October 2006

The Nordic-Baltic Office
International Monetary Fund

Report 2006/2

Recent Policy Developments in the International Monetary Fund

I. CONTENTS

1. Introduction

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

The report covers the principal topics dealt with by the Executive Board and the IMFC since the last Spring meeting of the IMFC in April 2006, and up to the Annual Meetings in Singapore in September 2006. Unlike earlier NBO reports, the present report only covers the principal *policy* issues discussed by the Executive Board/IMFC. Concerning the results of Article IV consultations with 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.

The work on implementation of the Fund's Medium-Term Strategy continues to dominate the Fund's agenda. The outline of the Medium-Term Strategy was first presented to and endorsed by the IMFC at the Annual Meetings in September 2005. In the last 12 months, the Medium-Term Strategy has been further refined and specified, and parts of the strategy are now ready to proceed to the implementation phase. The strategy aims at implementing reforms to make the Fund meet the challenges of the twenty-first century in all its business areas. During the half year from the Spring meetings to the Singapore Annual Meetings, work has, in particular, concentrated on the issues of Quotas, Voice and Representation, Surveillance, Fund facilities, Fund Income and the Fund's Role in Low Income Countries that has been discussed by the Board and the IMFC.

From July 1, 2006, Finland took over the EU Presidency after Austria. The EU Presidency plays a central role in coordinating cooperation among the representatives of EU countries in the Fund and, in some cases, also represents the EU's views in the Executive Board. The work of the NBO has, therefore, during the current half year, been directed not only towards representing the views of the Nordic Baltic Constituency within the Fund, but also towards bringing the views of the different EU chairs together to form a coherent EU position within the Fund.

2. Quotas, Voice and Representation (QVR)

One of the most important areas of the Fund's Medium-Term Strategy, since its conception in September 2005, has been to bring the Fund's quotas (which determine a country's access to financing and, together with basic votes, its voting share in the Fund's decision making) to reflect better the developments in the world economy. The reform was seen to comprise of two equally important elements. First, it was seen necessary that quotas reflect better member countries' evolving economic roles in the global economy. Second, the voice of developing countries needed to be strengthened, as agreed under the Monterrey consensus in 2002. In September 2006, the Executive Board agreed to recommend to the Fund's Board of Governors a Resolution on Quota and Voice Reform. This Resolution was approved during the Annual Meetings in Singapore on September 18, 2006, by members representing 90.6 percent of the total voting power.

The Resolution prescribes a two-year program of reforms.

As the first step, ad hoc quota increases are given to four countries: China, Korea, Mexico and Turkey. These countries were identified as the countries that were most clearly underrepresented based on all criteria which have traditionally been used to determine the Fund’s quotas: GDP, openness (share of imports and exports in total for all member countries), reserves and variability (of export receipts).

Second, the Resolution foresees as the next step that the Executive Board will agree on a proposal to change the Fund’s Articles of Agreement to provide for at least a doubling of the basic votes that each member possesses. Unlike the votes granted on the basis of quotas, basic votes are voting shares granted equally to each member regardless of their size. Hence, increasing basic votes would support the voting power of the low-income countries (LICs) which economic size, and hence quotas, are small. It is envisaged that the amendment should also introduce a mechanism to maintain the proportion of basic votes in total voting power in the future. At present, the number of basic votes is defined in absolute terms, which means that any increase in quotas will dilute the share of basic votes. In the future, if the quotas are increased, the number of basic votes is to increase in the same proportion, thereby maintaining their share of the total voting power.

The third element of reform is that the Executive Board is requested to reach agreement on a new quota formula to guide the future evolution of members’ quotas in the Fund. The new quota formula will provide the basis for a further round of quota increases, aimed at rebalancing members’ quota shares, to be presented to the Board of Governors preferably by the Annual Meetings in 2007 and no later than by the Annual Meetings in 2008.

Finally, the Resolution calls on the Executive Board to act expeditiously to allow for an increase of the staffing resources available to those Executive Directors elected by a large number of members whose workload is particularly heavy. Further, the Executive Board is to give consideration to the merits of an amendment of the Articles that would enable each Executive Director elected by a large number of members to appoint more than one Alternate Executive Director.

The Nordic-Baltic chair’s view is that all members of the Fund should be adequately represented, and that the voice of the poorer countries should be strengthened by, inter alia, an increase in basic votes. Also, our chair has accepted, as a general principle, to align its deliberations on a current basis with those in progress within the EU. In general, our chair has supported the Managing Director in his approach to the quota reform.

Two-stage approach. The Nordic-Baltic chair accepted throughout the discussions the two-stage approach with the package of reforms to be completed by the Annual Meetings in 2008, and emphasized that elements of the package should be thoroughly discussed by the Executive Board and the IMFC. Any proposal should address both the issue of ensuring that the distribution of quotas adequately reflects member countries’ economic weight in the global economy, and their ability to contribute financially. Our chair has also been a strong supporter of strengthening the voice of LICs.

First round of ad hoc quota increase. The Nordic-Baltic chair supported the partial compensation by way of an ad hoc increase as proposed by the Managing Director, as the first stage to address significant cases of under representation. Even though a large number of member countries, both inside and outside the EU are underrepresented, we saw it reasonable to focus the first ad hoc increases on a very small group of underrepresented countries. Keeping the group of benefiting countries small would enable making a meaningful correction to these countries' quotas, while at the same time keeping the increases modest in the aggregate, so as not to weaken incentives for an ambitious second stage. As China, Korea, Mexico and Turkey were the only countries that not only were substantially underrepresented on the basis of the existing quota formulae, but also were underrepresented based on all the component variables, then our chair agreed that these countries are the appropriate candidates for the first round of ad hoc increases. Our chair was willing to accept a first round of ad hoc quota increases of up to 2.5 percent of total quotas. The final recommendation of the Fund's Executive Board, which was approved by the Board of Governors, was to allocate an aggregate increase of 1.8 percent of total quotas to the four countries listed above.

A new quota formula. The Nordic-Baltic chair has throughout the discussions agreed that the existing quota formulas are outdated and non-intuitive, and need to be replaced by a new, simpler and more transparent formula. It has indicated its willingness to engage constructively in the search of such a formula, as part of the second stage, and also to discuss possible modalities for updating quota shares on a timelier basis in the future. While underlining that to make discussions genuine and fruitful, positions should not be nailed down prematurely, our chair has, alongside with other EU-majority chairs, favored giving a prominent role for GDP and openness in the new formula.

Second round of ad hoc quota increases. The Nordic-Baltic chair has indicated that once the new formula is available, it will support a second round of limited quota increases as part of the two-year package. The scope of such an ad hoc increase should be considered in light of the increase in basic votes. Beyond the second round of quota increases, which will be explicitly aimed at rebalancing representation within the Fund, any further quota increases should be triggered and guided by the Fund's liquidity needs.

Basic votes and capacity strengthening. The Nordic-Baltic chair has also supported the decision in Singapore to significantly increase basic votes, providing for at least a doubling, as part of the two-year reform package. Our chair has made clear that even though the Resolution only calls for "at least doubling", we will not be an obstacle to more than doubling the basic votes. Similarly, we are in favor of introducing a mechanism to safeguard the share of basic votes in total voting power and have supported other options that could strengthen the voice of LICs countries, including steps to increase the number of staff in the offices of Executive Directors representing a particularly large number of countries, such as the African constituencies.

Other governance issues. The Nordic-Baltic chair stands ready to consider more transparent procedures and selection criteria for appointments of senior management in the Fund and other IFIs. In contrast, our chair has considered it premature to discuss the size and composition of the Fund's Executive Board at this juncture. At the minimum, this discussion should wait until the effects of the revisions to quota shares and basic votes on voting shares, and possibly on constituency structures, are known.

3. The Fund's Surveillance Policies

Economic surveillance has from the beginning been at the core of the Fund's activities. The Medium-Term Strategy involves new directions for the Fund's surveillance, as explained in the Spring 2006 NBO report. Moving forward towards the implementation of concrete measures, the Executive Board has considered several proposals to make surveillance more focused and effective.

Financial Sector Issues in Surveillance

As set out in the Medium-Term Strategy, the Fund's work on financial sector issues will become more harmonized with other areas, recognizing its importance for the globalized world economy and for macroeconomic stability in general. Management has established a task force to consider more closely the integration of financial sector issues in Article IV consultations, and the Executive Board was briefed informally on its work on September 6. The task force identified a need to enhance the ability of Article IV missions to address financial sector weaknesses explicitly, and found that there was significant scope for utilizing more financial markets data for general surveillance purposes. The task force also suggested that the missions should aim at building more systematic analyses of balance sheets on an economy-wide basis to help identify cross-sectoral vulnerabilities contagion mechanisms.

The Nordic-Baltic chair has endorsed the plans for further work by the task force, including developing a new framework for the regular consultations. We have, however, emphasized the need to keep new initiatives cost effective, also in light of the Fund's strained financial situation.

Exchange Rate Surveillance

The Medium-Term Strategy envisages more emphasis on the original goals of surveillance, that is, promoting a stable system of exchange rates and avoiding manipulation of exchange rates and the financial system. This broad foundation of the Fund's surveillance over exchange rate policies is laid out in the Article IV of the Fund's Articles of Agreement, and further specified in a 1977 Decision of the Executive Board. The Decision spells out guidance on how to identify exchange rate and macroeconomic policies that are not consistent with national and international stability. Hence, much of the work on reshaping the Fund's exchange rate surveillance has focused on reviewing the Decision.

In July, the Executive Board considered the Decision and the possible merits of a revision. The issues are multifaceted, from a clarification of member countries' obligations and the appropriate anchoring of exchange rate surveillance in relation to other surveillance, to a revision of the procedures and methods applied. The main idea is to bring exchange rate surveillance more in line with the current challenges facing the global economy, as well as making its foundations more transparent to the public. One aspect of the discussion was a possible broadening of the concept of "exchange rate manipulation" to cover also such unsound policies that only affect exchange rates indirectly. Another theme was the possible use of the Decision as a tool to refocus the Fund's surveillance on areas of direct relevance to external stability and seek to reduce mission creep into other areas. The Executive Board discussion unveiled a number of issues which will need further elaboration in the near future.

The Nordic-Baltic chair was in principle open to amending the Decision, but took the view that any revision of the Decision should be considered in the context of other pending surveillance-related issues and in relation to other guidance instruments such as the Biennial Surveillance Reviews. Hence, our chair was only able to give a preliminary view. A number of further clarifications were needed regarding the interpretation of the proposed amendments to the Decision. However, our chair favored a revamp of the general design of the Decision, leaving the detailed specifications for supporting documents. Moreover, it should be ensured that a new Decision does not expand the Fund's authority, and that it maintains a strict focus on exchange rate policy.

Methodologies for Exchange Rate Assessments

Since the mid-1990s, the *Consultative Group on Exchange Rate Issues* (CGER) has provided regular exchange rate assessments for a number of advanced economies. This assessment, normally updated biannually, is an additional tool for bilateral surveillance, providing an analytical background and fostering consistency across different currencies. As the global economy is becoming more interlinked, and emerging market countries are becoming more important to global trade, the Executive Board has considered revised methodologies for the exchange rate assessments to increase their coverage and relevance.

Due to data limitations and large differences in the economic characteristics of different countries, a new framework for exchange rate assessments needs to take a wider approach. The CGER has so far based its analysis on the misalignment of the real exchange rate from estimates of an equilibrium value, which is derived from longer-term sustainable values of some economic fundamentals. In moving toward a broader assessment scheme, two other methods have also been considered, with the intention that an assessment should be based on several methods combined with significant country-specific judgment. One alternative method focuses on deviations in the current account from an equilibrium value, and assesses the real exchange rate adjustment necessary to eliminate any such deviation. The second method departs from the notion that in the medium-term, the current account should adjust through real exchange rate movements to stabilize the level of net foreign assets.

In the Executive Board discussion, the Nordic-Baltic chair supported further work to improve the Fund's exchange rate assessments, but underlined a number of challenges in communicating the assumptions and limitations of the various approaches. Our chair emphasized that, given the rather slow pace of academic advance in the analysis of equilibrium exchange rates, these limitations are not likely to diminish substantially in the coming years.

Surveillance remit

The IMFC communiqué from the spring 2006 states that “the IMFC should set 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”. Starting from this somewhat abstract beginning, staff and the Executive Board took the work forward. In a series of informal discussion leading to a formal discussion in August, it was agreed that the remit was to be a statement of priorities, flagging what the Fund should consider priorities for surveillance in the current global economic context, and also setting some operational objectives for the Fund. It was agreed that, while a political endorsement by the IMFC is vital for the legitimacy of any such remit, it would be practical and in keeping with the governance structure of the Fund that the remit is prepared by the Executive Board for submission to the IMFC.

In the discussion at the Executive Board, it was noted that the remit will join a host of other statements of surveillance priorities, including the Surveillance Decision, Biennial Surveillance Reviews and Surveillance Guidance Notes. Against this background, the need was seen for careful consideration over the design of the remit, to avoid overlaps and ensuring consistency and clear value added. Therefore, it was decided that work on the proposal would require further clarification of the focus of the remit, where and how the new remit would fit among the other existing instruments, how to assess the outcomes, but also the important issues of the remit-setting process and accountability. In its Singapore meeting last month, the IMFC took note of the work by the Executive Board and looks forward to discuss progress at its 2007 Spring meeting.

The Nordic-Baltic chair considered that a remit could be a useful communication tool, enhancing the visibility and political legitimacy of the Fund’s surveillance. Nevertheless, the content of the remit and its relation to the existing remit-like devices would require further elaboration. Hence, our chair saw a need for further work to ensure that the remit truly strengthens the Fund’s surveillance framework.

Multilateral surveillance

The Multilateral Consultations, endorsed by the IMFC in the 2006 Spring meeting, are seen as a new tool for the Fund to gain a stronger role in a global perspective. The first round of the Multilateral Consultations was launched this summer. It concentrates on the issue of global imbalances (in the balances of payments of various countries), and involves Saudi-Arabia, China, Japan, the euro area and the US. It has been stressed by the Managing Director that expectations have to be kept at realistic levels: Given the complexity of the issues, and the fact that imbalances have built up over a number of years, tackling them will be a lengthy process.

The Nordic-Baltic chair has, throughout the process, supported the Fund’s engagement in this new multilateral procedure, which helps to enforce the Fund’s role as a central forum for discussing global issues and for promoting multilateral thinking.

4. Fund Facilities

As part of the Medium-Term Strategy, and due to interest from especially emerging market countries, the Executive Board has had discussions on the possible establishment of a new liquidity instrument for countries with access to international financial markets. The intended clients would be emerging economies with strong policies but still suffering from vulnerabilities. The new instrument would aim to reduce the likelihood of crises by creating a two-way commitment: On the one hand, the member would commit to sound policies directed at reducing vulnerabilities; on the other hand, the Fund would commit to making highly liquid resources available in case market pressures arise. These two commitments would complement each others in safeguarding the member’s external stability.

The latest Executive Board discussion in August was on the basis of a staff paper that described a possible specific outline for such a facility. In the so-called Reserve Augmentation Line (RAL), qualification would be determined on the basis of an ex-ante assessment, initiated at the member’s request. There would not be explicit conditionality, but the member’s economic performance and implementation of policy commitments would be monitored periodically during the course of the arrangement. In case a need arises, the instrument would provide a country with an immediate, automatic access of up to 300 percent of quota, without an activation review by the Executive Board. The duration would be rather short – most likely one year – but with the possibility of consecutive arrangements.

In Singapore, the IMFC called on the Executive Board to continue its work on the necessary design features of a new instrument, while paying due regard to the interaction with existing Fund facilities, and invited the Managing Director to present a concrete proposal by the upcoming Spring meeting.

In Executive Board discussions, the Nordic-Baltic chair has approached the issue with an open mind. Our chair recognizes that, if a consensus can be found on the design features of the instrument, this could be a valuable addition to the services the Fund provides to its membership. However, the tradeoff between providing sufficient safeguards to the Fund’s resources and maintaining relevance and availability for the potential users is fundamental, and it is not yet certain that an instrument can be identified that meets the conflicting requirements.

5. The Fund’s Finances

As global growth continues at a buoyant pace and conditions in the international financial markets are benign, demand for the Fund’s credit remains on a downward trend. As members’ balance-of-payments positions continue to strengthen, new financing extended by the Fund is at a historically low level, and early repayments have reduced outstanding financing. At the end of August 2006, outstanding GRA credit stood at SDR 14.4 billion, compared to SDR 28.4 billion at the start of the year, and to the high of nearly SDR 70 billion just three years ago. Consequently, the near-term liquidity position of the Fund is ample.

While the improvement in members' financial situation is welcome and can be seen as a success by the Fund in its mission, the reduction in the Fund's financial operations has had a clear negative effect on the Fund's income. The Fund is now expected to post a financing shortfall slightly in excess of SDR 100 million this year. While this shortfall is large, the Fund has a strong balance sheet and ample reserves to cover the cost of its operations in the foreseeable future.

Nevertheless, the situation raises concerns about the long-run viability of the Fund's financing model. Hence, discussions have started on how to reform it to create a more stable and predictable income base and to reduce sensitivity to fluctuations in outstanding credit. In the Spring, the Executive Board decided on a two-pronged strategy to address the situation: First, the Executive Board agreed on a set of immediate actions, including the activation of an investment account, to meet the financing needs for the fiscal year 2006; Second, the Board agreed to launch a process to address the longer-term issues. For the latter purpose, the Fund has established a Committee of Eminent Persons, consisting of persons from outside of the Fund, whose task will be to identify and assess the full range of options available and to make specific recommendations for a sustainable long-term financing of the Fund's running costs. The Committee will give its report in the first quarter of 2007.

The Nordic-Baltic chair has endorsed the two-pronged strategy agreed by the Executive Board. It supported the immediate steps taken to fill the gap for the ongoing fiscal year, but emphasized that these represented only a modest step in broadening and strengthening the income base. Our chair saw the need to consider a full range of options, including using the investment revenue from a limited sale of gold, to ensure a sustainable income base for the Fund over the long-term.

While recognizing the important steps taken in limiting expenditure growth in the Fund, our chair also emphasized the need to continue to explore further options to reduce the Fund's administrative expenditures, especially in line with a reduced administrative burden from declining lending.

6. The Fund's Role in Low Income Countries

The Managing Director's report on the Fund's Medium-Term Strategy states that the Fund's relations with LICs should be defined by a more focused role, more emphasis on the Millennium Development Goals, more flexibility and less procedure. In the coming months, the Fund plans to continue to refine its policy advice to LICs on sustainable growth and on macro critical areas. The Executive Board has recently discussed two important LIC issues: the sunset clause of the HIPC initiative, and the Aid for Trade assistance.

HIPC sunset clause

In September, the Executive Board discussed how to deal with the expiration of the sunset clause which could leave the countries that have not yet fulfilled all HIPC initiative eligibility criteria with debt burdens above the initiative's thresholds. The Directors agreed that extending the sunset clause by an additional two years would not be sufficient for all potentially eligible countries to become eligible for the HIPC initiative, and further extension could weaken the HIPC initiative's credibility. Therefore, the Executive Board decided to let the sunset clause of the HICP initiative take effect at the end of this year. At the same time, the countries that have met, or may be assessed to have met (at some point in the future when the data comes available), the income and indebtedness criteria based on end-2004 data, were granted grandfathering rights and, therefore, will continue to have access to the HIPC initiative. The decision ensured that all potentially eligible HIPCs would have the possibility to benefit from existing debt relief initiatives, and each country will have sufficient time to go through the HIPC process at their own pace.

The Nordic-Baltic chair supported the proposal to allow the sunset clause to take effect at end-2006, and to allow grandfathering for the countries that are assessed to have met the criteria based on end-2004 data. Continued efforts are needed to monitor and limit moral hazard and free-riding issues related to the maintaining access to the HIPC Initiative. Additional resources will be needed if the Fund is to provide assistance to the identified HIPCs, including the protracted arrears cases. All creditors, including non-Paris club creditors, should provide their fair share of debt relief under the initiative.

Doha Development Round and Aid for Trade

The Doha Round, aimed at freeing global trade and at extending the benefits of globalization to developing countries, was suspended in late July due to a failure to reach agreement on reducing farm subsidies and lowering tariffs. While it is not clear when the Doha round will resume, Aid for Trade remains an important development priority, regardless of the status of the Doha round. The Fund, together with the World Bank, can assist developing countries in a number of ways, including through the provision of technical assistance and advisory services. In August, the Executive Board discussed the recent developments in the Doha Round negotiations and Aid for Trade, including recommendations of the WTO Task Forces on an Enhanced Integrated Framework and on Aid for Trade. The Directors agreed that the Fund should continue with selective interventions within its mandate and core areas of competence, including the macroeconomic implications of changes in trade policies and in the global trade environment, and tax and customs reform advice.

The Nordic-Baltic chair considers the suspension of the Doha Round negotiations regrettable. All parties should resume the Doha Round negotiations as soon as possible. Notwithstanding developments in the Doha Round, the enhanced efforts from bilateral donors and multilateral organizations, including the Fund and the Bank, are needed to bring the Aid for Trade agenda forward. Our chair supports the Fund's on-going work on trade issues, as well as its efforts to strengthen assessments, assistance and existing support instruments. The Fund's future work on trade-related issues should be conducted within the already existing framework focusing on its core areas of expertise. The Fund should continue close and efficient cooperation with the Bank.

II. STAFF OF THE NORDIC-BALTIC IMF OFFICE

III. AS OF OCTOBER, 2006

Tuomas Saarenheimo	FIN	Executive Director	tsaarenheimo@imf.org
Jon Sigurgeirsson	ICE	Alternate Executive Director	jsigurgeirsson@imf.org
Ole Hollensen	DEN	Senior Advisor	ohollensen@imf.org
Cecilia Roos Isaksson	SWE	Senior Advisor	croosisaksson@imf.org
Juris Kravalis	LAT	Senior Advisor	jkravalis@imf.org
Jon Bergundhaugen	NOR	Advisor	jbergundhaugen@imf.org
Timo Kosenko	EST	Advisor	tkosenko@imf.org
Lasse S. Lindegaard	DEN	Advisor	llindegaard@imf.org
Justas Minkevicius	LIT	Advisor	jminkevicius@imf.org
Maud Ljung-Lapychak	SWE	Adm. Assistant to ED	mlapychak@imf.org
Kari Romdahl	NOR	Adm. Assistant to ED	kromdahl@imf.org

International Monetary Fund. Tel.: 1 202 623 7000

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