June 2009

The Nordic-Baltic Office
International Monetary Fund

Report 2009/1

Recent Policy Developments in the International Monetary Fund

CONTENTS

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 main policy issues dealt with by the Executive Board ("the Board") since the Annual Meetings in October 2008, and outlines the *Nordic-Baltic chair's* position. The description of the issues covered is from the paper "Key Developments In IMF Policy Work, October 12, 2008-April 22, 2009", where references to various press releases and documents can also be found.

I. Introduction

Policy developments since the Annual Meetings in 2008 have been shaped by the international financial crisis and the downturn in the world economy. Most notable with respect to the policy initiatives was perhaps the work of the Group of 20. While the Nordic-Baltic Constituency in general has found the initiatives taken by the G20 welcome, including the important role given to multilateral institutions such as the IMF, our constituency also sees serious problems with the lack of legitimacy and representation in a formation where only a small number of the Fund's 185 members are represented.

All countries in our constituency are heavily affected by the crisis, not least Latvia and Iceland that have entered into Fund-supported programs. At the same time, countries in our constituency have committed to provide more than 17 billion dollars in support of Fund-supported programs (see table on p. 5), in addition to the usual financing via the Financial Transactions Plan. This is more than most other constituencies with a larger voting power in the Executive Board. Adding to this, countries in our constituency, taken together, are one of the largest contributors of ODA in absolute terms among OECD countries. As a constituency with some countries borrowing money from the Fund and others taking on such a large financial responsibility, our constituency has a strong interest in a governance structure giving adequate representation, e.g. in justification to our taxpayers.

The following describes the position taken by the Nordic-Baltic chair in the Executive Board in key policy discussions recently. Our main policy messages can also be found in our statement to the April-meeting of the IMFC (International Monetary and Financial Committee).

II. Lending Policies

Lending toolkit and conditionality
The IMF has completed a major overhaul of its lending facilities under the General Resources Account (GRA) and conditionality to enhance their flexibility and ensure they are well-suited to meet members' needs in the current crisis and beyond. The key changes are:
• The Flexible Credit Line (FCL), a new lending instrument that can address both actual and potential types of balance of payments (BOP) needs and can provide large and upfront financing for members with very strong policy frameworks, policies, and underlying fundamentals. Access is not capped, but it is expected that it would not normally exceed 1000 percent of quota. There is no conditionality after qualification.
• High access precautionary arrangements (HAPAs), available to all members.
• A doubling of access limits to 200 percent on an annual basis and 600 percent on a cumulative basis in the credit tranches and under the Extended Fund Facility (EFF) to restore the relevance of Fund lending within normal access limits and provide confidence to members that adequate financing will be available.
• A revised conditionality framework tailored according to members' characteristics, e.g., only ex-ante conditionality for very strong performers; and review based-conditionality for monitoring implementation of structural reforms (no structural performance criteria).
• Elimination of rarely-used facilities, including the Short-term Liquidity Facility (SLF). The SLF, approved in 2008, constituted an important step towards developing the Flexible Credit Line as a more general crisis prevention instrument (see above).
• Simplification of the charges and maturities structure (e.g., time-based repurchase expectations replaced with price-based early repurchase incentives).

The Nordic-Baltic chair generally welcomed the review and supported a simplification. We saw merit in codifying the recently established practice for the use of high access precautionary arrangements. Our chair was skeptical towards the proposed changes to the conditionality framework, viewing the referred criticism more related to program design than the modalities of reviews. In particular, we worked to retain performance criteria on conditionality that would be critical to a program's success, stressing in particular the need to avoid undermining the leverage given to country authorities of such criteria. Considering the absence of ex-post conditionality and the high access, we cautiously accepted the establishment of a Flexible Credit Line. We were in favor of simplifying the structure of surcharges and maturities designed in a way to ensure appropriate incentives to support the revolving nature of the Fund's resources. Finally, we supported doubling the access limits.

A. Reforming the Lending Toolkit for Low-Income Countries

Reform options for the lending toolkit

In March, the Board considered three broad reform options for a simplified and flexible toolkit, in light of diverse country needs and heightened exposure to global volatility:

- Option 1: making the Poverty Reduction and Growth Facility (PRGF) more flexible by allowing a short-term window and precautionary use, and broaden Emergency Post-Conflict Assistance (EPCA) to cover a wider range of needs;
- Option 2: retaining the PRGF and creating a concessional short-term financing facility similar to a Stand-By Arrangement and a unified concessional emergency facility; and
- Option 3: replacing existing facilities with a single concessional instrument with flexible length.

Fund policies on external financing and debt

In March, the Board also reviewed the Fund's policy on external debt limits in low-income countries (LICs) on account of changes in country situations and patterns of financing, including stronger macroeconomic management in a number of LICs; a strengthened framework to analyze debt sustainability; and to address implementation issues. Specifically, staff proposed moving away from a single starting point for concessionality requirements towards a menu of options depending in particular on the extent of debt vulnerabilities and the macroeconomic and public financial management capacity.

Augmented access limits

In April, the Board approved a doubling of access limits under the PRGF and the Exogenous Shocks Facility (ESF), while also raising the related PRGF access norms, and keeping unchanged access under EPCA and ENDA. Procedural safeguards were strengthened for countries with moderate or higher risks of debt distress as well as in cases with high access.

The Nordic-Baltic chair considers it crucial that the Fund is able to effectively assist LICs, particularly considering that the current crisis is strongly affecting these countries. Our chair have supported staff's and management's efforts in putting the needs of LICs on the agenda at a time when focus tended to be on countries in other parts of the world.

Recognizing the changing nature of some LICs economic circumstances, our chair found a precautionary instrument as well as a more flexible short-term instrument warranted. Our chair therefore favored the "three-pillar" approach in the second reform option for the Fund's lending toolkit for LICs, which would maintain the PRGF's role as a medium-term facility to support medium- and longer-term adjustment. We advocated a more flexible financing structure to make efficient use of donor resources provided for concessional lending, though due account will need to be taken in order not to discourage donors who may wish to earmark contributions. Our chair found it reasonable to extend the PRGF-ESF financing terms to all types of financial assistance in LICs, i.e. including emergency assistance which is currently on less favorable terms. Looking forward to a concrete reform proposal, our chair has called for keeping momentum to demonstrate equal determination in reforming the toolkit for LICs as for the rest of the membership.

The Nordic-Baltic chair also supported an approach to program design, including the rules for contraction of debt, that allowed for flexibility to take greater account of the diversity of situations faced by LICs. As such, we saw merit in a menu of options, and in particular in making more systematic use of the findings from debt sustainability analyses. At the same time, we pointed to caveats of the proposed changes, including that it could jeopardize the Fund's catalytic role and put a heavy burden on debt management capacities. Our chair therefore stressed the importance of following such an approach up with sufficient capacity building.

Awaiting finalization of the broader reform, the Nordic-Baltic chair supported doubling access limits for the PRGF and the ESF and increasing related norms, taking into account staff's assessment that existing subsidy resources would likely be sufficient to meet demand in the coming two years. Our chair stressed that program access must be compatible with debt sustainability. In the context of reform discussions, our chair has also called for considerations on how to avoid longer-term financing and prolonged use, considering the mandate of the Fund being providing temporary and limited financing.

III. The Fund's Resources

Adequacy and Options for Supplementing Fund Resources
Based on a staff analysis of the potential demand for Fund resources, most Directors agreed in February that a near-term doubling of the Fund's pre-crisis lending capacity (SDR 167 billion or US$ 250 billion) would be appropriate, at least on a temporary basis. Japan, EU member states and Norway were among the first to commit resources towards this objective. Subsequently, the G20 committed to a tripling of resources instead, initially through bilateral borrowing arrangements to be later incorporated into the New Arrangements to Borrow (NAB), but without identifying how the burden will be shared. The Japanese and Norwegian borrowing agreements are in place, and other borrowing agreements are under way. Advised by the IMFC, the Fund is in the process of initiating the 14^{th} general quota review with an aim of finalizing it by January 2011. The IMFC has also called for a general allocation of SDRs equivalent to USD 250 billion to become effective well before the 2009 Annual Meeting. Work is well under way to meet this timeframe.

Role and adequacy of the Fund's Precautionary Balances
The recent rapid increase in Fund credit has shifted the balance from income risk to credit risk. The Board decided in December to retain the target for precautionary balances (reserves) of SDR 10 billion for the time being, but it will be kept under close review. The Board endorsed the development of a more transparent and rules-based framework for reserve accumulation, even if considerable judgment will be needed.

Since last fall, countries in the Nordic-Baltic constituency have in total committed more than USD 17 billion in support of Fund-supported programs, see table below. Our chair believes that extending and increasing the New Arrangements to Borrow should be a key element in expanding the Fund's lending capacity, as it is well-established, designed to meet temporary liquidity needs and provides a transparent framework for ensuring fair burden sharing. We called for increasing the number of participants. At the same time, we recognized that bilateral arrangements might be needed in the short term, but we advocated that such would be terminated or folded into the NAB with time. We stressed, however, that the Fund remains a quota-based institution and, in the longer term perspective, quotas should be the main resource for financing Fund lending activities. Our constituency have called for a completion of the next quota review in 2011 based on the new quota formula.

Additional commitments of countries in the Nordic-Baltic constituency in support of Fund-supported programs during the current crisis

<u>Commitments to loans to the Fund:</u>		
Denmark (as part of EU member states' commitment)	2.7	bio.USD
Finland (as part of EU member states' commitment)	1.8	bio.USD
Norway	4.5	bio.USD
Sweden (as part of EU member states' commitment)	3.4	bio.USD
<u>Commitments to bilateral loans:</u>		
From Nordic countries to Iceland	2.5	bio.USD
From Nordic countries to Latvia	2.5	bio.USD
From Estonia to Latvia	0.1	bio.USD

Note: In addition, the Danish, Norwegian and Swedish central banks have entered into swap agreements with the Icelandic central bank, and the Danish and Swedish central banks also with the Latvian central bank. Some commitments have been made in a different exchange rate and converted into the value of the US dollar around the time of the announced commitment.

The Nordic-Baltic chair advocated developing a transparent framework for precautionary reserves that established transparent and clear rules to determine the medium-term level of precautionary reserves and to motivate the distribution of the burden of an eventual reserve accumulation. The distribution should depend on whether accumulation was needed to cover credit risk or risk related to the rest of the Fund's operational budget, consistent with the new income model. Awaiting the development of such a framework, we agreed to retain the proposed reserve target of SDR 10 billion. This will have to be revisited later on, e.g. in light of developments in the use of the FCL facility.

A. Financing the Fund's Concessional Lending to Low-Income Countries

Financing the Fund's Concessional Lending

When considering the increase in access limits, staff concluded that existing subsidy resources appeared sufficient to cover estimated demand for the coming 2 years, but that loan resources need to be mobilized soon. Additional subsidy resources would be needed to cover medium-term demand.

Subsequently, the Board had a preliminary discussion of possible options for mobilizing the necessary resources. Possible sources include bilateral contributions and the G20 countries' proposal to use resources from the agreed gold sales in a manner consistent with the Fund's new income model. The Board now awaits a follow-up paper from staff.

The Nordic-Baltic chair stressed the importance of not undermining the new income model. Primarily relying on contributions from members, as agreed under this model, is in our chair's view preferable, as it is much more transparent and straight forward. Noting the generous contributions from our constituency in the past, we called on others to do the same. Against the background that there was only a need for additional subsidy resources in the medium term, not in the short term, we found it too early to make decisions on using resources from the agreed gold sales, considering that the new income model is not yet fully implemented. Nevertheless, our chair remained open to using the Fund's resources and income, including the use of additional resources from agreed gold sales, consistent with the new income model.

IV. SURVEILLANCE

Having considered several surveillance-related policy items last summer, see the previous NBO report, the last half-year has primarily been dominated by a heavy "execution" agenda with discussions on: Initial Lessons of the Crisis for Regulation, Macroeconomic Policies, and the Global Architecture; The State of Public Finances; Dry-Run of the Early Warning Exercise; and An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency. This is of course on top of the regular discussions in the context of the World Economic Outlook, the Global Financial Stability Report and Article IV consultations. Following the difficulties with the implementation of the 2007 Decision on Surveillance, the process is moving towards normalization, with e.g. the Chinese Article IV consultation expected to take place over the summer.

V. GOVERNANCE

Governance

The paper forming the basis for the Board discussion on Initial Lessons of the Crisis also touched upon governance issues as part of the global architecture. The Board saw governance issues as important in their own right, and there was support for promptly resuming work on quota and voice reform. An in-depth discussion of broader governance issues is planned for before the Annual Meetings 2009, as also called for by the IMFC. The discussion will draw from a number of inputs, including the IEO report on Fund governance reform and the follow-up by the Executive Board Working Group; the report by the Committee on IMF Governance Reform appointed by the Managing Director; and work to engage civil society and other external audiences.

The Nordic-Baltic constituency welcomes a discussion of the Fund's governance which structure must contribute to making the IMF relevant, effective and legitimate. One of the interesting proposals that deserves further elaborations is to transform the IMFC into a ministerial council, although this will need to be discussed in light of its implications for the overall governance structure of the Fund. We have called for a swift ratification of the reform of quota and voice agreed upon last year and for finalizing the next quota review in 2011, cf. section III. We continue to call for the introduction of an open, transparent and merit-based system for the appointment of the Managing Director and Deputy Managing Directors regardless of nationality.

VI. Staff of the Nordic-Baltic IMF Office

as of June, 2009

Jens Henriksson	SWE	Executive Director
Jarle Bergo	NOR	Alternate Executive Director
Darius Abazorius	LIT	Senior Advisor
Björn G. Ólafsson	ICE	Senior Advisor
Janne Hukka	FIN	Advisor
Martins Bitans	LAT	Advisor
Katrine Graabæk Mogensen	DEN	Advisor
Maris Leemets	EST	Advisor
Marjatta Quini	FIN	Adm. Assistant
Tammy Timko	US	Adm. Assistant

International Monetary Fund. Tel.: 1 202 623 7000
Nordic-Baltic Office. Tel.: 1 202 623 4571, Fax: 1 202 623 5385