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Statement by Mr. Haarde

**Statement by Mr. Geir H. Haarde, Minister of Finance of Iceland,
on behalf of the Nordic and Baltic countries i.e.
Denmark, Finland, Estonia, Iceland, Latvia, Lithuania, Norway and Sweden
to the IMFC Meeting in Washington,
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The Global Economy: Prospects, Risks and Challenges

The global economy has shown substantial and noteworthy resilience in the face of various occurrences that earlier would have been likely to cause significant disturbances. While the global financial system has coped well so far, its ability to absorb additional shocks may have weakened.

In recent months the world economic outlook has deteriorated and world markets have been marred by uncertainties. Economic indicators emit mixed signals on short-term developments, which tend to exacerbate uncertainty and increase risk aversion among investors. These developments are reflected in downward revisions of the growth forecasts for most countries and increased volatility in markets adding to concerns stemming from irregularities in accounting practices. Furthermore, uncertainties remain in troubled emerging markets and regional security concerns compound global uncertainty.

Downside risks to global recovery have increased significantly. To underpin the recovery, policy makers are faced with the challenge of standing ready to respond in an appropriate fashion should prospects worsen, while adhering to a medium-term framework in their fiscal and monetary policy formulation.

In the United States, economic growth has so far shown resilience. However, recent economic data indicate that the economic recovery is slower than expected. The resilience of the economy is not least due to the stimulative stance of both fiscal and monetary policy. But this has also meant that the fiscal position has deteriorated and a budget deficit has reemerged. With a medium-term perspective, care should be taken to keep public finances on a prudent course and to address concerns related to the low national savings rate and the large current account deficit. The United States international financial position poses a severe risk of substantial corrections in the USD exchange rate with potential serious repercussions for the global economy.

In Europe, the short-term outlook remains stable but prospects are uncertain and the economic recovery more muted than anticipated. Fiscal imbalances have been on the rise, financial markets have been volatile and there are no significant signs of improvement in the labor market. The rigidities in European labor markets are likely to slow the pace of economic recovery. Additional action is needed to reform the labor market in order to decrease persistent structural unemployment. A further strengthening of the fiscal position is necessary, especially in the medium-term, due *inter alia* to problems relating to the aging population. The euro area in particular should address these deficiencies in order to reap the full benefits of the single currency.

The European Union accession process and its timetable has been a major factor in promoting sound economic policies in the accession countries along with continued economic growth, structural reforms, and sustainable debt levels. It is important that enlargement by up to ten countries be agreed by the European Union at the Council meeting in Copenhagen in December 2002.

Prospects for the Japanese economy continue to be volatile and perceived signs of recovery have been illusory. The same long-standing structural impediments continue to adversely affect the economy. Actions taken by the authorities to address them have so far only had a moderately positive influence. The main problems continue to be how to boost confidence and how to resolve the banking sector's deep-rooted difficulties. In particular, we find it important that the issue of non-performing loans is addressed directly by the government. Strong and decisive action is needed, especially in the banking and corporate sectors. Furthermore, the authorities should be on the alert concerning the mounting government debt, which in the medium-term has to be stabilized and eventually reduced.

The emerging market economies have recently shown mixed results. Some countries have shown generally adequate export growth and improved credit ratings as reflected in narrower bond spreads. The situation in some other countries gives cause for concern. We are particularly concerned about the developments in Latin America as the continent is again experiencing financial difficulties. The comprehensiveness of the Fund programs currently envisaged places a heavy responsibility on both the Fund and the program countries. The Fund has an obligation to ensure effective program design and country authorities themselves should take full responsibility for the required action. It is of crucial importance that governments in Latin America demonstrate a determined will to implement policies that build confidence in their markets and foster stability. Good governance and sound institutions are imperative in this endeavor. The fiscal balance must be such that it will not jeopardize debt sustainability. Monetary policy should be adjusted to the prevailing economic situation and a stable monetary anchor established where it is lacking.

Challenges on the Horizon

Two important issues figure high on the international agenda; one relates to governance and the other to world trade.

Governance

As we have recently witnessed, improvements in governance are relevant in all countries. Some of the difficulties that the world economy is currently faced with can be attributed to weak governance, both in the conduct of government policy as well as within the corporate sector.

Sound institutions and good governance are essential for economic and social development. Governments have the responsibility to nurture good governance and to ensure fiscal transparency. Experience has shown that countries with serious governance problems have had difficulties in attracting capital. This has limited their growth opportunities and underlines that governments have to set a good precedent in governance matters.

Sound corporate governance makes the difference between success and failure, particularly at times when uncertainty prevails in the financial system. Recent problems in the United States corporate sector have sent jitters throughout world markets. The falling markets have weakened consumer confidence and spending. If stock markets are to work efficiently it is important that investors are provided with accurate and correct information. Actions taken by the United States and by European countries in order to increase transparency are important in addressing these issues. We encourage other countries to be on the alert against possible malpractice in the corporate sector and to be prepared to take appropriate action.

The World Trading System

Growth in world trade has been fuelled by progress in trade liberalization. While great strides have been made, there is still much to be achieved in terms of increased welfare by freer trade in various goods and services. For the developing countries, freer trade in agricultural products and textiles would be especially beneficial in the long run. Trade in services such as tourism, banking, and insurance is of growing importance and has the potential to become a

key source of income in many regions of the world. We encourage the industrial as well as the developing countries to consider the merits of further opening-up their markets and reducing trade-distorting subsidies thereby unleashing new opportunities for trade led growth.

Recently, the Fund has placed greater emphasis on trade issues. The Nordic-Baltic countries welcome this, provided that the focus is kept on the macroeconomic elements of trade. This includes trade in financial services as well as trade related aspects of capital movements.

The International Monetary Fund and Policy Matters

Fund Surveillance and Crisis Prevention

One of the major contributing factors in the Fund's crisis prevention is its surveillance role. The Nordic-Baltic countries welcome the increased emphasis on financial sector surveillance (FSAP). Furthermore, we welcome the renewal of the Guidelines on Surveillance and increased emphasis on the follow-up on how authorities respond to the policy advice given by the Fund.

We support the Fund's efforts to strengthen its analytical tools *inter alia* aimed at determining when a country is reaching a level of unsustainable debt. Institutionally, the Fund is very well placed to monitor and forecast debt levels of individual countries, and to assess sustainability through its regular surveillance activity. A thorough debt sustainability analysis is central to the assessment of repayment capacity and thus instrumental in the Fund's lending decisions.

The transparency policy that the Fund has implemented in recent years has had a beneficial influence on surveillance and made the Fund as a whole more transparent and its policies more accessible to the public. The next phase is in the hands of member countries, therefore, we encourage more members to allow the publication of International Monetary Fund reports on their country, in order to further promote transparency.

Conditionality and Ownership

We welcome the Fund's efforts towards strengthening the effectiveness of its programs by streamlining and focusing conditionality and fostering greater national ownership of programs. We stress that measures covered by conditionality need to be clearly justified and be critical to a program's macroeconomic and financial stability objectives while preserving the strength of the programs. We believe that it is necessary to adhere to the principle of parsimony in applying conditions.

Anti-Money Laundering and Combating Financing of Terrorism

The Fund has an important role to play in ensuring the integrity of financial markets. This includes fostering compliance with international standards in the fight against money laundering and financing of terrorism. We appreciate the Fund's contribution in the fight against money laundering and the financing of terrorism on a global scale. We believe that the Fund should primarily focus on the assessment of financial and regulatory aspects, while external experts should bear the responsibility for assessing law enforcement. We welcome the joint effort by the Bretton-Woods institutions and the Financial Action Task Force (FATF) to finalize a comprehensive Anti Money Laundering (AML) and Combating Financing Terrorism (CFT) methodology in consultation with other standard-setting bodies. We support the suggestion to add the FATF 40+8 recommendations to the list of areas and associated standards and codes useful to the operational work of the Fund and the World Bank.

Quotas

The Fund's size has shrunk relative to most traditional indicators, but we do not think it is necessary for the Fund to grow automatically in line with indicators such as world trade and global output. To avoid moral hazard and ensure adequate private sector involvement, the Fund should always operate under the perception of limited, albeit adequate, resources.

At this juncture, the Nordic-Baltic constituency is skeptical about the need for a quota increase. The Fund has access to adequate liquidity through the large borrowing arrangements. More work is needed before we can make a conclusive assessment of the appropriate size of the Fund.

Access Policy and Crisis Resolution

We welcome the recent discussion in the Board on access policy in capital account crises. We would like to stress that exceptional access should only be granted after a thorough debt sustainability analysis has been made. The establishment of clearer guidelines and safeguards to ensure that lending beyond access limits is only provided in truly exceptional cases is welcome. It is important to strengthen the documentation and procedural requirements for access above normal lending limits. Furthermore, we welcome the increased emphasis placed on raising the "burden of proof" required in the Fund's documentation when access is above normal lending limits. These proposed improvements are important steps in making access policy more effective.

In the context of access policy and exceptional lending, it is important to make the Prague Framework for Private Sector Involvement (PSI) operational. Private sector creditors have to be made responsible for their own actions in the financial markets. They must not expect the International Monetary Fund or other international financial institutions to bail them out. In this regard we are concerned about the lack of PSI in recent programs.

Debt Restructuring in Crisis Resolution

The Fund has taken important steps towards addressing the problem of unsustainable debt by putting forward a twin track proposal for a new comprehensive debt-restructuring framework.

Strong emphasis should be placed on the inclusion of collective action clauses (CAC's) in sovereign bonds, as they can be advantageous for both creditors and debtors. Such clauses can increase the predictability of a possible future restructuring process and help to resolve the problems of inherent conflict between the groups of creditors. We believe that including CACs in bonds of industrial economies could be a way of changing market practice and increasing the possibility for broader progress. We also believe it is appropriate that potential first mover costs and signaling costs should be borne by strong issuers. Such an effort would increase the likelihood of emerging market issuers including collective action clauses in their bonds. In this respect, we welcome the recent decision of the European Union countries to include CACs in their international bond issues.

The Fund should continue to develop the proposed sovereign debt restructuring mechanism (SDRM). The SDRM has evolved since First Deputy Managing Director Anne Krueger presented it last autumn and we welcome the progress that has been made on this very important issue. We believe that the SDRM would lead to a more orderly, prompt and predictable restructuring that would be less prolonged and damaging than the existing process. However, there are a number of outstanding issues, for example the appropriate role of the Fund, the scope of debt to be covered within the mechanism, and deciding when the proposed SDRM will be applicable. We would welcome further work by the Executive Board with a view to present a coherent proposal for an SDRM for discussion at the Spring meetings in 2003.

Poverty Issues

One of the most important challenges facing the global economy is the ongoing struggle against poverty. This is a battle that can only be won by a joint effort. The Monterrey Consensus represents a milestone in this fight and both the industrial countries and the low-income countries have a role to play. Also, we welcome the World Trade Organization's decision in Doha to put the needs and interests of developing countries at the heart of the World Trade Organization Work Program. During the recent World Summit on Sustainable Development in Johannesburg the necessity to progress towards broad-based sustainable growth was clearly underscored.

Only six of the twenty-six countries that have reached the decision point have now reached their completion points under the HIPC Initiative. Some heavily indebted poor countries (HIPC) may not reach a sustainable debt situation at the completion point due to exogenous factors. Thus, additional financial assistance might be called on, as the current resources are not likely to be sufficient. To avoid the moral hazard that increased flexibility might entail, it is necessary to create a framework for additional finance, prior to providing it. As a first step, however, the financial gap in the HIPC Trust must be closed.

The PRSP approach represents a comprehensive framework for efforts to reduce poverty. The program is constantly under review and so far these reviews have led to the conclusion that, broadly speaking, this approach is working well. It has contributed to a significant progress in eradicating poverty, not least because it is country led, comprehensive and based on broad consultations. However, there is still clear scope for improvements and continuous evaluation. We believe that participation could be enlarged and particular emphasis should be placed on the business sector, which is currently underrepresented. Care should be taken to ensure that spending priorities are focused on social welfare issues such as healthcare and education. While some degree of flexibility has been introduced to allow for prompt implementation, special attention is needed to make sure that this increased flexibility does not take place at the cost of the quality of the programs.

The Fund's main objective is to promote macroeconomic and financial stability, both of which are necessary prerequisites for successfully raising living standards and for eradicating poverty. The fight against poverty can only be successful if the poor countries themselves lead the way, but with the Fund and other international organizations there to support them.