The Office of the Nordic-Baltic Constituency
INTERNATIONAL MONETARY FUND

Views and Positions on Policy Developments in the International Monetary Fund

June 2012

Contents

This report is prepared by the Office of the Nordic-Baltic Constituency (NBC), representing Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden in the International Monetary Fund's Executive Board. The purpose is to present the positions taken by the Nordic-Baltic chair in the Executive Board and to update interested audiences on IMF issues. The report is not an exhaustive review of IMF's work, but aims at presenting the key discussions over the past year through mid-June 2012. The next report is scheduled for December 2012.

The IMF has 188 member countries following the inclusion of South Sudan on April 18, 2012, and all countries are represented by one of the 24 chairs of the Executive Board. The main activities of the IMF include:

- conducting surveillance and providing advice to members on adopting policies that can help them prevent or resolve a financial crisis, achieve macroeconomic stability, accelerate economic growth, and alleviate poverty;
- making financing temporarily available to member countries to help them address balance of payments problems; and
- offering technical assistance and training to countries to help them build the expertise and institutions they need to implement sound economic policies.

For additional information, we generally refer to the IMF's website, www.imf.org, which we have also benefited from while preparing this report.

June 15, 2012

I. INTRODUCTION

The IMF remains central to efforts to restore the global economy to a robust and sustained growth path following the outbreak of the global economic crisis in 2008. The Fund is focused on bilateral and multilateral surveillance, providing policy advice, technical support and financial assistance to underpin member countries' adjustment efforts, and at the same time putting in place systems that strengthen the Fund's ability to identify and respond to global economic risks as they emerge.

At the helm of the IMF is Managing Director Christine Lagarde (the MD) who was selected by consensus and took over the position on July 5, 2011, following the abrupt departure of Dominique Strauss-Kahn. As is customary, the MD was chosen in a merit-based selection process assessing the qualifications of the candidates. The process was very swift, which was considered crucial, since the state of the global economy called for strong leadership by the IMF. The Nordic-Baltic Constituency (NBC) supports an open and transparent selection process, and that management selection in the international financial institutions should be merit-based, irrespective of nationality and gender.

Main policy topics over the past year were – in addition to assessments of the economic and financial situation – a further strengthening of the IMF's surveillance function as well as the International Monetary System, issues related to the Fund's resources and governance, and further work on the Fund's role in Low Income Countries (LICs). This report will deal with each of these themes respectively with focus on the positions taken by our chair in the Executive Board. Further information on NBC views can be found in the published statements by our member of the ministerial committee of the IMF, the International Monetary and Financial Committee (IMFC), which usually meets twice a year, in September or October at the Bank-Fund Annual Meetings and in March or April at what are referred to as the Spring Meetings.

It is also worth mentioning, that two countries in the Nordic Baltic Constituency – Iceland and Latvia - successfully concluded their IMF supported programs in 2011.

II. SURVEILLANCE

The IMF members have an obligation to consult with the Fund on their economic and financial policies regularly. Surveillance takes up most of the IMF's workload, and in implementing its surveillance function the Fund assesses risks to the global economy and provides economic policy advice at an individual country-level. Since the monitoring of the individual 188 countries is wide-ranging and also well covered at the IMF's website, we focus on the multilateral surveillance in the following.

At a regional level, the broadening of the scope of the IMF's work in Europe since the start of the global financial crisis in 2008 is noteworthy, and this has been further stepped up since mid-2010 as a result of the Euro area sovereign debt crisis. In addition to the regular macroeconomic surveillance of the 27 EU member states, the so called Article IV consultations, and the annual consultations for the Euro area as a whole, IMF staff conducted for the first time a European Financial Stability Framework Exercise in 2011, which is expected to be a precursor to a Financial Sector Assessment Program (FSAP) for the EU in late 2012. In addition, a number of European countries requested financial support from the IMF since 2008. In particular, three members of the Euro area—Greece, Portugal, and Ireland— adopted IMF supported programs entailing large amounts. In these countries, the IMF works closely together with the European Commission and the European Central Bank, a collaboration known as the "Troika". The Nordic-Baltic Constituency supports the IMF's involvement in the region.

On the global economy, the IMF's flagship reports are the World Economic Outlook, the Global Financial Stability Report and the Fiscal Monitor, which are all published semi-annually on the IMF's website. In addition, there are quarterly updates in between. Starting in 2011, the IMF also prepares a semi-annual Consolidated Multilateral Surveillance Report that pulls together the key findings and policy advice from the IMF's various multilateral reports. That report aims to sharpen the focus on concrete policy actions which reduce global imbalances and vulnerabilities, and which steer the global economy towards sustainable growth and financial stability.

Overall, the IMF is currently making special efforts to integrate more closely all dimensions of surveillance - multilateral, bilateral and financial - in order to make it more effective. These discussions also help address some of the weaknesses identified in the Fund's pre-crisis surveillance which were set out in the 2011 report by the IMF's Independent Evaluation Office on IMF Performance in the Run-up to the Financial and Economic Crisis.

GLOBAL ECONOMIC AND FINANCIAL OUTLOOK

Context. The IMF, in its most recent publication from April, 2012, forecasts the world economy to grow by 3.5 percent in 2012 and 4.1 percent in 2013, covering highly diverse developments in the regions. While growth is expected to be low in the advanced economies - most pronounced in the Euro area where a fall of 0.3 percent of GDP is expected in 2012 - more than a 7 percent increase in GDP is expected in developing Asia in both 2012 and 2013.

The Fund generally sees the global economy as struggling to regain its footing. Resolute actions by European policymakers in 2011/12 have helped avert a systemic crisis, but strains have been on the rise again in the spring of 2012. The recovery remains vulnerable and risks are firmly to the downside. At the time of writing, the most immediate concern is a further escalation of the Euro area crisis. Another key near-term risk is excessive fiscal tightening in the U.S. in 2013 (due to potential automatic spending cuts and expiration of fiscal measures). Also, an abrupt end to credit booms in some emerging economies may crimp activity. Fiscal sustainability concerns in the United States and Japan create a tail risk of disruption in their bond markets. The risks to global financial stability remain elevated and pressures from sovereign risks, weak Euro area growth, high rollover requirements, and the need to strengthen capital cushions to regain investor trust, remain on the European banks.

The Fund stresses the need for fiscal consolidation at a pace that is neither too slow (which could undermine credibility) nor too fast (which could undermine growth). The current rate of deficit reduction in advanced economies, about 1 percent of GDP on average in 2012, is seen as appropriate. Adjustment should only be front-loaded in countries where financing constraints leave no option. Hence, the IMF advices the advanced economies to proceed with fiscal consolidation mostly as planned, but to allow automatic stabilizers to operate where financing allows. Also, consolidation should be accompanied by a highly accommodative monetary policy, including, where necessary, unconventional measures and liquidity support, as well as bank recapitalization and restructuring to support credit. The IMF emphasizes that the United States and Japan must commit to credible and ambitious medium-term fiscal adjustment plans. More generally, structural reforms should be implemented to improve medium-term growth and competitiveness.

NBC view. Sound fiscal consolidation and securing sustainability of public finances are preconditions for, rather than obstacles to, growth. In most advanced countries, in particular in European countries facing market pressure, implementation of the agreed fiscal consolidation plans and structural reform commitments should continue as planned to ensure credibility and to pave the way for sustainable growth. Reforms and policies should be pursued to limit the social costs of unemployment, in particular by addressing structural or regulatory impediments to growth in labor markets and taxation systems. We agree with the IMF that the lack of credible medium-term fiscal adjustment plans in the US and Japan remains a cause for concern which should be addressed urgently. We are also alert to latent risks ahead arising from sustained high credit growth in several emerging markets.

TRIENNIAL SURVEILLANCE REVIEW AND INTEGRATED SURVEILLANCE DECISION

Context. The latest comprehensive review of the effectiveness of the IMF's surveillance, cf. the Triennial Surveillance Review, was completed in October 2011, covering both bilateral and multilateral surveillance. The review highlighted progress since the beginning of the global financial crisis, but also found remaining gaps in the IMF's surveillance. In particular, surveillance was seen as too fragmented, with risk assessments lacking depth and insufficient focus on interconnections and the transmission of shocks. Surveillance was also found to have less impact on policies in larger member countries. To enhance traction, the IMF is working on concrete proposals for a new, integrated surveillance decision that will foster a broader approach to global stability. A progress report will be prepared by September 2012.

NBC view. We fully support a prompt adoption of an integrated surveillance decision to strengthen and clarify the IMF's surveillance mandate. The decision should aim to adapt the formal surveillance framework to current economic realities, to better integrate bilateral and multilateral surveillance activities, to sharpen the focus on financial sector policies and stability, to correct the existing formal surveillance bias towards exchange rates, and to ensure effective surveillance of economic policy spill-over effects across borders. We see an integrated surveillance decision as an intermediate step to be followed, in due course, by an amendment of the Articles of Agreement that clearly and formally specifies the IMF's role in multilateral and financial sector surveillance and defines an explicit financial stability mandate. This amendment would define and formally anchor the broadened scope of members' obligations vis-à-vis the IMF, taking into account potential spill-over effects of their economic and financial policies. An appropriate division of responsibilities between the IMF and other international institutions should be ensured, based on their respective mandates.

III. INTERNATIONAL MONETARY SYSTEM AND FINANCIAL ARCHITECTURE

The international monetary system consists of a set of internationally agreed rules, conventions and supporting institutions that facilitate international trade, cross-border investment and generally the flow of capital between nation states. The IMF plays a central role in view of its surveillance mandate and as a lender of last resort for members with actual or potential balance of payments needs.

The Fund has a range of lending facilities which are regularly reviewed in order to strengthen the global financial safety nets and target the needs of member countries, while safeguarding the IMF's resources. Since the start of the crisis until June 11, 2012, the total lending commitments amount to about USD 326 billion and actual disbursements to about USD 143 billion. Undrawn commitments are at about USD 184 billion. In comparison, lending during the 1998 Asian crisis amounted to USD 52 billion (end-1998 exchange rate used). The peak of outstanding credit at the time of the Asian crisis was USD 85 billion.

Capital flows have been an important topic of discussion over the past year, partly in view of the IMF's reduced reluctance to the use of capital flow management measures during the crisis, partly in view of the significant capital flows stemming from diverse economic developments and fundamentals in different regions of the world.

CAPITAL FLOWS

Context. Capital flows are generally beneficial to economic prosperity, but excessive and/or volatile flows may give rise to macroeconomic or financial instability. The IMF has initiated a work process to inform policy discussions with members. A first paper in December 2010 dealt with the Fund's role in the area of capital flows. The second paper in March 2011 presented a view on how to best manage capital inflows. The third paper in November 2011 examined the multilateral aspects of policies affecting capital flows. A fourth paper, discussed by the Executive Board in April 2012, reviewed the issues of liberalizing capital flows and managing capital outflows. A final, fifth paper will integrate all of these elements into a "comprehensive, balanced, and flexible approach on policies affecting capital flows", as called for by the IMFC.

NBC view. We support the IMF's work on capital flows, in particular, the ambition to develop a comprehensive and flexible institutional framework for the management of capital flows. Such a framework will make staff advice on the issue more predictable and consistent. To manage capital flows, primacy should generally be given to structural measures that increase the capacity of the economy to absorb inflows, as well as to addressing underlying imbalances through macroeconomic and financial sector policies. While the temporary (re)imposition of capital flow management measures can be useful, such measures should not substitute for more fundamental macroeconomic and structural adjustments and should take into account the multilateral consequences of such policies.

IV. FUND RESOURCES AND GOVERNANCE

The voting power of IMF member countries is based on the so called quotas, which broadly reflect the countries' relative position in the world economy. Historically, IMF quotas have also been an important reference in determining access to the resources of the IMF. Commitments to the IMF quota resources form part of the countries' international reserves. The currency of the IMF is the Special Drawing Right (SDR), which is calculated as a basket consisting of the US dollar, the euro, the Japanese yen and the British pound. 1 SDR stood at 1.52 USD on June 15, 2012.

In recent years, improvements in the IMF's governance and resources have been at the top of the institution's agenda. While governance reforms aim to generally improve the functioning as well as the credibility of the institution, the focus on the adequacy of financial resources is derived from the global economic and financial crisis on the basis of the Fund's mandate. The current Chairman of the IMFC is aiming to strengthen the role of the IMFC, something we strongly support since we view the IMFC as *the* global forum for economic and financial cooperation.

THE 2010 REFORMS

Context. Reforms entailing the redistribution of quota shares and improved governance were formally adopted by the IMF's Board of Governors in December 2010. The quota increase agreed at the same time will double the IMF's quota resources to about USD 725 billion and the Executive Board composition will change as there will be fewer chairs for the advanced European economies. In addition, all Directors will be elected whereas the five largest members of the IMF have until now appointed their Directors. The reform will shift more than 6 percent of quota shares to emerging market economies and all BRIC countries will be among the 10 largest shareholders (the top three being the US, Japan and China). The implementation of these reforms awaits ratification by some member countries. The target is to complete these procedures by the 2012 Annual Meetings. The quota increase will not become effective until the 2010 Board reform amendment has entered into force. By mid-June 2012, 107 members with 66.84 percent of quotas had consented to the increase in their quotas (70 percent of quotas needed), and 80 members with 55.06 percent of voting power had accepted the Board reform amendment (113 members with 85 percent voting power needed)[1].

NBC view. We urge members to ratify the reforms by the deadline. We expect all the Nordic-Baltic countries to have ratified the reforms well in advance of the Annual Meetings. In our constituency, at the time of writing, countries representing about 95 percent of our total voting power have accepted the Board Reform Amendment, and countries representing about 98 percent of our quotas have consented to the proposed quota increase.

QUOTA FORMULA REVIEW

Context. As part of the 2010 reforms, it was agreed to review the quota formula by January 2013. The quota formula serves as a guide to quota adjustments and it consists of four variables agreed by the membership in 2008. Gross domestic product (GDP) has the largest weight (50 percent), consisting of a blend of GDP converted at market exchange rates (30 percent) and PPP-based (20 percent). The other variables are openness, which measures the sum of current payments and receipts (30 percent weight); variability of current receipts and net capital flows (15 percent weight); and official foreign exchange reserves (5 percent weight). A compression factor (of 0.95) is applied to the weighted sum of these variables. The initial discussions took place in September 2011 and in March and June 2012. Opinions differ widely in the IMF's membership on what constitutes a proper quota formula and discussions will continue in July.

NBC view. The formula should be improved to better reflect the broad mandate of the Fund, as well as the multiple purposes of quotas. Members' relative positions in the world economy and their capacity to support the Fund's work are best captured by GDP measured at market exchange rates and by their economic and financial openness. To protect the quota shares of the smallest members, many of which are emerging markets and developing countries, the degree of compression should be preserved or even increased. The legitimacy of the quota formula review will depend on the process leading to the final agreement. We call for a transparent and inclusive process that is fully anchored in the Executive Board and the IMFC.

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[1] Please see http://www.imf.org/external/np/sec/misc/consents.htm for the most recent status.

INCREASE IN FUND RESOURCES

Context. The Fund can supplement its main source of financing, the quota resources, through borrowing if it believes that it might fall short of members' needs. The IMF's main backstop for quota resources is the New Arrangements to Borrow (NAB), under which participants from 40 member countries stand ready to lend additional resources to the IMF. In view of the global crisis, it was decided to expand the NAB in 2009, and today the NAB amounts to about USD 565 billion. Activation of the NAB requires approval by the participants and this has been done continuously since April 2011. The latest 6-months' activation was effected on April 1, 2012. The NAB was reviewed and extended for a 5-year period starting November 17, 2011. However, the NAB credit arrangements are set to be rolled back in connection with the quota increase agreed in 2010, and this will become effective for each participant on the day the member pays its quota increase.

In order to increase available financial resources ("financial firewall") and further promote global economic and financial stability, the Managing Director has called for bilateral loans to further boost the IMF's resources. At this stage, member countries have pledged USD 456 billion to the IMF. The specific modalities for these bilateral loans are under consideration.

NBC view. Countries in the Nordic-Baltic Constituency have pledged bilateral loans of more than 30 billion USD to the IMF's General Resources Account to ensure the adequacy of the IMF's resources. The Nordic-Baltic Constituency has also been supportive of the continuous activation of the NAB, in which Denmark, Finland, Norway and Sweden are participants. At the same time, we underline that the IMF's resources must continue to be firmly safeguarded and that the main tools to mitigate risks are strong program design with tailored and strict policy conditionality and limitations on borrowers' access to Fund resources, and that the authorities have strong ownership of the program.

V. LOW-INCOME COUNTRIES

Economies in most LICs held up well during the global crisis compared to advanced and emerging market economies, partly reflecting the limited exposure of the former to the global financial sector troubles in advanced economies. Moreover, many LICs were able to use their strong pre-crisis macroeconomic buffers to pursue countercyclical fiscal responses. However, their macroeconomic policy buffers have been eroded over the last three years and LICs are now less well-prepared to cope with new shocks.

LICs have experienced a strong recovery since early 2010, but remain highly vulnerable to deterioration in global conditions and further commodity price volatility. According to a Fund vulnerability exercise undertaken in 2011, a sharp global downturn could increase the external financing need of LICs by USD 27 million and push additionally 23 million individuals into poverty. To build resilience against shocks, LICs should aim to increase the efficiency of public investment, while pursuing structural reforms to deepen financial systems, develop social protection systems, and diversify their economies. Many LICs face the challenge of balancing the need for investment in growth-supporting infrastructure whilst ensuring that macroeconomic and debt sustainability are maintained. Strengthening domestic revenue mobilization is essential to help reconcile competing objectives and reduce medium-term fiscal risks.

In order to mitigate the effects of the global crisis, concessional lending by the IMF to low-income countries rose sharply in 2009 to USD 3.8 billion, from USD 1.2 billion in 2008 and just

USD 0.2 billion in 2007. Concessional lending has since eased to USD 1.8 billion and USD 1.9 billion in 2010 and 2011 respectively, and commitments so far in 2012 amount to USD 1.8 billion. The Fund seeks to increase its concessional lending capacity to provide up to USD 17 billion during 2009-14 (the 2009 funding package).

To date, debt reduction packages have been approved for 36 countries, 30 of them in Africa, providing USD 76 billion in debt-service relief over time, including around USD 7 billion through the Fund. The debt relief initiative for heavily indebted poor countries (HIPC Initiative) was launched in 1996 and supplemented by the Multilateral Debt Relief Initiative (MDRI) in 2005.

DISTRIBUTION OF PROFITS FROM GOLD SALE

Context. On February 24, 2012, the Executive Board approved the distribution to the membership of about USD 1.1 billion, attributed to a part of the profits from its 2009-2010 gold sales program, in order to increase resources for subsidizing concessional lending. The distribution will be effected only when members provide assurances that they will make new concessional lending subsidy contributions equivalent to at least 90 percent of the amount distributed. As of June 11, 2012, 94 countries representing 72 percent of the proposed distribution had pledged their portion of the distribution to the Poverty Reduction and Growth Trust (PRGT).

NBC view. We fully support the strengthening of the IMF's ability to support low-income countries as reflected by the decision to use a portion of the windfall gold sale profits to facilitate new subsidy contributions to the PRGT. Most of our countries have already pledged an amount to the PRGT equivalent to the distribution of gold profits, though pending parliamentary approval in some cases.

DEBT SUSTAINABILITY FRAMEWORK

Context. The IMF and World Bank have conducted a comprehensive review of their joint Debt Sustainability Framework (DSF) developed to help guide borrowing decisions in LICs. Key enhancements include strengthened analysis of total public debt and fiscal vulnerabilities, and the introduction of an additional risk rating to reflect the overall risk of debt distress. The review also discusses ways to better capture the benefits of debt-financed public investment, thus addressing a recurring criticism of the framework.

NBC view. The indicated changes to the Framework and its application, as well as the underlying analysis, were all steps in the right direction. We strongly supported the development of an increasingly country specific approach when assessing the risk of debt distress, while at the same time stressing the need to maintain cross-country comparability and evenhandedness in implementation.

COUNTRIES IN FRAGILE SITUATIONS

Context. The Board discussed macroeconomic and operational challenges in countries in fragile situations in July 2011 to review the Fund's past engagement in fragile states and, on that basis, to boost the effectiveness of Fund work in such situations.

NBC view. We welcomed the proposed improvements in the Fund's engagement and supported the suggestions put forward, including the enhancement of the Rapid Credit Facility (RCF) and the establishment of a RCF-like facility for general emergency assistance in the case of non-LICs.

VI. STAFF OF THE OFFICE OF THE NORDIC BALTIC CONSTITUENCY

The Office of the Nordic Baltic Constituency presents the views of our member countries in the IMF's Executive Board in close coordination with our authorities in the eight capitals. The Office also regularly meets with representatives from the member countries' administrations or private delegations. All the positions in the office rotate between the eight member countries according to an agreed schedule and all countries are represented at all times.

Currently, our staff includes:

Benny Andersen	Executive Director, Denmark
Audun Gronn	Alternate Executive Director, Norway
Kari Korhonen	Senior Advisor, Finland
Andres Sutt	Senior Advisor, Estonia
Lilja Alfredsdottir	Advisor, Iceland
Rimtautas Bartkus	Advisor, Lithuania
Gundars Davidsons	Advisor, Latvia
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