The Office of the Nordic-Baltic Constituency
INTERNATIONAL MONETARY FUND

Views and Positions on Policy Developments in the International Monetary Fund

December 2012

Contents

This report is prepared by the Office of the Nordic-Baltic Constituency (NBC), representing Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden in the International Monetary Fund's Executive Board. The purpose is to present the positions taken by the Nordic-Baltic chair in the Executive Board and to update interested audiences on IMF issues. The report is not an exhaustive review of IMF's work, but aims at presenting the key discussions over the past six months through mid-December 2012. The next report is scheduled for June 2013.

The IMF has 188 member countries, and all countries are represented by one of the 24 chairs of the Executive Board. The main activities of the IMF include:

- conducting surveillance and providing advice to members on adopting policies that can help them prevent or resolve a financial crisis, achieve macroeconomic stability, accelerate economic growth, and alleviate poverty;
- making financing temporarily available to member countries to help them address balance of payments problems; and
- offering technical assistance and training to countries to help them build the expertise and institutions they need to implement sound economic policies.

For additional information, we generally refer to the IMF's website, www.imf.org, which we have also benefited from while preparing this report.

December 19, 2012

I. INTRODUCTION

The IMF maintains its central role in efforts to restore the global economy and international financial system to health, now half a decade after the global financial crisis erupted. The Fund is focused on bilateral and multilateral surveillance, providing policy advice, technical support and financial assistance to underpin member countries' adjustment efforts, and at the same time putting in place systems that strengthen the Fund's ability to identify and respond to global economic and financial risks as they emerge. In dealing with such broader risks, the Fund is currently focusing in particular on:

- strengthening global, regional and domestic financial systems;
- mitigating risks from and addressing underlying causes of global external imbalances; and
- helping members deal with historically high debt levels, refine their growth models to deliver sufficient new employment opportunities, and reduce inequality.

While being global in membership and outlook, current economic challenges in some regions, notably Europe and the transitioning Middle East and North Africa (MENA) region, are currently in particular focus of work in these areas.

Main topics covered by the Executive Board over the past six months– in addition to continuous assessments of the economic and financial situation – include a further strengthening of the IMF's surveillance function as well as finalizing an "Institutional View" on capital flow management issues, upgrading the Fund's resources and governance, and reviewing the Fund's role in Low Income Countries (LICs). This report will deal with each of these themes respectively with focus on the positions taken by our chair in the Executive Board (Nordic-Baltic Constituency views (NBC views)). Further information on NBC views can be found in the published statements by our member of the ministerial committee of the IMF, the International Monetary and Financial Committee (IMFC), which usually meets twice a year.[1] The latest IMFC meeting took place on October 13, 2012, as part of the Bank-Fund Annual Meetings, held in Tokyo, Japan.

II. SURVEILLANCE

The IMF members have an obligation to regularly consult with the Fund on their economic and financial policies. Surveillance takes up most of the IMF's workload, and in implementing its surveillance function the Fund assesses risks to the global economy and provides economic policy advice at an individual country-level. Given that the Fund's surveillance activities, in particular on the monitoring of the individual 188 member countries, are well covered at the IMF's website, we focus in the following on reforms to the institutional framework for surveillance on the one hand, and on multilateral surveillance on the other.

On the global economy, the IMF's flagship reports are the World Economic Outlook, the Global Financial Stability Report and the Fiscal Monitor, which are all published semi-annually on the IMF's website. In addition, there are quarterly updates in between. Starting in 2011, the IMF also prepares a semi-annual Global Policy Agenda (previously Consolidated Multilateral Surveillance Report and the Managing Director's Action Plan) that pulls together the key findings and policy advice from the IMF's various multilateral reports, setting out a forward-looking agenda for the institution.

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[1] The latest NBC IMFC statement can be found at: http://www.imf.org/external/am/2012/imfc/statement/eng/swe.pdf

REFORMS TO THE FUND'S FRAMEWORK FOR SURVEILLANCE

Context. Over the last few years, the IMF has been making special efforts to integrate more closely all dimensions of surveillance - multilateral, bilateral and financial - and to make it more effective. To meet this challenge, as well as to give better guidance to the Fund and member countries on their roles and responsibilities in surveillance, the Executive Board adopted a new Decision on Bilateral and Multilateral Surveillance, also known as the Integrated Surveillance Decision (ISD) in July, 2012. It will take effect in January, 2013. While the ISD maintains important features of the existing legal framework and does not change the scope of member countries' obligations (which would require an amendment to the Articles of Agreement), it enhances the legal framework for surveillance.

Also in July 2012, the Executive Board discussed a Pilot External Sector Report presenting a broad and multilaterally consistent analysis of the external sector for the world's largest economies. In September 2012, the Fund adopted a new Financial Surveillance Strategy that proposes concrete and prioritized steps to further strengthen financial surveillance. Together with the ISD, these actions will place the Fund is in a better position to address the possible effects of spillovers from members' policies on global stability; monitor the stability of members' external sectors in a more comprehensive manner; and engage members in constructive dialogue to safeguard the effective operation of the international monetary system and support economic and financial stability.

NBC view. We believe that the ISD provides an important update of the legal framework of the IMF's surveillance function, reflecting the need for more effective, relevant, even-handed and transparent surveillance, and recognizing the importance of spillovers and interconnections between the real economy and the financial sector as well as between countries and regions. We continue to support – as a longer term objective – a revision of the Articles of Agreement, clearly and formally specifying the IMF's role in bilateral and multilateral surveillance and defining an explicit financial stability mandate for the IMF. We also welcome the multilateral analysis of external imbalances in the Pilot External Sector Report, and are encouraged by its broad focus. As evident from the recent global economic and financial crisis, external imbalances add significantly to the build-up of global vulnerabilities. It is important that external stability assessments are not limited to analysis of exchange rates, but also acknowledge the importance of risks relating to cross-border capital flows, fiscal and structural policies, reserve accumulation as well as financial sector developments. As to the Financial Surveillance Strategy, it is an important element in strengthening the financial sector component of the IMF's bilateral and multilateral surveillance as called upon in the 2011 Triennial Surveillance Review.

GLOBAL ECONOMIC AND FINANCIAL OUTLOOK

Context. In its latest forecast, published in October 2012, the Fund sees the economic recovery as having suffered new setbacks, with uncertainty weighing heavily on the outlook. A key reason is that policies in the major advanced economies have not rebuilt confidence in medium-term prospects. Tail risks, such as those relating to the viability of the euro area or major U.S. fiscal policy mistakes, continue to preoccupy investors. Only a gradual strengthening of activity from the relatively disappointing pace of early 2012 is projected, with global growth forecast at 3.3 and 3.6 percent in 2012 and 2013, respectively. Output is expected to remain sluggish in advanced economies but still relatively solid in many emerging market and developing economies. Unemployment is likely to stay elevated in many parts of the world, and financial conditions will remain fragile.

NBC view. While good progress is made in euro area policies, both repair of asset quality and recapitalization need to continue in vulnerable advanced economies. This should be complemented by the winding down of unviable entities and with unsecured creditors participating in burden sharing. In Europe but also globally, progress on the fiscal front has been made, but not sufficient to restore confidence. Implementation of agreed fiscal and structural plans is of great importance, in particular for countries most affected by the crisis. Caution should be taken before any slackening of the pace of consolidation and structural plans is considered, given the unpredictable nature of financial market perceptions and the utmost need of securing the sustainability of public finances. In the US and Japan, policies to tackle large public imbalances at an appropriately balanced pace are still absent. Emerging market economies would be well-advised to address homegrown vulnerabilities and take measures to support sustainable growth, curbing asset bubbles and rebuilding policy buffers.

III. INTERNATIONAL MONETARY SYSTEM AND FINANCIAL ARCHITECTURE

The international monetary system consists of a set of internationally agreed rules, conventions and supporting institutions that facilitate international trade, cross-border investment and generally the flow of capital between nation states. The IMF plays a central role in view of its surveillance mandate and as a lender of last resort for members with actual or potential balance of payments needs. In the last few years, research and policy debate have centered on a number of underlying issues, most notably global economic imbalances, capital flows, the global reserve system[2] and on global financial safety nets. Addressing data gaps is an important horizontal issue underlying Fund work in all these areas, as well as in furthering more effective surveillance.

The Fund has a range of lending facilities which are regularly reviewed in order to strengthen the global financial safety nets and target the needs of member countries, while safeguarding the IMF's resources. Demand for Fund loans has increased dramatically over the last five-year period. As per December 6, 2012, the Fund had credit outstanding amounting to about USD 148 billion, and undrawn loan commitments (including for precautionary arrangements) of about USD 190 billion.

CAPITAL FLOWS

Context. Capital flows have increased significantly in recent years and are a key aspect of the global monetary system. They are generally beneficial to economic prosperity, but excessive and/or volatile flows may give rise to macroeconomic or financial instability. Capital flows have been an important topic of discussion within and outside the IMF over the past years, partly in view of the IMF's gradually increased acceptance as to the use of capital flow management measures during the crisis, partly in view of the significant capital flows stemming from diverse economic developments and fundamentals in different regions of the world. In November 2012, the Fund concluded a multi-year review process to develop a comprehensive, flexible, and balanced approach for the management of capital flows.

NBC view. We endorse the Institutional View on liberalization and management of capital flows. We believe that countries should aim for carefully sequenced liberalization of their capital accounts

[2] A report by the Fund's Independent Evaluation Office on IMF advice regarding international reserves was discussed by the Executive Board in December 2012, and can be found on http://www.ieo-imf.org/

along the lines of the integrated approach to reap the benefits of liberalization, while recognizing that the appropriate degree, pace, and sequencing of liberalization depends on a country's specific circumstances, e.g. the level of financial and institutional development. The IMF should give guidance to its members on the specifics and sequencing of the liberalization plan and promote a sustainable policy mix that avoids creating imbalances that fuel unstable capital flows. While priority should be given to the implementation of macroeconomic, financial, structural and macroprudential policies when dealing with risks associated with volatile capital flows, temporary capital controls and other capital flow management measures (CFMs) may be necessary to underpin macroeconomic and financial stability. Such measures should be temporary, targeted and accompanied by clear exit strategies that are adequately communicated to the markets.

CONDITIONALITY

Context. In September 2012, the Executive Board discussed a review of the guidelines on conditionality, as well as the design and effects of IMF-supported programs during the period 2002-September 2011 (with an emphasis on the recent years). The review finds that conditionality in programs is generally better tailored to individual country needs, more streamlined, and focused on core areas of Fund expertise. Programs have also adapted flexibly to changing economic circumstances, which has helped to achieve program objectives, and, at the same time, to safeguard social protection during crises (particularly in low-income countries). While the review found that the IMF's conditionality guidelines were broadly appropriate, it highlights areas where further strengthening in implementation of underlying policies might be required, including as challenges remained especially in some recent high-debt crisis programs.

NBC view: We are encouraged by the finding that streamlining of conditionality has been successful and we support further consolidation of this progress. Structural conditionality should be parsimonious and focused on IMF core areas. In this respect it is important to ensure that the macro-criticality criterion is applied to all reform measures. We agree that programs need to strike the right balance between consideration of country circumstances and evenhandedness among countries. It is important that conditionality reflects the implementation capacity, especially for low-income countries, in order to ensure realistic program objectives.

SUPPORT TO THE MIDDLE EAST AND NORTH AFRICA (MENA) REGION

Context. The IMF has intensified its policy dialogue, including possible financing support, with countries in the Middle East and North Africa to assist governments in managing the economic challenges arising from ongoing transitions there since early 2011.

NBC view. The Fund has an important role to play in the MENA region. As in all regions, the IMF needs to be evenhanded when it comes to program engagement and conditionality, but to apply this principle while coming up with country specific and concrete advice. Securing broad ownership of policy programs is a key challenge. We strongly encourage authorities in individual countries to scale back costly and inefficient generalized energy subsidies, and build a system of better targeted measures to support poorer households.

IV. FUND RESOURCES AND GOVERNANCE

The voting power of IMF member countries is based on the so called quotas, which broadly reflect the countries' relative position in the world economy. Historically, IMF quotas have also been an important reference in determining access to IMF resources. Commitments to the IMF quota resources form part of the countries' international reserves. Quota subscriptions are a central component of the IMF's financial resources. In the event that quota resources may fall short of members' needs, they are supplemented through multilateral and bilateral borrowing. As in recent years, IMF's governance and resource issues have continued to be high on the institution's agenda in the last six months. While governance reforms generally aim to improve the functioning as well as the credibility of the institution, the focus on financial resource adequacy is derived from the global economic and financial crisis on the basis of the Fund's mandate.

THE 2010 REFORMS

Context. Reforms entailing the redistribution of quota shares and improved governance were formally adopted by the IMF's Board of Governors in December 2010. Despite clear progress over the last six months, the implementation of these reforms still awaits ratification by a sufficient amount of voting power, notably since the quota increase will not become effective until the Board reform amendment has entered into force. By December 13, 2012, 129 members with 70.2 percent of voting power had accepted the Board reform amendment (113 members with 85 percent voting power needed). 144 members with 77.1 percent of quotas had consented to the increase in their quotas (70 percent of quotas needed).

NBC view. All the Nordic-Baltic countries completed ratification of the reforms well in advance of the targeted deadline of the 2012 Annual Meetings. We urge members which have not yet done so to ratify the reforms as soon as possible.

QUOTA FORMULA REVIEW

Context. As part of the 2010 reforms, it was agreed to review the quota formula by January 2013. The quota formula serves as a guide to quota adjustments and it currently consists of four variables agreed by the membership in 2008: gross domestic product (GDP), openness, variability of current receipts and net capital flows; and official foreign exchange reserves. A compression factor is applied to the weighted sum of these variables; this has the effect of reducing the share calculated under the formula for the largest members, and raising those for all other countries. Board discussions have taken place in September 2011 and in March, June, September and December 2012. Before completion of the review, further discussions are planned in January 2013 both by the Executive Board and by the IMFC Deputies.

NBC view. The formula should be improved to better reflect the broad mandate of the Fund, as well as the multiple purposes of quotas. Members' relative positions in the world economy and their capacity to support the Fund's work are best captured by GDP measured at market exchange rates and by their economic and financial openness. To protect the quota shares of the smallest members, many of which are emerging markets and developing countries, the degree of compression should be preserved or even increased. We seek a conclusion of the review through a transparent and inclusive process that is fully anchored in the Executive Board and the IMFC.

INCREASE IN FUND RESOURCES

Context. The IMF's main backstop for quota resources is the New Arrangements to Borrow (NAB), under which participants from 38 member countries stand ready to lend additional resources to the IMF. Having been substantially expanded since the start of the global and financial crisis, the NAB today amounts to about USD 565 billion. Activation of the NAB requires approval by the participants and this has been done continuously since April 2011. The latest 6-months' activation was effected on October 1, 2012. The NAB credit arrangements are set to be rolled back in connection with the quota increase agreed in 2010.

In view of the highly uncertain global economic and financial outlook in late 2011, the Managing Director initiated a process to further increase available financial resources through additional bilateral loans. This resulted in loan pledges to the IMF from 38 countries totaling USD 461 billion . At the time of writing, 10 bilateral loan agreements have been concluded (incl. with Norway and Denmark), while the remainder are in the process of being finalized. When completed, this process will bring the Fund's total lending capacity to above USD 1 trillion.

NBC view. Countries in the Nordic-Baltic Constituency have pledged new bilateral loans of more than 30 billion USD to the IMF's General Resources Account to ensure the adequacy of the IMF's resources. The Nordic-Baltic Constituency has also been supportive of the continuous activation of the NAB, in which Denmark, Finland, Norway and Sweden are participants. At the same time, we underline that the IMF's resources must continue to be firmly safeguarded and that the main tools to mitigate risks are strong program implementation, program design with tailored and strict policy conditionality, limitations on borrowers' access to Fund resources, and sustained program ownership of the authorities.

V. LOW-INCOME COUNTRIES

The rapid recovery in many low-income countries (LICs) following the global crisis has been sustained in 2012. Softening commodity prices have led to moderating inflation pressures in most LICs. Many countries began to rebuild policy buffers as their recovery began in 2010, but progress on this front has halted and even been partially reversed over the past two years, despite continued strong growth. As a result, many LICs have more limited fiscal space and larger current account deficits than prior to the crisis.

According to a Fund vulnerability exercise undertaken in the fall of 2012, the near term risks for LICs of a shock-induced recession have been reduced since the 2009 crisis, but vulnerabilities are re-emerging in 2012 given lower macroeconomic policy buffers and additional risk factors. Notably, many LICs remain highly vulnerable to global commodity price shocks. So long as their growth remains buoyant, the Fund recommends LICs to take the opportunity to gradually rebuild their policy buffers, without unduly compromising other development needs. The global risks highlight the importance of stoking domestic engines of growth in LICs that can, over time, substitute for lost global demand and reduce the impact of external shocks. These alternative drivers of economic activity would need to be nurtured through a range of structural reforms. Such reforms could include measures to deepen the financial sector and develop domestic debt markets, coupled with strengthened supervisory frameworks, as well as better-targeted investments in infrastructure to increase productivity and living standards by addressing bottlenecks, supported by measures to improve the business climate. To mitigate the impact of high food and fuel prices and the resulting inflationary pressures on the poor, social safety nets need to be made more effective.

In response to the increasing financial needs of LICs during the global financial crisis, IMF concessional lending increased significantly from USD 1.2 billion in 2008 to USD 3.8 billion in 2009, and USD 1.8 billion in 2010 to 1.9 billion in 2011. As per December 6, 2012, outstanding credit to LICs was USD 8.8 billion, and undrawn commitments totaled USD 3.1 billion. About USD 10 billion of concessional lending capacity remains available for low-income countries for the period 2012 through 2014. Fund analytical work focused on LICs during 2012 have covered a broad array of issues, discussing i.a. macroeconomic frameworks for resource-rich LICs as well as enhancing financial sector surveillance.

LOAN FACILITIES REVIEW

Context. The review, concluded in September 2012, found that the 2009 reforms have broadly achieved their aim of closing gaps and creating a streamlined architecture of facilities that is better tailored to the diverse needs of LICs. Supported by the medium-term financing package to the Poverty Reduction and Growth Trust (PRGT), the Fund was able to mount an effective response to LICs' needs during the global financial crisis. Use of facilities has been greatest among the poorer and heavily indebted LICs, and has increased strongly for small and fragile economies. The report also presents new empirical evidence suggesting that longer-term IMF program support has helped LICs support economic growth and build macroeconomic buffers, while short-term financing during the recent crisis helped preserve vital spending and facilitated a rapid recovery.

NBC view. The new architecture of LIC facilities is broadly appropriate and better tailored to the diverse needs of LICs. We are pleased to note that LICs have been offered more flexibility and the modalities are, to a certain extent, more country specific. It is important to ensure a balance between the supply and demand for PRGT resources. This should be taken into account when considering possible adjustments of the LIC facilities. Access levels in terms of quota should be reconsidered when the quota increase agreed under the latest quota review becomes effective. We see merit in the use of contingent tranches, which would allow for rapid additional financing to meet urgent unexpected needs, as well as in the extended use of blending PRGT with GRA resources.

FINANCING OF FUND CONCESSIONAL LENDING TO LOW-INCOME COUNTRIES

Context. In October 2012, an important milestone towards completing the 2009-14 LIC financing package was reached, as the necessary assurances were in place for transferring about USD 1.1 billion, attributed to a part of the profits from the Fund's 2009-2010 gold sales program, to the PRGT. The main longer-term challenge is to preserve the Fund's ability to provide concessional financing to LICs, in the face of projected sharp drop in lending capacity after 2014. A strategy to establish a self-sustaining PRGT was endorsed by the Executive Board in September 2012. It includes a further transfer of gold profits of about USD 2.7 billion to the PRGT.

NBC view. All NBC member countries during 2012 pledged an amount equivalent to their share of the first distribution of gold profits for transfer to the PRGT, and are currently in the process of effectuating this transfer. We fully agree with the importance of adopting a strategy to make the PRGT self-sustainable after 2014. While maintaining that subsidy financing for LICs should primarily be provided through bilateral contributions from member states, the second transfer of gold profits is acceptable as a financing solution with broad support from the membership. We welcome the principle that all future modifications to LIC facilities should be consistent with maintaining self-sustainability. We note that the level of PRGT lending should be monitored closely, given that the robustness of demand projections declines for long projection periods.

VI. STAFF OF THE OFFICE OF THE NORDIC BALTIC CONSTITUENCY

The Office of the Nordic Baltic Constituency presents the views of our member countries in the IMF's Executive Board in close coordination with our authorities in the eight capitals. The Office also regularly meets with representatives from the member countries' administrations or private delegations. All the positions in the office rotate between the eight member countries according to an agreed schedule and all countries are represented at all times.

By mid-December 2012, our staff includes:

Benny Andersen	Executive Director, Denmark
Audun Gronn	Alternate Executive Director, Norway
Gundars Davidsons	Senior Advisor, Latvia
Kari Korhonen	Senior Advisor, Finland
Lilja Alfredsdottir	Advisor, Iceland
Ramune Arust	Advisor, Lithuania
Martin Lindpere	Advisor, Estonia
Martin Holmberg	Advisor, Sweden
Gitte Wallin Pedersen	Advisor, Denmark
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