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The Nordic-Baltic Office
International Monetary Fund

Report 2004/2

The Global Economy and Recent Policy Developments in the International Monetary Fund

CONTENT

LIST OF ACRONYMS

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

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INTRODUCTION

This report is prepared by the staff of the *Nordic-Baltic Office* (NBO) at the International Monetary Fund in preparation for the Annual Meeting of the Fund and the meeting of the *International Monetary and Financial Committee* (IMFC) on October 2-3, 2004. These meetings will be the first with Rodrigo de Rato as Managing Director. De Rato, who served as Spain's Minister of Economy and Vice President for Economic Affairs during 2000-04, succeeded Horst Köhler from Germany as Managing Director of the Fund in June 2004. Köhler resigned from his post, March 4, following his nomination (and subsequent election) for the German Presidency.

The report covers the period from the IMFC Meeting in Washington D.C. in April 2004 to the end of September 2004 and centers on the following main areas:

- The global economic and financial markets.
- Selected country cases. This includes the Fund's main debtor countries, and a summary of the discussions on Nordic-Baltic countries that have taken place in this period.
- The main policy issues that have been discussed in the Executive Board of the Fund since the spring of 2004 and in preparation of the Annual Meetings.

In the various sections, a special reference is made to key views presented by the *Nordic-Baltic Constituency* (NBC). The main references are the *World Economic Outlook* (WEO), the *Global Financial Stability Report* (GFSR) and the *Annual Report* of the Fund. Those reports are available on the Fund's website www.imf.org.

The Nordic-Baltic Constituency consists of eight countries: Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. The NBC has 3.52 percent of the total votes at the Fund's Executive Board that consists of 24 chairs representing the 184 member countries. The Managing Director, or one of the three deputies, chairs the Board meetings. The *Nordic-Baltic Office* has ten staff members: An Executive Director, an Alternate Executive Director, two Senior Advisors, four Advisors and two permanent Administrative Assistants. Each of the member countries of the *Constituency* provides one staff member on a rotational basis. In accordance with the mandate of the Fund, the work at the NBO contributes to the policy formulation and decision-making of the Fund, with the aim to strengthen the role and further improve the efficiency of the institution. Moreover, the NBO shall serve the interests of the *Nordic-Baltic Constituency* by promoting its views and enhancing its role within the Fund. The NBO interacts with management, staff and other Executive Director Offices in the process of policy formulation and decision-making. The NBO cooperates with national authorities to receive guidance, exchange views and provide information on discussions and developments within the Fund.

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

The cooperation within the EURIMF is focused on broad Fund strategic policy issues as well as on countries of systemic importance, including emerging market countries with large Fund financial programs. In addition, upcoming *Article IV* consultations involving EU countries are discussed in the EURIMF. The EURIMF also meets with the Fund staff and management with a view to contributing to the work program of the Fund and to pushing 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 well-developed 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 the Deputy Governor 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 that meets formally twice a year, but consults more often, e.g. in telephone conferences.

For the individual countries in the *Nordic-Baltic Constituency*, their direct engagement with the Fund is now limited to surveillance in accordance with *Article IV* of the Fund's Articles of Agreement. Estonia, Finland, Latvia, Lithuania, Norway and Sweden are on a normal 12-month cycle, i.e. the Fund's staff visits these countries once a year to assess their economic policy and provide the authorities with policy advice. Denmark and Iceland are on a 24-month cycle. All the countries in the *Constituency*, except Denmark and Norway, have been assessed from a financial sector stability point of view within the framework of the *Financial Sector Assessment Program* (FSAP). Norway will have an FSAP in the Fiscal Year (FY) 2005 and Denmark is expected to have one in FY 2006. All countries in the *Constituency* are publishing the reports from the *Article IV* surveillance on their Central Bank websites. The country reports are also available on the Fund's website.

I. THE GLOBAL ECONOMY AND FINANCIAL MARKETS

The Executive Board conducted its twice-yearly comprehensive assessments of the **world economic outlook and global financial stability** in early September.

Global Economic Outlook

The pace of the global recovery has broadened and continued to exceed expectations. GDP growth is now projected by the Fund to average 5.0 percent in 2004, the highest for nearly three decades. However, given the recent further increase in oil prices and weaker than expected incoming economic data, the balance of risks has shifted to the downside. On the policy side, interest rates will need to rise further as the recovery proceeds, although the pace and timing varies considerably across countries. A key challenge is to take advantage of the upturn by making progress in addressing fundamental medium-term problems, including unsustainable fiscal positions, growth-restraining structural weaknesses, and - last but not least - the continuing global current account imbalances. Progress is being made but without further actions there is a serious risk of shortfalls in many regions, leaving the world more vulnerable to future shocks. For 2005, the Fund is projecting global growth of 4.3 percent. Economic prospects for 2005 are underpinned by continued progress in reducing financial vulnerabilities in the corporate and banking sectors.

In the US, the expansion remained strong in early 2004, but hit a soft patch in the second quarter with personal consumption growth falling back. While the slowdown in household demand is expected to be balanced by rising business investments, a possible increase in household savings ratio and the risk of reduced job creation have increased concerns that the soft spot could persist longer than assumed. In Japan the recovery is becoming increasingly broad-based. Strong growth in exports and business fixed investment has been supported by brisk private consumption recently. Growth in Asia has continued to exceed expectations, underpinned by global recovery, high growth in China and generally supportive macroeconomic policies, including highly competitive exchange rates. The recovery in the *euro area* has gained momentum. The upturn is still dependent on external demand and inventory building. However, growth is projected to be increasingly supported by domestic demand, as private consumption is boosted by rising disposable incomes. Increased savings by households have contributed to weaker domestic demand in Germany and Italy, while France as well as many other European countries is experiencing more broad based recovery.

At the Executive Board meeting, the *Nordic-Baltic chair* was in broad agreement with the assessment of staff and underlined that downside risks have increased. In particular, increasing oil prices may dampen the global recovery, if the prices prevail for an extended period. Despite the increased risks, the present upturn should be used to address global imbalances, move towards more sustainable fiscal positions and press ahead with structural reforms to prepare countries for future challenges, including for global aging. Against this backdrop, the moderation of growth from the present high level would not necessarily be undesirable if global imbalances are corrected and firmer foundation for sustainable growth is established. If growth disappoints, central banks may have to keep interest rates lower for a longer period than currently envisaged as there is little room for compensating fiscal policy. Moreover, automatic fiscal stabilizers should be allowed to work around a stable or tightening trend.

Turning to the main economic regions, the *Nordic-Baltic chair* stressed that the US fiscal consolidation should be more ambitious than now envisaged by the authorities, helping to correct the twin deficits and reduce the risk of an abrupt change in the dollar and a sharp rise in long term interest rates. In Japan and Europe revived efforts are needed to advance structural reforms and to put public finances on a sound footing to build confidence in the private sector and underpin the incipient recovery. Emerging countries in Asia would – through allowing real exchange rates to better reflect their economic strength – need to shoulder a larger share of rebalancing global demand. The *Nordic-Baltic chair* also underlined that while the outlook for many African countries is better than it has been for some time, strong efforts from the countries themselves are necessary to lay the foundations for sustained strong growth. The international community also has an important role to play in Africa, most notably through continued aid flows and debt relief, and through lower restrictions on developing country exports. In that regard, the recent WTO-agreement on a framework for continued trade negotiations is a positive development both for developed and developing nations.

Global Financial Stability

The broadening economic recovery has strengthened the global financial system over the past six months. The financial system looks more resilient than ever since the bursting of equity bubble three years ago. In light of this positive assessment, the *Global Financial Stability Report* (GFSR) emphasizes the need for the authorities of all countries to address weak spots in the financial systems. Short of major geopolitical risks, the GFSR finds it hard to see where systemic threats could emerge in the near term. However, the GFSR indicates three main medium-term down side risks:

1. The risk of complacency in the financial markets could lead to a return of indiscriminate risk behavior, due to a strong tendency to "search for yield".

2. The risk of higher inflationary pressures, and hence of a more substantial rise in the US interest rates could disrupt the so far orderly adjustment of markets to higher interest rates.

3. The risk of a disorderly adjustment of the global current account imbalances.

The key policy recommendations include a continued need for central banks to guide market expectations along the planned tightening course and to use the benign economic and financial conditions to enhance policy coordination to reduce global imbalances.

In one of the analytical chapters, the GFSR focuses on *Risk Management in the Pension Fund Industry*. In light of the projected growth of pension funds, this chapter argues for the need to establish better risk management practices and more stable funding strategies. The need to develop long-term fixed-income and index-linked instruments to facilitate pension funds to implement better asset-liability management was stressed. In many countries, reductions in state pensions and movements from defined benefit to defined contribution or hybrid pension plans by employers are increasingly transferring risks to the household sector. This raises the question of how well equipped households are to bear such risks. This issue will be discussed in the Spring 2005 GFSR.

The *Nordic-Baltic chair* welcomed the analysis of a number of topical financial stability issues, including on the pension sector, and generally shared the analysis and recommendations. This includes the positive view on global financial stability issues and the overall assessment that financial institutions have strengthened their balance sheets to a point where they could absorb considerable shocks. The *Nordic-Baltic chair* endorsed the policy conclusion that the current benign conditions should be used by all countries to address remaining vulnerabilities in the financial system. The importance of timely macroeconomic and structural policy measures was underlined to help address global imbalances. Also emphasized was the need for emerging markets to continue addressing the underlying structural vulnerabilities through efforts to improve their debt structure, enhancing the macroeconomic stability and accelerating growth-enhancing structural reforms.

II. SELECTED COUNTRY MATTERS

Table:

The Largest Borrowers under the General Resources Account,
Credit Outstanding (July 31, 2004)

	Billions of SDRs	In percent of quota	Share of total GRA credit, percent
Brazil	17.2	567	29.0
Turkey	14.8	1538	24.7
Argentina	10.0	471	16.7
Indonesia	6.6	317	11.0
Russia	2.6	44	4.3
Uruguay	1.6	531	2.7
Sub-total	*52.8*		*88.4*
Other GRA credit	6.5		11.6
Total GRA account	*59.3*		*100*

Argentina

A three-year *Stand-By Arrangement* for Argentina was approved on September 20, 2003, giving the country access to SDR 8.98 billion or USD 12.55 billion. The *Nordic-Baltic chair*, together with three other chairs, abstained from the Executive Board's decision. In the view of the *Nordic-Baltic chair* the program did not deal in a satisfactory manner with the serious economic and political difficulties facing the country. It was therefore not in the best interest of Argentina, the region and the Fund. The *Nordic-Baltic chair*, together with several other chairs, also abstained on the decision to complete the first review of the program in January 2004. The *Nordic-Baltic chair* could, however, go along with the completion of the second review in April, given the fact that there was progress in some areas where the *Nordic-Baltic chair* had expressed concerns.

The third review of the program has yet to be completed. Argentina still has to come to a comprehensive conclusion with respect to restructuring its sovereign debt. While recent macroeconomic developments in Argentina generally have been favorable, there is concern about insufficient policy progress under the program, including insufficient structural reforms. Moreover, Argentina has yet to define a medium-term primary-surplus fiscal policy path reflecting the macroeconomic outlook and Argentina's future obligations to the Fund, as well as the outcome of the debt restructuring. Together with a supportive medium-term fiscal framework, a comprehensive and sustainable agreement with Argentina's private creditors will be an essential building block going forward in normalizing Argentina's economy and standing in the financial markets, with a view to attracting the new investments necessary for sustaining growth and poverty reduction.

Program discussions between the Fund and the authorities will be resumed once the outcome of the debt restructuring and work on the structural fiscal issues has been assessed. The *Nordic-Baltic chair* has emphasized that future support would be conditional upon observance of the established performance criteria as well as further progress in the key areas.

The Fund's Role in Argentina (IEO)

The long-awaited report on the Fund's role in Argentina by the Fund's Independent Evaluation Office (IEO) was discussed in July. The report supplemented the Fund staff's own analysis of the Argentine crisis from November 2003, *Lessons from the Crisis in Argentina*. The IEO report stated that the severity of the crisis resulted from the failure of Argentine policymakers to take necessary corrective measures early enough. Fund surveillance failed to highlight the growing vulnerabilities in the authorities' choice of policies and the Fund erred by supporting inadequate policies for too long. Despite concerns about exchange rate and debt sustainability, the Fund supported Argentina's efforts to preserve the exchange rate regime, recognizing the large costs of exit. This support was justifiable up to January 2001 because large financial support, combined with strong policy corrections, had some chance of success. In retrospect, the resources used in an attempt to preserve the peg could have been better used to mitigate some of the inevitable costs of exit from the peg according to the report. Moreover, the Fund did not use the available tools effectively. Conditionality was weak, and Argentina's failure to comply with it was repeatedly accommodated.

Compared to the 2003 Fund staff report, the IEO report focused more on the recommendations pertaining to Fund governance and the role of the Executive Board, rather than on the economic factors behind the crisis. The report made a number of recommendations in the areas of crisis management, surveillance, program relationship and the decision-making process in the Fund. The need for the Fund to have a contingency strategy from the outset of a crisis was stressed. Where the sustainability of debt or exchange rate is in question, the Fund should indicate its support conditional upon a meaningful shift in the country's policy. Moreover, the IEO found it important for the Fund to refrain from entering or maintaining a program relationship with a member country when there is no immediate balance of payments need. Finally, the report made a number of suggestions for strengthening the role of the Executive Board.

In the Board discussion, Directors broadly agreed with the thrust of the lessons and recommendations of the report, but found that applicability to other crisis situations might be limited due to the uniqueness of the Argentine case. Directors did not agree on the implication in the IEO report that the Fund should not enter into a program relationship with a member country when there is no immediate balance of payments need. In this respect, they underlined the value of precautionary arrangements (programs in which the authorities *ex ante* have indicated their intention not to draw on the available resources) as an important crisis prevention tool.

The *Nordic-Baltic chair* stated that a clear lesson from the collapse of the Convertibility Plan was that no exchange rate regime in the long run can protect a country from suffering the consequences of an unsustainable fiscal policy. The durability of an exchange rate regime depends on supportive fiscal and structural policies and sound institutions. Thus, overall consistency of policies is more important than the choice of regime itself.

The *Nordic-Baltic chair* also agreed with the conclusion of the report that the Board was not always provided with all the elements required for well-informed decisions, and that important decisions in this area were being made by major shareholders outside the Executive Board. The *Nordic-Baltic chair* strongly supported the basic principle underlying the IEO recommendations, namely that the Fund's policy decisions should be taken by the Executive Board in Board meetings. Information should also be provided to the whole Board and not to a select group of countries, i.e. the major shareholders. Finally the *Nordic-Baltic chair* underlined the necessity for the Fund to be able to say "no" earlier when policies are inconsistent and be prepared not to support a strongly owned program if it is judged inadequate in generating a desired outcome.

Brazil

The seventh review under the *Stand-By Arrangement* from December 2003 was completed in June and the eight review was completed in September. The Brazilian authorities are treating the arrangement as precautionary as a part of a strategy to exit from Fund financial support. Brazil's performance under the program has continued to be encouraging. Economic growth in 2004 is projected to be over 4 percent after weak performance in 2003 and 2002. The primary surplus (fiscal surplus excluding interest payments) was 4.5 percent of GDP in 2003 and a primary balance of over 4 percent is projected for 2004. The authorities have confirmed that they will maintain a primary surplus of 4.25 percent of GDP through 2007 which implies significantly improved debt dynamics. The current account remains strong due to buoyant export growth in terms of both volume and prices. However, inflation and inflation expectations have increased. Despite progress in many areas, Brazil remains vulnerable to deterioration in market sentiment and the debt burden is heavy. Growth over the medium term will depend significantly on the authorities' ability to extend and deepen the structural reform agenda such as tax reforms, pension reforms and labor market reforms.

The *Nordic-Baltic chair* supported the completion of both reviews. The *Nordic-Baltic chair* noted, *inter alia,* that Brazil continues on the road of economic progress and commended that performance under the precautionary SBA has been impressive. The *Nordic-Baltic chair* emphasized that durable exit requires sustained macroeconomic prudence and further in-roads to address remaining long-standing structural impediments and found the broad-based and seemingly growing political support to the program to be encouraging.

Turkey

In July 2004, the Executive Board approved the eight review under the *Stand-By Arrangement* from February 2002 and concluded the 2004 *Article IV* consultation with Turkey. Economic performance has continued to be impressive with rapid economic growth and lowered inflation. Fiscal discipline and prudent monetary policies have contributed to these achievements. However, the size and composition of the public debt still makes Turkey vulnerable. In the medium-term, continued fiscal consolidation will be essential. In the Board discussion Directors, including the *Nordic-Baltic chair,* noted that continued high primary surpluses in a predictable medium-term framework would be helpful. It will also be critical for Turkey to continue with the implementation of the structural reform agenda, including reform of tax administration and the social security system, and to advance privatization, financial sector reform and labor market reforms. The immediate challenge is to avoid widening of the current account deficit. Strict fiscal discipline and saving budget over-performance will be needed. In August 2004, the Turkish authorities informed the Fund that they have decided to request a successor to the current Fund arrangement, which expires in early February 2005. Once information on the authorities' policies has been provided to the Fund, the request will be considered under the applicable procedures.

Iraq

Discussions with Iraqi officials as well as the provision of technical assistance have continued. Due to the security situation the contacts have mainly taken place outside the country. The interim government that took office in June has been recognized by the international community, a precondition for any financial support from the Fund. Iraq cleared its overdue financial obligations to the Fund and consented to a quota increase from SDR 504 million to SDR 1,188 million in September 2004. On September 29, the Executive Board approved Iraq's request for Emergency Post-Conflict Assistance in an amount of USD 436 million, or 25 percent of quota, as a sign of support for Iraq's economic reconstruction efforts through 2005 and to help catalyze additional international support, including debt relief.

Article IV Consultations with Nordic-Baltic Countries, May-September 2004

Denmark. The 2004 *Article IV* consultation with Denmark was completed on August 2. Executive Directors commended the Danish authorities for their record of sustained structural reform and strong fiscal policy. Directors also agreed that Denmark's fixed exchange rate has served the country well. Several Directors underscored that the Danish experience offers useful lessons for other countries and shows that it is possible to combine a strong welfare state with high employment and growth.

While acknowledging that Denmark has made progress in preparing for the medium-term challenges of population aging, Directors encouraged further efforts at containing public expenditure and increasing employment toward this goal. Directors generally agreed that Denmark's recent fiscal stimulus package was well designed to provide support for the upturn, without undermining medium-term fiscal objectives, while also addressing some longer term structural issues. They cautioned, however, that further fiscal stimulus should be kept as an exceptional response, to avoid jeopardizing the credibility of the medium-term targets. While acknowledging the helpful role of the tax freeze and the legally binding rules on counties to comply with budget targets, Directors considered that further action to control public consumption growth may be required.

Directors commended the strong performance of the Danish labor market. To alleviate labor supply constraints and lower the structural unemployment rate further, they encouraged the authorities to prepare additional reforms, in particular to reduce incentives for early retirement. Directors welcomed the recent reduction in labor income tax rates and they encouraged the authorities to consider further changes in tax and labor compensation structures that would increase incentives to work. The importance of greater wage dispersion and better integration of immigrant labor was also highlighted in this context. The next *Article IV* consultation with Denmark is expected in 2006.

Latvia. The 2004 *Article IV* consultation was completed on August 2. Directors commended the authorities for the favorable macroeconomic performance and sound policies. However, they pointed to the potential risks of overheating stemming from the rapid growth of credit and private consumption. Nearly all chairs pointed to the crucial role of a sound fiscal policy in managing domestic demand. They stressed the need to increase flexibility of fiscal policy over the course of the business cycle and advised the authorities to use the opportunity of strong growth for a tighter fiscal policy stance.

Latvia's strategy for re-pegging the currency to the euro and entering the ERM2 at the beginning of 2005 was seen as appropriate. It was pointed out that the authorities' desire to opt for a narrow band necessitates a further strengthening of budgetary and labor market policies to create more room to absorb shocks. The issue of the large share of non-resident deposits has traditionally been taken up in staff's reports and during Board discussions on Latvia. At the Board discussion, Directors pointed to the potential vulnerability of these deposits.

Sweden. The 2004 *Article IV* consultation with Sweden was completed on August 4. The Swedish authorities shared many of the conclusions and views expressed in the report. However, on some important fiscal and structural policies, the views of the Swedish authorities differed from those expressed in the staff report. For example, they did not share staff's view on the need to trim down the welfare state in order to lower taxes.

In the Board discussion, Executive Directors praised Sweden's strong economic performance in recent years, grounded in well-designed fiscal and monetary policy frameworks, and strong productivity gains that have succeeded in making the downturn in 2002-03 more moderate than the average in the European Union. Directors noted that such strong performance had been, thus far, consistent with the generous welfare state. They saw a need, however, to revitalize the agenda of structural reform in order to address the challenges of demographic transition and global economic integration.

Directors noted that Sweden's fiscal framework has a good track record and its fiscal position remains favorable in a comparative EU context. Nevertheless, noting that efforts to attain the fiscal surplus target have slackened in the recent past, Directors emphasized that safeguarding the target is central to maintain confidence in Sweden's medium-term fiscal framework. Most Directors encouraged the authorities to consider a more ambitious fiscal adjustment in 2005-06 to demonstrate their continued commitment to the surplus target.

III. Policy Issues and the Role of the Fund

Biennial Review of Surveillance

Every second year the Fund makes a comprehensive assessment of one of its core activities – surveillance. This year the focus was on quality and content of surveillance, as well as the policy dialogue and communication and signaling of surveillance. Regarding the focus, quality and content, a number of different areas were examined more closely, some of which are outside the institution's traditional areas of expertise: global and regional spillovers, exchange rate analysis, financial sector analysis, vulnerability assessments, growth in low-income countries, institutions and investment climate, social issues and governance. There were a number of proposals from staff to enhance the policy dialogue, including through policy statements by member countries, i.e. a statement prepared by the member country and provided to staff ahead of *Article IV* missions.

In the discussion, Directors underscored that well-focused surveillance exercises and high-quality analyses remain essential for effective surveillance. They reaffirmed the conclusions of the 2002 review of surveillance, which addressed how, under the expanded reach of surveillance, individual *Article IV* consultations must be kept focused on key issues. This is to be done by ensuring that coverage is adapted to country-specific circumstances, and that the selection of topics is based on macroeconomic relevance. Specifically, the matters at the apex of the Fund's hierarchy of concerns are external sustainability, vulnerability to balance of payments or currency crises, sustainable growth and the policies to achieve it, and, for systemically important countries, conditions and policies affecting the global or regional economic outlook.

Directors stressed that Fund surveillance is an ideal vehicle to analyze global and regional spillovers. They saw substantial room to improve treatment of these issues through greater integration of bilateral, regional and multilateral surveillance. Directors observed that clear and candid treatment of exchange rate issues remains a challenge. While recognizing the sensitivity of these questions, they stressed that a thorough discussion of exchange rate issues remains critical for surveillance. Directors welcomed recent improvements in the coverage of financial sector issues, but noted that this is not yet on a par with the coverage of other main areas.

Directors discussed how best Fund surveillance can respond to requests from some members for policy monitoring at high frequency and for delivery of a signal on the strength of a member's economic policies. They recognized the difficulties in designing appropriate signaling mechanisms. They mentioned different instruments and modalities, including low-access precautionary arrangements and low access PRGFs, and various forms of Fund and staff monitoring. Directors also considered whether, in a surveillance context, presentation by a member of its own quantitative economic framework, possibly complemented by a detailed policy agenda, might facilitate assessment by the Fund of the member's policies.

The *Nordic-Baltic chair* welcomed the recent improvements made in the coverage of Fund surveillance, especially in terms of increased transparency. The *Nordic-Baltic chair* found it important that surveillance focused more on potentially vulnerable countries, systemically important countries, and regional and multilateral issues. Countries with sound fundamentals could be considered to move to a 24 months surveillance cycle to save resources. The *Nordic-Baltic chair* observed that the total costs of the proposals from staff were large and saw little scope for implementing the recommendations fully without devoting additional resources to surveillance. Strengthening surveillance could be achieved through more strategic management of resources, better prioritization, and additional contributions from functional departments to *Article IV* consultations. The *Nordic-Baltic chair*, together with many other chairs, called for further consideration of resource savings and offsets, such as greater selectivity in the coverage of individual surveillance exercises, as well as adopting the longer consultation cycles on a selected basis. The *Nordic-Baltic chair* also suggested moving the surveillance review itself from a two-year cycle to a three-year cycle.

Crisis Prevention and Precautionary Arrangements

In September there was a discussion in the Board on *Crisis Prevention and Precautionary Arrangements – Status Report*. In the report staff concluded that it is unlikely that differences in views in the Board could be bridged with a detailed policy proposal at this stage. The main disagreement, which was reflected in the Board discussion, is whether a possible new policy on exceptional access under *Precautionary Arrangements* (PAs) would significantly strengthen the Fund's crisis prevention toolkit. Several Directors were of the view that existing Fund policies were adequate for, *inter alia,* the following reasons: 1) the quality of a country's own economic policies is the most important factor in reducing vulnerability, 2) Fund membership itself provides insurance, 3) regular PAs can support strong policies, 4) innovations to Fund surveillance are bearing fruit.

The opposite view is that the expiration of the *Contingent Credit Lines* facility left a gap in the Fund's toolkit for crisis prevention that could partly be filled by a new policy on exceptional access under PAs. This policy would: provide increased assurances of the availability of Fund resources, provide access more in line with potential need, reduce the probability of crisis, and provide enhanced initiatives to adopt strong policies. In the Board meeting it was agreed that staff would inform Directors on further work in this area in the context of the discussion on the Fund's *Work Program*.

The *Nordic-Baltic chair* welcomed staff's approach and continued to hold the view that existing Fund policies are adequate. The Exceptional Access framework should not be amended to accommodate PAs in exceptional access cases.

Progress with Crisis Resolution Initiatives

Crisis resolution issues have not been discussed in the Board apart from the discussion on the IEO's report on Argentina and the usual progress report issued for the IMFC meeting, which was discussed in September. The progress report noted that the issuance of international sovereign bonds, including *Collective Action Clauses* (CAC)[1] is becoming the standard practice in the New York market. Sovereign issues containing CACs have grown to represent more than 90 percent of total value of bonds issued since March 2004 and about 40 percent of the value of the outstanding stock of bonds from emerging markets as of end-July. So far there is no evidence of a premium associated with the use of CACs. Moreover, the progress report noted that discussions on a voluntary code of conduct for crisis resolution are continuing in fora outside the Fund. While welcoming these developments, the *Nordic-Baltic chair* has continuously asked for further progress in the Fund's crisis resolution framework.

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[1] In the event a country would need to restructure its sovereign debt, CACs can help making such a process more orderly.

The Fund should step up the work on an efficient framework for handling financial crisis that can ensure more predictability.

Policy Monitoring Arrangement

In September, the Board had an initial exchange of views on the possible design of a new signaling instrument: *Policy Monitoring Arrangement* (PMA) that should enable the Fund to convey assessment of the members' policies to the international financial community outside the context of a financial arrangement. At this stage, there is a variety of views on whether such a new mechanism might be useful. Further discussions on signaling issues are planned following consultations with potential users, donors and private market participants.

The *Nordic-Baltic chair* expressed major reservations towards a possible PMA as outlined. To create instruments for which one is not convinced of the need may entail credibility costs for the Fund. Any actual or perceived gap in the toolkit seems best filled by using more efficiently the untapped potential in existing instruments of surveillance and lending facilities. This includes low-access PRGFs and Precautionary Arrangements as well as enhanced transparency, which is an essential part of signaling. Rather than a piecemeal approach where new instruments are created to fill perceived gaps. The *Nordic-Baltic chair* stated that it welcomed a general review of the Fund's lending facilities.

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

The 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' *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 makes grants under the *Heavily Indebted Poor Countries* (HIPC) initiative. The *Nordic-Baltic Constituency* is supporting this work while underlining the importance of the Fund's involvement being focused on the institution's core areas of expertise *i.e.* macroeconomic policies and financial stability. During 2004, the *Nordic-Baltic Office* has paid special attention to developing countries where the members of the NBC have special engagement as major donors of aid. The NBO has encouraged staff of the embassies of our respective countries to provide first-hand information to enable as informed statements as possible. Low-income countries that have attained more focus include, *inter alia,* Tanzania, Mozambique, Uganda, Zambia, Malawi, Ghana, Nicaragua and Bolivia.

The Fund's Role in Low-Income Countries

The Fund's role in Low-Income Countries (LIC) was initiated as a special topic last year, and has been one of the key issues for recent IMFC meetings. The discussion covers four broad areas: the instruments the Fund should be equipped with in working with its low-income members, as well as the financing of these; issues related to debt sustainability; the collaboration between the Fund and the World Bank in these matters; and, finally, the design of programs for LICs. While discussions are ongoing with respect to the first three areas, the Board is expected to discuss PRGF program design issues after the 2004 Annual Meetings. Important follow-up discussion from the Spring Meetings includes that on donor coordination and signaling.

In a Board discussion in August, Directors welcomed the recently established *Committee on Low-Income Country Work*, chaired by the First Deputy Managing Director, which has the objective of ensuring policy coherence across the Fund on issues related to LICs. The Committee had prepared a mission statement on the role of the Fund in LICs for the Board meeting, which covered three complementary ways in which the Fund supports its low-income members: policy advice, capacity building, and financing, including debt relief. The proposed mission statement - consistent with basic principles agreed upon earlier - underlines that the Fund focuses its support to LICs on its core expertise; helping members to establish and maintain macroeconomic and financial stability, not least to create an environment conducive to growth and development. It also emphasizes that low-income members themselves must take the lead in putting in place the policies and institutions needed for their development.

Directors generally agreed that a clear and succinct statement formulating a framework for Fund engagement in LICs would usefully clarify the objectives and responsibilities, as well as guide the work of the Fund in these countries in line with its mandate. The *Nordic-Baltic chair* welcomed the mission statement and agreed with the thrust of it. At the same time, the *Nordic-Baltic chair* stressed that the Fund's work in this area is work in progress and that the mission statement would likely have to be revised further down the road as work progresses.

In September, there was a discussion on *Debt Sustainability in Low-Income Countries-Further Considerations on an Operational Framework and Policy Implications* following up on a discussion on debt sustainability from the spring. The paper contained joint proposals of Fund and Bank staff for an operational debt sustainability framework for LICs. The aim is to ensure that the large financing needs associated with the MDGs goals do not lead to unsustainable build-up of debt and debt relief under the HIPC Initiative will stay on a sustainable path. Further work will be undertaken on issues related to debt thresholds and the form and process of Fund/Bank debt sustainability assessments.

HIPC Sunset Clause, Progress Report and Topping-Up Issues

The Status of Implementation of the HIPC Initiative was discussed in September. Further progress has been achieved under the initiative. 27 countries have now reached their decision or completion points. Since September 2003, six countries (Guyana, Nicaragua, Niger, Ethiopia, Senegal and Ghana) reached their completion points, making the total number 14 (while 13 HIPCs are in the interim period, i.e. between the decision point and completion point).

For these 27 countries the HIPC Initiative has significantly reduced the overall debt stock.

Debt service ratios are now below the average for non-HIPC *Low Income Countries*. HIPC relief committed to these 27 countries (together with other debt relief initiatives) represents a two-thirds reduction of their overall debt stock. Debt service-to-exports ratios have also been reduced to an average of 10 percent, leaving room for increasing poverty-reducing expenditures in these countries. The cost of providing debt relief to 37 HIPCs is now estimated at USD 54.5 billion (in 2003 net present value terms). More than twenty non-Paris Club official bilateral creditors and most commercial creditors have still not indicated their intention to participate in the initiative. Updated debt sustainability analyses for post-completion point HIPCs indicate that sound economic policies and close monitoring are needed to prevent the re-emergence of unsustainable debt.

A main issue in the September-discussion was to decide whether the sunset clause should be extended. Directors agreed to extend the sunset clause by a further two years to end-2006. While many Directors supported extending the HIPC Initiative without modification, the majority favored limiting eligibility to a set of countries by using income and indebtedness criteria based on end-2004 data. Extending the sunset clause provides the countries that have not started establishing a track record an additional window of opportunity to press ahead with reform efforts in order to be able to benefit from debt relief under the Initiative.

The *Nordic-Baltic chair* welcomed the progress made under the Initiative and supported the extension by two years without any modifications as proposed by staff (except Finland that supported limiting eligibility). The *Nordic-Baltic chair* also urged broader creditor participation in the HIPC initiative.

The Fund's Experience with PRSPs and PRGF (IEO)

In July, the Independent Evaluation Office published a report on the experiences of the Fund's work related to *Poverty Reduction Strategies.* This includes the *Poverty Reduction Strategy Papers* and the *Poverty Reduction Growth Facility* (PRGF). The PRS approach was introduced in 1999 to make aid more effective in reducing poverty and underpin the HIPC initiative. The main principles underlying the PRS approach are country ownership, focus on results, and country led partnerships. The report mainly focused on several intermediate objectives and results: the quality of the broader-based policy formulation process, the nature of the evolved strategy and policy framework, the interaction between this framework and PRGF as well as the effectiveness of the Fund's role in the process.

The main findings of the IEO were that the PRS approach had the potential to encourage the development of a country-owned and credible long-term strategy for growth and poverty reduction and coordinate donor efforts. However, achievements fell short of potential. The IEO put forward six recommendations that aimed at improving the PRSP and PRGF approach:

1. Introduce greater flexibility in the implementation of the PRS approach to better fit the needs of countries at different stages of the process and with different capacities and political and administrative systems.

2. Shift the emphasis of the initiative from the production of documents to the development of sound domestic policy formulation and implementation processes.

3. Clarify the purpose of the *Joint Staff Assessment* (with the World Bank) and redefine the vehicle accordingly.

4. Clarify what the PRS approach implies for the Fund's own operations and strengthen the implementation of the agreed role.

5. Strengthen the prioritization and accountability on what the Fund is supposed to deliver within the broader partnership framework, built around the priorities emerging from the PRS process, and ensure resources match commitments.

6. The Fund should encourage a strengthening of the framework for establishing the external resources envelope as part of the PRS approach.

Directors and staff generally accepted the IEO's recommendations as being constructive for the future work of the Fund in LICs. Somewhat divergent views occurred on the involvement of the Fund in the public debate. Several Directors wanted the Fund only to provide information as requested, but not to try to directly influence the political decision-making process.

The *Nordic-Baltic chair* expressed support for the objectives underlying the IEO's recommendations, especially the need for a more flexible approach to prepare the ground for increased country ownership and allow for PRS processes customized to individual countries. The Fund's participation in the PRSP process should be set within a realistic resource constraint and focused on its area of expertise, particularly on macroeconomic options and options for macro relevant structural reforms.

Poverty Reduction Strategy Papers - Progress Report

A report on *Poverty Reduction Strategy Papers - Progress in Implementation* was discussed in the Board in September. The report showed where improvements have been made in *Poverty Reduction Strategies* (PRSs) and listed some remaining challenges. Since the introduction of the approach four years ago, the number of countries implementing PRSs has increased to 42. The report finds that poverty analysis, recognition of the strategic importance of growth and macroeconomic stability and sectoral coverage are areas where good progress has been made. However, less has been achieved in analyzing sources of growth and linking macroeconomic frameworks and financing requirements to medium-term goals. These are critical issues as a sustainable economic growth is the best remedy in the fight against widespread poverty in the developing countries. Several papers are planned in the coming months to deal with various issues related to PRS, including growth and distributional issues.

Directors noted the progress made in PRS, and there was a general acceptance of the *Poverty Reduction Strategy Paper* as the operational framework for progress toward the Millennium

Development Goals. Directors underlined the need to strengthen country ownership and the importance of linking PRS with the budget and increase the use of *Poverty and Social Impact Analysis*. The Technical Assistance of the Fund has a role to play in capacity building to facilitate more participation of stakeholders and the civil society in the PRS process. Directors stressed that the Fund's involvement in the PRS process should be limited to its main areas of competence and the Fund should not have a leading role in donor coordination. However, several Directors wanted staff in future reports to clarify better the potential role of the Fund in donor coordination. Directors supported staff's recommendation for changes in the *Joint Staff Assessment* and *Annual Progress* reports.

The *Nordic-Baltic chair* stressed, *inter alia,* that the MDGs should be the backbone of PRSPs. It was important to align the process with a country-specific decision-making process and medium-term expenditure framework. Moreover, the involvement in the PRS process should be extended to the local and regional level. The Fund's lending activities should continue to be based on PRSPs.

Aid Effectiveness and Financing Modalities

A joint Fund-Bank paper on *Aid Effectiveness and Financing Modalities* was discussed in September. This paper was requested by the Development Committee and the IMFC in the Spring Meetings 2004 to deliver a comprehensive review of aid effectiveness, absorptive capacity, and merits of various options to mobilize the financial resources to make progress towards the *Millennium Development Goals*. The paper makes the case for greater aid effectiveness and urgent scaling up of official development assistance to reach the MDGs. Two proposals on new financial modalities for additional aid are discussed in the paper: the International Financial Facility, which is a mechanism based on bond issuance that would enable the frontloading of aid, and global tax and voluntary giving mechanisms. Most chairs, including the *Nordic-Baltic chair*, were of the view that more official development assistance is the best approach, and stressed that donor countries need to move more forcefully toward meeting the UN target of devoting 0.7 percent of *Gross National Income* to aid. Director's views varied widely, however, on the alternative financial tools for additional aid. Most Directors, including the *Nordic-Baltic chair*, were supportive of the Fund to look into new financial modalities. Also, the *Nordic-Baltic chair* with several other Directors, stressed that the Fund should not go beyond its mandate in advancing the study on these new financial tools.

V. THE FUND'S ORGANIZATION AND FINANCES

Voice and Representation at the International Monetary Fund

At the Spring Meetings, the IMFC called for continued efforts to enhance the capacity of developing countries to participate more effectively in the Fund's decision-making, and called for the Board to continue working on quotas, voice and representation. The Board last discussed quota-related issues in July 2003, and received recently updated illustrative quota calculations. There is a broad consensus that changes in the area of voice and representation are best addressed within a broad "package solution" as part of a general quota increase.

The *Nordic-Baltic Constituency* supports enhancing the voice and participation of developing countries in the decision-making bodies of the Bank and the Fund. Important progress has been made on practical reforms, such as improvement of the capacity of the developing countries' constituency offices at the Fund and the Bank. The NBC supports increasing basic votes and enhancing capacity building. However, the NBC continues to uphold the basic principle that the major part of a member country's voting power shall be determined by the size of its quota. A general increase in quotas is needed to get any redistribution but, with the comfortable and improving liquidity situation of the Fund, this is not likely to materialize in the near term.

Audit of the Financial Statements of the Fund

In June, the *External Audit Committee* (EAC) presented its annual report for FY 2004 to the Executive Board. The report addresses the financial year which ended April 30, 2004 and states, *inter alia*, that "PricewaterhouseCoopers conducted the audit of the financial statements of the Fund, the related administered accounts, and the retirement and benefit plans of the Fund, in accordance with International Standards on Auditing. Unqualified audit opinions were issued on all the financial statements, which were prepared in accordance with International Financial Reporting Standards". The EAC also brought to the attention of the Directors three issues for further consideration by the Board:

1. The Fund should continue to devote resources with the proper expertise to assess in advance the applicability and impact of the new and amended financial accounting standards to the Fund.

2. The Fund should consider enterprise-wide self-assessment of risk identification and risk management.

3. The Fund should continue to review the external audit arrangements.

In July, 2004, two meetings of the *Audit Selection Committee* took place to discuss the selection of a firm to replace the external audit of the Fund. The Fund's five-year contract with *PriceWaterhouseCoopers* expires on October 31, 2004. Mr. Pentti Hakkarainen, member of the Board of Governors of the Central Bank of Finland, is a member of the EAC.

The Fund's Budget

The Fund's fiscal year runs from May 1 through April 30. On April 28, 2004, the Executive Board approved the Fund's administrative and capital budgets for FY 2005 in the total amount of USD 905.1 million and USD 31.8 million, respectively. A ceiling of 2,802 full-time staff positions was also approved. Staff benefits and allowances are expected to increase by 3.1 percent as compared to the FY 2004 budget, while the provision for all non-personnel expenditures in FY 2005 will fall slightly in nominal terms

The Fund has stepped up the reforms of its internal budgetary procedures since 2003, including the improved assessment of the resource content of the Fund's main outputs and the introduction of a three-year rolling capital budget. During the FY 2004, further important progress was achieved in the budget reform. First, a new time reporting system will be implemented to make the reporting on the use of staff's resources among the Fund's outputs more efficient and user friendly. Second, a cost allocation system is being developed along with the *Time Reporting System* to allocate staff and non-staff costs to outputs. Third, an internal task force on performance indicators recommended the Fund to develop a system of performance indicators. In approving the FY 2005 administrative and capital budgets, Executive Directors welcomed the further steps taken in implementing the ambitious budget reform agenda. However, several Executive Directors, including the *Nordic-Baltic chair,* stressed the desirability of adopting a more strategic and medium-term view of the budget process.

The *Nordic-Baltic chair* has supported this ongoing reform agenda to increase the transparency and accountability of the Fund's own operations. The *Nordic-Baltic chair* considers the implementation of a binding medium-term budgetary framework in the Fund as a key goal of the ongoing budget reform. In particular, the top-down budget constraint and departmental business plans are to be reconciled in one medium-term system. Within the context of the ongoing budget reform, the *Nordic-Baltic chair* also supported a comprehensive assessment of the Fund's compensation and benefits system, and further integration of the review on staff compensation and the discussion on the administrative budget of the Fund.

In the broader context, the *Nordic-Baltic chair* emphasized that the discussions on the budget and the Fund's work program and priorities should be clearly interlinked. At the same time, the Fund should increase the ability to shift its resources between departments and outputs, if needed. The *Nordic-Baltic chair* is also of the view that the relatively simple and broad-based system of performance indicators is a useful tool for the budget formulation.