

The Nordic-Baltic Office
International Monetary Fund

Report 2010/1

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 report covers the main policy issues dealt with by the Executive Board ("the Board") in preparation for the 2010 Spring Meetings in Washington and through the summer of 2010, and outlines the Nordic-Baltic chair's position.

I. INTRODUCTION

The global economy is slowly recovering after the major financial crisis, though the pace of recovery remains uneven and subject to downside risks. The recovery is led by strong growth in emerging market and developing countries, which have entered the global crisis with stronger macroeconomic fundamentals and less financial vulnerabilities. While growth in many advanced economies remains sluggish, since the adjustment to the pre-crisis financial and macroeconomic excesses has not yet been completed, these countries also have to start dealing with the post-crisis legacies of large fiscal deficits, mounting debt, and high unemployment. Going forward, a sustained global recovery will require successful rebalancing from public to private demand and from deficit to surplus countries; from financial sector repair and reform, to policies that address record-high unemployment.

A systemically important event occurred in May 2010, when faced with increasing difficulties to finance unsustainably high fiscal deficit, Greece had to request exceptionally high financial support from the IMF and the EU. Consequently heightened concerns about sovereign debt problems in Greece and other advanced economies tested the robustness of the global recovery, triggering market volatility and reducing investor confidence.

The key policy discussions in the Executive Board since the 2009 Annual Meetings have focused on two broad areas – the Fund’s mandate and governance.

Measurable progress has been achieved during the discussions on the Fund’s mandate. The Fund’s capacity to assist member countries during periods of stress has been enhanced by reaching an agreement on the reform of the Fund’s precautionary lending toolkit. A number of other innovative ideas on lending mechanisms that could promote global stability are also being discussed. In the area of surveillance, key emphasis has been placed on strengthening the multilateral dimension and integrating financial sector surveillance into the bilateral surveillance. The Fund has also strengthened cooperation with financial sector standard setters, particularly with the Financial Stability Board, and played an active role in assisting the G20 in their collaborative efforts to increase policy consistency among the key advanced and emerging market economies. However, while the Fund’s contribution to the G20 Mutual Assessment Process was well regarded, non-G20 IMF members were concerned about ensuring the flow of information to the Executive Board and the possible resource implications for the Fund from its engagement in this process.

The Executive Board continued discussions on quotas and other governance reforms, although it has been difficult to overcome the remaining wide differences in views. With the January 2011 deadline for reaching an agreement on quotas, and in parallel on other governance reforms, coming close, the discussions became even more complicated as the US in August 2010 unexpectedly did not support the Board of Governors resolution to continue having the Executive Board comprising of 24 Directors.

Supplementary to the discussions on mandate and governance, important results were also achieved in strengthening the Fund’s support to low income countries. Following the devastating earthquakes in Haiti, the Fund established a framework for post-catastrophe debt relief, which allows the Fund to assist very poor countries hit by the most catastrophic natural disasters. More recently, the Fund also provided a subsidized loan of \$ 451 million in emergency assistance for Pakistan to help the country deal with the consequences of the massive floods. In addition to the IMF’s efforts, countries in the Nordic-Baltic constituency

participated in providing emergency assistance to Haiti and Pakistan, and increased their commitments to provide resources for concessional lending in general.

Since the beginning of 2010, the Executive Board also had roughly 150 discussions on individual country cases, among them considering program reviews for Iceland and Latvia, and concluding regular bilateral economic consultations with all countries in our constituency, except Denmark which is scheduled to take place later this year.

II. FUND'S MANDATE

At the Istanbul Annual Meetings in October 2009, the International Monetary and Financial Committee (IMFC) called on the Fund to review its mandate to cover the full range of macroeconomic and financial sector policies that bear on global stability.¹ In line with the IMFC request, the Executive Board started discussions on the Fund's role in the post-crisis world. The Executive Board focused on the Fund's role in the key areas of its mandate: surveillance, financing, and the stability of the international monetary system. During these discussions, the need to clarify and improve the Fund's role in promoting global economic and financial stability was well recognized and various proposals were discussed with an open mind. The Executive Board noted that progress in updating the mandate should move in parallel with broader governance reform, particularly on the size and realignment of quotas. A general conclusion was drawn that while some changes to the Articles of Agreement could be necessary, a lot could be done without changing the international treaty.

A. Surveillance

The Executive Board noted that given real and financial integration in the global economy and the systemic nature of risks to global stability, the multilateral dimension of surveillance should be strengthened and the analysis of macro-systemic and financial sector risks and linkages be enhanced. Among the measures to secure this objective, the Executive Board is considering the possibility to adopt a formal Executive Board decision on multilateral surveillance, and also modalities for discussing reports that focus on the broader systemic effects of individual country policies. In the area of financial sector surveillance, the importance of close cooperation with other international bodies and standard setters was noted, as well as the need for greater availability of financial data. Enhancing the analysis and oversight of capital flows was also noted among the priorities. The Executive Board has now decided to make financial stability assessments under the Financial Sector Assessment Program (FSAP) mandatory for countries with systemically important financial systems. The Executive Board emphasized that bilateral surveillance should remain a cornerstone of the Fund's surveillance activities.

The **Nordic-Baltic** chair recognized the need to strengthen the analysis of systemic effects and risks stemming from macro-financial linkages as one of the key lessons from the crisis. The Fund is uniquely positioned to carry out this task and policy discussions on these issues should be anchored in the Fund. The Nordic-Baltic chair saw merit in further exploring the possibility to adopt a multilateral surveillance decision, which would clarify the Fund's role and the members' obligations when engaging with the Fund on multilateral surveillance issues. The Nordic-Baltic chair expects members to explain their reasons if they do not implement the Fund's policy recommendations and supported making financial sector

¹ 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.

assessments under the FSAP mandatory for systemically important countries. It was noted that the current Fund mandate provides sufficient space for enhancing financial sector surveillance. However, in the longer run, the Nordic-Baltic chair could support a more explicit mandate on financial stability and oversight of capital flows, which would require amending the Articles of Agreement.

B. Financing role

During the discussions on the future financial role of the Fund, the Executive Board concluded that to remain relevant the Fund's ability to respond effectively to systemic liquidity needs shall be ensured. It was also agreed that further potential reforms of the IMF's lending instruments could only partly reduce countries' incentives for reserve accumulation. A broader discussion was also initiated on more innovative means of global insurance, among them the merits of potential multi-country credit lines and support to regional liquidity pools. The issue of an adequate financial role for the Fund requires balancing flexible and sufficient financial support with the need not to expose the Fund to excessive financial risk and creating moral hazard.

In August 2010, the Executive Board approved a set of reforms to further strengthen the Fund's capacity to assist member countries in preventing crises. The Flexible Credit Line (FCL) has been refined with a view to increase its effectiveness and predictability, and a new Precautionary Credit Line (PCL) has been established to broaden the availability of crisis prevention instruments to countries that have sound fundamentals and policies but do not yet meet the qualification standards of the FCL.²

The duration of the FCL has been increased to up to two years and an implicit cap on access of 1000 percent of quota has been removed. The decisions on access will now be based on individual country financing needs. To ensure adequate safeguards, the procedures for early Executive Board involvement in assessing the contemplated level of access and its impact on the IMF's liquidity position were strengthened. The Executive Board decision also provided that the access under the newly established PCL will be frontloaded with up to 500 percent of quota made available on approval of the arrangement and up to a total of 1000 percent of quota after twelve months.

The **Nordic-Baltic** chair supported the reform of the IMF's precautionary lending framework, noting that the reform will provide more flexibility to respond effectively to the evolving needs of its members. As a complement to the precautionary role played by the Fund's surveillance, the Fund's lending facilities should be designed to promote sound incentives for the private sector and for conduct of sound economic policies of the membership at large. A central role for the Board in approving the individual programs remains essential for strong multilateral ownership of the Fund's work.

The Nordic-Baltic chair considered the proposals to allow the FCL to run up to two years and the elimination of an implicit cap on access as appropriate. Strong macroeconomic fundamentals of the qualifying members and their good track record of policy implementation mitigate the risks for the Fund, whereas amended structure of commitment fees and trigger point for assessing the impact on the Fund's liquidity provides additional safeguards. However, the resource implications of the lengthened duration of the FCL arrangements is likely to be significant, therefore the Nordic-Baltic chair noted that it expects

² IMF, The Fund's Mandate – Future Financing Role, Press Release No. 10/124, September 3, 2010.

access levels in any successor arrangements normally to be lower than in the initial arrangement.

The Nordic-Baltic chair welcomed the creation of the PCL, which will provide insurance against short-term shocks for an important subset of countries not qualifying for an FCL arrangement, signaling their overall strong policies and institutions to market participants. At the same time, the relatively stronger, compared to the FCL, conditionality framework under the PCL instrument provides adequate safeguards for the Fund and balances the risks, including possible moral hazard.

The Nordic-Baltic chair welcomed a proposed review of the crisis prevention toolkit no later than two years after this reform was approved.

C. International Monetary System

In May 2010, the Executive Board discussed the linkages between official reserves accumulation and the international monetary system (IMS).³ Reserve accumulation has accelerated in the past decade and reached levels well above traditional benchmarks, particularly in emerging markets. While the increased reserves have served countries well during the crisis by allowing for smoother adjustment to shocks, accumulating reserves is costly because holding them entails that a larger part of national wealth is invested in low-yielding international assets. The Executive Board noted that the unprecedented buildup of reserves and their concentration in a narrow set of currencies points to systemic imperfections, such as the absence of automatic adjustment to imbalances, asymmetric adjustment to shocks, and uneven availability of international liquidity.

The Executive Board considered initial ideas and options that would help to reduce incentives for excessive reserve accumulation and to broaden the supply of reserve assets. The Executive Board called for improved analysis of volatile capital flows, as well as further analytical work on an appropriate level of precautionary reserves tailored to country circumstances, including the costs and benefits of holding reserves, and ways to address ratchet effects. Many Directors noted that a shift toward a more multi-polar system of reserve assets supply will likely evolve gradually over time. Many Executive Directors were ready to explore in greater detail options to enhance the role of the Special Drawing Rights (SDR), including possible increase in supply, revising allocation rules, and encouraging broader use of SDR-denominated instruments.

The **Nordic-Baltic** chair welcomed the opportunity to discuss broader issues related to global imbalances and reserve accumulation, and underscored the need to strengthen the analysis of structural factors that contribute to external imbalances. At the same time, the Nordic-Baltic chair was, at this stage, not entirely convinced about whether, and to what extent, larger use of SDRs could alleviate unwarranted implications of reserve accumulation. Finally, the Nordic-Baltic chair strongly supported strengthening the analysis of capital flows, including for improved data collection, and called for enhanced transparency of countries' composition of international reserves.

III. GOVERNANCE

A. Quota and Voice

Due to a wide variance in views among the constituencies on where the roots of perceived lack of legitimacy lay, reaching an agreement on the IMF's governance reform has proved to be difficult. There is a broad understanding that quota and representation of the emerging

³ IMF, IMF Discusses Reserves Accumulation and International Monetary Stability, Public Information Notice No. 10/72, June 4, 2010.

market and developing countries should be enhanced to better reflect their changing weight in the global economy. It is also recognized that realignment of quotas, which determine the voting shares of member countries, is a core element of the governance reform, and there is a strong commitment to conclude the next quota review before January 2011 in line with the parameters agreed in the 2009 Annual Meetings in Istanbul. However, given the inter-linkages and trade-offs among different reform elements, the agreement has to be reached on the overall reform package. Other issues considered in parallel to the discussions on quotas are: management selection, ministerial engagement, the Executive Board's composition and size, voting majorities, and staff diversity.⁴

Major remaining issues in relation to quotas are: deciding on the size of the quota increase and the principles to be used in allocating it to member countries; the size of the relative quota shift from over-represented to under-represented countries; and whether this shift could be achieved without further modifications to the formula used for calculating quota shares of the members. On all these issues, there has been a narrowing down of options thanks to subsequent discussions in the Executive Board. There is however also a remaining concern that the last round of quota and voice reform from 2008 has not been yet implemented.⁵ Simulations done by the IMF have shown that in substance, depending on the interpretation of the quota review objective, the targeted shift (as outlined in Istanbul) could be achieved using the current formula.⁶

In July 2010, the Executive Board continued discussions on elements of the governance reform other than the quota review. However, only less substantive issues garnered broad support. Despite agreement in principle that strengthening ministerial engagement is essential for the effective discharge of the Fund's responsibilities, views on the best means to deliver such engagement continued to differ. Directors restated their commitment to an open and transparent selection of the IMF management, noting that the same should apply to the selection of management of other international financial institutions. Most Directors reiterated that the current size of the Executive Board strikes an appropriate balance between representation and effectiveness. At the same time, many Directors were open to consider moving to an all-elected Executive Board that eliminates the right for the five largest shareholders to appoint their own Executive Director. A few Directors were in favor of lowering the threshold for special majorities, thereby removing the de facto veto power of the largest shareholder. Directors in general underscored the importance of regional, gender, and educational diversity of the IMF staff, and welcomed progress in these areas, while agreeing that more needs to be done.

The work on IMF governance took an unexpected turn in August 2010, when the United States declined to vote in favor of the proposed Board of Governors resolution on the regulations for the conduct of the 2010 regular election of the Executive Directors, preventing its adoption. Approval of the resolution was required to continue with the current

⁴ Communiqué of the International Monetary and Financial Committee of the Board of Governors of International Monetary Fund, April 24, 2010.

⁵ 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 113 member countries having 85 percent of the voting power. As of October 1, 2010, 88 countries having 81 percent voting power accepted the amendments.

⁶ In its October 4, 2009, communiqué the IMFC noted its support to "a shift in quota share to dynamic emerging market and developing countries of at least five percent from over-represented countries to under-represented countries using the current formula as the basis to work from."

size and composition of the Executive Board.⁷ The United States motivated their move by their aim to enhance the representation of emerging market and developing countries at the Executive Board, hinting that this should be achieved by reducing representation of the European countries.⁸

The **Nordic-Baltic** chair underscored that the Fund should remain a quota based institution, where the overall size of quota is determined by what is needed for the Fund to pursue its mission in full. The Nordic-Baltic chair is ready to accept a substantial, up to a doubling, increase in quota resources of the Fund, understanding that some resizing of the Fund's temporary resources under the New Agreements to Borrow (NAB) may be needed in this context. The distribution of quotas should be done in a rules-based way that treats all member countries equally. The outcome should reflect the evolving international economic weight of individual member countries as reflected by the formula and the Fund's mandate, while the voting shares of low income countries should be protected.

The Nordic-Baltic chair has further reiterated that the agreement on the comprehensive governance reform must be reached within the relevant IMF-bodies, where all members are represented. Constituencies should continue to be formed based on voting power and countries should be free to form constituencies of their choice. The current size of the Board has proved to work well for the diverse Fund membership and should not be changed. The role and authority of the ministerial committee must be strengthened, be it through a reformed IMFC or the introduction of an International Monetary and Financial Board (IMFB), as proposed by the IMF. The Nordic-Baltic chair supports an open, transparent, and merit-based process for appointing the heads of International Financial Institutions, notably the IMF and the World Bank. High quality staff is the most valuable asset of the Fund and aspiring for greater diversity in terms of national background, professional experience, and gender should strengthen the institution even further.

B. Transparency

Related to the broader debate on IMF governance, a review of the Fund's transparency policy was carried out in December 2009, assessing the experience with the IMF's initiatives to enhance transparency and seeking for possible room for improvement. Transparency is an important aspect of good governance and essential for legitimacy, since it ensures that the IMF and its members, in their dealings with the Fund, are accountable to the international society. The

⁷ Based on the Articles of Agreement, five members with the largest quota have the right to appoint their Executive Director, whereas other members have to form constituencies in order to elect their Executive Director in a contested election. The Articles of Agreement also establishes that the number of elected Executive Directors is 15. The Board of Governors may decide to change this number by 85 percent voting majority. However, this decision does not become permanent and should be repeated before every regular election of the Executive Directors in two years intervals. To reflect the changed geopolitical reality after the breakup of the Soviet Union and to accommodate the large group of new members joining the IMF, the number of elected Executive Directors was increased by 4 in 1992 and has remained stable since then.

⁸ Currently Germany, France and the United Kingdom, along with the United States and Japan, have the right to appoint their own Executive Director. Other European countries are able to elect 6 Executive Directors from their region, though Spain has to rotate the Executive Director position with Venezuela and Mexico. Ireland is represented within the constituency led by Canada. Countries in Central Asia have also voted for, and are represented by, the Executive Directors from Europe. Other emerging market and developing countries are currently represented by 12 Executive Directors: four from Asia (Chinese, Indian, Korean, and Thai); three from Middle East (Saudi Arabian, Egyptian, and Iranian); two from Latin America (Brazilian and Argentinean) and two from Sub-Sahara Africa (Sierra Leonean and Rwandan). Russia has also been able to elect its own representative.

review has marked roughly a decade of efforts to increase the transparency of the IMF's operations.

Starting in the late 1990s, the IMF has published an increasing number of country reports, policy papers, and other documents, opened the IMF's archives to the public, and engaged proactively with the public via the Fund's external website, press briefings, and general outreach. However, publication lags continue to vary considerably across countries and the timeliness of information available to the public sometimes remains constrained by still long publication lags on country reports. At the same time, some members have never allowed the publication of a staff report, including a few large emerging market economies.⁹

The review of the transparency policy established an overarching principle for the IMF's approach to transparency and put forward proposals to increase the amount and timeliness of information made available to the public. Based on the revised decision on transparency the Fund will strive to disclose documents and information unless strong and specific reasons argue against such disclosure. Nevertheless, the publication of documents that pertain to member countries will remain voluntary.

The **Nordic-Baltic** chair supported the proposals to enhance the Fund's transparency and was willing to endorse even more ambitious proposals in the direction toward greater transparency. The Nordic-Baltic constituency is strongly committed to transparency and stands out as the only multi-country constituency of which all members have published all of their country reports for an extended period of time. Publication of staff reports on our constituency countries also tends not to be delayed. The Nordic-Baltic Constituency puts efforts to inform outside audiences about the policy developments in the Fund and its positions on the key IMF policy matters, e.g. by having the Executive Director's office prepare semi-annual reports, which are posted on the websites of the central banks and finance ministries of the countries in our constituency.

IV. SUPPORT TO LOW INCOME COUNTRIES

During the reference period, substantial progress has been achieved in reforming the Fund's framework for supporting low income countries (LICs).¹⁰ The reform of the IMF's LIC facilities adopted in July 2009 became effective in early-January 2010.¹¹ After consents were received from all current lenders to the Loan Accounts of the Poverty Reduction and Growth Trust (PRGT), the new framework to facilitate mobilization of loan resources for the PRGT became effective in June 2010. A framework for updating the list of PRGT-eligible countries became effective in April 2010.¹² New initiatives were also launched to support poor

⁹ According to the IMF paper Review of the Fund's Transparency Policy, published in October 2009, Bahrain, Brazil, Brunei, Dominican Republic, Guyana, Myanmar, Oman, Saudi Arabia, Turkmenistan, and Venezuela have never published a country staff report.

¹⁰ IMF's paper Update on the Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Countries provides a comprehensive overview of progress in reforming the Fund's LIC support framework.

¹¹ The reform of the IMF's lending framework to LICs and the Nordic Baltic chair's position on the issue was presented in the previous Nordic-Baltic Office Report on Recent Policy Developments in the International Monetary Fund.

¹² Based on the new criteria for PRGT-eligibility, Albania, Angola, Azerbaijan, India, Sri Lanka, and Pakistan graduated from PRGT-eligibility.

countries hit by most catastrophic disasters. On June 29, 2010, Liberia reached the HIPC completion point and received \$ 730 million debt relief from the IMF.¹³

A. Mobilization of resources to LICs

The framework for mobilization of loan resources for concessional lending established a voluntary encashment regime allowing claims of participating creditors under loan and note purchase agreements to qualify as reserve assets. It created possibility to mobilize loan resources through the issuance of PRGT notes. The framework also provides possibilities to lend to the PRGT at shorter maturities than under traditional loan agreements, albeit it gives the discretion for the Fund to unilaterally extend the maturities for additional periods up to the maturity dates for the corresponding PRGT loan disbursements. The new framework accommodates the willingness of some creditors to lend to the PRGT in SDRs.¹⁴

The Executive Board underscored the urgency of securing new loan resources to ensure that the Fund remains in a position to meet LICs' needs, and welcomed the recent pledges of bilateral loan contributions; it urged other members, including potential new lenders, to be forthcoming with additional contributions. Directors also emphasized that, in addition to securing the needed loan resources, efforts must continue to mobilize the targeted additional subsidy contributions.

Thirteen members have pledged about SDR 9.3 billion in additional loan resources, compared to the target of SDR 10.8 billion (including provision for a liquidity buffer to facilitate encashment). New loan and note purchase agreements totaling SDR 7.2 billion have been signed so far with nine lenders. The package approved by the Executive Board in July 2009 for securing the needed subsidies remains adequate to finance the potential PRGT demand through 2014. Twenty members have committed additional subsidies totaling SDR 131.7 million, compared to the target for bilateral contributions of SDR 200 - 400 million.¹⁵ The targeted subsidy contribution from the windfall profits of the IMF gold sales now also seems to be secured.¹⁶

The **Nordic-Baltic** chair underscored the importance of ensuring adequate funding for concessional lending to LICs. Countries in our constituency substantially increased their commitments to provide loan and subsidy resources for concessional lending. Denmark and Norway have signed borrowing agreements with the IMF of SDR 200 million and SDR 300 million respectively. Sweden and Denmark also pledged new contributions to subsidy resources, respectively SDR 4.6 million and SDR 3.6 million.

B. Post-Catastrophe Debt Relief Trust

In June 2010, the Executive Board established a Post-Catastrophe Debt Relief (PCDR) Trust that allows the Fund to join international debt relief efforts to very poor countries hit by the most catastrophic of natural disasters. The PCDR Trust provides exceptional debt relief on eligible debt to help lower income PRGT eligible members meet the exceptional balance of payments needs created by qualifying catastrophic disasters—such as the recent devastating

¹³ IMF, IMF and World Bank Announce US\$ 4.6 Billion Debt Relief for Liberia, Press Release No. 10/267, June 29, 2010.

¹⁴ IMF, Update on the Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Countries, October 2010.

¹⁵ Ibid.

¹⁶ The mechanism for using windfall profits from the limited sale of IMF gold is described in the Nordic-Baltic Office Report 2009/2.

earthquake in Haiti—and the subsequent recovery. It complements fresh donor financing and the Fund’s concessional financing through the PRGT.

The PCDR Trust is financed through a transfer of SDR 280 million from the MDRI-I Trust. The remaining amount in the MDRI-I Trust is expected to be sufficient to cover the debt eligible for assistance from the MDRI-I Trust.

Haiti received debt relief from the PCDR Trust of SDR 178.1 million to cover its outstanding debt to the Fund (including as a Trustee). Following this operation, available resources in the PCDR Trust amounted to SDR 102 million. It is expected that, over time, members will contribute to bilateral resources as may be needed to ensure adequate financing of the PCDR Trust for potential future cases.

The **Nordic-Baltic** chair welcomed the proposed debt relief for Haiti and supported establishment of the PCDR Trust. Most countries in our constituency have agreed to bilateral and multilateral debt relief to Haiti in addition to significant assistance for the relief and reconstruction efforts. The proposed eligibility criteria for debt relief under the PCDR framework appears to be reasonable, helping to target the support to the most vulnerable cases. The Nordic-Baltic chair agreed that the existing projected surplus from the MDRI-I Trust could be used for the PCDR Trust. The MDRI-I Trust resources were intended to be used for purposes that broadly correspond to the stated purpose of the PCDR Trust.

V. STAFF OF THE NORDIC-BALTIC IMF OFFICE
as of September, 2010

Per Callesen	Executive Director, Denmark
Jarle Bergo	Alternate Executive Director, Norway
Kari Korhonen	Senior Advisor, Finland
Andres Sutt	Senior Advisor, Estonia
Lilja Alfredsdottir	Advisor, Iceland
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