July 2017

Office of the Nordic-Baltic Constituency

VIEWS AND POSITIONS ON POLICY DEVELOPMENTS IN THE INTERNATIONAL MONETARY FUND

Semi-Annual Report

This report is prepared by the Office of the Nordic-Baltic Constituency (NBC), representing Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden in the International Monetary Fund's Executive Board. The purpose is to present the positions taken by the Nordic-Baltic chair in the Executive Board and to update interested audiences on IMF issues. The report is not a thorough review of IMF's work, but aims at presenting the key discussions over approximately the past six months through July 2017. The next report is scheduled for January 2018.

The IMF has 189 member countries. Each of them is represented by an Executive Director on the 24-member Executive Board. The IMF supports its membership by providing:

- policy advice to governments and central banks based on analysis of economic trends and cross-country experiences;
- research, statistics, forecasts, and analysis based on tracking of global, regional, and individual economies and markets;
- loans to help countries overcome economic difficulties;
- concessional loans to help fight poverty in developing countries; and
- technical assistance and training to help countries improve the management of their economies.

For additional information, we generally refer to the IMF's website, www.imf.org, which we have also benefited from while preparing this report.

August 2, 2017

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1 INTRODUCTION

This report provides an overview of the main Executive Board discussions and other IMF related issues during the first half year of 2017.

The anticipated pickup in global growth remained on track, with global output projected to grow by 3.5 percent in 2017 and 3.6 percent in 2018. Despite unchanged growth projections in the July update of the World Economic Outlook (WEO), the projected contributions to global growth changed from April. The US projection was reduced due to lower expectations of expansionary fiscal policy going forward, while a stronger growth momentum was anticipated for the euro area and Japan. Despite an improved short-term outlook, headwinds to medium-term growth remained, including from aging related challenges, weak investment and low productivity growth. Abrupt market corrections, rising vulnerabilities related to continued credit expansion in China, faster-than anticipated tightening in global financial conditions, inward-looking policies, and geopolitical factors constituted further downside risks. The IMF policy advice remained focused on reforms to boost potential output, calling for a comprehensive, consistent, and well-communicated policy mix.

Further progress in global economic growth hinged on policies to lift productivity growth and countries' resilience needed to be enhanced given continued downside risks, according to the Managing Director's Global Policy Agenda (GPA) at the April Meeting of the Fund's International Monetary and Financial Committee (IMFC). The "three-pronged approach" where domestic policies all pull in the same direction, should be used to help growth. Possible ways for increased resilience included balance sheet repair, reducing excess leverage, and economic diversification. While noting the substantial economic benefits of rapid technological progress and a cooperative multilateral framework for trade and financial integration, the Managing Director emphasized that some groups have been left out. Therefore, policies for more inclusive growth and greater sharing of the benefits needed to be put in place. Increased protectionism would make everyone lose.

During this period, the Fund continued its work on many of the GPA focused areas. The Fund has also been exploring options for strengthening the Global Financial Safety Net (GFSN) and examining how countries could increase their resilience to large and volatile capital flows. In addition, the Fund continued to assess global imbalances and their causes, highlighting practices that are distortive of the International Monetary System (IMS) and providing policy recommendations to address excessive imbalances. On the growth and productivity discussion, the Fund has used a new toolkit to identify structural policy gaps to make member tailored recommendations for reforms to boost productivity, investment, and growth in addition to giving policy advice based on the three-pronged approach. In its surveillance work and policy discussions, the Fund continued to focus on sustainable and inclusive growth, emphasizing the importance of adequate social safety nets and equal opportunity. In this context, "macro-critical" issues affecting the members have been emphasized such as social protection, climate change, migration, gender equality, corruption, and financial inclusion.

2 SURVEILLANCE & ECONOMIC POLICY

2.1 Global Economic & Financial Developments

CONTEXT: The IMF's Flagship Reports, World Economic Outlook (WEO), Global Financial Stability Report (GFSR) and Fiscal Monitor (FM), were published on April 6 and the Managing Director's Global Policy Agenda (GPA) on April 20, in connection with the IMF and World Bank Spring Meetings. In July, the Fund updated its forecasts for the global economy.

The April **WEO** concluded that the global economic activity had picked up with cyclical recovery in investment, manufacturing, and trade. World growth was expected to rise from 3.1 percent in 2016 to 3.5 percent in 2017 and 3.6 percent in 2018. Stronger activity, expectations of more robust global demand, reduced deflationary pressures, and optimistic financial markets were upside developments. There were, however, structural impediments to a stronger recovery and risks were tilted to the downside, which created challenges. The July updated WEO global growth projections were unchanged from April, but country contributions shifted somewhat. The US growth projections were revised down on assumptions of less expansionary fiscal policy than expected, but projections in the euro area and Japan were, on the other hand, revised upward, due to increased activity. China's growth projections were also revised up, reflecting a strong Q1 2017 and expectations of continued fiscal support. For the UK, the growth forecast was revised down on weaker-than-expected activity in Q1 2017.

The **GFSR** found that financial stability continued to improve. Economic activity was gaining momentum and higher longer-term interest rates helped boost the earnings of banks and insurance companies. Despite these improvements, threats to financial stability were emerging from elevated political and policy uncertainty around the globe. If policy developments in advanced economies make the path for growth and debt less benign than expected, risk premiums and volatility could rise sharply. Staff particularly highlighted that there should be no rollback of the post crisis reforms that have strengthened resilience and oversight of the financial system.

The **FM** noted that fiscal policy had gained prominence, both in public debate and in government policy. A reassessment of fiscal policy was taking place, stressing its greater role in fostering sustainable and inclusive growth and smoothing the economic cycle. At the same time, high levels of public debt required a better understanding and management of fiscal risks. Fiscal policy had the difficult task of achieving more in a more constrained environment.

The **GPA** concluded that the global economy was gaining momentum, but further progress hinged on policies to support the recovery, lift productivity growth, and enhance resilience. Rapid technological progress, a cooperative multilateral framework for trade, and financial integration had served countries well, producing large economic benefits. However, some groups had not been able to share in these benefits, a trend exposed by a too-slow post-crisis recovery, which limited the room for all segments of society to experience income gains. Working within the multilateral framework, countries should strive for strong and more balanced growth and to provide economic opportunities for all.

Nordic Baltic Constituency (NBC) VIEW: The NBC broadly agreed with the Fund's assessment of the global economy and financial developments. The NBC stressed that the positive developments should not distract from the implementation of comprehensive and well-targeted policies that strengthen resilience and improve the growth potential. A cyclical recovery was underpinned by stronger investment and confidence, though the medium-term prospects were more modest due to structural challenges, such as low productivity growth and demographics. Growth-friendly fiscal policy, including infrastructure investments, could be warranted where conditions allowed. In its IMFC statement, the NBC emphasized that the IMF should be the key institution in helping countries to adjust and reap the benefits of globalization and technological progress in an inclusive way.

FURTHER READING: World Economic Outlook, April 2017, World Economic Outlook, July 2017 Update, Global Financial Stability Report, Fiscal Monitor, Global Policy Agenda and IMFC Statement of the NBC.

2.2 Bilateral & Regional Surveillance

CONTEXT: During the reporting period, the IMF Executive Board concluded regular so called Article IV Consultations with six of the Nordic-Baltic countries, namely, Denmark, Estonia, Iceland, Latvia, Lithuania, and Norway. It also concluded discussions with some key economies, for example the euro area and the US. These discussions are summarized in Box 1, but the full country reports of the Fund on the consultations are available on its website.

NBC VIEW: The Nordic-Baltic authorities highly appreciated the IMF's analysis and policy recommendations for our respective economies and the euro area, which four of the NBC's countries are members of. The Fund's analysis had the right focus on topical issues and received good traction with the home authorities. In the US Article IV Consultation, the NBC highlighted the need to address the rising public debt and encouraged the authorities to take steps to address the increasing poverty and inequality rates. Policy action was needed in multiple areas, such as tax reform, trade, regulation, education, healthcare, immigration, and social support to raise the US growth potential.

FURTHER READING: Estonia Article IV Consultation, Denmark Article IV Consultation, Iceland Article IV Consultation, Lithuania Article IV Consultation, Latvia Article IV Consultation, Norway Article IV Consultation, Euro Area Article IV Consultation and US Article IV Consultation.

Box 1. IMF Art. IV for a selection of NBC countries, the Euro area and the US.

Denmark: The Art. IV concluded that the Danish economy was approaching its potential. Unemployment was low and close to its estimated structural level, and capacity constraints were gradually starting to bind in some sectors. The outlook was for continued moderate growth, projected at 1.5 percent in 2017 and 1.7 percent in 2018 with activity driven by strong and increasingly balanced private demand. Increasing labor shortages could, however, undermine medium-term growth prospects. Policy recommendations focused on slowing the pace of fiscal consolidation somewhat to facilitate tax cuts, new labor market reforms to raise the labor supply, and raising private and public investment, helping to reduce the current account surplus.

Estonia: The Art. IV found that notwithstanding sound economic and institutional fundamentals, Estonia's recent growth had been subdued, on the back of weaker labor productivity and external competitiveness. Growth in 2016 was estimated at only 1.3 percent, driven mainly by private consumption helped by strong wage growth. Growth was projected at 2.3 percent for 2017 and 2.8 percent for 2018, supported by consumption, investment, and exports, as well as the planned fiscal stimulus in 2018. Policy recommendations focused on enhancing productivity and preserving competitiveness through the three-pronged approach focusing on improving the effectiveness, scale, and take up of existing pro-growth programs, re-anchoring wage growth in fundamentals, and enhancing competitiveness through tax reforms.

Iceland: The Art. IV concluded that Iceland was stepping into a new era of financial openness with capital controls mostly gone. Tourism continued to drive growth, which reached 7.2 percent in 2016 and was projected at almost 6 percent in 2017, falling to around 2½ percent over the medium term. Policy recommendations focused on strengthening financial sector oversight with strong microprudential regulation and supervision of banks as the core elements of the financial stability toolkit, supported by well targeted macroprudential measures. Iceland needed to manage capital inflows carefully. Given Iceland's bitter experience, most Executive Directors were sympathetic to Iceland's current use of a special reserve requirement on selected debt inflows, while staff advised the authorities to immediately wind down the measure.

Latvia: The Art. IV noted that growth eased to 2 percent in 2016, as gross investment contracted significantly on the back of lower than expected absorption of EU funds. This effect was compounded by a drag from net exports, as import volume growth accelerated markedly, while export growth remained modest. Growth was expected to pick up to 3.2 percent in 2017 on the back of an accelerated pace of disbursement of EU funds and continued robust private credit growth. The IMF noted that policies to raise potential growth needed to focus on boosting productivity. Policies should focus on increasing Total Factor Productivity (TFP), raising investment and capital utilization, and strengthening the labor market in order to accelerate Latvia's convergence path with Western Europe. Going forward, fiscal policy should become more neutral over the medium term to avoid risks of procyclical growth.

Lithuania: The Art. IV revealed that the economy was gathering momentum, following sluggish performance in 2015 and most of 2016. The economy grew by 3.9 percent in the first quarter of 2017 on the back of strong private consumption. Economic growth was expected to reach 3.2 percent in 2017, helped by robust wage growth and low inflation supporting purchasing power. The IMF noted that the main policy challenge in Lithuania was to reinvigorate income convergence with Western Europe. To achieve that, Lithuania needs to narrow its productivity gap moving along with further structural reforms, while macroeconomic and financial stability needs to be maintained. Fiscal structural reforms should focus on pro-growth and pro-equity measures.

Norway: The Art. IV concluded that the Norwegian economy was slowly recovering from the oil shock as domestic demand had picked up, helped by accommodative macroeconomic policies while unemployment had been trending down. Mainland growth was projected to increase from 1 percent in 2016 to 1¾ in 2017 and 2¼ in 2018 respectively, supported by the recovery of exports and stronger private demand. Financial vulnerabilities have increased in the context of overvalued and rising housing prices, increasingly elevated household debt and higher money market premia. Significant policy actions had been taken to address financial stability risks, but further measures were needed. Staff suggested that the deployment of macroprudential tools to contain banks' commercial real estate exposures should be frontloaded.

Euro area: The Art. IV concluded that the recovery was firming and becoming broad based, supported by lower energy prices, stronger labor markets and recovery in credit growth which along with supportive policies had boosted domestic demand. The near-term outlook was favorable, with growth projected at 1.9 percent in 2017 and 1.7 percent in 2018. The improving near-term outlook was, however, subject to significant downside risks. Some high-debt countries could experience rising borrowing costs in the face of tighter global financial conditions or reduced monetary accommodation. Structural weaknesses in the European banking system also remained. Staff advised that further reforms, focusing on increasing productivity and competitiveness and reducing imbalances built up before the crisis were of importance.

U.S.: The Art. IV concluded that, despite growth dipping in the early part of the year, momentum had picked up and growth was projected at 2.1 percent in 2017 and 2018, supported by solid consumption growth and a rebound in investment. There were, however, two-sided risks to the growth outlook. A medium-term path of fiscal consolidation, such as the expenditure based consolidation proposed in the budget, would address medium-term fiscal imbalances but result in a growth rate below staff's baseline. On the upside, spending reductions could be less ambitious and tax reforms could lower federal revenues, providing stimulus to the economy and raising the near-term growth. Over the longer term, the U.S. is faced with secular structural shifts on multiple fronts including technological change reshaping the labor market, low productivity growth, rising skills premia, and an aging population. These forces could drag down both potential and actual growth going forward, diminish gains in living standards, and worsen poverty. Staff advised policies incorporating reforms on multiple, macro-critical fronts to raise productivity and labor force participation, and reduce poverty and income polarization.

2.3 Approaches to Macrofinancial Surveillance in Article IV Reports

CONTEXT: In March, the IMF published a policy paper on *Approaches to Macrofinancial Surveillance in Article IV Reports*. Building on past work to enhance financial sector analysis, IMF staff sought to develop a consistent and forward-looking view on how the financial sector affected each member's economic outlook. The aim was to strengthen staff's capacity to provide advice on macro-critical questions in a diverse range of Article IV Consultations. Staff saw benefits in mainstreaming this approach across the membership, while continuing to address analytical gaps and adapting to new challenges. There was, however, scope for the Fund to deepen its understanding of the macroeconomic effects of financial shocks to better adapt its policy advice.

NBC VIEW: The NBC is a strong supporter of increasing the Fund's surveillance of the financial sector and its linkages to the real economy and highlighted the importance of macro financial linkages being discussed in Article IV reports. The NBC supported integrating macrofinancial analysis in the baseline, risk assessment, and policy advice in the reports, and that it should progressively be mainstreamed across the membership. Knowledge sharing needed to be enhanced and greater cross-country consistency in policy advice ensured.

FURTHER READING: Approaches to Macrofinancial Surveillance in Article IV Reports and Press Release No. 17/103.

2.4 Role of the Fund in Governance Issues – Review of Guidance Note, Preliminary Considerations

CONTEXT: In July, the staff paper on the *Role of the Fund in Governance Issues – Review of Guidance Note – Preliminary Considerations* was published, as a response to the IMFC's request to review IMF engagement on governance issues. Against a growing recognition that systemic corruption could undermine prospects for delivering sustainable and inclusive growth, the paper assessed the extent to which corruption had been appropriately addressed in IMF's work in member countries in both economic reviews and Fund-supported programs. Staff used as a basis the Fund's Guidance Note on Governance Issues from 1997 that stated that corruption issues should be covered where they were assessed to have a significant short- to medium-term macroeconomic impact. In general, the review found that considerable progress had been made in implementing the Guidance Note. The IMF had undertaken numerous initiatives on governance and corruption across its operations and made significant contributions to the body of research on corruption.

NBC VIEW: The NBC highlighted that the IMF had a crucial role to play on the issues of good governance including fighting corruption, both at the national level and the multinational/global level. The NBC agreed with staff that an effective anti-corruption strategy needed to be multifaceted and that improvements could be made in the fight against corruption in program conditionality and the Fund's broader policy advice. The policy advice and strategy should be applied in an evenhanded and systematic way across the membership. Frankness and clarity of speech regarding corruption-related issues was an indispensable element to fight corruption.

FURTHER READING: Role of the Fund in Governance Issues – Review of Guidance Note, Preliminary Considerations, Background Notes and Press Release No. 17/315.

2.5 External Sector Report 2017

CONTEXT: The *External Sector Report* (ESR) annually analyzes global external sector developments and provides assessments of the largest economies' external positions, including current account balances, real exchange rates, external balance sheets, capital flows, and international reserves. The ESR 2017, published in July, found that excess current account imbalances that deviated from levels deemed consistent with medium-term fundamentals and desired policies represented about one-third of total global imbalances in 2016. The imbalances had broadly remained unchanged in recent years, although they had become increasingly concentrated in advanced economies. Staff advised that excess external imbalances should be addressed in a growth-friendly fashion requiring a recalibration of the macroeconomic policy mix and properly-targeted structural policies in deficit and surplus economies alike, particularly in the current environment of subdued global growth. Protectionist policies should be avoided as they are unlikely to reduce external imbalances and are detrimental to global growth.

NBC VIEW: The NBC highlighted that external imbalances can be appropriate and desirable, but in excess they could signal risks or harmful distortions. There could be several reasons for the continuation of a current account deficit or surplus, including investment needs in high-growth countries, deleveraging needs, financial center status, and demographic developments. The NBC broadly agreed with staff's assessment and key messages. As suggested, growth-friendly policy actions to counteract imbalances should include tailored and country-specific structural reforms, measures to stimulate investment and consumption for excess surplus countries, and policies to boost productivity and competitiveness in excess deficit countries.

FURTHER READING: 2017 External Sector Report, Individual Economy Assessments and Press Release No. 17/303.

2.6 Independent Evaluation Office (IEO) Evaluation: IMF and Social Protection

CONTEXT: In July, the IEO, which conducts independent and objective evaluations of Fund policies and activities, published an evaluating report on *The IMF and Social Protection.* In the aftermath of the global financial crisis, the IMF has moved beyond its traditional "fiscal centric" approach to recognize that social protection can also be "macro-critical" for broader reasons including social and political stability. This IEO evaluation found widespread IMF involvement in social protection across countries, although the extent of engagement varied.

The IEO made five recommendations of how the IMF could improve its work on social protection, which the Executive Board and Management supported. A clear strategic framework to guide Fund involvement in social protection needed to be established. Tailored, country-specific advice for countries should be provided where social protection was deemed to be a macro-critical priority. A more effective approach to program design and conditionality protecting the most vulnerable was desired. In addition, the Fund's approach should be realistically explained in external communications. Finally, the IMF should actively engage in inter-institutional cooperation on social protection with development partners and institutions with different mandates and policy priorities.

NBC VIEW: The NBC highlighted that this evaluation was timely, in the context of an increasing recognition of inclusive growth and well-being as positively linked with strong and sustainable economic development. The NBC supported all the IEO recommendations. The main challenge for the Fund would be to develop clearer frameworks and guidelines for the scope and delimitations of the Fund's work on social protection. In addition, the IMF should actively engage in inter-institutional cooperation, make efficient use of resources, and enhance the consistency of advice from the multilateral institutions.

FURTHER READING: The IMF and Social Protection and Statement by the Managing Director on the IEO evaluation IMF and Social Protection.

3 LENDING

3.1 Adequacy of the Global Financial Safety Net – Proposal for a New Policy Coordination Instrument (PCI)

CONTEXT: In July, a staff paper was published, proposing the establishment of a new non-financing Policy Coordination Instrument (PCI) to address gaps in the Global Financial Safety Net (GFSN) and the Fund's toolkit. This was a part of a series of discussions by the Executive Board on the adequacy of the GFSN. The proposal was approved by the Executive Board, with a few caveats. The new instrument was designed to help countries unlock financing from official and private donors and creditors, as well as to demonstrate countries' commitment to a reform agenda. It would enable a closer policy dialogue between the Fund and its members, more regular monitoring of economic developments and policies, as well as Board endorsement of those policies.

NBC VIEW: The NBC supported the proposal for a new PCI as it would be designed for countries that were seeking to unlock financing from official creditors or private investors and/or it would signal commitment to an economic reform agenda. Modalities for using the PCI, however, needed to be defined. In addition, using the PCI to unlock resources from other GFSN components could not be automatic and needed to respect the different characteristics, decision-making procedures, and mandates of the institutions that provided the actual financing. The NBC noted that the PCI was a strong signaling tool with sound standards for conditionality and welcomed that the instruments would be available to all member countries.

FURTHER READING: Adequacy of the GFSN – Proposal for a New Policy Coordination Instrument (PCI) and Press Release no. 17/299.

3.2 Lending Programs

CONTEXT: During the first half of 2017, the IMF continued to engage with Greece, resulting in an approval in principle (AIP) of a new IMF Stand-By Arrangement (SBA) in July. The third review under the Extended Fund Facility (EFF) for Ukraine, the first review under the EFF for Egypt, and regular reviews on Colombia's and Mexico's Flexible Credit Line (FCL) took place during this period, as well as Poland's request for a new FCL arrangement with a lower access level. Some Central African Economic and Monetary Community (CEMAC) countries reached an agreement with the Fund on new programs, including Cameroon, Chad, and Gabon. Other new Fund programs during the period included the EFF for Georgia and Extended Credit Facilities (ECF) for Niger and Benin.

NBC VIEW: The NBC supported the precautionary SBA for **Greece** on grounds of the recent and considerable commitments made by the Greek authorities, and underlined the critical importance of the Fund's involvement. Furthermore, the NBC supported the completion of the third review under the EFF for **Ukraine** on the back of the implementation of necessary reforms in areas that are crucial for restoring sustainable growth and program success as well as measures to safeguard financial stability. The same was the case for the first review under the EFF for **Egypt**, with the NBC supporting the authorities' ambitious economic reform program.

The NBC supported the completion of the reviews under the FCL for **Colombia** and **Mexico**, given their continued qualification, strong policy framework, and economic fundamentals. While noting that **Poland** was in a position to exit from the precautionary arrangement, the NBC endorsed a new two-year precautionary FCL arrangement with reduced access in the view of evolving external risks, the authorities' commitment to continue strengthening policy buffers, and the more market-friendly policy tone.

The NBC supported the requests for ECF programs for **Cameroon** and **Chad,** and an EFF arrangement for **Gabon** considering staff's assessment that risks were manageable and due to the authorities' strong commitment to the programs. The NBC welcomed the CEMAC authorities' coordinated response to the regional crisis. The NBC was also supportive of the new programs in **Georgia**, **Niger** and **Benin**.

FURTHER READING: Ukraine 2016 Article IV Consultation and third review under the EFF, Colombia FCL Review, Poland FCL, Mexico FCL Review, Chad ECF, Gabon EFF, Cameroon ECF, CEMAC Common Policies, AFR Press Briefing, Egypt EFF, Georgia EFF, Niger ECF and Benin ECF.

Box 2. IMF financial support to selected countries

On July 20, after reaching an agreement on policies, the Executive Board approved in principle (AIP) the SBA arrangement for **Greece**. The SBA arrangement with 55 percent of quota access (EUR 1.6 billion) will become effective only after the Fund receives sufficient assurances on debt relief to ensure debt sustainability and provided that the Greek authorities remain on-track in implementing policy conditionality.

The third review under the EFF and Article IV discussions on **Ukraine** in April concluded with a 1 billion USD installment from the Fund of the total of 17.5 billion USD financial support for the government's reform program. Staff noted that growth turned positive in 2016 by 2.3 percent and that flexible exchange rate and tight fiscal and monetary policies had greatly reduced internal and external balances. The strength and durability of the recovery would, however, depend critically upon the pace and depth of structural reforms which needed to be accelerated, including reforms to improve social conditions and the business environment.

The first review under the EFF for **Egypt** in July concluded with a 1.25 billion USD installment, bringing total disbursements to Egypt to about 4 billion USD. The authorities' reform program was off to a good start with a smooth transition to a flexible exchange rate. Policies supported by the program aim to correct external imbalances and restore competitiveness, reduce the budget deficit and place public debt on a declining path, boost growth and create jobs while protecting vulnerable groups.

In January, **Poland** cancelled its current FCL and requested a new precautionary FCL arrangement with a lower access level of 6.5 billion SDR, which was supported by the Executive Board. Poland's improved economic fundamentals and increased external buffers supported the lower access level, but external risks, however, have remained elevated. In May and June, the Executive Board reaffirmed **Mexico's** and **Colombia's** qualification for their precautionary FCLs from 2016 and supported the first reviews. Mexico faced a complex external environment characterized by a heightened risk of protectionism and financial market volatility while Colombia continued to adapt to the oil price shock, while also faced with elevated global and regional risks.

In June, the Executive Board supported new arrangements for a few **CEMAC** member countries. The sharp decline in oil prices has profoundly impaired the region's external and fiscal balances. The oil revenue shock and accommodative fiscal policy by member countries supported by expansionary regional monetary policies contributed to a fall in international reserves to a near critical point. As a result of widening fiscal deficits and accommodative monetary policy, the current account deficit also widened substantially. The Board approved a three-year arrangement under the EFF for **Gabon**; a three-year arrangement under the ECF for **Cameroon** and a three-year arrangement under the ECF for **Chad** as well as cancelled the current arrangement.

In January, the Executive Board supported **Niger's** request for a three-year ECF to help address persisting challenges and risks in the country and preserving fiscal and debt sustainability. In April, **Georgia** cancelled its SBA and the Executive Board supported its request for a new three-year EFF to tackle the structural weaknesses that unveiled when faced with an adverse external shock. In April, the Executive Board also supported **Benin's** request for a three-year ECF with focus on policies that would help create fiscal space.

4 FINANCIAL SECTOR ISSUES

4.1 Recent Trends in Correspondent Banking Relationships – Further Considerations

CONTEXT: In April, the IMF published a paper on *Recent Trends in Correspondent Banking Relationships – Further Considerations.* Correspondent banking relationships (CBRs), which facilitate global trade and economic activity, have been under pressure in several countries. So far, cross-border payments have remained stable and economic activity has been largely unaffected. However, in a limited number of countries, financial fragilities have been accentuated. These fragilities could undermine affected countries' long-run growth and financial inclusion prospects by increasing costs of financial services and negatively affecting bank ratings. Factors leading to global banks' withdrawal of CBRs are multiple, interrelated, and vary case-by-case. They generally reflect correspondent banks' assessment of the profitability and risk of the relationships. Addressing the withdrawal of CBRs will take time and would require strengthened, coordinated and collective action on the part of public and private stakeholders.

NBC VIEW: The NBC supported the Fund's involvement in helping affected member countries to contain and mitigate the withdrawal of CBRs. Responses to the withdrawal of CBRs need to be tailored, prioritized, and sequenced with regard to the intensity of the impact and taking case specificities and the multitude of causes into account. It should focus on measures to enhance respondent banks' capacity to manage risks, improve communication between correspondent and respondent banks, strengthen and effectively implement regulatory and supervisory frameworks in line with international standards, particularly for Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT), and remove impediments to information sharing. It is key that the Fund continues the ongoing collaboration with stakeholders such as the Financial Stability Board, the World Bank, G20, Financial Action Task Force, Arab Monetary Fund, and the Committee on Payments and Market Infrastructures.

FURTHER READING: Recent Trends in Correspondent Banking Relationships-Further Considerations and Press Release No. 17/137.

4.2 Increasing Resilience to Large and Volatile Capital Flows: The Role of Macroprudential Policies

CONTEXT: On July 5, 2017, a staff paper was published discussing how macroprudential policies could help increase resilience to large and volatile capital flows. The report was a follow-up work from the Board discussion in December 2016 taking stock of countries' experience with the Institutional View on the Liberalization and Management of Capital Flows (IV). There the Board supported further work particularly on the role of the macroprudential framework in addressing systemic financial risks arising from capital flows.

The July paper on this topic analyzed the relationship between capital flows and systemic risk by presenting five channels through which capital flows could increase systemic risk, and discussed the scope for macroprudential measures (MPMs) to help limit the systemic risk arising from capital flows, including factors that might influence the effectiveness of MPMs in this regard. The paper also explored the complementarities between the Fund's macroprudential framework and the IV, and identified principles for distinguishing between MPMs and capital flow management measures (CFMs), to help ensure that the Fund provides consistent advice. A number of Executive Directors suggested that an in-depth discussion on the question of whether CFMs could be used preemptively to manage systemic risks that may arise from capital flows was needed. In addition, the Directors encouraged staff to continue to deepen the understanding of macroprudential policies and their effectiveness, as well as how to apply the conceptual framework of appropriately distinguishing between measures, drawing lessons from country experiences.

NBC VIEW: The NBC has been a strong proponent of an enhanced role for the Fund in giving advice on capital flows and macroprudential policies. The NBC agreed overall with the conclusions and believed that the approach presented would help facilitate a more consistent, well-targeted, and transparent application of the Fund's two complementary frameworks. While international movement of capital has many benefits, large and volatile capital flows can pose risks to macroeconomic and financial stability. MPMs and CFMs should not be used as a substitute for necessary macroeconomic adjustment, nonetheless CFM/MPMs may be appropriate as a complement to macroeconomic adjustment in certain circumstances. The appropriate use of macroprudential policy measures could help strengthen the resilience of the financial system to cope with volatile capital flows. However, macroprudential policies should not be overburdened by objectives specifically related to the management of capital flows. Flexibility was needed while the Fund's frameworks evolved and as new insights were gained. Coordination and information-sharing was vital, both domestically and internationally in terms of limiting systemic financial risks. Filling the data gaps and continuing the advancement of the research agenda on capital flows and related policies is important.

FURTHER READING: Increasing Resilience to Large and Volatile Capital Flows: The Role of Macroprudential Policies and Press Release No. 17/260.

5 LOW INCOME AND DEVELOPING COUNTRIES / FRAGILE STATES

5.1 Large Natural Disasters—Enhancing the Financial Safety Net for Developing Countries

CONTEXT: In May, the Executive Board endorsed establishment of higher annual access limits of 60 percent of quota under the Rapid Credit Facility (RCF) and Rapid Financing Instrument

(RFI) for countries experiencing urgent balance of payments needs arising from large natural disasters. Qualification for higher access under the large natural disaster windows within the RCF and RFI is conditional, inter alia, on meeting a disaster damage threshold of 20 percent of the member's GDP. This would strengthen the Fund's financial safety net for countries experiencing urgent balance of payments needs arising from large natural disasters, while helping to catalyze other sources of financing to meet such financing needs. These proposals, and the case for adopting them, are explained in the staff paper *Large Natural Disasters—Enhancing the Financial Safety Net for Developing Countries*. The RCF and the RFI are valuable components of the disaster risk financing toolkit for Fund members, especially developing countries.

NBC VIEW: The NBC supported the proposal to increase the annual access limit and agreed with the threshold level for natural disaster-related damages. The NBC also underlined the importance of ex ante risk management in countries exposed to severe natural disasters.

FURTHER READING: Large Natural Disasters-Enhancing the Financial Safety Net for Developing Countries and Press Release No. 17/171.

5.2 Building Fiscal Capacity in Fragile States

CONTEXT: In May, the Executive Board discussed the staff paper *Building Fiscal Capacity in Fragile States*, which analyzes recent country experiences, describes the IMF's technical assistance (TA) approach for Fragile Sates (FS), highlights how it differs from non-FS, and derives lessons for future work. The number of countries in post-conflict or fragile situations represent slightly more than twenty percent of the IMF's membership. How to best support these countries in building their institutions continues to be a major concern for the IMF.

The paper notes the importance of targeting fiscal TA to achieve stability and secure revenues. Other key lessons include prioritizing reform sequencing, promoting effective donor coordination, implementing formal Medium-Term Revenue Strategies (MTRS), and expenditure reform strategies to help countries exit fragility, as well as considering further integration of TA to FS to better complement IMF lending and surveillance operations.

The TA approach to building fiscal capacity in FS differs depending on the stage of fragility. TA responds to demands from IMF member countries, and is designed to support the IMF's surveillance and lending activities. In this regard, annual TA programs are planned in collaboration with the authorities and the IMF area department teams, and reflect evolving country priorities. IMF staff also coordinate TA advice and activities with other donors and TA providers. These coordinating efforts are easiest when they are country-led, which underscores the importance of political ownership for the long-term success of reforms.

NBC VIEW: The NBC recognized the importance of helping fragile states to develop fiscal capacity and the beneficial impact it has on building state capacity and supporting economic growth, and therefore strongly supported Fund involvement in this area. The NBC supported staff's approach to building fiscal institutions in stages based on the country's starting position and agreed that the approach to fiscal TA must differ from country to country depending on how fragile the environment is and on the country's absorptive capacity.

FURTHER READING: Building Fiscal Capacity in Fragile States and Press Release No. 17/221.

5.3 Eligibility to Use the Fund's Facilities for Concessional Financing, 2017

CONTEXT: On May 15, 2017, the Executive Board reviewed the framework for determining eligibility of member countries to use concessional financial resources under the Poverty Reduction and Growth Trust (PRGT) and the current list of PRGT-eligible countries. The PRGT eligibility framework includes transparent and rules-based criteria to guide decisions on the eligibility of countries to access the Fund's concessional facilities. It is designed to ensure uniformity of treatment among members, alignment of access to concessional resources with PRGT objectives, and consistency with the financial self-sustainability of the PRGT. The framework includes differentiated criteria for entry and graduation. In general terms, countries enter onto the list of PRGT-eligible countries when their income per capita is below a specified threshold and they do not have the capacity to access international financial markets on a durable and substantial basis. Countries are expected to graduate from the list when they have achieved income per capita levels that exceed specified thresholds or have established the capacity to access external commercial financing on a durable and substantial basis and they do not face serious short-term vulnerabilities. The framework and the list of PRGT-eligible members are reviewed every two years. The next review of PRGT eligibility would be held on the standard two-year cycle. The Board concurred that the existing framework remains broadly appropriate, and did not see a need to introduce changes at this time. No members are currently eligible for entry onto, or graduation from, the list of PRGT-eligible countries.

NBC VIEW: The NBC concurred with staff assessment that the existing PRGT eligibility framework remains broadly appropriate and no country should be graduated from the PRGT-eligibility at the moment. The NBC welcomed that the application of the framework continues to be consistent with the self-sustained lending capacity of the PRGT.

FURTHER READING: Eligibility to use the Fund Facilities for Concessional Financing for 2017 and Press Release No. 17/188.

5.4 Social Safeguards and Program Design in PRGT and PSI-Supported Programs

CONTEXT: Poverty reduction is a core objective of IMF programs in low-income countries. Hence, the 2009 reform of PRGT called for PRGT facilities to support policies that safeguard and, where possible, increase social and other priority spending. On May 26, 2017, the Executive Board discussed a staff paper *Social Safeguards and Program Design in PRGT and PSI-supported*

Programs. The paper considers how poor and vulnerable groups can be protected in Fund supported programs in low-income countries using measures to safeguard and improve public spending on these groups. The paper finds that targets for social and other priority spending were included in virtually all Fund-supported programs in low-income countries, and met in more than two-thirds of cases; health and education spending have typically been protected. The paper recommends tightening the specification of program targets on social and other priority spending to improve the effectiveness of such spending. The focus should be on targeting spending where the benefit and impact on the poor is greatest. Collaboration with the World Bank and other development partners to draw on their expertise is needed to strengthen spending targets and social safety net measures, and should take place at an early stage, ideally during surveillance discussions.

NBC VIEW: The NBC generally shared the conclusions and supported the recommendations. While it is encouraging that Low-Income Country (LIC) programs have been successful in protecting health and education spending, it is a concern that social safety net coverage is the weakest in the world's poorest regions. This is a fundamental challenge that needs to be addressed by country authorities with support of the IMF and development partners. The NBC strongly supported the recommendations to pursue a more focused and efficient use of indicative targets, based on a thorough analysis of the expected impact. Moreover, a mix of build-up of expertise within the Fund and a close cooperation with relevant development partners such as the World Bank and regional development banks on topics related to social safeguards in LIC programs is important.

FURTHER READING: Social Safeguards and Program Design in PRGT and PSI-supported, Press Release No. 17/209 and Blog: Protecting education and health spending in low-income countries.

Office of the Nordic-Baltic Constituency

The Office of the Nordic Baltic Constituency presents the views of our member countries in the IMF's Executive Board in close coordination with our authorities in the eight capitals. The Office also regularly meets with representatives from the member countries' administrations or private delegations. All the positions in the office rotate between the eight member countries according to an agreed schedule and all countries are represented at all times.
As of July 2017, our staff includes:

Thomas Östros	Executive Director, Sweden
Kimmo Virolainen	Alternate Executive Director, Finland
Rimtautas Bartkus	Senior Advisor, Lithuania
Thomas Pihl Gade	Senior Advisor, Denmark
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