

Statement by Mr. Geir H. Haarde
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on behalf of the Nordic and Baltic countries
i.e. Denmark, Finland, Estonia, Iceland, Latvia, Lithuania, Norway and Sweden
to the International Monetary and Financial Committee
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Introduction

The pace of economic recovery continues to be sluggish and projections for world economic growth in 2003 have been revised downwards. Global markets continue to deal with the aftermath of the excesses experienced during the equity price bubble period. In addition, the current outlook is subject to unusual uncertainties in view of the geopolitical situation. In several industrialized countries, fiscal deficits have reemerged and government debt is increasing. The scope for policy measures has narrowed. The uncertain outlook has proven to be difficult for many emerging-market economies. Their success depends not only on the global environment, but even more importantly on how successful they are in strengthening confidence in their economies and institutions.

Despite this gloomy short-term outlook, the world economy has shown remarkable resilience and one of the contributing factors is the growing emphasis on crisis prevention through increased surveillance, openness and transparency. Although considerable progress has been made in crisis prevention, financial crises will continue to occur and need to be resolved. The International Monetary Fund has played an important role in this area but needs to be supported by the private sector in order to successfully resolve crises. We encourage the international community to work together and build a strong crisis resolution framework.

Risks and Challenges in the Global Economy

The current geopolitical situation has added to uncertainties and has to some extent held back the recovery of economic activity. At this juncture, developments in the price of oil are unpredictable and if geopolitical uncertainties continue, consumer demand could be significantly affected. Also, there has been a rapid growth in household debt, which might hold back consumer spending even further and thus make the upturn slower than earlier envisaged.

As regards the reconstruction of Iraq after the war, we expect the multilateral institutions especially the UN to play a major role. The Fund and the World Bank should contribute in accordance to their respective mandate and jurisdiction.

Prudent fiscal policies contribute to confidence and the market rewards countries that pursue sound fiscal policies with lower borrowing costs and increased investment flows. One of the major challenges in the current economic environment is the need for prudence in the use of policy instruments. Budget deficits have reemerged both within the advanced and emerging-market economies, and government debt has been on the rise. Care should be taken that economic policies are conducted in such a way that governments do not spend beyond their means and that private investment is not crowded

out. Moreover, it remains important for all countries to assess fiscal policy from a medium term perspective.

Financial markets have been adjusting after a period of severe asset price volatility and corporate distress, and some risks remain on the horizon. First, further price adjustments cannot be excluded, influenced *inter alia* by geopolitical developments. Second, insurance companies, especially in Europe, are experiencing significant difficulties due to mispricing of underwriting risks and poor performance of their investments. There is a need for stricter enforcement of regulations and enhanced supervision of insurance companies. Third, private companies' pension funds in some countries are estimated to have sizable funding gaps. It is necessary to address this problem, especially if these funding gaps are not narrowed soon by a rebound in financial markets.

Prospects in Selected Economies

Monetary and fiscal policies have been utilized to mitigate the economic downturn in the **United States**; hence the scope for a further fiscal and monetary stimulus has been reduced. It is both understandable and prudent that the authorities use the remedies at hand, but it can be risky to provide an exceptional stimulus over a very short period of time. There has been a dramatic turnaround in US fiscal policy. At this juncture, fiscal policy is expansionary and there is a risk that fiscal deficits will become entrenched, which could have serious repercussions. We urge the authorities to return as soon as possible to a sustainable medium term fiscal path. This will help unwind the twin deficits and contribute to stability in financial markets.

The **European Union** continues to harmonize the rules and regulations for the single market to increase efficiency and benefits are expected from its enlargement. However, the current economic outlook for Europe is clouded with growth projections having been revised downwards, consumer and business confidence is low and budget deficits are on the rise. There are certain issues that need to be addressed in particular. First, it is important that European economies deal with their structural rigidities and accelerate reforms of labor, product and capital markets in order to stimulate economic growth. These reforms will boost confidence in the economy if they are implemented promptly and decisively. Second, fiscal consolidation is necessary especially in countries that are close to or beyond the limit of the Stability and Growth Pact. Finally, as the numbers of retirees are rising fast, the current economic challenges have to be dealt with in a way that will enhance Europe's capacity to address the demographic pressures of the aging population.

Economic growth in the **acceding countries** has been more robust than envisaged. However, there are certain imbalances emerging in some economies such as large fiscal and current account deficits that need to be tackled before they become a hindrance to growth and future prosperity.

Japan needs to address its severe economic difficulties through further monetary easing and substantial structural reforms. The slight recovery of growth last year has not been sustained and the prospect of an export-led recovery has diminished. In addition, deflationary pressures reemerged in the last quarter and the authorities are running out of

policy options that could ease the economic difficulties. Policy makers have to deal with the liquidity trap facing monetary policy. In the current situation, monetary policy has become ineffective in improving the economy. Government debt is high relative to GDP and the scope for fiscal measures is close to being exhausted.

The economic performance of the **emerging market economies** has varied considerably. The economies in Asia have been doing remarkably well. Economic growth in Turkey has exceeded expectations, but the situation remains fragile and there is little room for policy slippages. Most Latin American economies experienced severe economic difficulties last year and there has been limited scope for using fiscal stimulus to mitigate the downturn, especially as government debt is high in many Latin American countries. Significant pressure has been put on public debt management due to the large amount of foreign currency denominated debt and short-term debt. In addition, some economies in Latin America find themselves in a difficult situation due to weak institutions, governance problems and inappropriate economic policies. This relates *inter alia* to Argentina. It is very important that sound economic policies are pursued. Governments must remain aware of the risks associated with their debt at all times and ideally create some room in their economic policy during good economic times. This would enable them to consolidate fiscal positions and reduce their vulnerability to volatilities in foreign capital flows. Policies aimed at making tax collection more effective should be encouraged and domestic savings increased. Furthermore, Latin American economies need to increase investor confidence in their policies and institutions by promoting transparency and good governance in addition to the necessary fiscal consolidation.

The International Monetary Fund and Policy Matters

Fund policies are subject to continuous scrutiny and recently a great deal of progress has been made in improving the Fund's operations. This includes work on sovereign debt restructuring, strengthening the voice of developing countries and countries in transition, renewing the guidelines for surveillance and conditionality, and a review of access policy. In addition, considerable progress has been made in the area of transparency and openness. We welcome this progress and support all further efforts by the Fund in improving its policies on transparency and external communication.

Strengthening Crisis Prevention: FSAP, Prolonged Use of Fund Resources and Institutional Capacity Building

The Nordic-Baltic Constituency believes that the quality of financial sector surveillance should be comparable to the analysis of traditional Fund surveillance areas. We welcome the recent review of the financial sector assessment program (FSAP) and we strongly support the FSAP as it has proved to be a valuable instrument in raising awareness among participants of the importance of a sound financial system, identifying weaknesses, and encouraging governments to address them. The FSAP has also contributed to increased transparency and promoted greater data availability, thereby facilitating surveillance. Most countries that have participated in the FSAP find them useful and we strongly encourage all members to participate and to publish the main reports. In addition, we welcome the integration of Financial Action Task Force (FATF)

recommendations on anti-money laundering and combating terrorist financing into Reports on Observance of Standards and Codes (ROSC) modules and FSAPs.

The Independent Evaluation Office (IEO) report on the Evaluation of the Prolonged Use of Fund Resources has revealed that prolonged users represent half the total number of ongoing Fund supported programs. This is worrying and the Fund has to address this issue decisively and systematically. The Nordic-Baltic Constituency is concerned that the credibility of the Fund will suffer if its facilities are extended excessively and resources continue to be made available despite policy slippages, especially since the Fund has limited resources that need to be continuously revolving. Therefore, we welcome the proposed measures that have been put forth to address the problem of prolonged use of Fund Resources. However, there are two points that we would like to underline in this context. First, the Fund is encouraged to be more selective in determining whether a country is prepared to implement a program. Second, we reiterate our view that it is necessary to clearly distinguish between habitual prolonged users and those who have used precautionary arrangements primarily as an instrument to guide policies through the challenges of reform and transition.

Experience from Fund programs shows that successful program implementation depends primarily on the domestic political economy in borrowing countries. As a matter of fact, many programs are interrupted because of political or economic turmoil where it is difficult to come to an agreement on the necessary policies or revision of a program. This finding indicates that political commitment is of decisive importance for the promotion and success of Fund programs. The Nordic-Baltic Constituency, therefore, encourages the Fund not to enter into financial arrangements with countries where political commitment to effective policies is obviously insufficient.

The Nordic-Baltic Constituency would like to stress the importance of institutional capacity building as one of the major contributors to economic prosperity. The Fund has an important role to play in promoting institutional reforms through its surveillance and technical assistance activities. In this context it is important to increase the transparency of government activities and strengthen the governance of the financial sector. International organizations can assist in developing stronger institutions; however, the main responsibility to improve the institutional framework lies with the countries themselves.

Enhancing Crisis Resolution: Access Policy, CACs, SDRM and a Code of Good Conduct

The Nordic-Baltic Constituency welcomes the new framework for criteria and procedures in exceptional access cases. One of the advantages of the new framework is that it is based on more clearly defined criteria and is likely to become more transparent and efficient than earlier. Strengthening the rules of access policy is the best insurance against irregular approaches in dealing with capital account crises. Despite a more clearly defined access policy, there will nevertheless still be a need for a framework for timely and orderly restructuring of unsustainable sovereign debt.

We welcome the crisis resolution framework that is emerging based on the Collective Action Clauses (CACs), an SDRM and a voluntary Code of Good Conduct. Our constituency believes that these three approaches complement each other and that they will improve debt restructuring.

The Fund has presented the IMFC with a draft proposal outlining the key features of a sovereign debt restructuring mechanism (SDRM) as requested at the last meeting of the IMFC. The Nordic-Baltic Constituency fully supports an SDRM and believes that the current proposal needs to be developed further and outstanding issues clarified. Furthermore, it will be important for the Fund to further improve its debt sustainability analysis.

In parallel to the work on an SDRM, considerable effort has been put into the development of model collective action clauses for international bonds. We encourage countries to include CACs in new issues of sovereign debt in foreign jurisdictions. In this respect, we welcome Mexico's initiative to include a collective action clause in its recent bond issued under New York law. We strongly encourage other governments to follow suit. Furthermore, we welcome the EU-member states intentions to use contractual provisions based on the framework developed by the G10 when issuing bonds in a foreign jurisdiction and/or governed by foreign law.

Work is progressing on a voluntary Code of Good Conduct for debt restructuring; however, we believe it is necessary to clarify further the text of the draft code so the parties involved in debt restructuring negotiations will be better informed about what is expected from them. The Nordic-Baltic Constituency believes that a Code of Good Conduct could complement both an SDRM and CACs, as well as providing an important interim step until an SDRM becomes effective and CACs have become the norm.

These approaches to debt restructuring all contribute in creating a comprehensive and viable framework for effective crisis resolution that will provide the international community with the benefits of a fair, rapid, and orderly resolution of unsustainable sovereign debt. It is our firm belief that an SDRM would complement the non-statutory approaches as being a more effective instrument in dealing with aggregated claims in comprehensive debt restructuring.

IMF and Developing Countries

The international community has been joining hands in various efforts to combat poverty and promote higher living standards in developing countries. Common undertakings, such as the Heavily Indebted Poor Countries (HIPC) Initiative, the Millennium Development Goals, the Monterrey Consensus, and the WTO's Doha commitment, are all steps in this direction. The Nordic-Baltic Constituency encourages the industrialized countries to increase their official development assistance (ODA) so that it will be possible to eradicate extreme poverty and reach the Millennium Development Goals. These joint efforts by the international community are of great importance, but in order to raise income and living standards in the medium term, it is necessary to secure sustainable growth. The challenge currently facing the international community is to fully incorporate the developing countries into the world economy through globalization and

trade. Also, it is important to strengthen their voice in the Bretton Woods institutions and promote the HIPC Initiative.

Trade and Market Access

As open economies tend to have greater growth potential, it is important to send a strong signal to consumers, producers and markets that further trade liberalization will be pursued and implemented. Small and less advanced countries especially have much to benefit from strengthened multilateral rules governing trade. Therefore, it is necessary that the Doha Development Agenda negotiations regain momentum and that results are achieved before the WTO ministerial meeting in Cancun. Of particular importance to many developing countries are the proposals for increased market access, a reduction in or phasing out of export subsidies and substantial reduction in trade distorting domestic support. In addition, rules of origin need to become more simple and transparent. Although the onus of adjustment will be mainly on the industrialized countries, it should not be ignored that substantial benefits will emerge for consumers in these countries. While a freer trade environment, both between developing and industrial countries and among developing countries opens up new opportunities for the poorest countries, investment is needed in order to take advantage of these opportunities.

Strengthening the Voice of the Developing Countries at the Fund

The Nordic-Baltic Constituency has traditionally both encouraged and advocated an increased say for developing countries in the international community. We believe that it is very important to implement the Monterrey Communiqué's call for a strengthened voice of developing countries in international financial institutions. Strengthening capacity building at constituency and country levels is strongly supported by our constituency. This includes adding Assistants and Advisors to Executive Director's offices, increased technological support, e.g. to facilitate communications, and additional external analytical support. Furthermore, we support giving increased weight to problems affecting developing countries in the discussions of the IMFC. Other measures that merit our support concern augmenting the voting power of developing countries through an increase in basic votes and possibly adding an Alternate ED to developing country chairs in the Executive Board.

The HIPC Initiative

Some developing countries that have reached their decision point, now risk reaching the completion point with unsustainable levels of debt. If such a situation should arise it would defy the very purpose of the initiative. The Nordic Baltic Constituency is therefore prepared to discuss the various measures that can be taken to *topping up* debt relief at the completion point in order to ensure debt sustainability. Such extra debt relief should only be provided to countries where exogenous factors have caused fundamental changes to a country's economic circumstances that have made the originally agreed debt relief to be insufficient. Also, additional relief should first and foremost be provided to countries that have followed sound economic policies.

Donor countries that have agreed to write off completely official developing loans to HIPC countries do this as an additional effort to improve the conditions of the country in question and not to reduce the debt relief provided by other creditors. The rules for calculating debt sustainability at the completion point should therefore be amended so they do not distort the burden sharing among the creditors and to ensure that such efforts really become additional debt relief.

Final Remarks

Despite the gloomy short-term outlook, positive developments are taking place on several fronts and growth projections for 2004 point to a gradual recovery on the whole. Measures to create an environment where investors will be more willing to take risks are being implemented after a period marred by discoveries of malpractice in the corporate sector. Historic developments have taken place in Europe, with ten new countries having been invited to join the European Union. Also, the emerging-market economies in Asia are growing strongly and repaying debt. Finally, it is important to work towards a general consensus among both the developed and developing nations to reduce debt to a sustainable level in the poorest countries and to further open up trade in order to create conditions that will unleash the economic potential of the developing nations.

The Nordic-Baltic Constituency believes that the International Monetary Fund has played an important role in the world economic system and that it will continue to do so by advocating sound economic policies through its surveillance and lending activities.