The Nordic-Baltic Office
International Monetary Fund

Report 2011/1

# Recent Policy Developments in the International Monetary Fund

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This report is prepared by the Nordic-Baltic Office (NBO), representing Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden in the International Monetary Fund's Executive Board. The purpose of these semi-annual reports is to update on a regular basis interested audiences on key IMF policy developments and to explain the position taken by the Nordic-Baltic chair when discussing these issues in the Executive Board of the IMF ("the Fund"). The report covers the main policy issues dealt with by the Executive Board ("the Board") since the 2010 Annual Meetings and in preparation for the 2011 Spring Meetings in Washington. It covers topics discussed and published material through early April 2011.

11 April 2011

## I. INTRODUCTION

The global economy has extended its recovery after the financial crisis although speeds of recovery vary by region and country. Activity in advanced countries is projected to remain sluggish at 2½ percent and insufficient to significantly reduce high unemployment rates. In many emerging economies, activity remains buoyant, and some signs of overheating have emerged, including very strong credit growth and surging asset values. The low-income countries proved remarkably resilient, but are now being particularly hit by high food and fuel prices. As a whole, growth in emerging and developing economies is expected at 6½ percent in both 2011 and 2012. Global output is projected to expand by 4½ percent in 2011.

While downside risks have diminished, great uncertainty still prevails. At the same time, the extension of accommodative monetary policies in advanced countries and relatively favorable fundamentals in emerging market economies have spurred strong capital flows to these economies. Food price inflation has started to strain the budgets of low-income households in a number of economies. These developments, coupled with high unemployment resulting from slower growth may have contributed to the major unrests in the Middle East and Northern Africa region.

Financial turbulence reemerged in the last quarter of 2010, particularly in Europe. It culminated in the case of Ireland, for which a substantial financing package was engineered by its European partners and the IMF in order to restore Ireland's banking system to health, place its public finances on a sound footing, and reclaim growth.[1] Also the use of preventive instruments was broadened during the observation period and further progress was made in provision of debt relief to low-income countries and the Fund provided emergency assistance to further countries that were struck by natural disasters. Notwithstanding new risks, financial stability has improved as a result of policy actions. Nevertheless, bank funding and sovereign risks remain elevated.

In the autumn 2010, the Fund concluded the lengthy discussions on the voice and quota reform resulting in the much expected realignment of voting powers and opening doors for a historical increase in resources. In this junction, also a broad consensus of keeping the size of the Executive Board at 24 chairs was found.

In addition to the protracted debates on governance issues and the Fund's resources in 2010, the main policy topics were strengthening the Fund surveillance, reforming the international monetary system and the global financial architecture, and important policy issues facing low-income countries. This report will deal on each of them in the following chapters.

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[1] In that context, IMF approved a three-year Extended Fund Facility arrangement, amounting to SDR 19.5 billion (about €22.5 billion) or the equivalent of about 2,322 percent of Ireland's IMF quota, to support the authorities' economic adjustment and financial stabilization program. IMF Press Release No. 10/496, December 16, 2010.

## II. SURVEILLANCE

Strengthening of the Fund's surveillance practices has been a key issue for the Executive Board in the last couple of years. An important effort to further improve the Fund surveillance is the triennial surveillance review process, which will be completed later this year. Its aim will be, among other things, to develop on an earlier analysis by the Internal Evaluation Office (IEO) on the performance of the Fund surveillance in the run-up to the global financial crisis[2].

The IEO report noted that the Fund did address many of the topical issues, but failed to convey the urgency of dealing with them effectively. The messages of the Global Financial Stability Report (GFSR) and the World Economic Outlook (WEO) were not sufficiently synchronized. The analysis of the former was not sufficiently observed in bilateral surveillance, symptomatic of insufficient attention to financial sector issues. The evaluation also stressed that in the case of surveillance of large countries, advice was poorly focused and weaknesses were interpreted as strengths. The failure to issue warnings on vulnerabilities or risks were interpreted to happen due to inter alia analytical weaknesses, knowledge gaps and political or organizational constraints (including lack of clarity on the roles of the Executive board, Management and senior staff). IMF's ability to correctly identify the mounting risks was also hindered by a high degree of groupthink, intellectual capture, a general mindset that a major financial crisis in large advanced economies was unlikely, and inadequate analytical approaches. Weak internal governance, lack of incentives to work across units and raise contrarian views were stressed as important contributing factors. **Our** chair emphasized that, in addition to the products, proper surveillance processes are important.

Enjoying the support of **our** chair, management is committed to bringing in staff with new skills and more diverse backgrounds in order to foster diversity of opinions. It is recognized that a cultural shift and a clear accountability framework is needed. In this sense, the **Nordic-Baltic** Constituency stressed that this should take the form of increased ministerial involvement in the International Monetary and Financial Committee (IMFC). As a result, the Fund would benefit from greater political traction and ownership by members. **Our** chair also noted that the Fund should look to preserve certain continuity in key senior positions in order to support consistency of surveillance activities.

Management believes that the reforms in train since 2007 to strengthen in particular multilateral surveillance will "go a long way to enhance the candor and traction of surveillance." The new tools introduced by IMF include among others: i) a new early warning exercise; ii) a vulnerability exercise for advanced economies; iii) Fund inputs to the G-20's Mutual Assessment Process; iv) increased integration of the analysis and messages conveyed in the World Economic Outlook and the Global Financial Stability Report; v) thematic cross-country reports and experimentation with upcoming spillover reports.

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[2] Internal Evaluation Office: IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07, January 10, 2011

An implementation plan in response to the endorsed recommendations will be taken up by the Board after the 2011 Spring Meetings.

Staff has constantly reiterated that the international community needs to improve data quality and comparability across countries. This is being dealt with under the IMF Data Standards Initiative in cooperation with other international bodies. This includes a proposal to develop an enhanced standard for countries that host systemically important financial sectors. Although broadly supporting the initiative, the **Nordic-Baltic** chair noted, in the context of the preparations for the upcoming triennial surveillance review, that there is often too much emphasis on data gaps and too little emphasis on the value of the Fund's advice, expertise, and integration of financial sector analysis into macro-analysis.

## A. Multilateral surveillance

In autumn of 2010, the IMF formally became a member of Financial Stability Board[3], which aims to help leverage the Fund's financial sector surveillance. The roll-out of some of the above novelties is only starting while others have already been put into practice. On top of the practicalities, the Executive Board was not successful in finding a sufficiently broad consensus to proceed with strengthening the legal mandate of multilateral surveillance, although it was supported by several chairs. In addition, the Fund's participation in the G20 Mutual Assessment Process as a technical provider has been fitted into the surveillance agenda, since it emphasizes macro-financial linkages and cross-country spillovers.

In the upcoming Spring 2011 WEO, focus in the more detailed background analysis is on the challenges arising from capital flows and on oil scarcity, growth and global imbalances. The GFSR stressed that although there has been some improvement, strong policies were needed to tackle structural fiscal and banking sector vulnerabilities including their detrimental interaction. Increasing capitalization was recommended for weak banks. [4]

Progress has been made on microprudential banking regulation aimed at ensuring the solidity of individual institutions, though important gaps remain. There are concerns that systemic vulnerabilities may build up again. How to deal with systemically important entities and markets remained a sticking point, not least because the issue requires cross-border solutions. The need for macroprudential policymaking is also very relevant for emerging market economies facing absorptive constraints on capital inflows. These policies are complements, not substitutes, for traditional macroeconomic policies.

November 2010 Fiscal monitor[5] analyzed the latest public finance developments and the fiscal implications of the financial and economic crisis. It estimated that fiscal tightening will become broader and driven by discretionary measures in both advanced and emerging

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[3] Established to coordinate the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability.

[4]World Economic Outlook Update 1/2011 and Global Financial Stability Report Update 1/2011. Spring 2011 editions should be published on April 11 (WEO) and April 13 (GFSR)

[5] Fiscal Monitor: Fiscal Exit: From Strategy to Implementation.

economies in 2011. However, public debt ratios would still rise rapidly in advanced economies, and fiscal risks remain elevated. The report evaluated rollover problems and risks arising from high long-term public indebtedness as the most critical fiscal risks. The Board also discussed more particular issues arising from a policy paper on the fiscal implications of health care reforms.

The **Nordic-Baltic** chair strongly supported the view that the Fund should continue to work on a Multilateral Surveillance Decision to complement the existing surveillance framework. In the view of the chair, IMF needs a stronger mandate for multilateral and financial surveillance. We also stressed that the "flagship" reports (WEO and GFSR) needed to be more systematic and integrated in terms of their messages.

### B. Bilateral surveillance

In addition to new forms of reporting on surveillance, IMF has also introduced a new way of collecting external views by creating Regional Advisory Groups, the role of which is to strengthen engagement with the membership, including on issues such as bilateral surveillance. Increased staff diversity should also help bilateral surveillance. Many other improvements have also already been undertaken. These include among other things regular and mandatory FSAPs, with strong support from **our** Constituency, on systemic countries, and increased emphasis on financial sector issues. Below we focus on the most recent surveillance of the members of the Constituency.

The recovery of the global economy and normalization of financial markets have boosted exports and confidence in *Denmark*. This, together with a large discretionary fiscal stimulus building on the strong macroeconomic framework, halted a rapid rise in unemployment. The Board broadly concurred that economic policies should be geared at managing two key risks: a possible worsening of growth prospects; and a tightening in monetary conditions, which could expose household and corporate vulnerabilities arising from highly leveraged balance sheets and variable interest rate loans. The Board welcomed the authorities' three-year fiscal consolidation package as an important step towards strengthening Denmark's fiscal position and reaching structural balance in 2015. With regard to the structural agenda, reforms of early retirement schemes and of sickness and disability leave benefits among other things should be a priority.

With the Euro area membership achieved, the policy discussions on *Estonia* focused on how to maintain a conservative fiscal policy and how the medium-term fiscal framework could best support it. Given the very high degree of financial interconnectedness, further enhancement of the cross-border financial stability cooperation, and ensuring sound capitalization and liquidity of the financial sector, remain essential priorities. Sharpening the growth potential requires climbing up on the technology and quality ladder. Human capital development and infrastructure improvements will be important for establishing a solid foundation for rising living standards.

In November 2008, *Iceland* received a Stand-By Arrangement with IMF amounting to US$2.1 billion with a program expected to be concluded by the end of August 2011. In addition, Iceland is receiving bilateral loans from four Nordic countries amounting to approximately US$2.5 billion. The fourth review was completed around the middle of

January 2011 and the fifth review is expected in April. At the outset of the program the three main objectives were the following: To contain the negative impact of the crisis on the economy by restoring confidence and stabilizing the exchange rate in the near-term; to promote a viable domestic banking sector and safeguard international financial relations by implementing a sound banking system strategy; and to safeguard medium-term fiscal viability by limiting the socialization of losses in the collapsed banks and implementing a multi-year fiscal consolidation program. The exchange rate has appreciated from its low point in 2009 and been broadly stable for consequential recent quarters. The banking sector has, to a large part, been restructured and a positive primary fiscal balance is expected in the year 2012.

In August 2010, at the time of the conclusion of the 2010 Article IV Consultation and Third Review of the Stand-By Arrangement, IMF announced[6] that *Latvia*'s economy appeared to be bottoming out with positive annual growth expected to return in 2011. Directors encouraged the authorities to focus on high-quality measures and durable spending cuts and to improve control over state-owned enterprises. Directors welcomed the substantial improvement in competitiveness since early 2009, but called for rapid action to restructure the two state-owned banks. The December mission[7] announced that the agreed adjustment would also keep Latvia on track to meet its medium-term goals of stabilizing public debt and reducing the 2012 general government deficit, in line with the ambition to adopt the euro by 2014 while promoting balanced growth.

## III. INTERNATIONAL MONETARY SYSTEM

Following the global crisis, there is scope and opportunity for reform of the international monetary system (IMS) which is the set of rules and institutions that shape how international payments are handled. The IMF's work focuses on four interlinked areas; global imbalances, capital flows, global reserve system and global financial safety nets.

Global imbalances are characterized by the large and persistent current account deficits in one group of systemic countries, most notably the United States, and corresponding surpluses in another group, which includes China, Germany and the oil exporters. Large capital flows move across borders to fill the gaps. Capital mobility can facilitate a more efficient allocation of capital, improve risk sharing and encourage greater discipline in policymaking. However, in emerging markets, in particular, these flows have proven to be large and volatile, and the directionality of flows has predominantly been pro-cyclical. To some degree, capital flows can be managed by a mix of policy tools, including greater exchange rate flexibility and reserve accumulation, but in some cases capital controls have been viewed as necessary, challenging the conventional thinking of free capital movements. The **Nordic-Baltic** chair has supported that IMF develops guidelines for managing capital inflows as a part of strengthening the surveillance framework. These guidelines need to be precise on the ranking of the various measures in order to facilitate their practical implementation. Also, they should

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[6] Public Information Notice (PIN) No. 10/104, August 12, 2010; IMF Country Report No. 10/356

[7] Press Release No. 10/495

neither be used to defend fundamentally unsustainable currency pegs nor to keep exchange rates undervalued to increase competitiveness at the expense of other countries. Temporary capital controls are an instrument of last resort, but can be justified to shelter economies from sudden swings in capital flows when all other macro-prudential measures, *inter alia* higher capital requirements and increased reserve requirements, have been exhausted. Any leeway obtained by introducing temporary capital control measures must be used to correct domestic imbalances and implement structural policy reform conducive to absorbing the capital inflows and transforming them into longer-term investments.

Reserve accumulation has played an important role in the global crisis – both for countries hit by the crisis experiencing capital outflows and for emerging markets consequently experiencing capital inflows – leading to discussions on reserve adequacy and reserve metrics. Also, it is being discussed whether there is a prospective enhanced role for the Special Drawing Rights (SDR) as an international reserve asset, although the dollar is expected to remain dominant for years to come. The SDR was revaluated on 1 January 2011 but the basket of currencies was kept unchanged.

Finally, the global crisis has highlighted the need to further strengthen financial safety nets. As part of the cooperative response to the global financial crisis, the IMF's lending capacity was tripled, and a general allocation of SDRs was made in the amount of $250 billion. In addition, IMF has approved further reforms to strengthen its capacity to assist member countries in preventing crises; i) the Flexible Credit Line (FCL) was refined to increase its effectiveness and predictability and ii) a new Precautionary Credit Line (PCL) was established to broaden the availability of crisis prevention instruments to countries that have sound fundamentals and policies but do not yet meet the qualification standard of the FCL. These reforms made the instruments more broadly available to members. During the observation period, the existing FCLs for Mexico and Poland were expanded and the first arrangement as the newly approved Precautionary Credit Line was granted to Macedonia, which in March announced that it would draw on the arrangement against initial plans. The **Nordic-Baltic** chair supported, together with other chairs, further discussions to clarify the principles of access to the new instruments even prior to the review scheduled for 2012.

## IV. INTERNATIONAL FINANCIAL ARCHITECHTURE

International financial architecture refers broadly to the framework and set of measures at an international level that can help manage crises and even prevent them from occurring. The main theme in this area was how to tackle financial interconnectedness not only in surveillance but also in international regulation.

On one hand, it involves the development of data standards and templates for data collection. The discussion on the Interim Report for the Eight Review of IMF Standard and Codes Initiative provided the Board with a good insight on the main topics well in advance of the major policy discussion taking place in 2012. It allowed the Board to accept a proposal on macroeconomic statistical methodologies to enhance data quality and comparability, with an appropriate transition period. The **Nordic-Baltic** chair further raised concerns over the fact that capital market participants had been disappointed with the cross-country and cross-sector comparability and data quality and emphasized the need for interaction with stakeholders.

There was a general support for an additional layer of standards on systemically important institutions' exposures to each other and to national markets to facilitate network analysis. Also the joint FSB/IMF Early Warning Exercise, which seeks to identify such vulnerabilities and triggers that could precipitate systemic crises, and identifies risk-mitigating policies, while supporting directly surveillance goals, contributes indirectly to development of macroprudential indicators and policy discussions on crisis prevention.

On the other hand, the Board discussed various staff contributions to international debates on structural and regulatory issues, including resolution regimes and usability of contingent capital instruments to strengthen capital standards in crisis. These are particularly relevant to cross-border institutions (or various forms of the so called too-big-to-fail institutions) and could contribute to the orderly conduct of crisis management and limiting related public costs. The Board also debated avenues for development of policy frameworks for macroprudential measures. The **Nordic-Baltic** chair supported staff's work in this area and stressed that interconnectedness was not in itself a problem, rather it generated vast benefits in various ways. It stressed that cross-border linkages and differences in regulation, or in legislation, between interconnected countries need to be revealed in order to address potential weaknesses and facilitate crisis-resolution.

## V. LOW-INCOME COUNTRIES

Low-income countries (LICs) continue to receive exceptional debt forgiveness on all interest payments due to IMF under its concessional lending instruments through end-2011.

Under multilateral surveillance, the Board discussed policy papers on various topics of interest, such as revenue mobilization in developing countries, macroeconomic challenges facing low-income countries and the role of the so called BRIC (Brazil, Russia, India and China) countries in driving growth in LICs. Fiscal prospects of LICs were also discussed in the Fiscal Monitor. Overall LICs fared better during this crisis than during past crises. Stronger counter-cyclical policy responses played an important role in this outcome. Such responses were conditioned upon countries having pursued more sound macroeconomic policies prior to the crisis and built larger "policy buffers" in the last decade. More flexible Fund advice and unprecedented levels of Fund financing during the crisis also played a part. For example, it was noted that LICs which had an IMF-supported program increased fiscal spending during the crisis by more than those without a program. Overall, the medium-term growth and fiscal outlook in LICs appear broadly favorable, but rebuilding fiscal buffers for some LICs – while protecting social and investment spending – could be challenging without additional donor support. Given large infrastructure and social needs, it was advised that the fiscal policies should favor strengthening revenue collection. In the discussion on revenue mobilization in developing countries, the **Nordic-Baltic** chair agreed with IMF staff, that further revenue mobilization is needed in many developing countries. The necessary investment in infrastructure and social spending require fiscal space. However, fiscal space is not only a question of increasing taxes. Revenue mobilization is a supplement, not an alternative, to meaningful spending and strong public financial management. **Our** chair added that corruption remains a significant problem in many countries and we agreed with staff that addressing governance problems in taxation can contribute significantly to state-building. The centrality of taxation as an exercise of state power gives governance issues in taxation a particular importance. Broad-based, efficient and transparent taxation systems, combined with well-governed institutions and quality in spending, will induce wider spread confidence and have the potential to significantly reduce corruption. In many countries, a strengthening of tax administration would be an important first step.

Further progress was made in the debt relief initiative for heavily indebted poor countries (HIPC Initiative), launched in 1996 by the IMF and World Bank. Three countries (Congo DR, Guinea-Bissau and Togo) reached the HIPC completion point in the latter half of 2010, two of which also benefitted from assistance under the Multilateral Debt Relief Initiative. In total 36 countries have now benefitted from HIPC assistance. The total cumulative debt relief has increased to some SDR 3.5 billion. A formal review of the HIPC initiative, including a discussion about reform proposals, is to be held later in 2011.

LICs received special protection in the 2010 quota and voice reform against reduction in influence (see further below). Individual IMF quota shares were capped at pre-reform levels for LICs whose shares would have been reduced according to the quota formula.

## VI. FUND RESOURCES AND GOVERNANCE

On 15 December 2010, the Board of Governors, the highest decision making body of the IMF, approved a package of reforms that redistributed quota shares and lead to a major overhaul of governance strengthening the Fund’s legitimacy and effectiveness, increasing the influence of the dynamic emerging market countries and developing countries in the organization.[8] The outcome is based on careful discussions at the Board, drawing on a proposal by the G20 Group. Based on this proposal, the Board of Governors proposed the completion of the 14th General Review of Quotas with a doubling of quotas to approximately SDR 476.8 billion (about US$756 billion at current exchange rates) and a major realignment of quota shares among members.

A member's quota subscription determines the maximum amount of financial resources the member is obliged to provide to the IMF, but also the amount of financing a member can obtain is based on its quota. Furthermore, the quota largely determines a member's voting power in IMF decisions.

The documents on the reform package have been published on the IMF website. The members have agreed to make their best effort to complete the approval procedures by the 2012 Annual Meetings. The quota formula will be reviewed in a comprehensive follow-up process by January 2013. In the meantime, the Fund liquidity was boosted by activation of the enlarged New Arrangement to Borrow in March 2011.

In the new distribution, advanced countries account for 55.3% while the voting power of emerging market and developing countries arises to 44.7%, which contains a 4.5% share of low-income countries. The 10 largest members, accounting almost for 52.5% of votes, will

[8] Press Release No. 10/477

be United States, Japan, China, Germany, United Kingdom, France, Italy, India, Russian Federation and Brazil.

The governance reform further included an agreement to a move to an all-elected Board, a commitment to maintain its current size of 24 chairs and to review of Board composition every eight years. Although the principle of free constituency formation was maintained, advanced European countries committed to consolidation, releasing two chairs no later than the first regular elections of Executive Directors following members' approval of the reforms.

The voting power of the Nordic Baltic Constituency declined slightly to 3.282% of the total. The Constituency looked at the reform package constructively stressing that the distribution should reflect the evolving economic weight of each member, especially dynamic emerging markets, as reflected in the quota formula and the mandate of the organization. It was felt that one of the main objectives should be the reduction of the out-of-lineness of member quotas from those calculated on the basis of the quota formula, which was capturing the evolutions and ensured objective and equal treatment. Under these assumptions, Nordic and Baltic countries would be ready to have more frequent realignments also in the future. The Constituency was also ready to accept a wider list of low-income countries protected against loss of quota shares. Nevertheless it was clear that the quota decisions could not be de-coupled from the broader governance reforms dealing with the representation of the members, such as the size and the composition of the Executive Board and the principles guiding free formation of constituencies. There was also an inclination to support that future reforms take due account of members' voluntary contributions to the Fund's activities.

While going along with the decision, the **Nordic-Baltic** chair in the discussion expressed disappointment that the G20 Group negotiated outcome suffered from shortcomings in terms of balance, equal treatment, and comprehensive coverage. Our chair emphasized that a strengthening of the IMFC, by transferring some decision making power to ministers, is crucial to anchor the political ownership to the institution. Elements in a reform of the IMFC should include inter alia identification of issues suitable for decision making, preparation for deliberations by the IMFC – including by the Board – and a structure of meetings which can facilitate effective decision making. Our chair supported a review of the quota formula that will assess the sound economic interpretation of each of its components. The weight given to components should be assessed against the international economic activities addressed by the Fund according to its mandate. The review has to be motivated by a desire to strengthen fairness and transparency, not by a wish to benefit specific countries or a group of countries. It has to ensure equal treatment and transparency in a process fully anchored in the governing bodies of the IMF.

## VII. STAFF OF THE NORDIC BALTIC OFFICE

as of April, 2011

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| Benny Andersen | Executive Director, Denmark |
| Audun Gronn | Alternate Executive Director, Norway |
| Kari Korhonen | Senior Advisor, Finland |
| Andres Sutt | Senior Advisor, Estonia |
| Lilja Alfredsdottir | Advisor, Iceland |
| Rimtautas Bartkus | Advisor, Lithuania |
| Gundars Davidsons | Advisor, Latvia |
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