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The Nordic-Baltic Office
International Monetary Fund

Report 2004/1

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

CONTENT

INTRODUCTION

This report is prepared by the staff of the *Nordic-Baltic Office* (NBO) at the International Monetary Fund in preparation for the Spring Meeting of the *International Monetary and Financial Committee* (IMFC) on April 24, 2004. The report covers the period from the Annual Meeting in Dubai in September 2003 to the IMFC Meeting in Washington DC in April 2004[1]. The discussion in the report centers on three main areas, first, the global economic outlook; second, the Fund's main debtor countries together with an overview of the Fund's involvement in a few special country cases; third, the main policy issues that have been discussed in the Executive Board of the Fund since the fall of 2003 with a special reference to the views presented by the *Nordic-Baltic Constituency*. The main references are the *World Economic Outlook* (WEO), the *Global Financial Stability Report* (GFSR) and *Report of the Acting Director to the International Monetary and Financial Committee on the IMF´s Policy Agenda.* Those reports will all be available on the Fund's website (www.imf.org) at the time of the IMFC Spring Meeting on April 24, 2004.

The Nordic-Baltic Constituency consists of eight countries: Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden. The Constituency has 3.52 percent of the total votes at the Fund's Executive Board that consists of 24 chairs representing the 184 member countries of the Fund. The Managing Director of the Fund or one of the three deputies chairs the Board meetings. The NBO in the Fund 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 the views and enhancing the role of the Constituency within the Fund. In this context the NBO interacts with management, staff and other Executive Director offices in the process of policy formulation and decision-making. The NBO interacts with national authorities to

[1] Issues that are mainly a continuation and implementation of the Fund's established policy, the Fund's finances or of a more technical nature have been omitted. These include the *Safeguards Assessment-Semi Annual Update*; *Review of Staff Compensation*; *Integrating the Balance Sheet Approach into Fund Operations*; *Strengthening the Effectiveness of Article VIII, Section 5*; *Contingent Financing Facility* and the work of the *Independent Evaluation Office* (IEO). The IEO provides regular independent assessments of the Fund's work. The IEO has published three reports: *Evaluation of Prolonged Use of Fund Resources*, *Recent Capital Account Crises: Indonesia, Korea, Brazil,* and *Evaluation of Fiscal Adjustment in Fund-Supported Programs*. Issues related to *Voice, Representation and Quotas* have also been omitted. For more information on all these issues the interested reader is referred to the Fund's website, the *Annual Report* of the Fund or the *Report of the Acting Director to the International Monetary and Financial Committee on the IMF´s Policy Agenda.*

receive guidance, exchange views and provide information on discussions and developments within the Fund.

Two permanent committees oversee and guide the work of the Constituency 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 Economic Affairs) and the Deputy Governor from the Central Banks. The *Alternate Committee* is composed of heads of International Departments in 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 is expected to have an FSAP in the Fiscal Year (FY) 2005 and Denmark 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, *www.imf.org*.

Staff of the Nordic-Baltic IMF office as of April, 2004

Jon A. Solheim	NOR	Executive Director	jsolheim@imf.org
Benny Andersen	DEN	Alternate Executive Director	bandersen@imf.org
David Farelius	SWE	Senior Advisor	dfarelius@imf.org
Tanel Ross	EST	Senior Advisor	tross@imf.org
Björn G. Ólafsson	ICE	Advisor	bolafsson@imf.org
Giedrius Sidlauskas	LIT	Advisor	gsidlauskas@imf.org
Jelena Zubkova	LAT	Advisor	jzubkova@imf.org
Satu Kivinen	FIN	Advisor	skivinen@imf.org
Kari Romdahl	NOR	Adm. Assistant to ED	kromdahl@imf.org
Maud Ljung-Lapychak	SWE	Adm. Assistant to ED	mlapychak@imf.org

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

I. THE GLOBAL OUTLOOK AND COUNTRY CASES

Growth, Trade and Financial Markets

World Economic Outlook
The global recovery is strengthening and broadening. In the *World Economic Outlook* from April 2004, the GDP growth in 2004 and 2005 is projected to be 4.6 and 4.4 percent, respectively, or 0.6 percentage points higher for both years than the projection in the September 2003 WEO. This more optimistic projection is based on faster growth in world trade, a rebound in financial markets and a broadening of the recovery. Downside risks include geopolitical uncertainties, global unbalances, oil price developments and the threat of viral epidemics.

While recovery appears underway in all regions its pace and nature vary significantly. The United States continue to lead, but other regions – most notably emerging Asia and specifically China are contributing to the robust upturn. A recovery seems to be on track in the euro area with signs of a pick-up in fixed investment, although household consumption remains weak. Differences in global domestic demand are noticeable and it is strongest in countries with the largest current account deficits, thus exacerbating underlying imbalances.

Commodity prices have benefited from the global upturn. Oil prices have increased substantially. Demand has increased in China and North America, while supply has not increased as expected from Iraq. Production cuts have been announced by OPEC in November 2003 and from April 2004. All this adds to an upward pressure on prices. Non-oil commodity prices rallied in the second half of 2003, aided by a pick-up in economic activity in the United States and China. Most increases have been in food, agricultural raw materials and metals. Inflation remains, however, subdued in most instances. Consumer price inflation in advanced countries is projected to be below two percent in 2004. Consumer prices in most other emerging and developing countries will be higher or below six percent in 2004, but on a declining trend.

The more benign outlook offers a favorable opportunity to fortify progress and press ahead with necessary reforms to protect against future problems. Among risks that need to be addressed are, *inter alia,* the large current account and fiscal deficits in the US, orderly timing of future interest rate hikes and prevention of asset bubbles due to the low interest rate environment. Furthermore, difficult medium-term fiscal positions and obstacles to progress in the Doha trade negotiations might slow growth and developments in international trade.

In the Board Discussion of the WEO, the *Nordic-Baltic chair* was in agreement with the view that the global economy was on the mend with the recovery deepening and broadening. Although downside risks had receded, substantial challenges and risks remained, including renewed geopolitical risks. An overriding priority would be to support confidence.

Reinforced commitment to close international cooperation was vital for further economic progress.

Furthermore, a key challenge was to make the recovery sustainable. The persistence of large global imbalances posed risks that should not be disregarded. A better burden-sharing by the major economies of the adjustment of global imbalances would be important. Fiscal consolidation was needed, particularly in the United States and Japan and in several emerging market and developing countries. The structural reform agenda was challenging in a large number of countries, including in Europe, Japan and China. Central banks in many countries might keep interest rates low for some time, but to manage the eventual transition to higher interest rates would be a challenge.

Policymakers should use the current benign outlook wisely to enhance the supply side potential and to strengthen the resilience of the economies by accelerating reforms and moving towards more sustainable fiscal positions. While the speed and timing of actions must be carefully calibrated to avoid derailing the recovery in the short term, a medium-term stability-oriented approach for economic policies diminished uncertainties and could also have positive short-term effects. It was important to use "sunny days to prepare for future rainy days" by building-up contingencies and shock absorbers.

Finally the Nordic-Baltic chair stressed that protectionism should be avoided, and the Doha round should be brought back on track and concluded successfully.

Global Financial Stability Report
The *Global Financial Stability Report* (GFSR) from April 2004 points to the reduction of global financial vulnerabilities since September 2003. In mature markets, particularly in the US, very low interest rates contributed to the recovery in economic activity and in corporate earnings, and thus to an improved outlook. Low short-term interest rates have helped to keep nominal yields in the major government bond markets at historically low levels, while the first signs of an economic recovery facilitated a sharp narrowing of credit spreads on corporate bonds and a strong broad-based rally in equity markets.

According to the GFSR, equity prices have risen strongly in most markets since September 2003, and bond spreads have narrowed. Financing flows to emerging markets have rebounded, with net private inflows rising to USD 140 billion in 2003 from USD 48 billion in 2002. Emerging bond markets have strongly benefited from the improved fundamentals, abundance of liquidity and search for higher yield. As a result, emerging market credit spreads fell precipitously in 2003. Many borrowers in these countries have taken advantage of the favorable external financing environment not only by increasing their issuance, but also by improving the structure of their domestic and external debt.

Looking ahead, in the context of global market surveillance, the GFSR report highlights two sources of downside risks to the global outlook:

1. A forthcoming tightening of US monetary policy could have a significant impact on the asset markets. While markets remain sanguine in this regard, such a tightening might have broad implications since asset prices have been boosted not only by fundamentals, but also by low interest rates and the abundant liquidity environment.

2. Adverse developments in the currency markets could heighten investor risk aversion and spillover into other asset markets. Concerns over the sustainability of the capital flows into the US have contributed to a weakening of the USD. So far, the adjustment of the USD has not noticeably affected most financial asset processes. However, if downward pressure on the USD intensifies, it may impair orderly and gradual adjustment of the large global imbalances. This could have a negative spillover effect on the asset markets in Europe and the emerging markets.

In the Board discussion, the Nordic-Baltic chair stressed the need for a careful management of the transition to a more normal interest rate environment. Forward-looking communication becomes particularly essential to guide the markets and avoid excessive volatility. The risk of a disorderly unwinding of the external imbalances continues to represent the greatest threat to the global financial system. The Nordic-Baltic chair endorsed the GFSR's call for global cooperative efforts to secure orderly reductions in global external imbalances.

The Nordic-Baltic chair also advised the emerging market countries to use the favorable circumstances in international capital markets to develop local financial markets. It was at present an unusually good opportunity to press ahead with the reduction of vulnerabilities, including improving the structure of debts.

Adopting the Euro in Central Europe

In February, a report on *Adopting the Euro in Central Europe - Challenges of the Next Step in European Integration* was discussed in a Board seminar. The report discusses economic and monetary issues related to the process toward the euro adoption. It provides a framework for the Fund's surveillance, including examination of possible vulnerabilities on which the Fund's surveillance will need to focus during the process of the euro adoption. According to the study, the euro adoption is likely to bestow substantial benefits on the Central European Countries (CECs) over the long term, provided that strong supporting policies are in place. These benefits will stem from the elimination of an exchange rate risk, lower transactions costs, enhanced policy discipline, lower real interest rates and greater transparency of prices. The benefits will be manifested primarily through increased trade and investment and more rapid productivity and income growth. To realize these gains, the countries will need to secure sound macroeconomic and structural conditions and continue to foster private sector development. In particular, goods and factor markets should be flexible, and public finances should be put on a sound and sustainable track.

The Nordic-Baltic chair noted that that fiscal consolidation and structural reforms remain important challenges for the CECs, particularly in view of the euro entry preparations. The CECs should not enter the ERM II until they have achieved a high level of nominal convergence and implemented the necessary changes in the policy framework. When entering the ERM II the countries should be ready to adjust monetary and fiscal policy to the exchange rate target. It was not the exchange regime *per se* that promoted stability, but the supporting policies.

The Nordic-Baltic chair underscored that the optimal length of the stay in the ERM II varies across countries and depends, *inter alia,* on whether a proper division of responsibilities between monetary and fiscal policy is established. A prolonged stay in the ERM II will not be justified if the right policies were in place.

Finally, the Nordic-Baltic chair underlined that a more detailed discussion of the Baltic countries in the report would have been useful, although these countries face fewer challenges than other candidates and are relatively well placed for euro entrances within a fairly short period.

State of the Doha Round and the Fund's Role in Promoting Trade Liberalization
The Fund is increasingly involved in promoting trade liberalization and has expressed serious concern about the impasse in the Doha round. The Nordic-Baltic Constituency has internationally supported increased trade liberalization on a multilateral basis. In November 2003, in a letter to the Heads of Government in all member countries, the Fund's Managing Director, Horst Köhler, and the World Bank's President, James D. Wolfensohn, called for renewing progress on world trade talks. They emphasized the fundamental importance of multilateral trade liberalization to growth and prosperity over the past fifty years. Expanding trade by collectively reducing barriers is the single most powerful tool that countries, working together, can deploy to reduce poverty and raise living standards. In the letter, the Bank and the Fund reaffirmed their commitment to help member countries to take full advantage of the opportunities of more open trade and to help them manage the risks.

The benefits of liberalization grossly outweigh costs in the long run. However, transitory balance of payments difficulties might be prompted by the timing of impacts and supply responses. Some developing countries are concerned that reduced competitiveness in export markets may lead to worsening terms of trade and weakening of their balance of payments position. To respond to these concerns, a new mechanism has recently been launched by the Fund called *Trade Integration Mechanism* (TIM). The purpose of the TIM is to provide additional assurances that short-run financial imbalances are not standing in the way of ambitious liberalization targets. The TIM is not a special facility, but rather a policy designed to increase the predictability of resource availability under existing Fund facilities.

Country Matters

The Largest Borrowers under the General Resource Account, Credit Outstanding
(February 29, 2004)

	Billions of SDRs	In percent of quota	Share of total GRA credit, percent
Brazil	19.1	628	29.7
Turkey	15.7	1632	24.4
Argentina	10.7	505	16.6
Indonesia	6.8	328	10.6
Russia	3.2	54	5.0
Uruguay	1.7	561	2.6
Sub-total	*57.2*		*88.9*
Other GRA credit	7.1		11.1
Total GRA account	*64.3*		*100*

Argentina

A three-year Stand-By Credit Arrangement (SBA) for Argentina (SDR 8.98 billion or USD 12.55 billion) was approved on September 20, 2003. The Nordic-Baltic chair, together with a few other chairs, abstained from the Executive Board's decision as the program did not deal in a satisfactory manner with the serious economic difficulties facing Argentina and therefore was not in the best interest of Argentina, the region and the Fund. The Nordic-Baltic chair encouraged the authorities to set higher standards during the program period. The Executive Board completed, with some delay, the first review of Argentina's performance under the three-year arrangement on January 28, 2004. The Nordic-Baltic chair, this time along with several others, abstained again, referring especially to the lack of progress in Argentina's discussions with creditors, but also insufficient progress in implementing the program and setting the necessary higher standards. Argentina is in default on bonds amounting to close to USD 90 billion.

In March 2004, Argentina paid, as scheduled, USD 3.1 billion to the Fund. Thereby, a default was avoided that would have counted as one of the largest in the history of the Fund. The payment followed an announcement on the same day that the Fund's staff had reached an agreement with the Argentine authorities on a letter of intent and the Fund's management would recommend completion of the second review under Argentina's three-year Stand-By Arrangement. With progress in some areas where the Nordic-Baltic Constituency has expressed concerns, including those concerning commitments to concrete debt-restructuring negotiations with creditors, the Nordic-Baltic chair went along with the completion of the second review. The Nordic-Baltic chair emphasized that future support would be conditional upon observance of the established performance criteria and further progress in various areas.

An upgraded policy strategy, addressing the need for structural reforms and a higher primary fiscal surplus, should be formulated in time for the third review.

A main concern of the Nordic-Baltic Constituency has been that the program is not living up to normal Fund standards and that Argentina has not been fulfilling the requirements of the Fund's *lending into arrears* policy and the *good faith criterion*. In the March 2004 agreement, the authorities confirmed that they accepted the recommendation by the Fund to enter into formal negotiations with creditors.

Macroeconomic developments in Argentina have continued to improve in 2004 with growth projected to reach over five percent. Inflation is well contained and the Central Bank's reserve position has strengthened. This improved macroeconomic performance is partly due to a bottoming-out effect and will be difficult to sustain without accelerated structural reforms.

Brazil

In December 2003, the Executive Board including the Nordic-Baltic Constituency approved an extension for 15 months and an augmentation by SDR 4.5 billion of Brazil's Stand-By Arrangement that was originally approved in September 2002. The authorities indicated that they did not intend to draw under the arrangement. This decision was taken simultaneously with the completion of the fifth and the last scheduled review of the original program. All performance criteria and structural benchmarks associated with the fifth review were met.

Brazil's performance under the program has continued to be encouraging. Strong macroeconomic policies and structural reforms have increased confidence. Economic growth has, however, been slow to recover. After a period of weak economic performance, the economy is expected to expand by 3.5 percent in 2004. The primary surplus (fiscal surplus excluding interest payments) was 4.5 percent of GDP in 2003, and the improved public debt structure has helped to ease concerns over the stability of debt dynamics. However, the public debt ratio is still over 80 percent of GDP. The current account remains strong due to buoyant export growth in terms of both volume and prices. Despite progress in many areas, there are a number of downside risks to the outlook and Brazil remains vulnerable to deterioration in market sentiment.

Turkey

The seventh review under the Stand-By Arrangement from February 2002 was approved by the Executive Board including the Nordic-Baltic Constituency in April 2004. The Program performance has been relatively positive. Turkey's economic program has resulted in a significant strengthening of market confidence with interest rates falling and inflation declining. Economic growth has exceeded the program targets. At the end of 2003, the authorities announced pension and minimum wage increases – measures that ran contrary to the program. A main challenge continues to be the timely implementation of reforms. Progress is needed in structural fiscal reforms, in advancing privatization and in banking reform including resolving intervened banks, accelerating asset sales and reforming state banks. Also, a key challenge for the authorities within the program context is to achieve the 6.5 percent of GNP primary fiscal surplus target for 2004.

Iraq

An internationally recognized government must be in office in Iraq before any financial involvement by the Fund can take place, possibly starting with an emergency post-conflict disbursement later in 2004. It is estimated that the Fund's total assistance could amount to USD 2.5 - 4.25 billion over a three year period. It should be noted that the new government has to clear Iraq's arrears with the Fund. Meanwhile, the Fund published in October 2003 its macroeconomic assessment on Iraq and continues to provide technical assistance to rebuild the monetary and financial infrastructure.

II. Policy Issues and the Role of the Fund

Crisis Prevention

The focus of the Fund's policy discussions has gradually shifted from crisis resolution to issues related to crisis prevention. During the summer of 2004, a biennial surveillance review will take place. The review will examine the Fund's bilateral, regional, and multilateral surveillance activities over the past couple of years. The review is expected to take a closer look at the way that the surveillance treats four specific issues, namely global and regional spillovers, exchange rate issues, balance sheet analysis, and institutional underpinnings of growth in low-income countries. The review will also follow up on guidance from the 2002 review, including how to increase the effectiveness of surveillance across the whole membership, and the lessons to be learnt from experience. Regarding the latter, attention will be paid to examples of successful surveillance as well as cases where, with the benefit of hindsight, the Fund could have done better.

Transparency

Transparency helps economies to function better and makes them less vulnerable to crisis. Greater openness on the part of member countries will encourage more widespread discussion and examination of members' policies by the public. It enhances the accountability of policymakers and the credibility of policies, and it facilitates efficient functioning of financial markets. Greater openness and clarity by the Fund about its own policies, and the advice it provides to members, will contribute to a better understanding of the Fund's role and operations. Moreover, it will increase the Fund's accountability for its policy recommendations. The Nordic-Baltic chair has actively supported a more open and transparent Fund.

The Fund's Executive Board has adopted a series of measures aiming at improving member's transparency policies and data, in addition to enhancing the Fund's own external communications. As a result of these measures, it is presumed that, effective from June 2004, all country and policy documents will be made public. The Fund's Executive Board's calendar is now also being made public at the Fund's website.

Review of Data Provision to the Fund

In March 2004, the Executive Board reviewed progress on the provision of economic and financial data to the Fund. It welcomed the progress achieved in recent years in improving data provision by the member countries to the Fund for surveillance purposes. Better data enable the Fund to strengthen surveillance and crisis prevention and allow members to formulate sounder economic policies. Still nearly one-third of the Fund's membership (mostly countries with small populations or low per capita incomes) has inadequate data for the Fund's surveillance and policy analysis. Therefore, future efforts to strengthen data provision will focus on these countries as well as addressing the quality of the data.

Contingent Credit Lines
As part of its response to the financial market crises in the late 1990s, the Fund introduced the *Contingent Credit Lines* (CCL) in the spring of 1999 to provide a precautionary line of defense for members with "first-class" policies, but which nevertheless might be vulnerable to financial market crises. The facility was intended to provide assurances of the Fund's financial support in the event of financial market pressures due to external events, and to reinforce the incentives for implementing sound policies. Under the facility, a member that met the eligibility criteria could draw on a large pre-specified amount of resources if hit by a financial crisis due to factors outside its control. The facility has never been used, partly because countries feared being "stigmatized" as a crisis country if they applied. Therefore, on November 26, 2003, the Executive Board, with the support of the Nordic-Baltic chair, concluded its review of the facility by letting it expire on its scheduled sunset date of November 30.

Also discussed was the option to establish an Enhanced Monitoring Policy (EMP). The EMP would provide a framework for close Fund monitoring, without performance criteria, and with a limited financial backstop. Executive Directors, including the Nordic-Baltic chair, generally felt that such a policy would not be effective in meeting the CCL's objectives. Given its great similarity to *precautionary arrangements* it would not be a useful addition to the toolkit of existing financing facilities. A number of Executive Directors, nevertheless, considered that an EMP might be a useful signaling device for low-income member countries making the transition to a pure surveillance relationship. They encouraged staff to explore this idea further.

Crisis Resolution

Sovereign Debt Restructuring Mechanism and Collective Action Clauses
In 2003, a proposal for a *Sovereign Debt Restructuring Mechanism* (SDRM) did not receive the necessary support. Since then issues related to crisis resolution have not been at the center of the Fund's policy discussions. Progress has been made, however, with respect to the increased use of *Collective Action Clauses* (CACs) in international bond issuances, a development that the Nordic-Baltic Constituency has welcomed. The Constituency supports, furthermore, the development of a *Code of Conduct* for debt negotiations, although the Fund is not taking on an active role in this process. These instruments are not sufficient to secure orderly and swift debt restructuring, especially as the problem still remains of how to aggregate and deal simultaneously with many different types of claims. While the IMFC decided to let the proposal of a *Sovereign Debt Restructuring Mechanism* rest for the time being, the Nordic-Baltic chair's position is that it is necessary for the Fund to continue making progress on promoting certain features of the proposed SDRM.

Access Policy
The Fund agreed in 2003 on a framework for exceptional access. It includes stronger procedures and the necessary criteria for decision-making when approving a request for

exceptional access to the Fund's resources (above 100 percent of quota per year and 300 percent accumulated) in a capital account crisis. The four criteria are:

1. The member is experiencing exceptional balance of payments pressures on the capital account resulting in a need for financing from the Fund that cannot be met within the normal limits.

2. A rigorous and systematic analysis indicates that there is a high probability that debt will remain sustainable.

3. The member has good prospects of regaining access to private capital markets within the time the Fund's resources would be outstanding, so that the Fund's financing would provide a bridge.

4. The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans, but also its institutional and political capacity to deliver that adjustment.

Experience with the framework was reviewed in April 2004. It was agreed that this framework would be kept unchanged at this time. Directors noted that the criteria had helped to improve the clarity and predictability of the Fund's response to such crises. They also recognized that in rare circumstances - including instances where members have large preexisting Fund credit outstanding - a need for exceptional access could arise in situations other than capital account crises. Similarly, while the strong presumption remains that exceptional access should be provided in the form of Supplemental Reserve Facility (SRF) resources, it was recognized that the SRF's maturity structure may sometimes be too short relative to the duration of the balance of payments need. The Board judged that the strengthened decision-making procedures for exceptional access cases - with early Board involvement and provision of additional information and documentation - have worked well. These views were in line with the position of the Nordic-Baltic Constituency. The Constituency believes that to secure a predictable Fund involvement and equal treatment of member countries it is important to safeguard that the implementation of the rules of the framework is not becoming too flexible. Future reviews of exceptional access policy will take place at the same time as general reviews of access to the Fund's resources. The next review will be at the end of 2004.

The Fund's Role in Low-Income Countries

One of the central themes in 2004 is the discussion of the Fund's role in *Low-Income Countries* (LICs). The Fund has an important role to play in helping to achieve the *Millennium Development Goals* (MDGs) in 2015 within its areas of core competence. The discussions in the Board are focusing on how to adapt the institution's instruments better when dealing with low-income countries. The discussions also cover co-operation with the World Bank as well as issues related to debt sustainability and program design.

The Fund's Instruments for LICs
The Nordic-Baltic Constituency is of the view that the Fund has an important role to play in LICs. Given the commitment towards the MDGs and the underlying achievements under the *Heavily Indebted Poor Countries* (HIPCs) initiative, it is essential that LICs generally borrow only on concessional terms (at subsidized interest rates) from the Fund. The view of the Nordic-Baltic chair has been that the *Poverty Reduction and Growth Facility* (PRGF) should continue to be the Fund's main lending instrument for LICs. Given the Fund's role as provider of short-term financial assistance, there should be a clear exit strategy for countries that are prolonged users.

For countries that are emerging from a conflict, the Nordic-Baltic Constituency is of the view that technical assistance should be the main vehicle for the Fund's support. The Fund's assistance should be mainly through the *Emergency Post-Conflict Assistance* (EPCA). For countries that are early/mature stabilizers and mostly need the Fund's *seal of approval* in order to obtain bilateral concessional assistance, the best way forward is low-access PRGF arrangements. For countries that are approaching emerging market status, the PRGF should be used, with successively lower access. An enhanced surveillance-based relationship – with no financing – could also be contemplated for such countries.

Financing Options
The financing of the PRGF is separated from the Fund's general resources. The financing has been from bilateral loans, subsidized through bilateral contributions. On the financing options for future operations of the PRGF (for a self-sustained facility from 2006), various options have been discussed, including additional bilateral loans, turning the resources into grants and using the Fund's general resources as a principal. The Nordic-Baltic Constituency takes a positive view towards additional bilateral loans (with emphasis on the importance of fair burden-sharing). The PRGF could be considered a public good for LICs and it is probable that there will be a demand for such loans in the foreseeable future. The Nordic-Baltic Constituency does not support turning this facility into grants as this will run against the goal of a self-sustained PRGF facility. It is important to continue to separate the Fund's general resources from the concessional lending to maintain the revolving character of the Fund's general resources.

Millennium Development Goals
The first *Global Monitoring Report* (GMR) was discussed in a Board meeting in March 2004. The report was prepared jointly by the Bank's and the Fund's staffs. The objective was to assess how developing and developed countries and international financial institutions (IFIs) are making their contributions, as agreed to at the *International Conference on Financing for Development* held in 2002 in Monterrey, Mexico. Given the current trends, most Millennium Development Goals will not be met by most countries, according to the report. Achievement of the MDGs requires effort above current trends and accelerating progress toward the goals.

The report found that the MDGs' poverty goal related to income was likely to be achieved at the global level, but Africa would fall far short if recent trends continued. For the MDGs' human development goals, the risks were much more pervasive across the designated regions. Likely shortfalls were especially serious with respect to goals related to health and environment. Only one region was on track to achieve the mortality goals.

An action agenda to address the likely shortfalls would have three essential elements:

1. Accelerating reforms to achieve stronger economic growth - Africa would need to double its growth rate.

2. Empowering and investing in poor people - scaling up and improving the delivery of human development and related key services.

3. Speeding up the implementation of the Monterrey partnership - matching stronger reform efforts by developing countries with stronger support from developed countries and international agencies.

The Nordic-Baltic Constituency has consistently supported the MDGs, including the need for increased development aid flow. Three countries in the Constituency (Denmark, Norway and Sweden) are among the largest donors in terms of aid as a ratio of Gross National Income.

HIPC Countries
The status report on the HIPC initiative was discussed at the Annual Meetings in 2003. Since then, HIPC-related issues have been raised during country discussions, e.g. for Niger and Ethiopia as their *completion point* decisions have been postponed. The main reasons for these postponements have been uncertainties regarding the treatment of new borrowing and discount rate changes in the context of *the topping-up framework* (the enhanced HIPC initiative contains provisions that allow for additional debt relief, topping-up, under exceptional circumstances to countries reaching their completion point). To clarify these issues, staff issued a paper that was discussed in March 2004. Many Directors, including the Nordic-Baltic chair, considered that the new borrowing and the change in discount rates should not be treated automatically as exogenous exceptional shocks to the debtor country. A thorough case-by-case handling would be necessary.

Debt Sustainability
In February 2004, *Debt Sustainability in Low-Income Countries - Proposal for an Operational Framework and Policy Implications* was discussed in a Board Meeting. The key elements of the debt sustainability framework are (i) the analysis and careful interpretation of actual and projected debt-burden indicators, including measures of the debt stock in present value terms and debt service, under a baseline scenario and in the face of plausible shocks; and (ii) an assessment of these indicators in relation to indicative thresholds taking into consideration the quality of the country's policies and institutions.

The Nordic-Baltic chair was in broad agreement with the debt sustainability framework for low-income countries as presented. It would help clarify countries' prospective capacity to service debt and consequently provide guidance for prudent borrowing decisions. The Nordic-Baltic chair called for inclusion of debt sustainability analyses in Article IV reports and lending papers, so these analyses would be subject to the Fund's transparency policy. The views differed, however, on how to move forward. Therefore, the results of applying the framework to pilot country cases will most likely be discussed as background documents to the Article IV reports.

The Nordic-Baltic chair stated in the Board discussion that the proposed operational framework provided an informed basis for designing suitable country-specific borrowing and lending policies in low-income countries. It was important to guide borrowing decisions of low-income countries in such a way that the availability of funds was matched with their current and prospective ability to service debt.

The Nordic-Baltic chair recommended to link aid and lending decisions more clearly to demonstrated and prospective implementation of economic policies and development of good institutions. While donors and creditors could contribute to debt sustainability, the main responsibility lied with the low-income countries themselves. Debt sustainability analyses should be incorporated to Article IV consultations and lending papers on a regular basis and subject to the transparency policy of the Fund.

Fund-World Bank Relationship
In March 2004, Bank-Fund collaboration in program design and conditionality was reviewed (*Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality*). The Board's discussion indicated that collaboration was considered broadly satisfactory. While some duplication of work is unavoidable, the Nordic-Baltic chair emphasized the need for clearly defined mandates of the two institutions. In LICs the Fund's role should be primarily directed at stabilizing macroeconomic frameworks that can support high sustained growth and poverty reduction. The importance of conditionality and the desirability of strengthening the "lead agency" concept were underlined as well to avoid undue overlapping. The HIPC and PRSP frameworks have helped improve cooperation. No radical changes seem to be required in the collaboration as the institutions seem able to continuously adjust their work in the light of experience.

Other Policy Issues

Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)
The Board reviewed the 12-month pilot program of AML/CFT in March 2004. Over the course of the pilot program, the AML/CFT assessments have been conducted in 41 jurisdictions. The overall view was that the close collaboration between the Fund and the World Bank and the *Financial Action Task Force* (FATF) had led to a significant progress in the fight against money laundering and financing of terrorism. With regard to the future, the

Board decided that the AML/CFT assessments would continue to be a regular part of the work of the Fund and that the Fund would continue to collaborate with the FATF.

The Board endorsed the revised *FATF 40+8 Recommendations* as the new standard for the Fund's *Report on the Observance of Standards and Codes* (ROSCs) and the new AML/CFT methodology to assess that standard. The most significant changes are that the revised *Recommendations* and the methodology will expand the range of financial institutions to mortgage brokers, leasing companies, etc. and apply to designated non-financial businesses and professions, such as casinos, real estate agents, lawyers and others.

Another important decision made by the Board was to make the Fund and the World Bank fully responsible for AML/CFT assessments in the future. A clear majority of the chairs, including the Nordic-Baltic chair, supported the extension of the Fund/World Bank involvement. This extension of the Fund's activities is warranted by the importance of the fight against money laundering and the financing of terrorism. Moreover, the Fund is well positioned to play a central role in this matter.

The Nordic-Baltic chair underlined, *inter alia,* that the Fund and Bank should take the responsibility for the full AML/CTF assessment and make it a regular part of all FSAP and OFC assessments. Staff should report to the Board in 2005 with cost estimates based on the actual experience of the expanded assessments and technical assistance requests. Decisive in determining the Nordic-Baltic position was the critical importance of strong and sustained efforts in the global combat against money laundering and financing of terrorism. The Nordic-Baltic chair noted that the Fund takes on new responsibilities with significant budgetary implications. In a strict budgetary environment as envisaged for FY 2005, this would require re-allocation of resources from other less prioritized areas.

Technical Assistance

In March 2004, the Fund reviewed of *Technical Assistance* (TA). TA remains an important vehicle for helping countries, especially low-income countries and those countries emerging from conflict situations, to strengthen the administrative capacities of their institutions that are responsible for the implementation of economic policy and governance. The Nordic-Baltic chair emphasized in the Board discussion, in line with many other chairs, that strong ownership and commitment from the countries' authorities are key components in enhancing the effectiveness of TA. To promote transparency and accountability, both among recipients and within the Fund, a further dissemination of information on TA is essential. In low income-countries TA is important to help build sound institutions and promote good governance. Implementation of prudent monitoring and evaluation systems are particularly important due to the long-term nature of the engagement. Finally, close and constructive coordination and cooperation between the Fund and other TA providers is essential. A clear delineation of responsibility vis-?-vis other TA providers is vital to ensure that the Fund's TA remains firmly anchored in the core areas of its competence

Public Investment and Fiscal Policy
In April 2004, the Board discussed in a seminar a paper on *Public Investment and Fiscal Policy* and a background paper on *Public-Private Partnerships.* The paper pointed to that public investment, including infrastructure investment, had declined in recent years as a share of GDP in several countries. In some cases fiscal adjustment, including in Fund-supported programs, might have contributed to insufficient infrastructure investment. Directors stressed that the factors determining the appropriate level of public investments are complex and depend on the government's own evolving priorities. The primary responsibility for safeguarding public investment remains with the authorities. Also, borrowing to finance public investment should be consistent with macroeconomic stability and debt sustainability. The fiscal balance should cover the whole of the public sector, but excluding commercially run public enterprises. Directors underlined the potential for public-private partnerships to attract private capital to infrastructure investment and securing efficiency gains in asset building and service provision.

The Nordic-Baltic chair agreed with most of the conclusions of staff, but underlined that capital expenditures do not warrant a special status, neither in the budget policy of countries nor in the fiscal indicators and targets used by the Fund. Commercially run public enterprises should be excluded from the fiscal targets, but there should be regular and transparent reporting on their finances. Private-public partnerships (PPPs) can play a valuable role in facilitating investments in highly productive infrastructure projects. A strong legal and institutional framework for PPPs is essential for success and appropriate accounting and reporting rules should be in place.

III. THE FUND'S FINANCES AND ORGANIZATION

The Fund's Financial Position

Financial Risk in the Fund and the Level of Precautionary Balances
In February 2004, the Board discussed a report on *Financial Risk in the Fund and the Level of Precautionary Balances*. The Fund's precautionary balances provide protection against the risk of an income shortfall and capital losses of a general nature. The decision taken in 2002 for a target level of precautionary balances of some SDR 10 billion was reaffirmed.

The Board agreed that mitigating financial risk at the Fund rests heavily on rigorous implementation of the policies governing the use of its resources and careful management of its liquidity, along with an adequate level and pace of accumulation of precautionary balances. Recognizing that credit risk to the Fund stems mainly from large arrangements with middle-income countries, sound risk management requires the Fund to be prepared for the possibility of payment disruptions, which could arise from the increase in and concentration of its outstanding credit.

The Fund's preferred creditor status, i.e. members giving priority to repayment of their obligations to the Fund over other creditors, is fundamental to its role in the international financial system and its own financing mechanism. The preferred creditor status has allowed the Fund to take the necessary risks to provide financial assistance to members in exceptionally difficult balance of payments situations. The Fund's members have traditionally supported the preferred creditor status, which benefits them, official and private creditors alike.

The Nordic-Baltic chair expressed, in its statement, concerns about the sharply increased credit concentration over the last few years. The Fund should follow a cautious lending policy and a strong arrears policy, and keep adequate precautionary balances. It is also important to grant lending on terms that promote incentives for early repayment to secure the revolving character of the Fund's resources. In cases with exceptional access, in-depth scenario analysis of the financial impact on the Fund was encouraged in addition to an explicit recognition of the potential costs for general borrowers due to members incurring arrears to the Fund. Finally, the Nordic-Baltic chair stated that credit risk models, which are best practices in other financial institutions, should be used as appropriate.

The Fund's Budget
Major reforms of the Fund's budget system have taken place since the financial year (FY) 2003. The main aim is to bring the Fund's budget process in line with best practices. In this context the Fund attempts to take a more forward-looking view of capital expenditure and to maintain a more transparent and stronger link between the uses of resources and the policy priorities. The reform agenda for the coming years endeavors to upgrade the activity

reporting system, to develop the measures of performance indicators, both for inputs and outputs, and to step up the periodic departmental zero-based budget reviews of outputs.

In light of the relatively steep budget increases in recent years, the Nordic-Baltic chair has in preparatory meetings, in line with many other chairs, argued for a zero real growth budget in the FY 2005 to enhance efficiency and prioritization. The chair has also argued for an unchanged number of total staff positions. Moreover, the Nordic-Baltic chair has, with many others, asked for a review of the existing salary and benefit structure system.

Organization and Public Relations

Public Relations, Communication with Parliaments, Outreach

The final report of the working group on *Enhancing Communication with National Legislators,* chaired by the Nordic-Baltic Executive Director, was published in November 2003. The report concluded that the focus of the suggested outreach should be at the country level and the role of the Executive Director as the main interlocutor was underlined. Generally, it was presumed that Article IV missions will have a dialogue with parliamentarians, especially on issues that need new legislation.

The Functioning of the Fund and the Executive Board

On the basis of the discussions at the Retreat of Executive Directors and Alternate Executive Directors in January 2004, a number of issues related to the functioning of the Fund and the Executive Board are to be assessed. These relate to governance of the Fund as well as the functioning of the Executive Board and the Executive Directors' offices. A number of small Working Groups have been established and they are expected to present their assessments in the course of 2004.

Selection of a New Managing Director

In March 2004, the Managing Director of the International Monetary Fund, Horst Köhler, announced that he would resign from his post, following his nomination for the German Presidency. First Deputy Managing Director Anne Krueger is the Acting Managing Director until the Fund's Executive Board names a successor to Mr. Köhler. According to the Fund's Articles of Agreement, the Executive Board selects the Managing Director.

In July 2000, the World Bank's and International Monetary Fund's Executive Directors established separate Working Groups to review the process for the selection of the heads of their respective institutions. The Bank and the Fund Working Groups reviewed in 2001 the search and selection processes at various international institutions, including the IFIs, and came up with recommendations for guidelines with regard to the nomination of the Bank's President/the Fund's Managing Director. The report from the working groups was never formally adopted.

In March 2004, a group of Executive Directors, representing somewhat more than 100 emerging and developing countries, in addition to some industrialized countries, released the following statement on the selection of a Managing Director:

1. The above group is of the strong view that the candidate nominated for the position must be an eminent person, familiar with the goals of the institution.

2. The process of identifying and selecting the candidate must be open and transparent, with the goal of attracting the best person for the job, regardless of nationality. A plurality of candidates representing the diversity of members across regions would be in the best interest of the Fund.

3. All members of the Executive Board should be consulted in the process of considering candidates that leads to the selection of the Managing Director and informed in a timely manner regarding candidates, including their credentials and knowledge of the institution.

The Nordic-Baltic chair, in line with other European chairs and the US and the Japanese chairs, supported the view that the 2001 Report is not necessarily well suited as the basis for the present selection process although it addresses important issues. The position of those chairs was that prospective candidates should be persons of high integrity having outstanding professional and managerial qualifications. Executive Directors should be informed in a timely manner regarding candidates. Moreover, the Board should seek agreement on a candidate having broad support among the membership.