heavily Indebted Poor Countries (HIPC) initiative. According to a status report discussed in September, 28 countries have reached their decision points and 18 of them have now reached the completion point. As a result, debt-service payments for most HIPCs are expected to decline to less than 10 percent of exports and thus to help HIPCs to increase their poverty-reducing expenditures substantially.

During the Board discussion, Directors underscored that continued adherence to a strong policy framework and appropriate debt management remain essential after the completion point, for ensuring a lasting exit from unsustainable debt and maximizing the benefits for poverty reduction and attainment of the Millennium Development Goals. Notwithstanding these achievements, Directors recognized that many countries have yet to progress to the completion point. They noted that, for these countries in the interim period between the decision and completion points, progress toward reaching the completion point will depend on satisfactory performance under their PRGF arrangements and on the development and implementation of their poverty reduction strategies. Directors acknowledged that the majority of HIPCs' bilateral creditors have agreed to provide debt relief, but stressed that ensuring the full participation of non-Paris Club and commercial creditors remains an important challenge. Directors welcomed the preliminary list provided by staff to identify countries that could be eligible for HIPC assistance under the extended sunset clause and looked forward to receiving the final list of potentially eligible countries early in 2006.

The Nordic-Baltic position

It is encouraging to see a further increase in the number of countries that have reached the completion point. By lowering debt stock and debt service, the HIPC initiative continues to free additional resources for poverty reducing expenditures in participating countries. Continued sound policies, including good governance and appropriate debt management, will be needed to prevent the re-emergence of unsustainable debt. While most countries in the interim period are advancing with the implementation of their economic program, fewer interruptions would have been preferable. Moreover, it is worrisome that four out of ten countries in the interim period continue not having a Fund supported program in place following insufficient progress in establishing a satisfactory track record of progress. All countries potentially benefiting from debt relief should make the best use of the current window of opportunity and press ahead with the necessary stabilization and reform efforts. Participation by all creditors in a fair and evenhanded manner is central to the effectiveness of the HIPC initiative. The Fund and the World Bank can play a useful role in achieving progress in this area, including through promoting transparency and moral suasion.

Review of the PRS Approach

In September, the Board discussed two joint Fund/World Bank papers reviewing experience in implementing the Poverty Reduction Strategy (PRS) approach. The PRS process had encouraged countries to prioritize their development goals and set concrete targets and appropriate intermediate progress indicators, the review said, thus contributing to enhancing domestic accountability. Several countries had begun this process, but many PRSs would benefit from a more explicit link between goals and the policies needed to achieve them. While the MDGs could be a good starting point for defining a country's development priorities, few countries had fully customized them to local circumstances. Closer links between the PRS, the medium-term expenditure framework and annual budgets would also enhance prioritization. More could also be done to engage in a broad national dialogue on economic policies and poverty reduction, and to set up effective national systems for monitoring results. A major criticism of PRSPs was that they were generally not formulated as an operational framework for reaching the MDGs. Action was required from donors and countries alike to make the PRS the framework for scaling up country-level efforts to meet the MDGs, according to staff. Donors must align their assistance with the countries' development priorities and provide more aid in a timely, predictable and more effective manner. Countries will need to alleviate absorptive capacity constraints and institutional weaknesses, and strengthen the analytical underpinnings of their PRSs.

The Nordic-Baltic Position

By putting the country in the driver's seat of their own development process, the PRS process has provided a framework for accelerating efforts at the country level to attain ambitious development outcomes and bring countries closer to the achievement of the MDGs. The PRS initiative continues to be a work in progress, and now it is time to tailor best practices, learned during the past five years, to individual country circumstances.

The design of a Poverty Reduction Strategy must be country driven and be broadly understood and formulated by all-important stakeholders. There is a need to enhance the linkage between the PRS framework and a country's Medium-Term Expenditure Framework and its budgetary process as well as to the MDGs. Although the PRS approach provides no panacea, and is still a work in progress, it is a highly valuable instrument for implementing country driven poverty reduction strategies that deserves full support from the international community.

IV. FUND SURVEILLANCE AND CRISIS PREVENTION

Within the important area of Fund surveillance and crisis prevention, only a few policy discussions have taken place since the Spring IMFC meeting.

Review of Transparency Policy

Greater openness in economic policy-making and in the dissemination of data on economic and financial developments is a key element of the international community's efforts to be more effective at preventing financial crises. Many countries have taken steps in recent years to become more transparent. The Fund has undertaken initiatives to make its operations and policy deliberations more open to the public while safeguarding its role as confidential adviser to governments. Significant strengthening of its transparency policy in recent years includes a decision adopted in January 2001 by the Executive Board to allow the voluntary publication of country documents and more systematic publication of policy papers and associated *Public Information Notices* (PINs).

On June 20, 2005, the Executive Board reviewed the Fund's transparency policy. At the time of the last review, in September 2003, the Executive Board endorsed a move to a policy of voluntary but presumed publication for most country reports, in particular all staff reports on bilateral surveillance and the use of Fund resources (UFR), and of presumed publication of most policy papers. The current review noted, in particular, that publication rates for country reports had increased markedly since the last review, reaching 77 percent of all *Article IV* and UFR staff reports, while regional differences in publication rates had declined sharply. The review also highlighted a lengthening in the lag between the Board's discussion and publication for country documents. The review discussed various operational aspects of the experience under the publication policy, including the use of corrections and deletions, implementation costs, the impact on candor and the timeliness of publication. A key element of the Fund's publication policy is the existence of safeguards to maintain the frankness of policy discussions with members and to strike an appropriate balance between transparency and confidentiality. These safeguards include the possibility for members to request deletions of highly market-sensitive material.

During the Board's discussion on the 2005 Transparency Review, Directors agreed that the key principles of the publication policy remain appropriate. They welcomed the continued rise in publication rates, but noted the lengthening of the average time lag between a Board discussion and the publication date. It is important to preserve the frankness of the policy dialogue between the Fund's staff and members, as well as the information provided in staff reports to the Board.

Nordic-Baltic Position

The *Nordic-Baltic chair* supports further increasing transparency regarding the activities and recommendations of the Fund, and the proposals by staff were broadly supported. The publication lag is a serious concern that needs to be addressed along the lines proposed by staff. These efforts must go hand in hand with improving publication rates. The prohibition of sharing draft staff reports with the authorities

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must be retained. A more proactive use of the current operational guidance would likely go a long way to avoid requests for potentially unnecessary modifications. If there is a conflict between candor and publication, candor should be given priority. It is important that the views of the authorities are fully reflected in the documents.

All Member Countries should publish *Article IV* reports, *Use of Fund Resources* reports, FSSA reports and also the position of the authorities as reflected in the so-called Buff statements by the Executive Director representing the country under discussion. In addition, members are encouraged to post staff's concluding statements on *Article IV* Consultations on their websites to promote more public discussion on the Fund's policy advice.

Review of the Standards Codes Initiative

On July 25, 2005, the Executive Board considered a joint Fund/World Bank staff paper on the Standards and Codes Initiative. The Initiative was launched in 1999 and was designed to promote greater financial stability through the development, dissemination, adoption and implementation of international standards and codes. Its three intermediate objectives are to assist countries in making progress in strengthening their economic institutions, to inform Bank and Fund work, and to inform market participants. The initiative covers 12 areas and associated standards that relate to policy transparency, financial sector regulation and supervision, and market integrity. Assessments of the degree of implementation of these standards by countries result in Reports on the Observance of Standards and Codes (ROSCs).

Directors generally concurred that the scope of the Initiative and its key governance features should be left unchanged at this time. They recommended a number of changes to enhance the Initiative's effectiveness. The current policy of voluntary publication of ROSCs should continue. A few Directors recommended moving toward a policy of voluntary but presumed publication.

The Nordic-Baltic Position

ROSCs have contributed to strengthening legislation, regulation and institutions in member countries especially in emerging countries. However, there is room for improvement in various areas to make the initiative more effective. Efforts should aim to strengthen the observance, refinement, associated methodologies of the existing standards, and expand coverage particularly in developing countries and countries of systemic importance. Countries, primarily developing countries, which so far have been lagging behind in their participation, are encouraged to more actively take part in the Initiative, not least as a means for building stronger institutions and to identify vulnerabilities at an early stage. As data compilation and self assessments of ROSCs are quite extensive and tend to be resource intensive for national authorities, further streamlining of the data and information requests is called for. The integration of the Initiative with other Fund work should be strengthened. The Fund should have a continuous focus on how to simplify and clarify the ROSC's conclusions. The ROSC publication rate can be improved and more countries should publish their reports.

V. CAPACITY BUILDING

Review of the Fund's Regional Technical Assistance Centers and Conclusions of the Task Force on IMF Technical Assistance.

The Fund is providing technical assistance to help member countries strengthen their capacity to design and implement effective policies. Technical assistance is offered in the areas of 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 in the summer of 2005. The first was a review of the Fund's Regional Technical Assistance Centers (RTACs) and the second on conclusions of a Task Force on the Fund's technical assistance. The RTACs have been established by the Fund with extensive donor support, including from countries in the *Nordic-Baltic Constituency*. The Task Force was formed by the Fund's management to suggest an action plan for implementing the earlier recommendations of the Independent Evaluation Office (IEO) on improving delivery of the Fund's technical assistance.

Directors agreed that the RTACs have proven to be an important and useful addition to the Fund's TA program. The effectiveness of the RTACs should be further enhanced along the lines mentioned by the independent evaluations. Their potential to assist member countries in formulating a medium-term technical assistance strategy should be fully developed as well as implementation of such a strategy in the context of PRSPs. The role of the Steering Committees for the RTACs should be better defined to clarify the roles and responsibilities of all stakeholders and to strengthen their role in providing guidance, setting priorities and monitoring the performance of the RTACs.

Regarding Technical Assistance, Directors noted that the Task Force's proposals address the IEO's main recommendations, namely to (i) introduce a more medium-term perspective for setting TA strategy and priorities; (ii) strengthen the tracking and evaluation of TA implementation and results; and (iii) enhance country ownership of TA activities. Directors broadly endorsed the Task Force's proposals. Directors saw particular merit in greater involvement by country authorities in the design and follow up of technical assistance activities, based on the needs and priorities set out, where possible, in PRSPs. Therefore, they supported the Task Force's proposal to strengthen and expand the Technical Assistance Evaluation Program.

The Nordic-Baltic Position

RTAC activities need to be aligned with the overall TA strategy of the Fund. It is important for the RTACs to develop their activities under the new medium-term budget framework in line with the business plans of the Fund's area and functional departments following the medium-term strategic directions. Further expansion of RTACs should be carefully considered taking into account the cost and benefits, while better planning of donor financing would be preferable (e.g. defining funding sources for at least three years upon the establishment of new RTAC and lengthening the funding cycle from three to five years) to secure a smooth operation

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of RTACs. The potential of the RTACs to assist countries in identifying and implementing TA needs in the context of PRSPs should be improved. The use of regional expertise (i.e. hiring experts from the region) in RTACs would help to build a pool of experts in a particular region.

The proposals of the Task Force are well based and should be implemented in pilot cases to assess the real cost of the recommended measures. In countries with PRGF arrangements, milestones for TA continuation should be set as proposed where capacities to implement TA were limited. The purpose is to promote country ownership to implementation and align TA provision with absorption capacities. TA reports prepared by the Fund's staff could be shared more widely with specialists and the public to promote sharing of know-how and strengthen the authorities' commitment to implement TA recommendations

VI. CRISIS RESOLUTION ISSUES

The customary report to the IMFC on crisis resolution reviews progress on issues related to the orderly resolution of financial crisis, including the incorporation of *Collective Action Clauses* (CACs) in sovereign bond contracts and developments with regard to the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets. The Fund has taken an active role in promoting the inclusion of CACs in international bond issues. Such clauses prevent a small group of creditors from blocking potential future restructuring deals to which large majorities agree. The use of CACs has become the market standard in New York law governed sovereign bonds, with only one sovereign issue not including CACs since March. As a result, the share of sovereign bond issues with CACs in the total of outstanding sovereign bonds from emerging market countries grew from 39 percent at the beginning of 2004, to 53 percent at the end of June 2005. 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 *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*.

The *Principles* have received support from a number of emerging market countries and private creditor associations, although market views are varied. While supporting the drafting of such Principles, the Fund has left their specification to sovereign debtors and their creditors, since the effectiveness of voluntary rules hinges critically on their acceptability to the affected parties. The *Principles* are, in most respects, consistent with the Fund's policies and can be applied in a manner consistent with the Fund's lending into arrears (LIA) policy. However, the *Principles* call for a resumption of partial debt service, to the extent feasible, as a sign of good faith to facilitate a restructuring. Such payments are not a feature of the Fund's good faith criterion under the LIA policy. The Executive Board has discussed in various seminars the determinants of and prospects for market access by countries emerging from crises, including when this has involved a restructuring of sovereign debt. The Executive Board has also examined financial sector issues in the design of sovereign debt restructurings; and the managing of systemic banking crises in the context of sovereign debt restructurings.

The Nordic-Baltic Position
The continued progress on market based crisis resolution initiatives is encouraging. The special seminar discussions on market access and specific issues related to debt restructurings, including banking sector issues, have also been very useful. However, more needs to be done in terms of formulating a robust framework for the resolution of sovereign debt crises. Recent work programs have been too weak on crises resolution and the implementation of the *Fund's Lending into Arrears* policy, in spite of the IMFC's continued call for further work on these issues. Furthermore, a comprehensive review of the Fund's crisis resolution framework is overdue. While welcoming the increased use of CACs and the development of the *Principles*, it will be important for the Fund to study more how it can define its own role more precisely in relation to the *Principles.*

VII. Use of Fund Resources and Other Instruments

Review of Charges and Maturities

In June 2005, the Executive Board had preliminary discussions of experience with policies on surcharges and time-based repurchase expectations with a focus on their contributions to discouraging unduly large and prolonged use of Fund credit, and more generally to reinforcing the revolving nature of Fund resources. The Fund has modified this structure in recent years, helping the institution and its members to adapt to a changing economic environment, but also adding to its complexity. Directors saw room for improvements in the structure of the Fund's charges and maturities. Any changes should aim toward simplification, transparency and clarity while at the same time improving incentives. Further study of these issues would be important. The present benign global environment provides an opportune time for such work.

The Nordic-Baltic Position
Surcharges across the Fund's facilities should be aligned. The Fund's policies on charges and maturities - and lending facilities more generally - have to strike a balance between ensuring that members have access to adequate financing when necessary, and providing an incentive structure to ensure that a member's use of the Fund's facilities is temporary. The rate of charge should be established based on the total amount of resources outstanding (level-based surcharges). This would ensure a simple and transparent system of surcharges, and it would eliminate any existing incentives for members to seek to repay quickly while pursuing successor arrangements. If the incentives for early repayment were strengthened, the policy on time-based repurchase expectations could be eliminated. The *Supplemental Reserve Facility* (SRF) suffers from serious design weaknesses. Given alignment of surcharges and elimination of the policy on time-based repurchase expectations, a more fundamental evaluation of the SRF is necessary, while carefully considering the inter-linkages with the exceptional access framework.

VIII. MANAGING AN EFFICIENT INSTITUTION

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

Progress has been made in strengthening the budget process in the Fund in recent years. Further reforms have been launched to establish a medium-term output oriented budget. Progress includes implementing the key elements of the budget process by reconciling bottom-up, output oriented approach with a top-down constraint, attaching ever-greater importance on how the Fund's resources are divided between main output categories, and ensuring the availability of resources for implementation of the main policy priorities. In 2005 and early 2006, the Fund intends to move forward with a deepening of the budget reform process, further work on the Fund's finances and financial structure, and consideration of ways to strengthen internal control, audit and risk management. A process of introducing dollar budgets in the offices of Executive Directors has also been initiated.

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 draws on external expertise and is expected to be finalized toward the end of 2005. The Executive Board discussed and approved the Administrative and Capital Budgets for FY 2006 on April 22 that included also a medium-term budgetary framework and capital plan. The Fund's gross budget will equal to US$937 million (US$876.1 million net of estimated receipts), a 3.6 percent increase from the previous fiscal year. The ceiling of full-time staff positions is unchanged at 2,802.

The Nordic-Baltic Position

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. To ensure efficient every-day work in the Fund, the IMFC communiqués, the Fund's medium-term budgets and work plans, and the biannual statements by the Managing Director on the Board's work program are to be firmly linked together in the overall planning and budgeting framework.

The comprehensive review of the Fund's compensation and benefits system and its terms of reference is welcomed by the *Nordic-Baltic chair*. It is necessary, *inter alia*, to increase flexibility in this system and maintain an expatriate approach to the benefit system. The compensation and benefits system should be in accordance with "best practice". It is essential that the Fund is able to attract qualified staff of diverse nationalities and skills, including from Europe, while avoiding excessive salary increases. Expatriate benefits and allowances play an important role in that respect. The costs of expatriate benefits should be accommodated through a reallocation within the benefit system rather than an overall increase in benefit costs. In order to attract a diverse international staff, the allowance system should be more targeted toward family friendly benefits. This includes improved support for maternity leave, children's education in pre-school and post secondary education, day care, and spouses job possibilities. This

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could be done using a model with an annual lump sum, possibly to be gradually phased out. The recruitment policy should be revised in order to widen the knowledge and expertise of the Fund, including through more diversity.

IX. QUOTAS, VOICE AND REPRESENTATION

The Fund normally conducts general reviews of members' quotas every five years to assess the adequacy of its resources base and to adjust the quotas of individual members to reflect changes in their relative positions in the world economy. The most recent formal Board discussion under the ongoing 13th review of quotas took place in July 2003. At that time, most Directors felt there was no current need for a quota increase. Since then the Fund's liquidity position has further improved. The 13th review will need to be concluded before January 2008. The Monterrey consensus on the importance of strengthening the voice and representation of developing countries and countries with economies in transition has remained a key focus in the deliberations, but also the issue of some emerging market (particularly Asian) countries under-representation in terms of quotas has gained increased attention. European countries' aggregate actual quotas are currently someway below calculated quotas.

There is broad agreement that it is important to ensure that all members are properly represented in the Fund's policymaking bodies and have voice appropriate to their weight, but also that it remains fundamentally an issue for shareholders. During discussions, many Directors have suggested exploring prospects for pursuing various suggestions that would facilitate progress even in the absence of a general increase in the Fund's quotas.

The Nordic-Baltic Position

Member countries must be treated equally and objectively. Quotas should reflect economic size based on objective criteria. It is essential that a proper balance is ensured between creditors and debtors in such a way that creditors continue to uphold the majority. The liquidity situation in the Fund is still good, and at this stage, there is no need for a general quota increase. An *ad hoc* increase is warranted in some cases for making adjustments in the quota distribution. This targeted approach could help to correct the present substantial misalignments that exist for some countries. A proper representation and voice of all member countries should be ensured and can be improved from its current stance. The decline in the relative importance of *basic votes* implies a weakening of the voice of small countries in the decision-making of the Fund. Their voice should be enhanced through an increase in basic votes, aiming at restoring the original level of basic votes as a share of total quotas. Progress in enhancing the African EDs' *offices technical and administrative capacity* and their capacity should be further strengthened. There is a need for a less complicated quota formula. It is essential that a new formula, in addition to GDP, contains variables that incorporate economic openness.

X. 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 IEO operates independently of the Fund's 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. In April 2005, Thomas A. Bernes of Canada was selected as new Director of the Independent Evaluation Office succeeding Mr. Montek Singh Ahluwalia of India. While only the report on the *Evaluation of the Fund's Approach to Capital Account Liberalization* has been discussed by the Board since the last IMFC meeting, work is underway on other items on the IEO's work program. This includes evaluations on the Fund's 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 the Fund's Approach to Capital Account Liberalization

The report reviews the Fund's policy advice on capital account liberalization and related issues in a sample of emerging market economies over the period 1990-2004. The evaluation finds that the Fund encouraged countries that wanted to move ahead with capital account liberalization, especially before the East Asian crisis. However, there is no evidence to suggest that the Fund pushed countries to move faster than they were willing to go. In encouraging capital account liberalization, the Fund pointed out the risks inherent in an open capital account as well as the need for a sound financial system, even from the beginning. These risks, however, were insufficiently highlighted, and the recognition of the risks and preconditions did not translate into operational advice on pace and sequencing until later in the 1990s. In recent years, the Fund's analysis of such supply-side factors has intensified. Even so, the focus of policy advice remains on the recipient countries.

Two main recommendations of the IEO report were:

1. There is a need for more clarity on the Fund's approach to capital account issues.

2. The Fund's analysis and surveillance should give greater attention to the supply-side factors of international capital flows and to what can be done to minimize the volatility of capital movements.

In the Board's discussion on May 11, Directors stressed that the Fund has long attached importance to capital account issues and vulnerabilities, and that the process of clarifying their role in surveillance is well under way. There is a scope for sharpening the Fund's advice on capital account issues. The Fund's staff should continue to draw upon all available research in its policy advice to members. Further research and study are needed to fully understand how best to obtain the benefits and manage the risks of capital account liberalization, including sequenc-

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ing issues. Directors agreed that the Fund's future work on capital account issues should seek to buttress efforts to promote financial stability, while helping ensure that controls are not used as a substitute for adjustment. As a follow-up to the findings of the IEO report, Directors looked forward to capital account issues being addressed in the context of the Fund's ongoing strategic review.

The Nordic-Baltic Position

The Nordic-Baltic chair broadly agreed with the recommendations of the IEO, and concurred with the need for clearer guidance on the Fund's approach and role in capital account questions. While international capital movements are inherently beneficial to capital market integration and competitiveness, they can also give rise to problems, especially if countries open up their economies relying on an inappropriate strategy. Although the Fund has generally encouraged liberalization of capital movements, it has not been promoting capital account liberalization indiscriminately or required capital account liberalization as formal conditionality. The ex-post assessments of the Fund's involvement in countries with capital account crises indicate that innocent victims of contagion are hard to find, and sudden stops of capital flows together with the ensuing adverse impact on output largely reflect macroeconomic and structural inconsistencies.