December, 2009

The Nordic-Baltic Office
International Monetary Fund

Report 2009/2

Recent Policy Developments in the International Monetary Fund

CONTENTS

This report is prepared by the Nordic Baltic Office (NBO), representing Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden in the International Monetary Fund's Executive Board. The 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 report covers the main policy issues dealt with by the Executive Board ("the Board") in preparation for the 2009 Annual Meetings in Istanbul and beyond, and outlines the Nordic Baltic chair's position.

I. INTRODUCTION

Increasing signs of stabilization in the global economy have bolstered confidence that the worst of the global crisis has been passed. The atmosphere in the major international meetings on economic and financial affairs during the fall was that of cautious optimism. During the IMF - World Bank Annual Meetings in Istanbul it was noted that global cooperation played a vital role in preventing a far deeper crisis. While the global economy has started to recover, it is still too early to declare victory. For the time being leaders of the key economies have agreed to maintain supportive fiscal, monetary, and financial sector policies until a durable recovery is secured, while starting to prepare exit strategies to be implemented in a cooperative and coordinated way when the time is right.

In the wake of the crisis, the international community and G20, that has emerged as an important informal forum for international economic cooperation, have recognized the IMF's central role in coordinating multilateral crisis response and providing support to countries in crisis. The Nordic Baltic constituency notes the IMF's universal membership and underscores that maintaining the integrity of its governance structure is essential for the IMF to fulfill its tasks effectively in the future. The Nordic Baltic constituency - a major contributor to the IMF's finances and whose members are active players on the international stage – is not represented directly in the G20.

During its meeting in October the International Monetary and Financial Committee (IMFC) outlined further the policy agenda for the IMF. In the Istanbul Decisions, as they were coined by the Managing Director of the IMF, the IMFC asked the IMF to advance the reforms in four key areas: the IMF's mandate, its financing role, multilateral surveillance, and governance. The debate on the revised mandate of the IMF is still at a very early stage.

On the IMF's financing role, there has already been a substantial overhaul in the IMF's lending toolkit to ensure more flexible support to the countries affected by the crisis. More recently the architecture of the IMF's support to low-income countries (LICs) and its financing framework was revised and should soon be fully implemented. To meet higher credit demand the IMF's membership also provided swift immediate response in enlarging IMF's lending resources through bilateral contributions. Integrating these temporary measures into a more structured New Arrangements to Borrow (NAB) framework is well underway. The IMFC also asked the IMF, based on the success of the Flexible Credit Line (FCL), to explore further options how to enhance its financing role in order to provide credible alternatives to excessive accumulation of international reserves for self-insurance purposes.

In the surveillance area there were important stocktaking discussions on the Financial Sector Assessment Program (FSAP).[1] The first full Early Warning Exercise (EWE) round was launched at the 2009 Annual Meetings, and the IMF was asked to contribute to the G20 mutual assessment process.

In the area of IMF governance, the membership is tasked with achieving a consensus on the broad governance reforms by the next quota review, set to take place by January 2011. In this regard, the IMFC set an indicative target for the size of a further shift in quotas and spelled out the overarching principles to guide this adjustment. The Nordic Baltic constituency has emphasized that the IMF governance reform shall aim to reduce the misalignments in

[1] Due to its voluntary nature the FSAP is usually referred to as technical assistance in the categorization of the IMF's services to its members. However, given the public good element of these assessments, and its importance for the financial sector surveillance, in this report the FSAP related developments are covered under the surveillance topic.

members' quota shares and be based on economic and financial criteria, consistent with the IMF's core mandate, maintaining the linkage between financial contributions and representation.

II. The Fund's Resources

Substantial progress has been achieved since the 2009 Spring Meetings in delivering on the commitments for a trebling of the IMF's lending resources as well as for increasing the resources to LICs, as agreed by the IMFC. Together with the unprecedently large allocation of SDRs in 2009, enhancing the IMF's resources played an important part in the multilateral response to the global crisis. It helped in particular in giving confidence that, faced with balance of payments difficulties, emerging market and developing countries will have access to the necessary external financing.

A. SDR allocation

After the approval by the IMF's Board of Governors the general allocation of SDRs equivalent to about $ 250 billion became effective in late August. Emerging market and developing countries received nearly $ 100 billion through this SDR allocation. The purpose of the allocation was to provide liquidity to the global economic system by supplementing foreign exchange reserves of the IMF member countries. The SDRs allocated to the member countries are unconditional resources, which countries can exchange into freely usable currency and use for their balance of payments needs. A special one-time allocation of about $ 34 billion was also implemented in September after the US accepted the Fourth Amendment to the IMF Articles of Agreement and thus sufficient support for the amendment had been achieved.

The **Nordic Baltic** chair supported the general SDR allocation. However, it noted that post allocation monitoring will be important and asked for the inclusion of a review clause in the related Board of Governors resolution. The Nordic Baltic constituency was also concerned about the effects of the SDR allocation on the debt sustainability in low income countries and was not inclined to support using the allocated funds for development financing. It called on other members to join the voluntary SDR Trading Arrangements in view of burden sharing considerations and in order to ensure that the system for exchanging the SDRs will be able to handle higher transactions. Four countries in our constituency – Denmark, Finland, Norway and Sweden – participate in these arrangements.

B. Borrowing agreements

In July, the IMF started drawing on the resources made available by the members under the bilateral borrowing agreements. The agreements with Japan, Norway and Canada were put in place first and the IMF used resources available under these agreements. By September, individual country pledges had reached the promised total of $ 500 billion in contingent resources that the IMF could use if needed. The EU countries committed to provide additional up to EUR 125 billion on top of its original commitments under the NAB. Some individual EU countries, including Denmark, have already finalized their bilateral agreements, while work with others is ongoing.[2]

The People's Bank of China also signed an agreement with the IMF under which it stands ready to purchase up to SDR 32 billion in IMF notes. This Notes Purchase Agreement (NPA) is the first in the history of the IMF and follows the framework for issuing notes to the official sector endorsed by the Executive Board in July. Similarly to the other bilateral agreements between the IMF and member countries the actual provision of resources under the NPA will occur only at the time of a loan disbursement to a member. Other BRIC countries also identified notes purchase as a preferred option for their contribution to the IMF's lending resources. Financial terms of the NPA would be similar to those under other bilateral agreements.

The IMFC agreed that while bilateral financing from member countries is an appropriate immediate measure to ensure that the Fund has adequate resources to help crisis-prone countries, the most appropriate way forward would be to incorporate these bilateral agreements into the more flexible and expanded New Arrangements to Borrow (NAB) framework. In this regard, the ongoing discussions among current and potential new NAB participants on expanding the NAB and making it more flexible led on November 25 to an agreement in principle on expanding the NAB to up to $ 600 billion and on the new operational framework.[3] A formal decision on the expanded NAB is expected to be taken by the Executive Board of the IMF in the coming weeks.

The **Nordic Baltic** constituency recognized that bilateral borrowing agreements could provide a flexible response to the rapid increase in the demand for the IMF's financial assistance. Norway and Denmark were among the first to sign such agreements with the IMF. Countries in our constituency have also provided significant bilateral contributions as part of some IMF-supported programs. At the same time, the Nordic Baltic constituency was a strong supporter of increasing the NAB and expanding its membership. As a well established framework, the NAB promotes equitable burden sharing and transparency of financial contributions. The Nordic Baltic constituency also emphasized that the IMF should remain a quota based institution and the future size of the NAB must be reassessed in light of the outcome of the 14th review of Quotas.

C. Gold sales

In September, the IMF's Executive Board approved gold sales to finance its new income model and to boost its concessional lending capacity. The gold sales are limited to 403.3 metric tons and will be conducted in a way not to disrupt the gold market. About half of this amount of gold has already been sold to the official sector.[4] After the relevant amendments to the IMF Articles of Agreement will become effective, the profits from gold sales will be

[2] As of November 5, the IMF has signed borrowing agreements with the following EU countries: Spain (up to about $ 6.2 billion), United Kingdom (up to about $ 15.8 billion), Netherland (up to about $ 7.9 billion), France (up to about $ 16.4 billion), Germany (up to about $ 22.3 billion), and Denmark (up to about $ 2.9 billion). Based on the euro, US dollar and SDR exchange rate as of 11/05/09.

[3] IMF, NAB Participants Agree to Expand Fund's Borrowing Agreement to up to US$ 600 Billion, Press Release No. 09/429, November 24, 2009.

[4] Reserve Bank of India acquired 200 metric tons of the IMF's gold, other purchases so far were Mauritius and Sri Lanka.

transferred to the IMF's investment account and be used for income generating investment purposes. As agreed by the Executive Board in July 2009, it is intended that windfall profits be used for the subsidy resources to finance concessional lending to low income countries.[5]

The **Nordic Baltic** constituency supported the decision to sell a limited amount of the IMF's gold. It also supports the use of windfall profits from the agreed gold sale as contributions for concessional lending to low income countries. It stressed that mechanisms for conducting the transactions will have to be carefully considered to ensure that part of the resources linked to the gold sales will be used for LICs subsidy financing, as agreed by the IMF's Executive Board in July 2009.

III. LENDING POLICIES

A. Current financial arrangements

Since the 2009 Spring Meetings, 10 new IMF programs and two precautionary Flexible Credit Line (FCL) arrangements were approved.[6] The total credit outstanding increased from less then SDR 25 billion at the end of April 2009 to more than SDR 40 billion by end-November, whereas the increase in overall commitments has been even more sizeable reaching SDR 111 billion. In spite of the unprecedented depth of the crisis, the outstanding IMF credit is only approximately half of the size reached during the East Asian crisis of the late 1990s. That should be viewed in light of the relatively smaller size of the countries applying for the IMF credit in the current period.

The **Nordic Baltic** chair shared the conclusion of the review of recent IMF supported programs that the IMF's assistance helped these countries to weather the worst of the crisis. While it might be too early to draw firm policy conclusions, the recent experience seems to suggest that the new FCL facility contributed to strengthening confidence in countries having it. During the overviewed period two countries in the Nordic Baltic constituency – Latvia and Iceland - each completed the first reviews of their programs with the IMF.

B. Reform of the IMF's support to low income countries

In July the IMF Executive Board approved reform measures of the IMF's concessional lending instruments and financing framework for low-income countries (LICs).[7] The comprehensive reform, encouraged for long by our constituency, responds to recent calls by the international community for the IMF to strengthen its capacity to help LICs cope with the impact of the global crisis, which is taking its toll on LICs export receipts, FDI inflows, remittances, and aid flows. While growth in LICs is expected to rebound as the global economy recovers, external financing needs in 2009-10 are estimated to increase by around

[5] Windfall profits constitute income from gold sale at a price above that assumed when the IMF's Executive Board approved the new income model for the IMF. To the extend that the realized windfall profits fall short of the contribution agreed by the Executive Board (SDR 0.5-0.6 billion), the difference will be generated through investment income from the gold endowment.

[6] For a list of agreed IMF programs, see http://www.imf.org/external/np/exr/map/lending/index.htm

[7] IMF, Factsheet – Financing the Fund's Concessional Lending to Low-Income Countries, October 1, 2009.

$ 25 billion a year relative to pre-crisis levels.[8] The proposed changes will increase both flexibility and concessionality of the IMF's financial assistance to LICs.

The IMF's concessional lending resources available to LICs are expected to increase by up to $ 17 billion by 2014, up to $ 8 billion of which should be available over the next two years. It is intended to mobilize the required additional loan resources ($ 14 billion) through bilateral contributions, whereas most of the needed subsidy resources ($ 2.8 billion) will come from the IMF's internal sources – including the use of resources linked to the limited sales of gold.[9] Through the end of 2011 LICs will receive exceptional relief of all interest payments on outstanding concessional loans to the IMF.

The proposed new concessional financing framework foresees establishment of a Poverty Reduction and Growth Trust (PRGT), which shall replace and expand the previous PRGF-ESF Trust. The structure of concessional lending instruments under the PRGT was also amended to allow for a more flexible response to the needs of LICs, and consists of:

- The Extended Credit Facility (ECF), which replaced the Poverty Reduction and Growth Facility (PRGF) as the Fund's main tool for providing medium-term support to LICs with protracted balance of payments problems.
- The Standby Credit Facility (SCF) aimed at LICs with short-term balance of payments needs, similar to the Stand-By Arrangement (SBA).
- The Rapid Credit Facility (RCF) designed to provide rapid low-access financing with limited conditionality to meet urgent balance of payment needs.

In September, the IMF Executive Board also reviewed the LIC Debt Sustainability Framework (DSF) and adopted a more flexible policy on debt limits in IMF-supported programs.

The **Nordic Baltic** chair welcomed the proposed new architecture of facilities for LICs. The enhanced flexibility helps better tailor the IMF facilities to the diverse and changing needs of LICs. In the context of a global crisis, our chair supported increasing access limits and higher level of concessionality. The Nordic Baltic constituency viewed the increased uniformity of financial terms as a strengthening of equal treatment. However, we also underscored that risks to debt sustainability must be carefully considered, including in the more flexible approach on debt limits. We saw merit to review the new framework in a post-crisis setting.

IV. Surveillance

With reduced tensions in the global financial system, the updated priorities for IMF surveillance start shifting the focus to exit strategies that would allow for an orderly unwinding of crisis-related policy measures as soon as the recovery takes hold. Following a dry-run during the Spring Meetings the first full Early Warning Exercise (EWE) round was launched at the 2009 Annual Meetings. EWE is a joint IMF-Financial Stability Board product designed to assess systemic, low probability-high impact events to the global outlook and identify possible policy actions to mitigate those risks.

[8] IMF, The Implications of the Global Financial Crisis for Low-Income Countries – An Update, September 28, 2009.
[9] Although the bulk of these resources will come from the IMF, additional SDR 0.2-0.4 billion bilateral contributions will also be needed to cover the remaining gap.

In September, the IMF Executive Board assessed experience with the Financial Sector Assessment Program (FSAP) and considered further options for strengthening the program going forward.[10] Complementary reforms to financial sector surveillance and the assessment of standards and codes were also discussed. The Executive Board concluded that the FSAP had established itself as an important instrument for assessing countries' financial systems. It underscored the importance of FSAP participation by all systemically important countries and endorsed the proposals to enhance flexibility and strengthen analytical underpinnings of the program.

The IMFC welcomed the agreement reached by the G20 in Pittsburgh to develop a mutual assessment process and called on the IMF to assist the G20 in this process by developing a forward-looking analysis of whether policies pursued by individual G20 countries are collectively consistent with more sustainable and balanced trajectories for the global economy.[11] The timeline for the first year of implementation of this mutual assessment process was set during the G20 Finance Ministers and Central Bank Governors meeting in St. Andrews.[12] The IMF's involvement in this process raises certain legal and policy questions as the IMF's participation in the exercise is separate and distinct from the IMF's regular surveillance. The precise nature of the IMFs involvement shall become clearer as the process evolves.

The **Nordic Baltic** constituency considers surveillance being the core mandate of the IMF and supports efforts to strengthen the IMF's work in this area, particularly measures taken to enhance financial sector surveillance and to better integrate financial sector issues into the overall surveillance. In this regard, the Nordic Baltic constituency supported recent initiatives to enhance focus on the tail risks under the EWE, as well as the proposals to allow for greater flexibility in the FSAP. The constituency views increased regional surveillance as vital to detect cross-border linkages and inform the IMF's policy advice. It also notes that the parallel surveillance in other fora should not undermine the IMF's mandate.

V. GOVERNANCE

In response to the request by the IMFC the Fund's Executive Board presented a report on broad governance reforms for the 2009 Annual Meetings.[13] It was noted in the report that while preliminary Board discussions have yielded agreement in some areas, the topic is complex and more work is needed to refine proposals and garner broad consensus. In the view of the Board, recent experience during the current crisis confirms that the Fund's decision-making structures can deliver the innovative and rapid response to the needs and expectations of its membership. However, achieving a viable progress in the governance area remains an important objective in order to enhance legitimacy of the Fund and to maintain political backing, which is essential for the Fund's ability to deliver the results in accordance

[10] IMF-World Bank, The Financial Sector Assessment Program After Ten Years: Experience and Reforms for the Next Decade, August 28, 2009.
[11] Communiqué of the International Monetary and Financial Committee of the Board of Governors of International Monetary Fund, Press Release No. 09/347, October 4, 2009.
[12] G20 Communiqué: Meeting of Finance Ministers and Central Bank Governors, United Kingdom, November 7, 2009.
[13] IMF, Executive Board Report to the IMFC on Reform of Fund Governance, October 3, 2009.

with its mandate. In the meantime, it is important to conclude implementation of the already agreed reforms.[14]

Previously agreed by the G20 members in Pittsburgh, the agreement on the shift in quota share to dynamic emerging market and developing countries of at least 5 percent from over-represented to under-represented countries using the current IMF quota formula was confirmed during the 2009 Annual Meetings.[15,16] Achieving this target by January 2011 remains an ambitious task as the modalities of this transfer in quotas are yet to be developed. Given the interconnectedness of quotas with other elements of the Fund's governance, the most reasonable way forward would be to reach the agreement on a broader package of governance reforms within the set time frame.

The **Nordic Baltic** chair agrees that further progress in reforming the Fund's governance structure is important so as to safeguard the legitimacy and effectiveness of the Fund, as well as its future role. It is essential that the realignment of quota shares is principles based, aims to reduce the misalignments in members' quota shares as determined by the quota formula and is dealt with within the broader reform package. We welcome the proposals to enhance high-level engagement by strengthening the IMFC, whereas the proposal for transferring the IMFC into a Ministerial Council warrants further consideration. We note that the Board shall be at the centre of decision-making in the IMF, focus on key strategic issues and maintain its responsibilities in surveillance. The size of the Board should remain unchanged to allow adequate representation of the membership. While the prevailing norm of a consensus-based and efficient decision-making system should be preserved, the proposals to amend the voting rules merit further discussion. We strongly support the agreement that senior leadership of international financial institutions should be selected through an open, transparent and merit-based process.

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[14] A package of governance reforms requiring amendments to the IMF Articles of Agreement was agreed in April 2008. In order to enter into force these amendments need to be ratified by at least 111 member countries having 85 percent of the voting power. 42 countries having close to 70 percent of the voting power had ratified these amendments as of October 5, 2009.

[15] Communiqué of the International Monetary and Financial Committee of the Board of Governors of International Monetary Fund, Press Release No. 09/347, October 4, 2009.

[16] G20, Leader's Statement: The Pittsburgh Summit, September 24-25, 2009.

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