

November 2007

The Nordic-Baltic Office
International Monetary Fund

Report 2007/2

Recent Policy Developments in the
International Monetary Fund



CONTENTS

I. Introduction	2
II. Selection of a New Managing Director and IMFC Chairman	3
A. Selection of a New Managing Director.....	3
B. New Chairman of the IMFC.....	3
III. Quotas and Voice in the Fund.....	3
IV. Surveillance	5
A. 2007 Decision on Bilateral Surveillance over Member Policies	5
B. Multilateral Consultations.....	6
C. Setting out Surveillance Priorities.....	7
D. The Nordic-Baltic Financial Integration Report	7
V. A new Liquidity instrument	8
VI. The Fund's Role in Low-Income Countries	9
A. The Fund's Role in Poverty Reduction and Collaboration with Donors	9
B. Implementing HIPC and MDRI.....	9
C. Aid for Trade.....	10
D. Liberia	10
E. Scaling up Aid	11
F. Implementation Plan for the IMF and Aid to Sub-Saharan Africa.....	11
VII. The Fund's Financial Situation	12
A. The Budget and the Medium-Term Financial Situation	12
B. Developing a New Income Model	13
VIII. Staff of the Nordic-Baltic IMF office	14

I. INTRODUCTION

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

The report covers the principal topics on the Fund's agenda since the spring meeting of the International Monetary and Financial Committee (IMFC) in April 2007 and up to the Annual Meetings held in October 2007 in Washington DC. The report concentrates on the main *policy* issues, with references to the positions taken by the Nordic-Baltic chairs. Concerning the results of the Fund's economic surveillance, including for countries in the Nordic-Baltic Constituency, the reader is referred either to the Fund's general website (www.imf.org) or the websites of each of our countries' authorities where staff reports, press information notices etc. are published.

Implementation of the Fund's Medium-Term Strategy (MTS) has remained the central element on the Fund's policy agenda. The outline of the Medium-Term Strategy was first presented to and endorsed by the IMFC at the Annual Meetings in September 2005. During the last half year, work has concentrated on the issues of quotas and voice, surveillance policies, Fund finances, Fund engagement in low-income countries (LICs) and a new liquidity instrument for market access countries.

Following the resignation of Mr. Rodrigo de Rato, the Managing Director of the Fund, and Mr. Gordon Brown, Chairman of the IMFC, the Executive Board selected Mr. Dominique Strauss-Kahn as Managing Director effective as of November 1, 2007 and the IMFC chose Mr. Tommaso Padoa-Schioppa as the new IMFC Chairman.

II. SELECTION OF A NEW MANAGING DIRECTOR AND IMFC CHAIRMAN

Since the Spring Meetings, the Managing Director of the Fund and the IMFC Chairman have resigned and successors have been appointed. The Managing Director is formally selected by the Executive Board, whereas the 24 ministers and governors of the IMFC choose their own chairman.

A. Selection of a New Managing Director

In June the Managing Director, Mr. Rodrigo de Rato, announced that he would leave the Fund after the Annual Meetings. The Executive Board initiated the process of selecting a new Managing Director by establishing a candidate profile and selection procedure in July. The nomination period for candidates ended on August 31, with two candidates nominated: Mr. Dominique Strauss-Kahn and Mr. Josef Tošovský. After interviewing the candidates, the Executive Board unanimously selected Mr. Strauss-Kahn as the Managing Director to succeed Mr. de Rato.

At the IMFC meeting in October, the Nordic-Baltic chair welcomed the selection of Mr. Strauss-Kahn, and stated that a fully open and transparent selection process for the heads of all International Financial Institutions was vital for the legitimacy of these institutions.

B. New Chairman of the IMFC

In July, Mr. Gordon Brown tendered his resignation as the Chairman of the International Monetary and Financial Committee (IMFC), upon taking up his new responsibilities as Prime Minister of the UK. The following selection process resulted in the IMFC choosing the Minister of Economy and Finance of Italy, Mr. Tommaso Padoa-Schioppa, to succeed Mr. Brown. For the first time, the IMFC-chairmanship was given for a term of up to three years.

III. QUOTAS AND VOICE IN THE FUND

As part of the Fund's Medium-Term Strategy (MTS), the Fund is engaged in a reform of its system of quotas and voice, with the ultimate aim of enhancing the credibility and legitimacy of its governance system.

This process was given impetus at the Annual Meetings in Singapore last year, when the Board of Governors approved a resolution, stating as the dual aims of the reform to realign members' quota shares with their weight and role in the global economy and to enhance the participation of low-income countries. The reform is to be completed no later than by the Annual Meetings 2008.

Over the last half year, the Executive Board has had formal discussions on the quota system, including on a new quota formula, but also on other elements of the reform package. As requested in the Singapore resolution, the Executive Board submitted a progress report to the 2007 Annual Meetings of the Board of Governors in October.

There is now broad agreement that an outcome of the reform should be a further increase in the voting share of emerging market and developing countries as a group. Discussions continue on the appropriate size of this shift and on the ways to achieve it.

Voting shares in the Fund are largely determined by members' quota shares, and hence most of the recent discussions have focused on changes in the Fund's quota system. The Singapore resolution calls for quota shares to be guided by a simple and transparent quota formula, which would capture the members' relative positions in the world economy.

On this account, the Executive Board reported that there is now agreement that GDP should be the most important variable in the new formula, and that GDP measured at purchasing power parities (PPP) should play a role in the quota system. It is also agreed that external openness, variability of trade and capital flows, and foreign exchange reserves should be the remaining three variables in the formula, although further discussions are needed on the weights assigned to them. Finally, it reported about substantial support for the inclusion of a non-linear compression factor in the formula, as a way to curtail the influence of the economic size in the quota formula.

The Executive Board also reported on progress in other areas of strengthening voice and participation. Discussions on increasing basic votes, the second component of Fund voting shares, have continued, and the legal framework for amending the Articles of Agreement accordingly was agreed upon in principle. There is a commitment to at least a doubling of basic votes, with increasing calls for going beyond that. In May, the Executive Board approved an increase in the staffing of the Executive Directors' offices of the largest constituencies, the two African constituencies. Moreover, the Board has started discussions on possibly allowing these Directors to appoint more than one Alternate Executive Director (AED).

In the IMFC meeting in October, ministers and governors welcomed the report of the Executive Board and reached agreement on some important further elements of the quota system. Besides confirming that GDP measured at PPP should play a role, the IMFC agreed that compression factor should be included in the quota system and that the total quota increase should be of the order of ten percent.

The Nordic-Baltic chair has from the beginning been supportive of the quota reform process. Throughout the discussions, our chair has emphasized the need to reach a quota and voice reform that supports the legitimacy of the Fund and its willingness to compromise from its own part. Moreover, the Nordic-Baltic chair has emphasized the importance of achieving an outcome that improves the voice and representation of dynamic economies and LICs. Given that, our chair strongly supports a tripling of basic votes and introducing a mechanism to safeguard the share of basic votes in total voting power. In addition, we have supported increasing staffing and the appointment of a second AED in the two African constituencies. These are important elements in ensuring an adequate voice for LICs in the Fund.

The Nordic-Baltic chair has underscored the need for a simple, transparent and credible quota formula that can stand the test of time. Our chair has emphasized that GDP and external

openness should be the main variables in the formula, while a less prominent role should be assigned to the variability of trade and capital flows and to the size of foreign exchange reserves. However, the Nordic-Baltic chair recognized early that in order to ease convergence of views in the Executive Board, GDP converted at PPP will have to play a role in the reform package. As the originator of the idea, our chair has also strongly supported a non-linear compression factor in the formula, as a way to achieve a rules-based and predictable quota system that provides for a balanced and politically acceptable distribution of quotas.

IV. SURVEILLANCE

A refocus of the Fund's surveillance has been a central element of the MTS. The major milestone in this regard was the revision of the three-decade-old pillar of bilateral surveillance, the 1977 Decision on Surveillance Over Exchange Rate Policies, which was replaced by a modernized 2007 Surveillance Decision. The Board has also evaluated the experiences with the first multilateral consultations (completed in the spring 2007), to draw lessons for possible future rounds of multilateral consultations. Finally, following up on a request of the IMFC in the spring 2006, the Executive Board decided to set up a system of defining time-bound surveillance priorities to provide guidance for and improve the accountability of the Fund's surveillance.

A. 2007 Decision on Bilateral Surveillance over Member Policies

In June 2007, the Executive Board adopted a new [Decision on Bilateral Surveillance over Members' Policies](#). It marked the conclusion of a year-long review of the 1977 Decision on Surveillance over Exchange Rate Policies, with the 2007 Surveillance Decision repealing and replacing that Decision.

The adoption of the new Decision was deemed necessary in order to better align the surveillance practices of the Fund with the global financial system that has undergone substantial changes over the last thirty years. In particular, the reach of the 1977 Decision was seen limited by its focus primarily on exchange rate manipulation undertaken for balance-of-payment reasons. In today's world, the most prevalent exchange-rate-related disputes relate to exchange-rate policies that are rooted in domestic considerations, not directly aimed at affecting the balance of payments.

The new Decision was also viewed as an important tool to address a number of issues raised by the IEO report on the Evaluation of the IMF Exchange Rate Policy Advice 1999, discussed in the Executive Board in May 2007. The revision of the 1977 Surveillance Decision was seen necessary to make progress in areas where the IEO report saw significant room for improvement, such as enhancing the effectiveness of the Fund's exchange rate analysis and policy dialogue with member countries, as well as ensuring the evenhandedness of exchange rate surveillance.

The new Decision organizes the Fund's surveillance around the concept of external stability. To focus the Fund's surveillance, it introduces the "principle of proximity" to external stability: member's policies are subject to the Fund's surveillance only to the extent that they have an impact on external stability. Apart from exchange rate policies, monetary, fiscal, and

financial sector policies typically fall under the application of the new Surveillance Decision. Also structural policies, if they are critical at the macroeconomic level, can affect external stability and hence fall within the reach of the new Decision.

The Nordic-Baltic chair supported the adoption of the new decision and has considered it an important step in making the Fund's surveillance more effective and transparent. At the same time, our chair emphasized the fact that in order for the Fund's surveillance to be effective, it needs to be perceived as evenhanded and based on a shared understanding of members' obligations. Hence, throughout the process, our chair stressed the need for a broad consensus among the membership as a prerequisite for successful implementation of the new Decision. This prerequisite was largely met when the new Decision was adopted in June.

B. Multilateral Consultations

Following the conclusion of the first Multilateral Consultations (MC) on global imbalances in the spring 2007, the Executive Board reviewed the experiences and drew lessons for possible future rounds of MC.

The Executive Board recognized that, while the policy commitments made in the context of the first MC were important and helpful in resolving global imbalances while sustaining healthy global growth, imbalances remain high, and the possibility of a disorderly and potentially costly adjustment cannot be ruled out. Implementation of the participants' policy commitments will be crucial, and the Fund needs to monitor it in both its bilateral and multilateral surveillance.

The MC were seen as providing an appropriate forum to strengthen mutual understanding and to reaffirm support for the policy strategy. It was emphasized that the policy commitments made by each participant, while contributing to reducing global imbalances and thereby benefiting the global economy and the broad membership of the Fund, were also in each participant's individual interests – something that was considered crucial for ensuring effective implementation of the strategy at the level of individual participants.

The Nordic-Baltic chair welcomed the MC as a useful addition in the surveillance tool box and stressed the need to elaborate further on procedures. Our chair suggested that the Board should agree on and document the general "ground rules" to guide future rounds of the MC, recognizing that, depending on the topic, situations will differ and such rules would need to be interpreted flexibly. The Nordic-Baltic chair emphasized the need to bring an independent, comprehensive assessment of the policies to the Board, and for all participants of the MC to keep spillovers and common interests in the picture. While it is important, for political reasons, that MC participants see the outcome in their individual interests, to justify the MC as a separate policy tool, it must be able to cross the line from promoting individual interests to promoting the collective interest of the participants and the broad membership.

C. Setting out Surveillance Priorities

The IMFC Spring 2006 Communiqué foresaw “a new annual remit for both bilateral and multilateral surveillance through which the Managing Director, the Executive Board and the staff are accountable for the quality of surveillance”. Setting up the remit quickly became a central part of reshaping the overall surveillance framework.

After a year of discussion on the modalities and content of such a remit, the Executive Board reached an agreement in July 2007 to adopt, and periodically update, a Statement on Surveillance Priorities, as the remit was renamed. This Statement would be time-bound and “circumstance driven”; i.e. it would seek to identify those areas of the Fund’s surveillance or such economic phenomena which merit heightened attention for a period of roughly three years ahead. The surveillance priorities would cover both operational objectives (such as improving the Fund’s exchange rate analysis) and economic objectives (such as contributing to the reduction of current global imbalances).

Besides helping to improve the focus on topical issues, the Statement will also provide a tool for better accountability of the Fund’s surveillance, as called for by the IMFC. The first Statement of Surveillance Priorities will be adopted in 2008.

The Nordic-Baltic chair believes that the Statement of Surveillance Priorities may become a useful element in the Fund’s surveillance framework. A useful Statement of Priorities would bring together and synthesize the priorities identified in the Fund’s various work streams and products, such as the World Economic Outlook, Global Financial Stability Report and Triennial Surveillance Review, into a single compact Statement. To enhance the Statement’s effect as a tool for communication and focus, we have emphasized the need to keep the list of priorities short and to publish it visibly as a stand-alone document.

D. The Nordic-Baltic Financial Integration Report

In June, the Executive Board held a seminar on the report of the Nordic-Baltic Regional Financial Sector Project which was initiated in 2006¹. The staff report described the high level of cross-border integration as a defining feature of financial systems in the Nordic-Baltic region. The report examined the extent to which supervisory and crisis management arrangements were adopted to the increasing level of integration.

Although the financial sectors of the Nordic-Baltic countries have become less vulnerable to domestic shocks, the risks of financial contagion and a credit crunch, especially in the Baltic states, have increased. Cross-broader conglomerates, together with the blurring of the distinction between subsidiaries and branches, have increased the systemic importance of foreign financial institutions in domestic financial markets and a higher degree of interdependence, as well as exposure to a variety of financial risks. These conglomerates pose oversight and supervision challenges.

¹ [Financial Integration in the Nordic-Baltic Region, IMF Policy Seminar, June 5, 2007](#)

Supervision of cross-border financial activities in the region is anchored in the broader European framework, but the authorities in the region have gone beyond that framework by creating additional arrangements, in the form of memoranda of understanding (MoUs). The report finds that these arrangements work well, but acknowledge that they have not yet been tested under financial distress.

The report saw scope for further strengthening of supervisory arrangements, such as establishing more institution-specific MoUs and specific mechanisms for resolving disagreements or governing early supervisory intervention. Room for improvement was found particularly in the area of crisis management, where the report recommended specifying the general principles for burden sharing in the event of a crisis. As part of more rules-based burden sharing, the report also suggests further harmonization of deposit insurance schemes in the region.

The Nordic-Baltic chair welcomed the report as an important pilot study, opening the way for further work on regional financial integration. Our chair broadly agreed with the challenges identified and conclusions drawn in the report. The Nordic-Baltic chair found that the day-to-day work among the supervisory bodies is guided by practical considerations and in reality extends beyond what is covered in the MoUs. The present structures of cooperation work well in the present subsidiary-based structure, but things may get more difficult if branch structures spread – one obvious question being, who will pay for host country supervision. The Nordic-Baltic chair recognized the moral-hazard issues involved in pre-planning of bailouts, but saw that the general principles guiding the sharing of the fiscal cost, once a public intervention has occurred, could be discussed separately from the inherently more sensitive issue of the circumstances under which such intervention should take place.

V. A NEW LIQUIDITY INSTRUMENT

As a part of the MTS, discussions have continued on the possible establishment of a new liquidity instrument for emerging market countries with access to financial markets. The purpose of introducing a new instrument would be to reduce the likelihood of crises by making highly liquid resources available to potential users, in the case of rising market pressures, in exchange for commitment to strong policies.

Progress has been made in the Executive Board discussions on many features of such a facility, but agreement has been held back by differences of views over key design features and concerns about the potential demand for the facility. In its October 2007 meeting, the IMFC recognized the progress made and concerns remaining, and called on the Executive Board to continue its work on these outstanding issues.

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

VI. THE FUND'S ROLE IN LOW-INCOME COUNTRIES

A. The Fund's Role in Poverty Reduction and Collaboration with Donors

The MTS foresees re-focusing the Fund's work in LICs on macroeconomically critical and financial sector issues, while enhancing collaboration with the World Bank and other institutions. In October, the Executive Board considered a series of recommendations for making operational these aspects of the MTS, and defining more precisely the Fund's role in the Poverty Reduction Strategy (PRS) and donor collaboration processes. The discussion also included a joint management action plan to enhance Fund and World Bank collaboration, following up on the Malan report on Bank Fund collaboration from February.

The Executive Board agreed that the primary focus of the Fund's work in LICs in the context of the PRS process should be to provide policy advice and technical support on the design of appropriate macroeconomic frameworks and on macroeconomically critical structural reforms. The Board also stressed that Fund staff have an important role in helping the authorities to manage the macroeconomic impact of aid inflows and to avoid a re-accumulation of unsustainable debt. It underscored the importance of effective collaboration with the World Bank and other development partners, based on clearly defined lead roles and responsibilities in supporting countries' development efforts.

The Nordic-Baltic chair reiterated that the Fund's work within the PRS approach should be well coordinated and complimentary to other institutions involved, including the World Bank. Our chair agreed that the focus should be on macroeconomic stability and public financial management and underlined that this would be commensurate with essential development priorities. We also emphasized the need for considering the costs and cautioned against "mission creep" in the Fund's work in the LICs. Our chair considered the Debt Sustainability Framework an important tool in improving countries' ability for long-term fiscal planning and debt management strategies to reduce the need for long-term reliance on aid.

B. Implementing HIPC and MDRI

In September 2007, The Executive Board discussed the status of implementation of the HIPC and MDRI initiatives. Since mid-2006 Malawi, São Tomé and Príncipe and Sierra Leone had reached HIPC-completion point, while Afghanistan and Haiti had reached HIPC-decision point. The Inter-American Development Bank joined in to provide full debt relief under the initiative in March 2007. In the review period, countries receiving HIPC and MDRI debt relief had benefited from reduced debt service payments while increasing pro-poor spending.

The Executive Board noted that HIPC and MDRI debt relief envisaged for countries beyond decision point would reduce their overall debt stock by more than 90 percent. Directors called for close monitoring and advice by staff to ensure the quality of pro-poor spending and sustainability of debt, by promoting poverty reduction strategies, prudent macroeconomic policies and debt management systems. The Board regretted the disappointing participation

rate of non-Paris Club creditors, and encouraged outreach activities and information by staff through Article IV consultations and other missions in creditor countries. The Executive Board broadly supported publishing a “scorecard” to identify the HIPC Initiative debt relief granted by each bilateral creditor. It expressed concern about the growing number of lawsuits by private creditors against HIPC countries, which presents a major challenge to the implementation of the Initiative.

The Nordic-Baltic chair supported the use of a “scorecard” to improve incentives for creditor participation, and agreed that staff could prepare case-by-case notes on the HIPC initiative to support LICs caught in litigation processes. Our chair noted that economic progress is becoming more difficult for remaining pre-completion point countries, often with debt dynamics overshadowing the relief provided under the initiatives. Programs with these countries need to be focused and provide realistic conditionality. We promoted increased use of debt management strategies consistent with the Debt Sustainability Framework, and called for increased transparency and debt sustainability considerations by all creditors.

C. Aid for Trade

The Fund and World Bank staffs regularly report to the Development Committee on progress and challenges in trade-related donor assistance (Aid for Trade). The report for the 2007 Annual Meetings, discussed by the Executive Boards of both institutions, *Harnessing Globalization for Economic Development* highlighted competitiveness as a key channel to enhance trade. While urging for a completion of the Doha round, the Fund’s Executive Board underscored that the Aid for Trade agenda should prevail independently. The Board considered trade openness and trade sector development crucial to economic growth, and advised the inclusion of trade policies in national Poverty Reduction Strategy Papers.

The Nordic-Baltic chair was broadly supportive of the findings and recommendations of the report. In particular, our chair emphasized that trade-enhancing efforts needed to be clearly linked to domestic needs and to each country’s development agenda, in a process owned by local authorities. We also cautioned about the impact of the stalled Doha round, such as the already evident upsurge in bilateral and regional trade agreements, and called for more analysis on the adverse effects of this development.

D. Liberia

The Executive Board has met on several occasions to discuss the normalization of Liberia’s financial relations with the Fund, including the financing of arrears clearance and subsequent debt relief. In this regard, Fund staff has identified a financing need of some SDR 530 million. In September, the Board agreed on the modalities of a financing package, based on bilateral contributions, which will allow for the clearance of arrears to the Fund and establishing a program aiming at HIPC and post-HIPC debt relief. Liberia has performed satisfactory under the Staff Monitored Program (SMP) since February 2006. The bilateral financing commitments, however, still remain somewhat short of the necessary amount.

The Nordic-Baltic chair supported the proposed financing package, and all the eight countries in our constituency have pledged their share of the financing package. In the Board

discussions, our chair agreed that the SMP was strong enough to be used as qualification for HIPC debt relief in the future, and encouraged further bilateral contributions for arrears clearance.

E. Scaling up Aid

LICs are benefiting from larger aid flows as donors increase efforts to help them meet the Millennium Development Goals (MDGs). The Fund has worked to ensure an enabling macroeconomic environment for effective use of aid through its policy advice, technical assistance and financial support. Moreover, advising LICs on appropriate macroeconomic policies within the context of high and volatile aid inflows is an integral part of the MTS. In July, the Executive Board discussed the operational implications of scaling up aid for Fund advice and program design. The discussion was partly motivated by findings in the February 2007 report of the Independent Evaluation Office (IEO) on the IMF and Aid to Sub-Saharan Africa.

The Executive Board reiterated that the Fund's engagement in LICs should continue to be focused on the core competence areas of the institution. The Fund should give advice on a case-by-case basis, generally supporting the full spending and absorption of aid, provided that macroeconomic stability would be maintained. The Board also considered that measures for eventually reducing reliance on aid should be an integral component of macroeconomic policy for managing scaled-up aid. Furthermore, the Fund should help countries develop medium-term frameworks to guide policy formulation in the face of increasing and volatile aid flows, including smoothing expenditures over time. The Executive Board also underscored that strengthening fiscal institutions and public financial management systems in LICs would be critical for effective utilization of higher aid.

The Nordic-Baltic chair emphasized the Fund's focus on macroeconomic issues and welcomed the clarification of the Fund's role in LICs, noting that in most cases there is no conflict between macroeconomic stability and main development priorities. Our chair also agreed with the importance of strengthening fiscal institutions, including long-term planning and expenditure smoothing, and considered saving of development assistance only as a last resort, if warranted by macroeconomic stability concerns. We also called for effective cooperation between various technical assistance providers and country authorities.

F. Implementation Plan for the IMF and Aid to Sub-Saharan Africa

The Implementation Plan following the report of the IEO on the IMF and Aid to Sub-Saharan Africa is the first required under a new framework established to ensure a more systematic approach for following up on and monitoring the implementation of Board-endorsed IEO recommendations. This new framework, which was established following the External Evaluation of the IEO in 2006², envisages i) the presentation to the Board of a forward-looking implementation plan for Board-endorsed recommendations soon after the Board

² [Report of the External Evaluation of the Independent Evaluation Office – March 29, 2006.](#)

discussion of each IEO report, and ii) periodic monitoring of the state of implementation of actions set out in such plans.

In its discussion, the Executive Board noted that the MTS envisages a more focused Fund engagement in support of its low-income members. It reaffirmed that the IEO report had provided valuable input into the process of adapting and clarifying the Fund's work in this area, and noted the relevance of Fund-Bank collaboration. The Board also noted that the Implementation Plan provided an overview by identifying a number of work strands which would be discussed by the Board in more detail individually.

The Nordic-Baltic chair agreed with the content and the timeline of the Implementation Plan, which provided useful assurance that all aspects of the IEO recommendations were being phased in to the many work streams in the Fund. Recognizing the rather generalist nature of the Plan, our chair called for more detailed reports in the near future, presenting consolidated work programs for all aspects of the implementation of the IEO recommendations. We underscored the importance of detailed cost assessments and that the scope of a reshaped Fund involvement in LICs must fit, with other priorities, within the medium-term budget framework.

VII. THE FUND'S FINANCIAL SITUATION

An increasing share of the Fund's membership has succeeded in strengthening the domestic financial situation, gained improved access to the global financial markets and, as a consequence, graduated from Fund financial support. As a result, the revenue from the Fund's lending operations has fallen drastically and placed the Fund's existing income model under pressure. The Fund has sufficient reserves to finance its projected budget deficits for many years, yet the current situation highlights the need for a broader and more predictable income base.

A. The Budget and the Medium-Term Financial Situation

In its Financial Year (FY) 2007, the Fund recorded its first net operational loss since 1985, of SDR 71.3 million. The first quarter review of the Fund's income position in the Financial Year (FY) 2008 showed a net operational loss of SDR 40.3 million for the quarter ending July 31, 2007. The level of credit outstanding has halved from end-July 2006 to SDR 7.3 million by end-July 2007³. Under the central scenario for credit outstanding and with no sizeable new arrangements, the income shortfall for FY 2008 is estimated at about SDR 146 million. The projected income shortfall is increasing towards about 265 million SDR in fiscal year 2010⁴.

³ [Financial Statements of the International Monetary Fund](#)

⁴ [IMF Executive Board Reviews the Fund's Income Position and Leaves Rate of Charge Unchanged for FY 2008, Press Release No. 07/82, April 30, 2007](#)

As a response to the deteriorating financial situation, the Executive Board has put in place a medium-term program of expenditure constraint, reducing the Fund's real resource envelope by two percent a year over a three year period.

In its meeting in October, the IMFC welcomed the Fund's ongoing efforts to reduce administrative expenditures, but saw the need for greater efficiency and saving through Fund-wide priority setting. The Committee called on the Executive Board to develop specific proposals on the new income model and the new expenditure framework by the time of the 2008 Spring meeting, and to agree on a new and detailed medium-term budgetary envelope for the FY 2009 budget that is consistent with the emerging income and expenditure framework.

The Nordic-Baltic chair has called for further investigations on how to pursue restraint on expenditures. Our chair expects preparations for taking decisions on proposals, involving different compositions and substantial reduction of expenditure. The overarching objective is an appropriate balance between the tasks and resources assigned to the Fund.

B. Developing a New Income Model

Concurrently with efforts to curb spending, work has proceeded on developing a new income model for the Fund. It is now widely accepted that the new model will be built on the recommendations made in January 2007 in the report of the Committee of Eminent Persons chaired by Mr. Andrew Crockett. During the past half year, discussions have turned to the operational and implementation aspects of the Committee's recommendations.

The initial formal Executive Board discussion in July confirmed a broad consensus that the Fund should no longer rely primarily on income from lending to cover its administrative expenses, and that the Crockett report's key recommendations form a sound basis for developing a new model. In particular, there was support for broadening the Fund's investment mandate, using a portion of the Fund's gold holdings while safeguarding the gold market from disruptions. Furthermore, the Executive Board has discussed preliminary proposals for amending the Articles of Agreement to encompass a more flexible income model. While the mandate for the Crockett Committee only covered the income side, the IMFC noted in October 2007 that both income and expenditure will need to contribute to restoring the Fund's finances on a sustainable footing.

The Nordic-Baltic chair has supported creating a new, durable income model for the Fund, one that responds to changes in the Fund's mission and its operating environment. We continue to support a limited sale of gold and a prudent relaxation of the Fund's investment guidelines. However, our chair has emphasized that the Fund's financial situation cannot be resolved on the income side alone, and that expenditure restraint must be an important part of the solution.

VIII. STAFF OF THE NORDIC-BALTIC IMF OFFICE
as of November, 2007

Tuomas Saarenheimo	FIN	Executive Director
Jon Sigurgeirsson	ICE	Alternate Executive Director
Darius Abazorius	LIT	Senior Advisor
Cecilia Roos Isaksson	SWE	Senior Advisor
Jon Bergundhaugen	NOR	Advisor
Martins Bitans	LAT	Advisor
Lasse S. Lindegaard	DEN	Advisor
Maris Leemets	EST	Advisor
Marjatta Quini	FIN	Adm. Assistant
Kari Romdahl	NOR	Adm. Assistant

International Monetary Fund. Tel.: 1 202 623 7000

Nordic-Baltic Office. Tel.: 1 202 623 4571, Fax: 1 202 623 5385