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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/47

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Executive Board Attendance

E. Aninat, Acting Chair
S. Sugisaki, Acting Chair

Executive Directors

M.J. Callaghan
R.F. Cippà

P.C. Padoan

P. Duquesne
A. Mirakhor

F. Varela

M. Portugal

A.S. Shaalan
Wei Benhua

A.G. Zoccali

Alternate Executive Directors

A.S. Alosaimi
M.F. Melhem, Temporary
D. Ondo Mañe
N. Guetat, Temporary
F. Vermaeten, Temporary
C.J. Faircloth, Temporary
T. Skurzewski
R. von Kleist
B. Bossone, Temporary
Low K.M.

R.A. Jayatissa
C. Josz, Temporary
B. Andersen

M. Lundsager
P.A. Dohlman, Temporary
S. Boitreaud
S. Rouai, Temporary
A. Lushin
L. Palei, Temporary

M.A. Brooke
R. Junguito
G.M. Campos, Temporary

Wang X.
P.A. Nijssse, Temporary
M. Yanase, Temporary
G.R. Le Fort

S.J. Anjaria, Secretary
A. Mountford, Acting Secretary
S. Soromenho-Ramos, Assistant
Y. Chia, Assistant

Also Present

ECB: B. Kisselevsky. European I Department: R. Cocker, L. Kodres, A. Leopold. External Relations Department: F. Baker. International Capital Markets Department: G. Haeusler, Director Independent Evaluation Office: M.S. Ahluwalia, Director: D.J. Goldsbrough, Deputy Director. Legal Department: H. Elizalde. Monetary and Exchange Affairs Department: S. Ingves, Director; V Sundararajan, Deputy Director. Policy Development and Review Department: M. Fetherston. Secretary's Department: L. Hubloue, T-Turner-Huggins. Statistics Department: C.S. Carson, Director; P.L. Joyce, Deputy Director. Technology and General Services Department: B.C. Stuart, Director; I.E. Prebensen, Deputy Director. Treasurer's Department: E. Brau, Treasurer; M.G. Kuhn, Deputy Treasurer; B.S. Newman, Deputy Treasurer; T. Catsambas, B.V. Christensen, S. Fennell, H. Hatanpaa, M. Kandil, S. Lurie, P. Ross. Western Hemisphere Department: G. Flores. Office of Budget and Planning: B. Potter, Director. Advisors to Executive Directors: A. Baukol, M. Beauregard, W.-D. Cho, J.A. Costa, B. Couillault, S.S. Farid, F. Manno, J. Milton, A. Monajemi, A. Muganda, E. Nyambal, Y. Patel, H.E. Phang, A.A. Tombini, F. Zurbrügg. Assistants to Executive Directors: A.S. Al Azzaz, A.A. Al-Nassar, Cao L., V. de los Santos, M. Di Maio, N.H. Farhan, M. Faulend, R. Gauba, B. Gulbrandsen, C. Harzer, T. Komatsuzaki, J.K. Kwakye, D. Lombardi, A. Maciá, R. Manivat, T. Moser, R. Moulié, G. Nadali-Ataabadi, M.L. Nikitin, A. Rambarran, L. Rizzotti, A. Stuart, D.B. Waluyo, Wei X., Yu J.

1. FUND LIQUIDITY POSITION—REVIEW AND OUTLOOK

Document: The Fund's Liquidity Position—Review and Outlook (EBS/02/68, 4/16/02)

Staff: Kuhn, TRE; Trines, TRE; Kashiwagi, PDR

Length: 2 hours, 50 minutes

Mr. Shaalan and Ms. Farid submitted the following statement:

At the outset, we would like to express a warm welcome to the proposal to adopt the concept of “forward commitment capacity” as the appropriate measure of the adequacy of the Fund's liquidity position. We believe this change is long overdue, and accordingly we have no regrets in bidding farewell to the “liquidity ratio”, which is complicated and non transparent, and difficult for anyone outside the Treasurer's department to understand or to assess its findings. In contrast, the forward commitment capacity measure provides a more straightforward calculation of the resources available to the Fund to make new financial commitments in a given period of time, and makes it easier to judge the adequacy of the Fund's liquidity position. Since the concept is grounded in existing accounting data, it would allow for regular updates on a rolling basis.

As the staff rightly point out, one particular drawback of the current liquidity ratio concept, which makes it difficult to interpret, is that it mixes accounting data with judgmental elements, particularly through the adjustments made to undrawn balances for nonoperative and precautionary arrangements. Furthermore, as the status of arrangements changes from precautionary to non-precautionary, as we have recently witnessed with some current arrangements, the liquidity ratio can change dramatically. The sharp increase in the size of resources made available to a few members can increase the volatility of the liquidity ratio and hence its usefulness in assessing the Fund's financial position. If more use is made of large precautionary arrangements, this drawback becomes more serious, particularly if the activation of arrangements is simultaneous.

To arrive at the Fund's forward commitment capacity, an important judgment needs to be made on the minimum prudential level of own resources needed to safeguard the position of the Fund's creditors and to guard against the possible erosion of its resource base. We find the proposed range of SDR 35–45 billion minimum prudential level reasonable, since it would provide 35 percent coverage of reserve tranche positions at maximum lending capacity using own resources. This coverage would be slightly above the historic minimum coverage ratios of 25–30 percent. This is justifiable given the rising level of participation in the FTP by emerging market countries, where balance of payments difficulties in the future cannot be ruled out. Thus the proposed

minimum level takes account of the possibility that participation in the FTP, which is currently at a record level of 73 percent of aggregate quotas, may decline.

Of course, the supply of uncommitted usable resources over a given period has to take account of repurchases by members. While the introduction of time-based expectations schedules has introduced some uncertainty to the future timing of repurchases, we find that the staff proposal in this regard strikes a good balance and is appropriately prudent. Thus, we have no problem with using the expectations basis for assumptions of SRF and CCL repurchases, and the obligations basis for all other Fund arrangements.

The assessment of the adequacy of the Fund's forward commitment capacity is based on estimates of future potential demand for use of Fund resources. Naturally, the more robust these estimates are, the more robust is the assessment. This said, the increased degree of volatility in the demand for Fund resources, given the potential for larger financing needs, has made projections of demand increasingly difficult despite our ongoing work on vulnerability assessments, early warning indicators, and the like. Thus, as we look forward to reviewing new approaches to better project the demand for Fund resources, we should accept the fact that a measure of uncertainty and volatility are inevitable in an increasingly globalized world economy. This makes the semiannual reviews of Fund liquidity all the more important.

Turning to the near term outlook for the Fund's liquidity position, we do not foresee difficulties with the assessment that the Fund's forward capacity to commit GRA resources, at SDR 50 billion from own resources and SDR 84 billion including use of available NAB/GAB resources, appears adequate in light of potential demand. The relatively modest current projections of new commitments during the remainder of 2002 appear reasonable, in view of the current expectation of an improvement in the world economy relative to the outlook a few months ago. Nonetheless, we should note that these expectations have been marked down in recent weeks. However, the possible inclusion of Mexico in the FTP later this year would potentially increase usable currencies by SDR 2.6 billion. There is thus some margin to accommodate large unforeseen commitments that may arise. In the latter case, we would expect staff to provide the Board with a timely update of the forward commitment capacity.

We welcome the regular publication of the Fund's forward capacity to commit GRA resources with an explanation of its principal components and the method of calculation.

Mr. Portugal and Mr. Tombini submitted the following statement:

We thank staff for the well-focused paper which responds to some Board members' request for more detailed information regarding the methodology used in assessing the Fund's liquidity position.

We share the staff view that the Fund needs a transparent and quantifiable framework to assess its liquidity position. In this regard, we consider that the proposed measure of the forward capacity to commit resources is better suited for the Fund's needs than the current liquidity ratio and can be one of the tools of the new framework. While recognizing that interest rate surcharges and repurchase expectations schedules have improved the revolving nature of Fund resources, to assess Fund liquidity we need to account better for the potential impact of precautionary arrangements. We share the views expressed in the report that the forward capacity indicator is less subject to judgment and has the desired feature of improved treatment to precautionary arrangements. Purchases under the Supplemental Reserve Facility (SRF) and/or the activation of a Contingent Credit Line (CCL) can generate a sudden spike on the use of Fund resources, and significantly change the liquidity ratio. The proposed forward capacity would not be affected by this type of events since it takes into account precautionary arrangements when calculating the uncommitted usable resources. Under the current system it is possible, for instance, to envisage a situation where large precautionary arrangements have been agreed upon—the Fund is very liquid according to the traditional liquidity ratio indicator—but the sum of committed resources could prevent new contingent commitments being agreed upon.

While we agree that the forward capacity represents a better concept to assess the Fund's capacity to respond adequately and promptly to member countries' requests, this indicator, albeit forward looking, provides just a snapshot position. Hence, caution and prudence are needed when applying this measure, specially by the Fund that, in our view, should be a paradigm of financial prudence. In this regard, we are not fully convinced that, in calculating forward capacity, repurchase expectations schedules for the SRF and CCL should be considered. It would be prudent to consider as baseline the repurchase obligations schedules for all types of resources. The transformation of expectations into obligations for an existing program is a more likely event than agreement on a new arrangement. Therefore, for the sake of prudence, this event should be taken into account when calculating forward capacity.

On these same grounds, we are not convinced by the proposal made by staff in Box.2 of using the minimum level of uncommitted resources observed in 1998. We do not dispute the criteria used to scale up the minimum level of uncommitted usable resources, but rather the choice of the year 1998 as the benchmark. As the staff pointed out, the minimum level reached in 1998

(SDR 26 billion) led to the activation of the borrowing arrangements. We understand that the benchmark should be one that did not require the activation of borrowing arrangements, if the minimum level of resources is intended to serve as a buffer against a possible erosion of the resource base and to provide the Fund with adequate working balances to accommodate requests by members for specific currencies in purchases from the Fund. In light of the above, maybe the staff could consider the second lowest level of resources verified in 1992, when no borrowing arrangement was activated.

It is well known that developments in the global financial markets, with greater liberalization of capital accounts, and the changed nature of balance of payments crises in the recent years have posed new challenges for the international community. Tools that had been used in the past to assess the vulnerabilities and to deal with current account crises are no longer adequate to cope with the capital account crises. Meanwhile, new tools that are being developed, such as MPIs and EWSs, are still not fully operational or tested, and would not provide a readily quantified projection of the demand for Fund resources.

We strongly support the staff's view that a more robust approach to determining potential demand for Fund resources is required. The recent experience shows that the traditional probabilities-based approach, which determines access on the basis of normal annual and cumulative limits can grossly understate demand, as stressed by the staff.

The paper's main shortcoming is the lack of a framework for assessing the potential demand for Fund resources. The demand for Fund resources needs to be assessed with considerable carefulness, taking into account elements such as the Augmented Gross Financing Needs of emerging markets, transition economies and other developing countries, the global financial and economic environment and the availability of private market and other multilateral resources. We look forward to the development of a more robust framework for projecting potential demand, based on alternative scenarios and stress tests, which could be used to make conservative judgments about the adequacy of Fund resources. We remain concerned that the Fund size has been shrinking in relative terms compared to the world economy and that, in addition, the quota shares of some countries are not representative any more of their position in the world economy. These events have been particularly troublesome for emerging markets that have faced capital account crises and that need to draw resources perceived as large owing to the combined effects of such events. We look forward to discussing these issues both in the context of the 12th General Review of Quotas and of the upcoming discussion of access policy.

After incorporating the results of today's discussion, we support the publication of the methodology for calculating the forward capacity of the Fund.

Ms. Lundsager and Mr. Baukol submitted the following statement:

Key Points

We can go along with the introduction of the new 'forward capacity' indicator, subject to certain modifications. While the 'forward capacity' indicator has conceptual advantages, it is built on assumptions that are too conservative.

Most important, the proposed 'minimum level of uncommitted resources' of SDR 40B is too large. A figure of SDR 20-25B is a prudent amount, for reasons described below.

In any case, the current liquidity position is clearly quite comfortable. We are encouraged that the more pessimistic scenario envisioned last fall has not materialized.

We support the staff's proposal to publish the new indicator on the Fund Web site on a weekly basis. This should also include an explanation of its components and calculations.

The Forward Capacity Indicator

The staff proposes replacing the IMF's standard liquidity ratio indicator with the 'forward capacity' indicator. In our view, the liquidity ratio provides a useful snapshot of Fund liquidity, and some of the staff's objections to it are not persuasive. Nonetheless, the liquidity ratio is complex, and the forward capacity indicator can provide a useful look ahead at resource constraints. Hence, we can support the proposed introduction of a 'forward capacity' indicator, if specific modifications to the proposal are made.

Like the liquidity ratio, the forward capacity indicator requires that the Fund make judgments regarding specific assumptions. The most important is to set the 'minimum level of uncommitted usable resources', which are needed in case creditor members withdraw their reserve positions and in case countries drop out of the financial transactions plan (FTP). The paper proposes that SDR 35-45 billion (\$45-\$57 billion) are needed for these purposes; we would propose SDR 20-25 billion (\$25-\$32 billion):

Reserve tranches: Some cushion is needed to preserve the unconditional right of members to withdraw reserve tranches for BoP needs. We note, however, for the period 1993-2001, members withdrew less than

SDR 2 billion in total from their reserve tranches (excluding 1999 when many members withdrew reserve tranches related to the quota increase). During 1997, when the Asia crisis was emerging, reserve tranche withdrawals were only SDR 606 million.

FTP participation: Some cushion may be needed to cover times of stress to the FTP. During the Asia crisis, a number of countries dropped out of the FTP, and their total quotas now equal about SDR 7.5 billion. Nonetheless, participation in the FTP has been increasing over time, so the Fund's usable resources will tend to increase, not decrease. In addition, the Fund's 'usable resources' would decline if countries drop out of the FTP, and thus the 'forward capacity indicator' would decline automatically in tandem.

Comparison to Liquidity Ratio

The paper argues that a minimum level of uncommitted resources of SDR 40 billion is conservative because it compares to a liquidity ratio of only 21 percent. However, this is correct only if one uses implausible assumptions about Fund lending. In particular, when comparing to the liquidity ratio, the paper assumes full disbursement of all Fund commitments. A recent average suggests that about 70 percent of Fund commitments at any given time have been lent while 30 percent remains as commitments. (The current split is about 65/35.) Using the assumption that 70 percent of IMF commitments are actually lent, the liquidity ratio is significantly higher. Based on realistic assumptions, a cushion of SDR 40 billion is comparable to a liquidity ratio of about 37 percent.

Cash Cushion

The forward capacity indicator automatically builds in a large cash cushion by allowing for all commitments to be actually disbursed. This cash cushion—equal to undrawn balances under GRA arrangements—has fluctuated between SDR 15 billion and SDR 30 billion in recent years. This cash cushion should be more explicitly recognized in the description of this indicator.

Other Assumptions

The 'forward capacity' indicator treats precautionary programs and CCLs in the same manner as disbursing programs, as opposed to the liquidity ratio that assumed that 50 percent of such programs would be disbursed. Given the conservative approach already built into the new indicator, we would support retaining the 50 percent assumption for precautionaries and CCLs.

The new indicator assumes that SRF and CCL repurchases will be on an expectations basis while other repurchases are on an obligations basis. This approach seems balanced and is consistent with other IMF programming assumptions.

Near-Term Liquidity Outlook

Given our proposal above, the current one-year 'forward capacity' is about SDR 65-70 billion (excluding GAB/NAB), up from about SDR 50 billion cited in the staff paper. In either case, it is more than comfortable, given projected new commitments from the GRA of only SDR 6 billion for the remainder of the year. While projected demand for IMF resources is subject to great uncertainty, the Fund has adequate resources to deal with members' needs.

Mr. Yagi and Mr. Yanase submitted the following statement:

Introduction

Ensuring that the Fund has adequate resources to help its members in need is always essential for this institution. This requires not only looking at the amount of disposable resources the Fund has, but also establishing a robust and transparent benchmark against which the adequacy of resources can be measured. Thus we welcome today's discussion on the Fund's liquidity and commend staff for a concise yet insightful paper, which includes a new measure to assess this liquidity.

Forward Capacity to Commit GRA Resources

This chair supports staff's proposal to use the forward capacity to commit GRA resources (FCC) as the principal measure of the Fund's liquidity and as a replacement for the liquidity ratio. We also support most of the related specific proposals; namely, to project repurchases in line with programming assumptions, to make downward adjustments for the undrawn balances under precautionary arrangements in calculating the FCC, and to publish the FCC on the Fund Web site .

However, we share the objection expressed in Mr. Portugal's and Mr. Tombini's preliminary statement against the staff proposal to set the minimum prudential level of the FCC at SDR 40 billion, for the following reasons:

The figure of SDR 40 billion is based on the late-1998 level when the Fund's uncommitted usable resources declined to their lowest level in the two decades, but this low level was accepted only because it fell under exceptional circumstances: a quota increase under the Eleventh General Review of Quotas

had already been agreed and the prospect of it becoming effective was solid. This level should not be used as a precedent for the Fund's minimum prudential level of resources under normal circumstances.

The volatility in the demand for Fund financial resources has escalated due to the expansion of international capital flows. The possibility that a country that has been included in the FTP may request substantial assistance from the Fund after a short period of time due to sharp deterioration of external accounts has risen substantially. This calls for the minimum prudential level to be set higher than what was previously acceptable.

Unlike the liquidity ratio, the FCC incorporates future projected repurchases over the course of a year, expecting that these repurchases will be made in line with programming assumptions. This inevitably introduces a risk unique to the FCC, and needs to be taken into account in setting the minimum prudential level.

In the past, a liquidity ratio of 30 percent was recognized as the minimum level of the Fund resources. This 30 percent can be translated to roughly SDR 48 billion of uncommitted usable resources with the current level of the Fund's overall quota. To reduce this figure would not be appropriate. Moreover, the facts noted above indicate that a higher minimum prudential level should be set. Therefore, this chair strongly suggests that the minimum prudential level of uncommitted usable resources should be set at SDR 50 billion. Of course, there is room for judgment. But given that quota increases cannot be agreed instantaneously—it usually takes several years—it would seem better to err on the conservative side.

Demand Considerations

With the introduction of the FCC, the importance of projecting future demands for Fund resources will increase significantly. We look forward to efforts on improving demand assessments as noted in the staff paper. Given the need for the Fund to be conservative in its resource projection, we must emphasize the need for a built-in mechanism to prevent demand projection from being overoptimistic, and call on staff to work on it. There may be a potential risk that country desks, which play a central role in constructing demand projections, may be biased in underestimating the possibility and scale of the financial need of their assigned countries.

The staff should also look further into what is the level of FCC to be deemed appropriate against a given level of projected demand. The consideration of such a level is important for giving assurance to member countries that the Fund is in a comfortable position to provide financial resources to them unless the situation changes substantially.

Current and Projected Fund Liquidity

On the current level of the Fund's liquidity, we do not agree with staff's assessment that the FCC is projected to remain adequate during this year. If we set the minimum prudential level of uncommitted usable resources at SDR 50 billion, the remaining level of FCC is SDR 39.8 billion. Even compared with the resources needed in past crises, this is not a comfortable figure. Given that larger resources may be required in the future, there is a clear need for an immediate quota increase. Again, since we cannot expect a quota increase to be agreed in a short period of time, it becomes our urgent task to accelerate our discussion on the Twelfth General Review of Quotas.

Mr. Cippà submitted the following statement:

Key points

I agree that the forward commitment capacity should become the principal measure of Fund liquidity.

I also agree that repurchases should be projected in line with programming assumptions.

The minimum level of uncommitted usable resources, however, should not be a nominal figure. Rather, it should be determined as a percentage of the Fund's total own and actually borrowed resources.

I propose a 20 percent ratio, which would translate into about SDR 40 billion in case of full activation of NAB/GAB, and into only 31 billion under the current circumstances.

I welcome the staff's proposal for a new measure of the Fund's supply of resources to make new financial commitments. The forward commitment capacity is superior to the liquidity ratio, insofar as it is forward-looking and as it provides a specific amount of resources that can be committed for new Fund programs. Moreover, it is derived from more comprehensible assumptions and can thus be understood more easily.

The determination of the forward commitment capacity is to a large extent contingent on two elements: first, the minimum level of uncommitted usable resources, and second, the projected repurchases. With regard to the latter, I agree that repurchases should be projected in line with programming assumptions. I have more trouble, however, with regard to the former element, the fixing of the minimum level of uncommitted usable resources. While the staff proposal of using a historically low level as a benchmark seems reasonable, I do not see any value in stipulating an absolute nominal amount, i.e., SDR 40 billion. That way, the extent of safeguarding creditors' claims

will vary with the level of the resource base, which is rather counter intuitive. An increase in the resource base, e.g., under a NAB/GAB activation, would lead to a decline in the coverage ratio, while a drop in the resource base would lead to an increase in the coverage ratio.

Instead, the minimum reserve should be determined as a percentage of the resource base. Accordingly, I would suggest that the minimum level of uncommitted usable resources is determined as a percentage of the Fund's total own and actually borrowed resources. Taking into account only actually borrowed resources makes sure that we safeguard the position of NAB/GAB creditors only when the NAB/GAB are activated. Thus, the staff's proposal of a minimum reserve in the amount of SDR 40 billion would translate into a reserve ratio of 26 percent, if one takes only current own resources (SDR 155) and zero borrowing as a base, or into a reserve ratio of 21 percent, if the SDR 40 billion were also to cover potential borrowing under the NAB/GAB.

Determining the minimum reserve as a percentage of the resource base would also, in my view, be at least as easy to communicate, as it could still be published as a nominal amount. But it would be more transparent and comprehensible than an absolute nominal amount, since the determination of the level would be much more transparent and logical. Moreover, unlike an absolute nominal value, a relative value would not have to be revised in case of a significant change in the resource base, such as an increase in the quotas.

Given that, under the assumption that the minimum reserve also has to safeguard the position of NAB/GAB creditors, the staff proposal of SDR 40 billion seems to translate into a reserve ratio of 21 percent under my proposal. I could go along with a minimum level of uncommitted usable resources in the amount of 20 percent of the Fund's total own and actually borrowed resources, in order to have a plain and simple number. Accordingly, under the prevailing circumstances with own resources amounting to SDR 155 billion and no NAB/GAB borrowing, that would translate into a currently necessary minimum level of uncommitted usable resources of SDR 31 billion. Under full NAB/GAB activation we would be back at about SDR 40 billion.

As to publication, I agree that the forward commitment capacity be published regularly on the Fund Web site. For internal purposes, I think it would be useful to calculate the forward commitment capacity under different assumptions, e.g., under the assumption of obligation schedules for all repurchases.

Finally, assessing the Fund's current liquidity position, I share the staff's view that under reasonable assumptions the present position is comfortable. Under my proposal, the current one-year 'forward capacity' would amount to SDR 59 billion.

Mr. Lushin submitted the following statement:

We agree that the concept of the forward capacity to commit GRA resources represents significant progress as a measure of Fund's liquidity as compared to the existing liquidity ratio. Therefore, the replacement of the latter with the former is warranted. Projecting repurchases in line with programming assumptions looks reasonable.

Staff's approach to calculating the minimum level of uncommitted resources looks overly simplified and we do not see a convincing justification for the figure of SDR 40 bn, which staff proposes to use for calculation of the forward capacity indicator. As shown in the Appendix to this preliminary statement, a set of quite reasonable assumptions may bring the amount of reserves required for safeguarding the position of the Fund's creditors to only SDR 18 bn. While not insisting on this specific figure, we think that the methodology used to produce it may deserve some attention.

Concerning the amount of resources needed as a cushion against a declined FTP participation, a figure of SDR 7-8 bn could be reasonable. This amount corresponds both to the combined quota of FTP members that have used Fund resources during the past decade (and hence, being more vulnerable), and the total quota of members that dropped out of the FTP during the Asian crisis.

Items (2) and (3) above suggest that staff's estimate of minimum uncommitted reserves may be too conservative. Further development of the appropriate calculating procedures could be required before the forward capacity to commit GRA resources is brought into operation.

We agree with the proposal to publish data on the indicator of the forward capacity together with the underlying methodology. Before this happens, however, we think that the methodology should be refined.

Appendix: Determination of the Coverage Ratio

Definitions:

Total resources available to make financial commitments (or sum of quotas of FTP participants): R_t

Minimum uncommitted usable resources: R_{mu}

Resources that potentially can be committed: $R_c = R_t - R_{mu}$

Credit outstanding (or actual reserve tranche position of FTP participants): R_{tp}

Ratio of credit outstanding to total available resources: $\alpha = R_{tp}/R_t$

Ratio of possible creditors' withdrawals of their reserve position to the actual size of all reserve tranche positions: β

Coverage ratio, staff definition: $\gamma = R_{mu}/R_c$

Suppose that minimum uncommitted resources (R_{mu}) should only cover possible withdrawals by creditors of their reserve positions. Then:

$$(1) \quad R_{mu} = \beta * R_{tp} = \alpha\beta * R_t$$

From this expression using definitions above one can easily arrive at the formula for the coverage ratio:

$$(2) \quad \gamma = R_{mu}/R_c = \alpha\beta/(1 - \alpha\beta)$$

During the 90s α has fluctuated between 0.25 and 0.35 and only in 1998 it jumped to almost 0.60¹. To be on the safe side for a relatively calm year (see para 25 of staff paper), let's assume that $\alpha = 0.35$. Historical data is most likely to provide very low figures for β . But even assuming that 1/3 of all reserve tranche positions are withdrawn by creditors during next year (an event highly unlikely) we shall get the coverage ratio (γ) equal to 13 percent and the amount of minimum uncommitted resources of SDR18 bn.

In general, different combinations of α and β could lead to very different coverage ratios, and, correspondingly, different calculated amounts of minimum uncommitted resources (see the table below). Therefore, thorough consideration of the values for α and β is needed in order to arrive at a reasonably justifiable figure for minimum uncommitted reserves.

α	0.20	0.25	0.30	0.35	0.40	0.45	0.50	0.55	0.60
β	0.30	0.35	0.40	0.45	0.50	0.55	0.60	0.65	0.70
γ	0.06	0.10	0.14	0.19	0.25	0.33	0.43	0.56	0.72
R_{mu}	9	14	19	24	31	38	47	55	65

Mr. Zoccali and Mr. Pereyra submitted the following statement:

We thank staff for following up on the concept of forward commitment capacity advanced last October. At that time, we concurred with the assessment that the events of 2001 called for a more appropriate measure

¹ See Financial Organization and Operations of the IMF, 2001, p.67, Figure II.5.

of the Fund's capacity to commit GRA resources. While the conceptual and statistical refinements proposed on this occasion move us in the direction of a more robust measure of the supply of Fund resources, the difficulty of estimating with precision the prospective demand for Fund assistance make considered judgment in this domain critical.

The shortcomings of the liquidity ratio as a measure of the supply of Fund resources relate to the fact that it does not directly indicate the size of available Fund resources for new financial commitments over a given period, and that it involves discretionary adjustments to undrawn balances that could be subject to unexpected activation.

The numerical exercises included in the staff paper suggest that the liquidity ratio lacks the stability that would be desirable in a liquidity indicator. Moreover, staff point to its significant volatility in the event that precautionary arrangements are activated, as these would be reclassified as non-precautionary, and deducted from usable resources in the numerator while increasing liquid liabilities in the denominator. Nevertheless, since precautionary arrangements in most cases are still intended to play only a signaling role, a more nuanced approach for the definition of uncommitted usable resources may be advisable. Given the conservative features built into the new indicator, we would not be opposed to preserving the fifty percent assumption for undrawn balances under precautionary arrangements.

The more forward-looking indicator proposed by staff takes into consideration the revolving character of Fund resources. In this regard, the assumptions used for the timing of repurchases, based on expectation schedules for the SRF and CCL, and obligations schedules for repurchases made in the credit tranches and under the CCFF and the EFF is more consistent with the program design under Fund arrangements.

Concerning the minimum prudential level of uncommitted usable resources, Box 2 provides a calculation that is both transparent and consistent with past experience. In our view, the judgmental elements involved in the estimation: the election of the historical low of the third and fourth quarters of 1998 and its scaling by changes in the size of the Fund's potential resource base since 1998, provide a useful starting point for determining the minimum prudential level of own resources the Fund needs to safeguard the effectiveness of its role in the international financial system. The implied liquidity ratios corresponding to a minimum level of uncommitted usable resources in the range of SDR 35-45 billion would provide, in our view, a large cushion to hedge against a potential erosion of the resource base, considering that participation in the FTP is currently at a record level of 73 percent of total quotas, despite the higher risk of balance of payments difficulties that confronts emerging market participants.

The adequacy of any measure of supply of Fund liquidity cannot be assessed independently of the properties of the indicators of potential demand for financial commitments. Given an environment in which capital flows and financing needs have become much more volatile, as shown by the experience of 2001, we welcome the initiative to bring into the framework alternative scenarios and stress tests. We look forward to further progress in this field. At the same time, we underscore the importance of allowing for considered judgment to ensure that Fund financing decisions remain effectively geared to facilitating the orderly resolution of members' external payments imbalances. The ongoing efforts to develop early warning indicators and vulnerability assessments, and the work with large access policies and private sector involvement should be approached in this light.

In closing, we can agree with the staff proposal that the measure of forward capacity to commit GRA resources replace the liquidity ratio as the principal measure of Fund liquidity. We concur that repurchases be projected in line with programming assumptions. We can go along either with the proposed or a somewhat lower minimum prudential level of uncommitted resources. Finally, the regular publication on the Fund's Web site of data on the forward capacity to commit resources and its calculation methodology would be in line with the Fund's transparency policy.

The Deputy Treasurer (Mr. Kuhn) made the following statement:

I thank Directors for their statements.

I will respond first to some of the issues and questions that Directors have raised, starting with a few general remarks about the concept behind the forward capacity to make commitments.

First, our aim was to come up with a measure that is useful for decision-making. Since the Board makes financing decisions on a commitment basis, the relevant question for decision-making is the capacity of the Fund to make new commitments. The traditional liquidity ratio does not provide an answer to this critical question.

Second, in order to be credible, we believe that any new measure should be simple and that it should be transparent, a test that the traditional liquidity ratio certainly cannot pass. Transparency has two aspects. First, the measure should be fully consistent with and be easily derived from the financial data that are currently published. In particular, the hard accounting data in the Fund financial statements and other readily available sources on the level of usable resources, the level of financial commitments that the Fund has already entered into, and the level of repurchases over a given period. The second and related aspect of transparency is that the Board's judgments on the minimum prudential level of uncommitted usable own resources be clearly

stated and expressed in one place. This minimum is clearly a matter of judgment, though we believe within a very narrow range.

Before coming to the question of the appropriate prudential minimum, I would like to underline one fundamental conceptual point. The new measure is a commitment concept, not a cash flow measure. Mixing commitments with cash flow considerations would make the measure of the forward commitment capacity essentially useless, both as a concept and as an operational tool for decision-making, and in fact recreate the problems that have made the current liquidity ratio ineffective.

This means that precautionary arrangements and CCLs, if approved, cannot be treated differently and should not be discounted by some judgmental factor. To be sure, we would recognize that precautionary arrangements and CCLs may have a lower likelihood of being drawn on than other Fund arrangements, but this should not mean that they represent a lesser commitment by the Fund. This may strike some as conservative, and indeed it is conservative in the sense of conserving the credibility of the Fund's financial commitments vis-à-vis its members and also vis-à-vis the markets, and in conserving the Fund's capacity to deliver on its financial commitments at all times. I would want to underline that it is normal standard banking practice to have the financing sources for all contingent lending commitments fully identified and readily available. Any financial institution that enters into a commitment to provide funds without having the sources of financing fully identified could not pass muster with its supervisory authorities or its auditors.

Any financial institution must be prepared for a run on undisbursed credit. For the Fund, which does not operate in the market, has no discount window to go to, and has no lender of last resort behind it, this means that the full commitments, contingent or not, must be fitted within the existing envelope of available financial resources. That is, the Fund's own resources and the potential availability of borrowed resources under the NAB and GAB.

The Fund's overall commitment capacity is currently SDR 189 billion. This consists of SDR 155 billion in quotas of members that participate in the financing of the Fund through the FTP and a potential SDR 34 billion in borrowed resources that are available under exceptional and well-specified circumstances. The suggested minimum prudential level of uncommitted resources of SDR 40 billion must be measured against this overall capacity. It needs to cover not just the own resource base but also potential borrowing. It would therefore be conceptually and operationally quite difficult to operate with two different levels, including a lower one for own resources that would then need to be increased if the Fund needed to borrow.

On the level of the minimum, we proposed in the paper a range of SDR 35 to 45 billion with 40 billion as a midpoint. We have given a lot of

thought to this level, and I would like to go over our reasoning again. Basically, we used existing policies and judgments that are incorporated in the liquidity ratio, albeit in a very nontransparent manner, and translated these existing judgments and policies into the new measure. There is, therefore, no additional more or less conservative assumptions by the staff behind it. As described in Box 2 on page 7, we arrived at the level by taking the historically lowest level of own and committed resources in relation to the size of the Fund of SDR 26 billion in late 1998. At that time the Fund's liquidity—I think everybody would agree—was clearly under very acute stress and both the GAB and the NAB had been activated. We then scaled this historical low point by the increase in the Fund's quotas as well as its commitment capacity. This gave us a range of SDR 38 to 43 billion. We then did a number of cross-checks to see how this range would stack up against the two main prudential reasons for holding a minimum level—the safeguarding of creditors' positions and protection against the resource base. Some of these cross-checks are explained in the footnotes. There are also other prudential reasons which we did not note in the paper, such as liquidity shocks from arrears because we did, in fact, not want to base our reasoning on worst case scenarios but, rather, what we consider very plausible assumptions.

On the possible erosion of the resource base, footnote 9 on page 8 provides some illustrations that put the erosion at between possibly SDR 8 billion to 21 billion. Again, these are not worst case scenarios. SDR 20 billion in erosion is entirely plausible, given that we are at record participation in the FTP at this stage. A more conservative assumption would have been to consider only those members that have participated in the FTP without interruption over the past decade. This would lead to an erosion in the resource base of SDR 47 billion. But we discarded this as a worst case erosion.

On the second main prudential reason, the safeguarding of creditor positions, the paper lays out, in footnote 6 on page 5, the possible consequences for the financial nature of the Fund as an exchange of reserve by central banks rather than as governmental lending. Here clearly the views of adequacy of coverage by the Fund will differ, but it is important to note, again, that the cash flow is not a relevant indicator here, and from a prudential point of view, experience with actual reserve tranche purchases in the recent past cannot be used as a test for adequacy.

Finally, we also compared—and that is on Table 1, page 9—the proposed minimum range against the coverage ratio and the traditional liquidity ratio, and we have provided alternative illustrations in footnote 11 on page 8 that show that the proposed range is indeed consistent with, but could also be well below, the historical low points of the past.

In their statements, some Directors have suggested alternative minima, some much lower, some higher. The U.S. proposal is for a range of SDR 20 to 25 billion. This would be even lower than the actually observed minimum in 1998 when the Fund was in a critical liquidity situation and when the size of the Fund was much smaller. It would, in our view, simply not be possible to explain to the public why the Fund was cutting its prudential limits at this time by a very large amount. Moreover, if one traces the proposal to its logical conclusion—as one should in order to see the effects—under a forward capacity to make commitments of SDR 65 to 70 billion, together with a proposed 50 percent discount on possible CCLs, the Fund could—I realize this is extreme—make precautionary or CCL commitments of the order of SDR 130 to 140 billion before exhausting its commitment capacity; but this level of commitments would far exceed the Fund's identified and available resources and could and would therefore seriously undermine the credibility of these commitments. However, I do find myself in agreement with Ms. Lundsager and Mr. Baukol in their calculation, on page 2 of their statement, that a minimum of SDR 40 billion could, under certain assumptions which they find realistic, result in a liquidity ratio of 37 percent. If they were to add in potential borrowing and assume the same disbursement ratio, the resulting liquidity ratio would, in fact, be slightly below 30 percent. This provides, under the disbursement assumption of the U.S. proposal, itself support for the staff's proposal of a minimum of SDR 40 billion.

Mr. Portugal and Mr. Tombini, as well as Mr. Yagi and Mr. Yanase, suggested a higher minimum level. Mr. Portugal suggested that we should look at an earlier low point in 1992 as the basis for deriving the minimum. If that point was used, the derived minimum would be of the order of SDR 70 billion. Using this higher level would exhaust a large part of the Fund's current capacity to make commitments and also result in much higher coverage in liquidity ratios than were observed in the past.

I will come back to some of the specifics as further questions arise.

The Acting Chair (Mr. Sugisaki) asked whether the Deputy Treasurer had any comment on Mr. Cippà's proposal that the minimum prudential level should be expressed not in terms of an absolute amount, but in terms of a ratio of total resources.

The Deputy Treasurer (Mr. Kuhn) replied that the proposal had a certain attraction because it would link the minimum prudential level directly to the overall commitment capacity. However, at this stage, he would consider it of a second order given that the minima proposed by Directors covered a very wide range, and that agreement on a range would be needed before one could translate it into a ratio. Moreover, the ratio would need to be translated again into nominal amounts because the forward commitment capacity was expressed in nominal terms. A ratio would be helpful over the longer run, because it would automatically adjust the agreed level in terms of the overall commitment capacity of the Fund, but at this stage it just presented the question of the level in a different form.

Mr. Rouai noted that his chair was satisfied with the staff's answer on Mr. Cippà's proposal.

Mr. Cippà stated that he was a bit surprised that the staff was dismissing his proposal by saying that what was important at that moment was to fix a nominal figure. His chair's point was precisely that a nominal figure was quite arbitrary, and that it would be more transparent to express the amount as a ratio of the Fund's total own, as well as actually borrowed, resources. That was common practice in the private sector, and most people would understand it quite easily. The staff's proposal was much more complicated.

Mr. Portugal agreed with Mr. Cippà that the staff's proposed level of SDR 40 billion was arbitrary. As the staff had noted, it was a question of judgment, and he himself would prefer a different figure. However, one would not eliminate the problem of arbitrariness by changing from a nominal figure to a percentage. There would still be the problem of explaining why 20 percent, rather than 25, or 30, or 40 percent, and the percentage would also be arbitrary. The advantage of a nominal figure, as Mr. Kuhn suggested, was that it was a measure that was more useful for decision-making because, when the Fund committed resources, it did not commit them in terms of percentages, but in nominal terms.

Mr. Brooke, responding to Mr. Portugal's comment, said that he did not agree that using a ratio would be more arbitrary than using a nominal amount. The aim was to provision against a contingent liability, and the contingent liability was that creditors in the Financial Transactions Plan could decide to draw down their reserve tranche positions. As such, identifying a minimum reserve percentage would be a normal approach that one would take in any bank towards provisioning. One never provisioned against all contingencies, nor against none, but in proportion to the risks of that contingent liability. The problem with just stating an absolute nominal number was that it would not appear to be directly linked to changes in that contingent liability, whereas a percentage approach would be clearly linked to the size of the contingent liability, and could be automatically adjusted in line with it. That would be far preferable.

Mr. Lushin asked whether any explicit and specific numerical assumption concerning the potential withdrawal by creditors of their reserve tranche position was embedded into the staff's proposal of SDR 40 billion to be used as uncommitted precautionary reserves. Moreover, he agreed with the comments made by Mr. Cippà and Mr. Brooke. It would be preferable to use a ratio, because the amount of actual reserve tranche position against which there should be a reserve could move with time. In his own statement, he had proposed an approach for calculating that ratio, and his approach was really the same as Mr. Cippà's, in that it involved a determination of uncommitted reserves as a proportion of total available reserves. The only difference with Mr. Cippà's proposal was that Mr. Cippà thought that the level should be 20 percent, whereas he himself preferred to go further. The ratio could be presented as a product of two more simple ratios—that is, the ratio of outstanding credit to overall resources, and the percentage of potential withdrawal by creditors of their reserve tranche positions. Those were much simpler ratios that would allow for better judgment in estimating the necessary figure for the ratio that Mr. Cippà was talking about.

The Acting Chair (Mr. Sugisaki) observed that the question of how to measure the minimal prudential level remained an issue.

Mr. Low stated that he also agreed with the views expressed by Mr. Cippà and Mr. Brooke. The aim was to provision against a potential drawdown of reserves by determining a minimum reserve requirement which could not be lent out, in the same way that banks set aside a percentage of their deposit liabilities which they could not lend out. Having been a banking supervisor for a large part of his career, it made more sense to him to represent this figure as a ratio. The benefits of a ratio over a fixed figure was that a ratio was much clearer and more transparent, in the sense that, if resources changed, the reserves automatically needed to change. With a nominal amount, it would be necessary to keep coming back to the Board to say that the figure should change from 40 billion to 50 billion, and back to 30 billion, for example. There was more arbitrariness in doing that than in having a fixed ratio that would determine the actual nominal amount. The question was what that ratio should be, and that decision was certainly arbitrary. Perhaps it might be useful for the staff to look further into Mr. Cippà's proposal, and come up with some possibilities.

Mr. Yanase pointed out that, under Mr. Cippà's proposal, whether the number was defined by a ratio or a nominal amount did not matter because the amount would be a percentage of the overall Fund usable resources, which would not change unless quotas increased. However, he had some problems with Mr. Cippà's proposal because it would require an increase in the minimum prudential level when there was borrowing through the NAB or GAB, i.e., at a time when it would be difficult for the Fund to increase its reserve margin. Moreover, the discussion on the prudential level only concerned the cases where creditors dropped out of the FTP, or withdrew from their credit tranche. In the case of late 1998, there was concern that the level had reached such lows because it was possible that some countries were going to draw further, even if they were not in the FTP. In that sense, the minimum prudential level needed to be not only protected against the parliaments in the creditor countries, but also some potential debtor countries that were not in the FTP. Unlike banks, it did not seem wise for the Fund to deny countries further commitments even if there were no room for commitment. Therefore, the Fund's minimum prudential level should have enough margin so that the Fund is able to provide some financial assistance even if the situation were to be very difficult.

Mr. Cippà replied to Mr. Yanase that the size of usable resources was not fixed. In fact, as the staff mentioned in the paper, it could change quite substantially even without an increase in quotas. One big consideration was whether to include the NAB/GAB or not. His own proposal was that those resources should be covered only if they were used. Of course then the question was how to do that, but it could be done simply by adding the percentage of the ratio into the reserves. Therefore, he agreed with Mr. Portugal that there was an arbitrariness in fixing the 20 percent or 26 percent, for example. He had chosen 20 percent because it would yield an amount roughly equivalent to the staff's proposal of SDR 40 billion—and he accepted the idea that SDR 40 billion could be appropriate if the NAB/GAB was included. He also understood that there were two levels of discussion. One was to fix the rate and the other one to fix the methodology. However, he did not agree with the staff assertion that the number should be fixed first and then the methodology discussed later on.

Instead, the methodology should be discussed first, and then the actual arbitrary amount should be fixed.

Mr. Brooke said that he fully agreed with Mr. Cippà's point about the changes in the size of usable resources. The total size of the quotas was SDR 212 billion, but the usable currencies would change depending on the position of countries in terms of moving in and out of the Financial Transactions Plan. That was why the total amount of provisioning would not stay constant, but rather move in line with the strengths and weaknesses of the membership of the Fund. Furthermore, in response to Mr. Yanase's point about the volatility of demand and the volatility of countries moving in and out of the Financial Transactions Plan, that was very much more a question of demand forecast, rather than of provisioning against the contingent liabilities of countries in the Financial Transactions Plan. He agreed with Mr. Yanase that that was an issue that needed to be considered, but it should be addressed where it arose—on the demand side of the forecast—and through greater scenario analyses on the demand side. He did not see how that should affect the minimum provisioning level of usable resources.

Mr. Baukol, picking up on Mr. Cippà's idea that the broad methodology should be discussed, noted that he had also wanted to come back to something that the staff had mentioned about the rationale for their proposal, which was that the current measure would be based to the extent possible on existing judgments, but that there was one in particular that would not be included—the 50 percent assumption on precautionary and CCL arrangements. The staff had indicated that the reason for that was to provide a measure that was focused purely on commitments and that did not include any cash flow measures. However, it seemed that a number that was purely based on commitments would probably not be the most useful, relative to something that was mainly based on cash flow, which was what the liquidity ratio had been, and the liquidity ratio had not been completely useful. Therefore, some combination would seem reasonable, and keeping the assumption on 50 percent of precautionary and CCL arrangements would seem to be most useful. Moreover, he was not sure exactly why it was necessary to get rid of the liquidity ratio all together, which was part of the staff's proposal.

The Deputy Treasurer (Mr. Kuhn) replied to Mr. Lushin that there were no explicit assumptions about the cash flow of the reserve tranche position embedded in the SDR 40 billion. The staff did not think that the cash flow that actually had been experienced was a good indicator for the amount the Fund should hold as provisioning against reserve financial tranche drawings. It was very difficult to disentangle the various different effects, although the staff had tried to do so. The staff had made some cross-checks, but looking at actual reserve tranche drawings over the past in fact would suggest a much smaller ratio than what the staff had observed as the behavior of the Board. The right of unconditional drawing of reserve tranche positions still remained. Whether that right had in the recent past actually been used or not was not necessarily a good predictor of possible future drawings.

Similarly, in response to Mr. Baukol, a level of 50 percent of provisioning for precautionary and CCL arrangements would be the worst of all worlds, the Deputy Treasurer continued. The 50 percent was entirely arbitrary—it had no basis in either experience or

history, and would get the Fund into a position where it could over commit without having a precise explanation every time whether the forward capacity included or excluded CCLs. It would be preferable, indeed necessary, to have a clear measure that took into account the Fund's commitments because, after all, precautionary commitments, and in particular CCLs, for which there was not any experience yet, are often in place as a protection against financial contagion and so there is a likelihood that they would be drawn at the same time. Therefore, in those circumstances, it would be necessary to have enough resources to honor those commitments. An arbitrary judgment would be very difficult to explain, and it would not be fully consistent with the commitment measures, as the staff proposed. In that case, the liquidity ratio, which incorporated that assumption in an arbitrary way, was as nontransparent and as unhelpful as one could get.

Mr. Lushin stated that he agree with the Deputy Treasurer that historical data was not a good basis for judging possible future withdrawals, but regardless, some kind of judgment should have been made because, for example, if one took the current level of reserve tranche position—about SDR 55 billion—the proposed figure of SDR 40 billion represented a ratio of about 72 or 73 percent of possible withdrawal. If those figures were meant as a cushion against withdrawal, a range between 50 and 75 or 80 percent could be thought about in that context. Why not? It was better to be clear about the assumptions that were being made in order to arrive at a specific figure, rather than just trying to avoid any specificity.

Mr. Baukol agreed with the staff that a level of 50 percent provisioning for precautionary and CCL arrangements would be an arbitrary assumption. However, arbitrary assumptions were being made in any case in defining the measure. Therefore, that argument did not dissuade him from thinking that it would still be a good idea. In terms of clarity, the staff also mentioned that the liquidity ratio had not been completely transparent. However, anything could be transparent if it was published. It would be sufficient to describe the methodology in detail, and publish it. There was a possibility, as the Deputy Treasurer had pointed out, that one could, in theory, approve CCLs worth SDR 130 billion—but that was extremely unlikely, and the Board might realize what it was doing in such a case and be able to take that into account.

Mr. Cho made the following statement:

At the outset, we would like to express strong support for the staff's proposed new concept of forward commitment capacity. In our view, it is a better and more easily understood indicator of the resources available to the Fund to meet members' needs.

The staff is right when they say that it is very hard to figure out the true picture of the Fund's future commitments capability from the current liquidity ratio. The ratio is a mixture of accounting data with judgment elements hidden in it, so that the interpretation of the true liquidity position of the Fund is not easy to make, especially for a layman.

The new measure of forward commitment capacity proposed by the staff is a big step forward in gauging the liquidity position by making it clear where the judgments are made, while also providing accounting data. In fact, the staff has demonstrated its own judgments in a number of areas based on the Fund's past experience. It is proposed that the SDR 40 billion be set aside as a minimum level of uncommitted usable resources, which is equivalent to 35 percent of the maximum reserve position when the Fund lends its own resources to the pool. It is assumed that the 100 percent of current and precautionary arrangements would be covered, as the U.S. chair just mentioned. It also assumes that the SRF and CCL would be repaid on an expectation rather than obligation basis. It is tempting to argue about the reasoning behind the various assumptions. For example, why determine the minimum level of uncommitted usable resources equivalent to 1998 levels which are considered low enough for the Fund to have to activate borrowing arrangements, as noted by Mr. Portugal, Messrs. Yagi and Yanase, and Mr. Tombini? Why also does the minimum level of uncommitted usable resources have to be a fixed amount? Would it not be more realistic to assume that the greater amount of uncommitted resources is required at the event of borrowing, as Mr. Cippà suggested? Or should there be an explicit assumption for a working balance in the uncommitted usable resources calculation?

We will refrain from getting into the details behind the assumptions because in the end we recognize that it ultimately comes down to judgment calls. Nonetheless, we think it will be appropriate that such judgment calls, in terms of assessing the Fund's forward commitment capacity, should be highly conservative. The Fund should be a bastion of conservatism when it comes to its financial position. Of course, the Fund should maintain its standards and principles when deciding on making Fund resources available in actual cases, but there should be absolutely no questioning of the Fund's ability to be able to meet members' needs or meet its commitments.

Without the market's confidence in the Fund's capability to meet its future commitments, the Fund's guiding role in the market would be significantly undermined, including any concept of the Fund playing a catalytic role in PSI. When it comes to what assumption to make in assessing the Fund's usable resources to meet members' needs, we should follow the policy of planning for the worst and hoping for the best.

The very reason why the Fund needs a new index of liquidity position is to prevent a situation where the Fund lacks resources to meet members' needs. In this respect, the new index should give a fairly advanced warning signal for members to react if a shortage situation is at all envisaged. This cannot be overemphasized, given the political reality that obtaining consensus for a quota increase—which is a preferred means to address a potential resource shortage at the Fund—tends to take time.

This leads to another comment on the staff's new index. That is, it mainly deals with the supply side of the Fund's liquidity position while leaving mostly unanswered the question as to what is happening on the demand side. The index covers only members' needs that have already been committed, but it does not explicitly project future potential demand. While we endorse the staff's view that this potential demand requires separate rigorous work, we emphasize at this point that the new index tells only a half picture of the Fund's liquidity position, without proper projection of the members' future potential demands. So we hope to see an equally robust paper on this matter soon.

Mr. von Kleist made the following statement:

We thank staff for a clear and persuasive paper and we can support the proposals. I especially also welcome and support the additional remarks Mr. Kuhn just made. We do, however, have suggestions for some minor further improvements.

With regard to the proposed replacement of the liquidity ratio with the forward capacity indicator, we see the benefits of introducing the newly developed indicator. However, we would like to keep the liquidity ratio as an additional indicator for the time being. The liquidity ratio has served the Fund well in assessing the adequacy of its resources. The new forward commitment indicator is a useful and clear indicator of the lending capacity of the fund. Yet, being an absolute number, the forward commitment indicator has some limitations in assessing and comparing the lending capacity of the Fund in the medium and long term. We, therefore, suggest that we keep the liquidity ratio as an additional indicator which enables us to set current developments in the right perspective by creating comparable numbers over a longer time horizon.

We explicitly endorse the proposal to fully include the undrawn balances of precautionary arrangements in the calculation of any indicator. We have suggested this in the past and appreciate it that staff has made this proposal in the context of this discussion.

More and more Fund resources are concentrated among only a few borrowers. Recent examples of large access have shown that program assumptions often do not materialize as envisaged. Therefore we could support an approach which is even more careful. This could either be an approach in which we use obligation schedules for all repurchases or an approach in which we decrease the repurchases assumptions by a certain margin.

On the proposed minimum level of uncommitted usable resources of SDR 40 billion, we think this a prudent level. This being said, while it can be argued that the number of 40 billion SDR is in a sense arbitrary, any other

number is at least equally so. We certainly prefer to err on the side of caution without exaggeration in either direction. On the proposal of Mr. Cippà, we certainly see merit in his or some related proposal of using a ratio, provided this results roughly in the same provisioning as the SDR 40 billion that staff has proposed. The other generally conservative assumptions, for example assuming full disbursements of all committed resources, are also prudent and appropriate for a monetary institution. Footnote 6 on page 5 of the staff document makes a very valid point in this regard.

Finally, on the publication issues. We support the publication of the forward capacity to commit GRA resources. However, as I said earlier, we are in favor of keeping the liquidity ratio for the time being and we would therefore appreciate it if the liquidity ratio could be continued to be published as well.

Mr. Duquesne made the following statement:

Let me first thank staff for this interesting and stimulating report that takes significant steps towards a simplification of our financial apparatus. But before analyzing the new proposals, let me say a few words on the liquidity position of the Fund.

I agree with staff to consider that the liquidity position remains comfortable despite a sharp drop of the liquidity ratio and a degradation of the forward commitment capacity in 2001. I would like nevertheless to point out the extreme concentration of our commitments since more than 90 percent of the new commitments between January 2001 and March 2002 were made on three countries Argentina, Brazil, and Turkey. Such information, which sheds a different light on the evolution of the liquidity of the institution, is in my view very useful to complement our assessment of the liquidity position. I thank staff for drawing our attention to this question and it should go on and systematically provide us with an analysis of the concentration of our commitments.

Turning now to the proposal to shift from the liquidity ratio to the forward commitment capacity, let me say that I welcome this simplification and that I see it as a positive step in terms of our institution's transparency. I appreciate in particular the fact that it makes it easy for the public and the authorities to assess the room for maneuver of this institution. I have therefore no difficulty to support the use of the forward capacity as the principal measure of the Fund's liquidity. Moreover, to calculate it in SDR gives a more accurate idea of this room for maneuver than any percentage. Percentages which can change either because of the numerator or of the denominator are not less arbitrary than figures. Answering Mr. Low: why 8 percent for the Cooke ratio and not 10 percent?

This being said, this new indicator is based on conventions, which, like every convention, can be discussed.

For example, some can argue that the minimum level of uncommitted usable resources, which sets a minimum prudential level of SDR 40 billion, is too high. Such an assessment is eventually a judgment call and we have no strong views on it. We share staff's views that there is a need to protect the Fund from an erosion of the resource base and I find the staff's argumentation relatively convincing. On the need to safeguard the position of the Fund's creditor, it is very difficult to determine what should be the right coverage ratio and, here, again, I tend to trust staff to determine the appropriate level.

On the manner the Funds' commitments should be recorded, we note that staff proposes to take fully into account the amounts committed on a precautionary basis and committed in the context of a CCL. This way of accounting is indeed consistent and simple but may turn out to be overly cautious. We can support the proposal but we should keep it under review depending on how the CCL evolves.

Finally, we support the publication of the forward capacity. However, we believe that the difference of treatment in terms of calculation of forward commitment capacity between an SRF or a CCL and a Stand-By Arrangement or an EFF which can be understood when you keep in mind the discussions on the reform of facilities, remains highly conventional and will not facilitate our communication policy. It thus does not respect the criterion of simplicity put forward by Mr. Kuhn. Therefore we encourage staff to review this question and to find a solution to harmonize the two treatments. In this context, I find Mr. Portugal's comments sensible and therefore I would tend to harmonize on the basis of the use of the obligation schedule for all facilities.

To conclude, let me say that we welcome the work underway to refine the determination of potential demand for Fund's resources and in this context we look forward to a discussion on large access to Fund resources. We also encourage staff to pursue its work on a more judgmental approach based for example on alternative scenarios.

Mr. Varela made the following statement:

I thank staff for the clear and concise report they have prepared for today's discussion, and Mr. Kuhn for his comments this morning.

We support the staff proposal to adopt the forward commitment capacity as the main measure of adequacy of the Fund's liquidity. We think this new concept provides a more transparent way of assessing the amount of resources available for new commitments, and it incorporates also in a more transparent and clear way the judgments that are needed to determine it.

We also support that the forward capacity to commit resources be published regularly on the Fund's web site with an explanation of its principal components and the way it is calculated.

We think, nevertheless, that it would be useful to continue using the liquidity ratio as a complement of this forward commitment capacity variable, as has been suggested by Mr. von Kleist. The main element that is needed to calculate the forward capacity indicator is the minimum prudential level of uncommitted usable resources. We would always need an element of judgment to reach a consensus on the appropriate figure in this regard, and for this I think we need to take into account the key role of the Fund in the international financial architecture. Staff considers a range of SDR 35 to 45 billion and finally proposes to use a midpoint of SDR 40 billion. We would favor a higher figure than that, closer to SDR 50 billion. We concur with Messrs. Portugal and Tombini, Messrs. Yagi and Yanase, and now Mr. Cho, that it is not very convincing to use the figures observed in 1998 as a benchmark, particularly considering that, as staff points out, that level, SDR 26 billion, was considered acceptable only because a quota increase had already been agreed and was to become effective shortly, and in fact lead to the activation of borrowing arrangements. Moreover, it is important to highlight that the main reason to maintain a minimum level of resources is safeguarding the position of the Fund's creditors. A reduction in the minimum level could jeopardize the usability of creditors' position as an exchange of reserves assets. This might have significant implications for the Fund's resource base, so it is necessary to provide a minimum level that is perceived as comfortable by the membership.

Another element to obtain a reliable calculation of the forward commitment capacity is the repurchase schedule of Fund facilities. Although we could go along with the staff proposal to use repurchases for SRF and CCL on an expectation basis and other repurchases on an obligation basis, we think it would be more prudent to assume obligation schedules for all repurchases. Like Mr. Cippà, we think that calculations could be made on a regular basis, taking into account both assumptions.

The weakest part of the current analysis is the lack of a strong framework for projecting future demand for Fund resources. We look forward to the new approach that is going to be prepared by staff based on different scenarios and stress tests. Nevertheless, here again it will be necessary to use judgment in order to come up with a figure that could be used for the calculation of future financing needs. In this regard, besides increased volatility in financial markets, recent episodes show that the nature of economic and financial crises has changed. Capital account crises are now much more common than current account crises. They not only appear in a certain way, but they also demand sizable amount of resources to deal with. Therefore, the projections based on past experience need to be modified in

order to be more realistic and for the Fund to be better prepared to attend possible financial needs.

Although the current level of the Fund's liquidity seems adequate according to staff figures, I think that the more conservative approach should be followed, and also we will need to know the outcome of the new framework for projecting future demands. We share the views expressed by Mr. Yagi and Mr. Yanase that larger resources might be needed in the future. We also share other colleagues' concerns about the reduction of the size of the Fund's total resources relative to developments in the international economy. As Messrs. Portugal and Tombini stress in their statement, the quota shares of some countries are no longer representative of their position in the world economy. We need to continue discussing these issues before reaching a final conclusion. The 12th General Review of Quotas and the issue of access policy to Fund resources will provide good opportunities to further analyze them.

Mr. Padoan made the following statement:

We welcome this discussion on the Fund's liquidity position and we thank staff for providing us with an informative paper.

On a general ground, we agree with staff that a forward commitment capacity measure is a more informative indicator of the Fund's supply of resources. Of course, this depends on the fact that a liquidity measure is not a lending capacity measure and, therefore, it cannot serve a purpose for which it has not been designed.

This new indicator is more helpful in guiding us through lending decisions as it takes into account commitment of resources already agreed, as well as repurchases by member countries.

In providing support to lending decisions, however, the effectiveness of the indicator is conditional upon two main assumptions: about repurchases and about the demand side.

Inevitably, a consideration of repurchases is based on a judgment on program success. Hence, if such an indicator is to become a reliable measure of forward lending capacity, we need to further strengthen program-monitoring. If program countries were to find themselves in a position not to make the repurchases—as expected under a program—then the framework we would have adopted would be seriously flawed.

Furthermore, in contrast with the current approach whereby the liquidity ratio offers a static picture, staff correctly point out that the new framework is of a forward-looking nature. However, the extent to which this is going to be helpful also depends on the ability to make a reliable assessment

of what the demand on Fund resources is going to be for the relevant period. The staff report only devotes limited attention to this aspect, while pointing to key issues to be discussed in the future.

As the report suggests recent efforts on Early Warning Systems and vulnerability assessment exercises may help Treasury in assessing liquidity needs. The use of EWS, which I believe is to be encouraged, would only be a part of the complex exercise in assessing demand. Indeed, as the report mentions, a more exhaustive analysis of the demand side implies looking at key issues such as access limits, private sector involvement, and debt sustainability, and we look forward to our future discussion on these items.

This also implies however, that we will need to return to an assessment of Fund liquidity once further steps have been taken in this direction. I concur with the statement in the report (para. 17.) that it will be difficult to come up with readily-quantifiable projections of the demand for Fund resources. Nonetheless, I do hope that demand-side consideration will be taken into proper account in the future so as to avoid that the assessment of Fund liquidity is bias towards supply considerations.

Also in this respect I look forward to the paper on alternative scenarios, which could fruitfully incorporate alternative assumptions for the demand side.

Finally, a last remark concerns the determination of the minimum level of Uncommitted Usable Resources. An issue on which there seems to be a wide range of opinions. As this Chair pointed out in the recent discussion on the Fund's income position, we believe that, in a context of increasing uncertainty about the level of the resources demanded, increasing concentration and volatility associated with their use, as well as other sources of uncertainty including the extension of FTP, we should strengthen our efforts to develop a more suitable framework for deciding on the appropriate minimum level of resources to set aside.

In this regard, on the one hand, the staff's paper assumes full disbursement of the resources committed, including CCL, which may be excessively cautious. On the other, it is assumed that all repurchases materialize as envisaged under Fund's programs, which may be too optimistic. Overall, we see a strong need for improvement in the basic assumptions. This would also have the desirable effect of focusing discussions on methods as well as on outcomes. Meanwhile, given the uncertainty with which such figures are determined, we prefer to be more on the cautious side and support the level of uncommitted resources as suggested by staff, that is about 40 billion SDR.

Mr. Brooke made the following statement:

Like other Directors, I feel that the forward capacity indicator that the staff has proposed involves fewer judgments, is simpler, and more transparent than the existing liquidity ratio. As a result, I agree in principle that it should replace our existing liquidity ratio. That being said, I have a number of reservations, and I would hope the staff would be able to make some changes before we begin to publish this indicator.

First, as I think is quite clear from comments we have already heard today, we should be careful not to interpret the new indicator with an inappropriate degree of certainty. To overcome this, I would like the Treasurer's Department to provide a more detailed variance analysis than they have in this paper that would include more information about plausible good and bad scenarios relating to developments in the Fund's liquidity position. We could then publish either a range estimate for the forward capacity indicator or accompany a point estimate with more explanatory text on the uncertainties.

Second, like Mr. Cippà and Mr. Lushin, I am concerned about the arbitrariness of the procedure used by staff to derive the minimum level of uncommitted usable resources. I do not have any strong views on what the appropriate level should be, given that I did not really feel that we had enough information to make such a judgment, but in line with Mr. Cippà and Mr. Lushin, I would much prefer it if we were to adopt an approach that took greater account of the changing nature of the underlying contingent liability. My preference therefore would be to include a measure for the minimum level of uncommitted usable resources that more explicitly takes account of the idea that the longer it has been since a country has had an IMF program, the less the Fund needs to provision against the likelihood of that country running down its reserve tranche position.

Turning to the other elements of the capacity indicator, on undrawn balances under GRA arrangements, I agree that the central assumption should be that these commitments will be fully drawn. However, in the variance analysis that I just requested, it would be helpful to also include information about the average fraction of Fund commitments that do not get drawn down due to programs going off track or to more favorable and expected outcomes, leading to programs being treated as precautionary.

On the projected repurchases, I agree that the central assumption should be that the SRF and CCL repurchases will be repurchased on an expectations basis and that all other repurchases will be on an obligations basis. Here again, though, we could expand the analysis in the variance section to include information contained in footnote 30 and about the best and worst case repayment scenarios that did not involve any overdue obligations.

Going beyond this, we could also helpfully include information about the average fraction of Fund commitments that get repaid ahead of expectations schedule and the average fraction that go into arrears.

Turning to demand considerations, I agree with staff that recent experiences made it extremely difficult to forecast the level of new IMF commitments. While we should continue to make use of the individual desk economist projections, I look forward to the forthcoming paper outlined by staff that will consider ways to refine our forecasts in this area. Clearly this work will also need to take account of any changes to our access policies. In the absence of anything more precise being available, I agree that it is appropriate to use a scenario analysis approach for future demand commitments. In this regard, staff's analysis provides some helpful indicators of the potential evolution of the Fund's liquidity position over the next two years. In line with my earlier comments, however, I would have liked to have seen a bit more discussion about the standard areas surrounding these demand projections and hope that the new papers will look into these issues.

Finally, turning briefly to a couple of comments raised by Mr. Von Kleist and Mr. Duquesne about concentration risk, I very much agree with Mr. von Kleist that we should be explicit when we publish this information about the coverage of our precautionary balances, but I certainly feel that one needs to make sure that we are aware that the precautionary balance is what they are actually covering are risks against and what our minimum usable resources calculation is covering for, and that there are not necessarily overlaps. They should be provisioning against different contingent liabilities.

Mr. Josz made the following statement:

The forward capacity to commit GRA resources proposed by the staff would give a much clearer indication of the Fund's liquidity than the liquidity ratio used up to now. Its three components—namely, uncommitted usable resources, projected repurchases, and the minimum prudential level of uncommitted usable resources—are more straightforward concepts, and its value—expressed in SDRs—has more operational utility than the liquidity ratio. I support all elements of the staff proposal except the two which follow.

The first is the staff's suggestion that when determining the forward capacity to commit GRA resources, the treatment of precautionary arrangements should be different from that used in determining the liquidity ratio. In light of recent occasions when members actually used resources that had been committed under precautionary arrangements, it could be prudent to subtract all, rather than only half, of balances committed under precautionary Stand-By Arrangements from the Fund's usable resources when determining the level of uncommitted resources. Before agreeing to such a change, I would

like to know more about how often precautionary arrangements have been activated. Also, the full subtraction of committed resources should not apply to commitments under the CCL. Of these only half should be subtracted, as is done when determining the liquidity ratio. The purpose of the CCL is to shield exemplary countries with no balance-of-payments problems from external financial contagion. It is therefore sufficient to assign a probability of 50 percent to the activation of CCL arrangements when calculating liquidity prospects. Since there has been no experience with the CCL, there is no basis for changing the assumptions from those used when calculating the Fund's liquidity ratio.

Second, at SDR 40 billion, the minimum level of uncommitted usable resources that the staff proposes maintaining seems rather high. The U.S. chair quotes the level of reserve tranche purchases during the past decade as SDR 2 billion, and the staff quotes the potential erosion of the Fund's resource base, supposing that all countries that have used Fund resources during that period will no longer participate in the Financial Transactions Plan, as SDR 8 billion. I support Mr. Cippà's proposal to define the minimum level of uncommitted usable resources as a ratio of the total resources available to make financial commitments.

I agree to the regular publication of data on the Fund's forward capacity to commit GRA resources with a self-containing explanation, once the Board has reached agreement on the assumptions to be used in the calculation.

Finally, I share the staff's view that the Fund's liquidity position can comfortably meet the members' needs that can be expected under any reasonable set of assumptions.

Mr. Campos made the following statement:

We thank staff for the well-written paper, which provides an update on the developments on the Fund's liquidity position and the near-term outlook and sets the basis for this Board review. We also thank Mr. Khun for his additional comments, which contributed to clarify some of our questions.

We welcome the staff's proposal to replace the IMF's standard "liquidity ratio" indicator with the "forward commitment capacity" measure. Like staff and several other Directors we are also of the view that the current "liquidity ratio" is complex, non-transparent and difficult to understand. As staff points out, the "liquidity ratio" has a number of disadvantages: (i) it does not provide a measure of capacity to make new financial commitments; (ii) it does not provide a measure to assess the coverage of reserve positions by available resources; (iii) it mixes accounting data with judgmental elements through a number of non-transparent adjustments; and (iv) it can reveal

volatility in the face of changes in the status of arrangements from precautionary to non-precautionary.

Unlike the liquidity ratio approach, the proposed “forward commitment capacity” indicator is relatively simple and easily understood. In addition, it gives a clear indication of the amount of resources available for new commitments, is transparent and derived from accounting data of the Fund’s financial position, which is now being regularly published. In this regard, we concur with staff that the proposed indicator is a more robust and reliable measure for the Fund to make new financial commitments.

The calculation of the forward commitment capacity requires quantification of the minimum prudential level of uncommitted usable resources, for which staff proposes a level of SDR 40 billion. Like Mr. Shaalan and Ms. Farid and Mr. Zoccali and Mr. Pereyra, we consider this level to be reasonable, as it is in line with historic minimum levels and provides adequate coverage of reserve tranche positions at maximum lending capacity using own resources.

A shortcoming in the staff paper is the lack of a framework for assessing the potential demand for Fund resources. To this extent, staff emphasizes the difficulties in projecting demand in view of recent experiences and recognizes that a more robust approach to determining demand for Fund resources is required. We, therefore, look forward to reviewing new approaches based on alternative scenarios as indicated by staff. A matter of concern that we share with Mr. Portugal and Mr. Tombini is the fact that the Fund size has been shrinking in relative terms compared to the world economy and that, in addition, the quota shares of some countries are not representative any more of their position in the world economy. This is particularly worrying for developing countries facing capital account crises and needing to draw resources. We therefore look forward to discussing these issues both in the context of the 12th General Review of Quotas and of the upcoming discussion of access policy.

Turning to the near-term outlook, we note that the Fund’s forward capacity to commit GRA resources appears very comfortable in light of the current potential demand. The projections of new commitments during the remainder of 2002 appear reasonable, in as much as the current WEO indicates an improvement in the outlook for the world economy. To this extent, we are pleased to note that Mexico is expected to be included in the FTP later this year.

Finally, we support the publication on the Fund’s Web site of the forward capacity to commit GRA resources and its calculation methodology.

Mr. Rouai made the following statement:

I thank staff for their efforts in designing a better tool for assessing the adequacy of the Fund's liquidity position. The proposed concept of forward commitment capacity (FCC) appears simple, transparent, and superior to the liquidity ratio and could better serve the Fund's external communication and transparency efforts.

Like the liquidity ratio, the FCC is a tool for assessing the adequacy of the Fund's supply of resources and its financing needs. However, the decision to augment quotas, or expand the level of borrowed resources will always be based on a set of criteria and considerations that go well beyond financial indicators like the liquidity ratio or the FCC. It is for these considerations that, while I support the staff approach with regard to the treatment of precautionary arrangements and of repurchases, I would like to go further in reducing the judgmental element in the calculation of the FCC, in particular with regard the calculation of the minimum level of uncommitted usable resources to cover potential calls on reserve tranches and exits from the financial transaction plan (FTP). As it appears from Directors' statements, those of us who believe that there is a need for quota increase will always argue for higher level of uncommitted usable resources. Those who are not willing to support future quota increase will justify a lower level of uncommitted usable resources. Because of these considerations I suggest, like Mr. Cippà, the use of a percentage of the sum of usable currencies, activated borrowed resources, and reserves tranche positions for the determination of the minimum level of uncommitted usable resources instead of the staff proposal of a fixed amount of SDRs 40 billions. A coverage ratio of 25 percent gives the same total amount. On the use of ratios, while I do not dispute the judgmental element, may I remind the Board that major Fund's financial policies are ratio-based, namely access policy, income target, and precautionary balances. The advantage of using a coverage ratio is that it helps avoid some of the misgivings expressed by many Directors since it takes into considerations developments in FTP participation and uses of reserves tranches. Because of its direct link to the financial transaction plan, the review of Fund's liquidity should also be merged with the quarterly review of the FTP. This will help somewhat streamline staff and board work. If the FCC is adopted, I am against the idea of keeping the liquidity ratio.

Finally, like Mr. Shaalan and Ms. Farid, I look forward to the staff work on new approaches to better project the demand for Fund resources. I support the publication of the FCC on the Fund Web site .

Mr. Melhem made the following statement:

I join other speakers in thanking the staff for preparing an informative paper for today's discussion. It is encouraging that the Fund liquidity position

is comfortable and is projected to remain so over the next year under both the traditional liquidity ratio and the proposed “forward commitment capacity” indicator. In this connection, I agree that the “forward commitment capacity” indicator is appealing and provides a clearer picture than the liquidity ratio. Turning to the details.

First, I agree with Ms. Lundsager and Mr. Baukol’s views regarding the minimum level of uncommitted usable resources. SDR 40 billion appear to be on the high side given the experience over the past decade on reserve tranche withdrawals and FTP participation. Moreover, not all commitments are actually disbursed as noted in Ms. Lundsager and Mr. Baukol’s preliminary statement.

Second, I support maintaining the current 50 percent weighing of commitments under the precautionary arrangements and CCLs. Indeed, the efforts to increase involvement of the private sector at an early stage, the Fund’s strengthened surveillance, and the countries’ own efforts, should reduce the frequency, intensity, and especially spread of a crisis. As we have clearly seen, the contagion from the Argentine crisis has been relatively limited. This trend is likely to continue as markets become even more discriminating. Therefore, the likelihood regarding simultaneous activation by many countries of their precautionary arrangements or CCLs should be relatively small.

Third, I can go along with the proposal to assume that SRF and CCL repurchases will be on an expectations basis and other Fund repurchases on an obligations basis.

Finally, I agree that projecting demand for Fund resources has become more difficult. The main issue here is the lack of a clear access policy. Addressing this issue is a priority.

Mr. Bhaskar made the following statement:

We welcome the staff proposal to adopt the forward capacity to commit Fund resources as its principal liquidity measure. While the liquidity ratio focuses on the ability of the Fund to meet its immediate liabilities, by itself it is not adequate to indicate the Fund’s capacity to make future commitments. For example, it does not incorporate a provision for future repurchases, which would improve the liquidity. We also agree with staff that adjustments to undrawn balances made in the course of computing the ratio are not objective and therefore not transparent.

It is interesting to note that the net uncommitted usable resources using the liquidity ratio approach are significantly higher than the forward capacity to commit resources computed in Box 3 using the present approach. This

seems to imply that the liquidity ratio approach is less conservative than the forward capacity approach, and yet as staff point out in paragraph 10, the reverse is the case if the liquidity ratio is computed for both these approaches. Clearly both approaches are strictly not comparable, being designed to do different things, though they have common elements. Inclusion of the minimum level of uncommitted resources in the forward capacity computation addresses the main concern that the liquidity ratio aimed at—the Fund’s ability to meet reserve tranche demands as well as repayment of borrowings. It is in the computation of this figure that we have some reservations.

We note that the recommended minimum level of uncommitted resources has been derived from historical precedent and scaled up to be consistent with the subsequent increase in quotas. Like Mr. Portugal and Mr. Tombini, as well as Mr. Yagi and Mr. Yanase and other Directors, we are not comfortable with such an approach because the present situation is not comparable to the occasion when the lowest level of uncommitted usable resources was reached. At that time, as has been mentioned, a significant quota increase had been agreed upon, which would have an impact on the decision to allow the level of resources to fall to the historic low. A similar argument applies to the low of SDR 27 billion reached in 1992.

With the outcome of the 12th General Review of Quotas unclear, it may be necessary to arrive at the minimum level in a more cautious manner. The level of SDR 40 billion assumed by staff may be unduly optimistic in the sense that the level may need to be higher. How much higher would of course depend on how far we can quantify these requirements. Staff may concentrate work on a forward-looking framework for deciding this instead of the historical one presently suggested. Such a computation may also affect the conclusion that the present forward capacity to commit resources is adequate.

We are in favor of the general proposal to enhance transparency of the Fund’s operations as well as its financial position. However, given the difficulty in forecasting the demand for Fund resources, as well as the possibility of sudden changes, we suggest that all the assumptions made while arriving at the FCC be suitably highlighted while publishing it on the Fund’s Web site.

Mr. Andersen made the following statement:

Like others, I thank the staff for a clear and concise report. I support to replace the traditional measure of the adequacy of the Fund’s liquidity position, the liquidity ratio, by a measure that better reveals the Fund’s capacity to make new financial commitments like the “forward capacity to commit GRA resources”. I can also support many of the related proposals, including to publish data on this indicator regularly on the Fund Web site . And I can support the proposal made by Mr. von Kleist to keep both

indicators alive, at least for the time being which I think also is the intention of the staff.

On the proposed “minimum level of uncommitted usable resources”, while I do find that a somewhat lower level than the SDR 40 billion suggested would still appear to be rather conservative and acceptable, it seems to me that a level around SDR 40 billion perhaps could get the broad support which I want to be part of, so I can go along with it on this basis. Given the many relevant remarks and suggestions made during the discussion, including the need for greater clarity of the future potential demand, I think it is important to keep it under close review.

Mr. Kuhn made an analogy to commercial banks to which Mr. Brooke mentioned that banks make provisions against contingent liabilities based on a proper risk assessment. I fully agree with Mr. Brooke and would add that it is also of concern for shareholders in commercial banks if the banks are too conservative in their provisioning policies. This institution does, of course, differ from commercial banks in many respects. Let me only refer to the very high concentration of our recent lending to just a very few members, as mentioned also by Mr. Duquesne and others.

I have a lot of sympathy with the arguments put forward by Mr. Cippà in favor of a relative rather than an absolute nominal amount and could support that.

On the future potential demand for financial commitments, I agree with the staff that a more robust approach is warranted and look forward to further discussions in the Board on other relevant issues, including vulnerability assessments, PSI, and last but not least the access policy. While I recognize that even in good times, variability is to be expected in the need for Fund resources, strengthened Fund surveillance, the increased discrimination by creditors between different country risks, and the improved global outlook should reduce the potential need for Fund resources. I therefore agree with the staff's assessment that the present forward capacity to commit GRA resources appears comfortable. Needless to say, for a monetary institution like the Fund, the liquidity position will always have to be monitored closely.

Mr. Vermaeten made the following statement:

Like other Directors, let me thank the staff for their well-written paper. I agree that the new forward commitment capacity measure should become the principal measure of Fund liquidity, but as Mr. von Kleist and others have pointed out, it would be useful to also keep the liquidity ratio.

The new forward commitment capacity measure gives a clear indication of the amount of resources available for new commitments, is

transparent and derived from accounting data, and provides the capacity to incorporate a transparent judgment about the prudential minimum level of uncommitted resources. The most contentious issue of the capacity measure, as evidenced by the comments by Directors, is determining the appropriate minimum level of uncommitted resources.

There are many possible approaches, and ultimately it is a judgment call. However, in the final analysis, we can only adopt one methodology, and I was most persuaded by Ms. Lundsager and Mr. Baukol's approach, which draws on practical experience with the size of the reserve tranche withdrawals and effects of FTP participation during a major crisis rather than the staff's approach which, as stressed by Mr. Kuhn, relies on historical judgment of liquidity ratios which, in our opinion, are overly cautious. I would therefore like to endorse the U.S. methodology and associate myself with those Directors that proposed a level of uncommitted usable resources in the range of SDR 20 to 25 billion. I would also like to support Mr. Cippà's proposal of converting this minimum level into a ratio.

That being said, whatever decision is made today should not become written in stone. Staff should continue to monitor the appropriateness of the level, and as Mr. Padoan has pointed out, the approach will have to continue to be adjusted in light of the discussions under way on a number of issues that could lead to changes in the Fund's financing role. Specifically we may find that the level of SDR 20 to 25 billion level proposed by Ms. Lundsager and Mr. Baukol may still be overly cautious if we develop firm access limits and more concrete arrangements for determining private sector involvement in crisis resolution.

Mr. Wei made the following statement:

We thank the staff for the informative paper and appreciate the opportunity to review the Fund's liquidity and discuss the proposed conceptual changes.

We share the view that the concept of forward commitment capacity is more transparent, more practical and more reliable than the concept of liquidity ratio in measuring the adequacy of the Fund's liquidity position. With the new concept it is easier to interpret the Fund's liquidity position, and the Fund's financial soundness can be assessed more clearly not only within the Fund but also by the outside world. In this context, the transparency of the Fund in this respect is significantly improved. Therefore, the forward commitment capacity is a better concept in almost every aspect and we are in favor of staff's proposal to adopt the concept of the forward commitment capacity. This being said, we have the following observations.

First, the forward commitment capacity includes the element of projected repurchases. While we agree that this item should be included, we would like staff to clarify whether it is prudent to assume that all the repurchases will be made on schedule and how the impact on the forward commitment capacity for the amount of repurchase should be calculated if they cannot be made as scheduled.

Second, I share Mr. Portugal's view that to use the minimum level of uncommitted resources observed in 1998 may not be appropriate. The development of the global financial market and greater liberalization of the capital market have changed the nature of financial crises and balance of payments problems. As a result, we have observed increasingly large and volatile financing needs and Fund lending has been increasingly concentrated. In this context, a minimum level of uncommitted usable resources must be prudent enough to provide adequate protection for the Fund's financial soundness. 1998 was an exceptional period with the Fund dealing with the Asian financial crisis and its contagion to the rest of the world and the quota increase approval in the eleventh general review of quotas. We believe a more prudent level should be set. In this context, we encourage staff to actively consider proposals by Mr. Portugal and others.

Third, like some Directors, we also feel the urgency to develop a more reliable approach to measure demand for Fund resources given the increasing volatility and concentration that will bring about significant risk and inconvenience to the financial operations of the Fund and have an important bearing on the adequacy of Fund resources. In this regard, Mr. Shaalan has given detailed comment in paragraph 7 of his preliminary statement which I fully share.

My last point is that although the present liquidity position is generally comfortable, it may face a challenge in the case of a major crisis. In addition to the size of Fund resources, the misalignment between quotas and economic development for certain countries further exacerbate the problem. In this connection, we believe that the Fund should further strengthen its liquidity position through a quota increase in the twelfth general review of quotas.

In conclusion, we support publishing the forward commitment capacity together with its methodology on a regular basis.

Mr. Low made the following statement:

There seems to be clear unanimous agreement that the forward capacity to commit GRA resources would be a better indicator, and I agree that it is a much clearer approach compared to the liquidity ratio, so I would not want to deviate from the consensus on that.

Having said that, however, given the unique nature of the IMF, the guiding principle that we should follow is to err on the side of caution, because the risk of understating our liquidity position would be much greater than the risk of overstating it. In this regard, I note what Mr. Andersen said—that in the case of banks, shareholders would not want the bank to be too conservative, because their objective is for the bank to have a higher return. I do not think that my authorities' participation in the Fund is aimed at getting higher return, so I do not think that the same principle applies here.

In terms of the elements of the forward capacity to commit, and using the guiding principle that I have mentioned, I am inclined to thinking that a higher figure for the minimum level of committed usable resources would be better, and I suppose Mr. Rouai would know where we stand on the quota issue if that is the case.

On the issue of projected repurchases, I share what Mr. Portugal and Mr. Duquesne said, that we should use an obligations basis for all facilities rather than have a different approach for the CCL and the SRF. Again, it is preferable to be cautious than to understate, and expectations are expectations, whereas you want to be prepared for the worst-case scenario, as Mr. Cho mentioned.

Ultimately, on the figure that we should focus on, I want to emphasize that our decision should consider the forward capacity to commit resources based on our own resources, rather than taking into account potential borrowings under the NAB/GAB, because as has been understood, that borrowing is only under exceptional circumstances, and I do not think we should focus so much on that figure. It is good to have additional facilities, but our main focus should be on what is available in our own resources, and borrowings should be only considered as a last resort.

Others have also mentioned the issue of estimating the demand for Fund resources, and here I would join them in emphasizing this, because the usefulness of this measure of forward capacity to commit will only be to the extent that we are able to project demand in a fairly reasonable and comfortable way. Here a lot more work needs to be done, because it is easier to decide on how much supply we can provide, but the demand side is the more critical issue. I note what Mr. Varela pointed out—that given the recent experiences that we have had in the cases of crisis that we have seen, and especially the new capital account crises, the amount of Fund resources needed is quite sizable.

Taking all this into account, I am not sure whether we can safely say that we are comfortable with the staff's proposal for a minimum level uncommitted usable resources of SDR 40 billion. As staff has noted, during the Asian crisis the amount of funds that were committed was SDR 59 billion.

Therefore, learning from experience, it does not seem that SDR 40 billion is sufficient. On this note, I agree with Messrs. Yagi and Yanase that the 12th quota review would be urgently needed.

Finally, on publication, I join others in saying that we will agree to publication of this after we have clarified all the points, and agreed on the actual formulation of the forward capacity.

Mr. Nijse made the following statement:

Like most others, I think that the use of the forward capacity to provide resources as a measure of Fund liquidity is a clear improvement compared to the liquidity ratio. I therefore agree that the forward capacity should become the principal measure of Fund liquidity. However, for the near future, like several other speakers, I would appreciate keeping the liquidity ratio as an information variable, assuming that the extra resources cost of calculating the liquidity ratio are almost zero.

I also think that repurchases should be projected in line with programming assumptions, although I agree with Ms. Lundsager and Mr. Baukol that it would be somewhat overcautious to subtract the full value of outstanding CCLs from the usable resources. Countries eligible for the CCL are supposed to prequalify with good economic policies, which would make it unlikely that even 50 percent of all CCLs outstanding would be drawn upon in one year. I therefore agree with Ms. Lundsager and Mr. Baukol that the weight of the CCL and the calculation for the monthly resources could be set at 50 percent.

As regards the minimum amount of reserves, I tend to agree with staff that SDR 40 billion would be a reasonable amount, which would seem to have the support of the majority of the Board; although, like a few other speakers, we feel that it could also be somewhat lower. The level of SDR 40 billion seems to cover roughly the size of two large program packages, like in the past for Mexico and Argentina, combined. That does not imply that we think those packages should be standard for future Fund lending—we should manage our resources so as to give all members access to a certain amount of Fund resources instead of providing these proportionally large lending packages to only a few countries. Although the staff paper seems to suggest that the supply of resources should be tailored to the demand, I think that, for the large part, the demand of Fund resources will be constrained by the supply. I therefore look forward to the Board discussion on access limits.

I also have sympathy for Mr. Cippà's proposal to express the minimum liquidity position in terms of a percentage of the resource base. I could go along with the proposal if the percentage would be in a range that would yield a level similar to the SDR 40 billion proposed by the staff. But

connected to this somewhat higher percentage, I would not suggest to also apply this percentage to NAB and GAB drawings.

Finally, looking at the different ratios discussed today, I think that the current liquidity position is fully adequate to deal with all upcoming financing needs in the foreseeable future.

Mr. Guetat made the following statement:

Let me commend staff for the continued efforts made to improve the assessment of the Fund's liquidity in order to improve the Fund's decision-making process and to enhance transparency in its financial operations.

On the issues proposed for discussion, my comments are as follows:

Regarding the Fund's liquidity, it needs to have an indicator that is reliable, transparent, easy to understand, and forward looking, in order to facilitate the decision making process. This is necessary, particularly in light of the uncertainties that usually surround global economic prospects and developments in international financial markets. In that sense, I see merit in the arguments provided by staff to consider the forward commitments capacity as a principal measure of Fund liquidity.

With regard to the present forward capacity to commit GRA resources, I am pleased to note that the Fund's position appears comfortable.

Concerning the determination of the minimum prudential level of uncommitted resources, I welcome the information contained in Box 2.

As regards the minimum prudential level, the staff's proposed range of SDR 35–45 billion, including the midpoint, appears reasonable. However, as suggested by the staff, it will be necessary to revise the range if substantial changes occur in the resources base.

Finally, on the issue of the publication of data on the forward capacity to commit GRA resources on the Fund web site, I can support the staff proposal. This will enhance transparency in the Fund's financial operations.

Mr. von Kleist, in reply to those Directors who had argued that potential CCLs should only be provisioned for at only 50 percent, noted that the fact that there was no experience so far with the CCL was an argument for full provisioning, not against it. If at some point in the future there was to be a larger number of CCLs running simultaneously, and there was a spread of risk and a record of not drawing, then one could argue for going to something like the 50 percent rule, but for the time being, it would be wiser to stick to the full amount of any potential future CCL.

The Deputy Treasurer (Mr. Kuhn) made the following statement in response to questions and comments from Executive Directors:

I thank Directors for their comments, and for their general support for the concept of the forward capacity to commit. It is clear that the liquidity ratio will remain an indicator for historical reasons for some time, but most of you have considered that our proposal for a more straightforward, transparent number that gives a clear sign for decision-making would be a vast improvement in terms of the indication of the supply of Fund liquidity.

We will take on board your comments on forecasting demand. Clearly, more work is needed in this area, as we have indicated in the paper .

Coming back to the forward capacity, there is still a wide range of views on the minimum prudential amount, although I see a lot of support for our proposal, which is a reflection of past practice and past policies. It is, in fact, a translation of past judgments of the Executive Board into a new concept. To the extent that it does not break with the historical record and previous judgments of the Board, the range we proposed is not new, except that it is expressed in the form of a nominal number of SDR 35 to 45 billion, or SDR 40 billion for the midpoint. Therefore, it is not surprising that there is a large measure of support around this number, though with some variations.

I also thank Directors for their support for our proposal for publication of the level of forward commitment capacity. We need to consider further how to explain the concept. In that regard, the question of whether to express the prudential minimum in terms of a percentage or in terms of a nominal number is part of the more general question of how to explain the concept and how precisely its components are combined to calculate forward commitment capacity. Given the comments that Directors have given us, this should be a relatively straightforward exercise.

What I would have considerably more difficulty with—and would in my view be entirely inconsistent with the concept—is the question of whether commitments could be scored in different ways. It is normal standard commercial banking practice to have the resources identified for all contingent lending. It would be inconceivable for the Fund to enter into commitments on which members depend, and on which markets count, without having identified and having readily available the related resources. As a financial institution, the Fund cannot enter into a financial commitment to provide resources to any member—a commitment which is published, and on which the member can draw if the member meets certain conditions without further action by the Fund—without having the resources clearly identified. This is standard normal banking practice, and the Fund should hold itself to the same standards as it holds other financial institutions. Discounting commitments is not consistent with the definition of the concept of forward capacity to make

financial commitments, which takes usable resources, and subtracts all undrawn balances under arrangements. It would be inconsistent to somehow discount the commitments that are reflected in these undrawn balances. Moreover, such a treatment would result in a difference in the amount of uncommitted usable resources that appears in our financial balance sheets and that is being published elsewhere. The links between the levels of usable resources, outstanding commitments, and uncommitted usable resources should be a very straightforward and transparent accounting process.

There were also some questions on how to account for repurchases. The timing of repurchases have become rather more complex, with expectations and obligations schedules. We have chosen the approach of using the repurchase expectations schedules for purchases under the SRF and potentially the CCL, and the repurchase obligations schedules for other purchases. This would imply that when the Board decides to give an extension, it would be equivalent to, and would be treated as, a new commitment.

On Mr. Brooke's question for a number of various detailed, varying scenarios in looking back on use of reserve tranche positions, this could be done, but I would expect that it will give us very little in terms of indicating the level of the prudential minimum, because these calculations have a high degree of standard errors.

Finally, in terms of presenting the concentration ratio of commitments in a future paper, we have done this in the context of the income paper, but we could have some indications in future liquidity papers.

Mr. Rouai asked Mr. Kuhn to comment on the idea of merging the review of the liquidity position with the review of the Financial Transactions Plan.

Mr. Nijse stated that he had not been convinced by the staff's argumentation on the required provisioning for CCL arrangements, because such arrangements would not exactly constitute an unexpected demand for Fund resources—and in any case the NAB/GAB was intended to cover such cases, as it was also a sort of CCL provided by member countries to the Fund. Therefore, it seemed perfectly fine to have one contingent liability covered by another contingent measure.

Mr. Baukol remarked that he agreed with Mr. Nijse on the issue of provisioning for CCL liabilities. Moreover, it seemed that there was quite a range of views on the various issues presented in the paper, with some Directors arguing for higher minimum balances, for example, and other arguing for lower ones. Then there was also the interesting proposal from Mr. Cippà to convert that minimum into a ratio, as well as Mr. Brooke's ideas on further work on scenario analyses. Given the diverging views, he would be in favor of not publishing the paper as it was now, but rather having the staff do some more work along the lines suggested by Directors, and then coming back to the Board for another discussion as soon as

it would be feasible for the staff. The new paper could present different options or scenarios, looking for instance at the amount of lending versus actual commitments that had been outstanding, and the amount of repayments in terms of late payments versus advance payments. He would also look at precautionary programs and see exactly how many and how much had been drawn in recent years. In response to Mr. von Kleist's comment on CCLs versus precautionary arrangements, his own understanding was that CCLs would probably be less likely to be drawn than precautionary programs. Perhaps the staff could provide some estimation based on the history of precautionary arrangements as to what might happen with CCLs. Finally, it would be interesting to explore Mr. Cippà's suggestion to use a ratio, something which many Directors had commented on.

Mr. Brooke supported Mr. Baukol's suggestion to have the staff give some consideration to the various alternative proposals put forward, and then to revise the paper before publishing it.

Mr. Portugal stated that, if Mr. Baukol's suggestion to redraft the paper was agreed, it would be necessary to also present in the new paper the demand element of the whole framework, which was not present in the current version. It would not be useful to discuss the issue again without having the demand part clearly spelled out.

Mr. Vermaeten expressed support for the previous three speakers, noting that there was no rush to make a decision and it would be worthwhile to wait for the next paper.

The Acting Chair (Mr. Sugisaki) noted that, overall, it seemed that the Board liked the new concept of the forward commitment capacity, and that there was consensus around a minimum prudential level of uncommitted usable resources of about SDR 40 billion. Although there were still questions on how to express that number—and in particular whether it should be expressed as ratio or as an absolute amount—he would suggest that the number of SDR 40 billion be used for the publication of the forward commitment capacity, and that the Board perhaps look at the issue again in one year's time. Nevertheless, before publication, the staff would come back to the Board on some of the elements and assumptions underlying the number, through a fairly concise paper focusing only on the issues relating to the publication of the number at that stage. Looking further ahead, he had taken note of the various Board members' request for the staff to address other issues, such as demand side problems.

When Directors discussed the minimum prudential level of uncommitted usable resources, he knew that they had, in the back of their minds, the issue of whether there was a need for a quota increase or not, the Acting Chair remarked. Nevertheless, that day's Board discussion was on the Fund liquidity position, and the quota increase issue, including the formula, should be discussed in a separate context. The Board would have a chance to discuss the paper on quota formulas, which had already been issued, in due course.

Mr. Shaalan stated that he fully agreed with the Acting Chair's last comment.

Mr. Baukol said that he would not be satisfied with the brief paper that the Acting Chair was suggesting to clarify the assumption underlying the amount of SDR 40 billion as the minimum prudential level. More extensive work was needed to try to get at least some sort of consensus on that issue, and as others had mentioned, there was no hurry to publish the new indicator. A few more months would not make that big a difference.

Mr. Lushin observed that the Acting Chair's remarks suggested that all Executive Directors had agreed to a minimum prudential level of SDR 40 billion, and that the only problem that remained was how to explain it to the public. However, he believed that several Directors, including himself, wanted to have more clarity on the methodology first, and not focus on finding a good explanation for a specified figure. On the basis of a clearer methodology, any other figure could be obtained, not necessarily SDR 40 billion.

Mr. Duquesne stated that, like Mr. Shaalan, he agreed with the Acting Chair's comments. There was no hurry to publish the new indicator, but there was also no need to devote too much time to something that was considered as being, in any case, conventional and arbitrary. The Board would never agree on specific measures. He had heard many colleagues saying that they were flexible, and he would ask those who had not said so to be flexible, too.

Mr. Portugal noted that he had been one of seven Directors—if his count was correct—that wanted a higher minimum level of uncommitted resources. He had also counted an equal number of Directors that preferred a lower minimum. Recognizing that his was not a majority position, he agreed with the thrust of the Acting Chair's presentation that the consensus of the Board was around SDR 40 billion, particularly as it would be difficult to come to a consensus on a different number than the one suggested by staff. However, perhaps it could be reflected in the summing up that some had wanted a higher number and some had wanted a smaller one.

Mr. Vermaeten reiterated that he did not see the advantage of making a commitment at that time, and locking in the status quo. Several Directors had asked for more information, and it would be worthwhile to have a fresh look, including in the context of the demand side as well.

The Acting Chair (Mr. Sugisaki) suggested that the Board had gone beyond the status quo, and was closer than Mr. Vermaeten was suggesting. However, he would like to hear a few other Directors on that issue.

Mr. Josz said that he agreed with most of the conclusions that the Acting Chair had drawn, but not all. It seemed that no Director was really satisfied with the justifications given for the minimum prudential level of uncommitted resources. Valid proposals had been made by Mr. Cippà and Mr. Lushin to try to improve the way that the Fund should arrive at that crucial number, and he certainly saw some merit in reflecting a bit more on those very good proposals before coming to a decision, to see whether it might be possible to improve even more on the proposal made by the staff.

Mr. Low stated that he shared the views expressed by Mr. Shaalan, Mr. Duquesne and Mr. Portugal on that issue.

Mr. Padoan suggested putting the issue in terms of communication policy. If a paper were to be published, it would send out two messages: one on the methodology, for which many suggestions—which the staff would certainly take into consideration in drafting the next paper—had been made; and the other on the actual amount for the minimum reserve requirement. With regard to the latter, it would be unfortunate if the paper suggested that, while the Board had discussed methodological issues, it did not have any idea of what the minimum should be. Like Mr. Portugal, his own count indicated that there was not majority support for the SDR 40 billion figure proposed by the staff, but that that level was probably the average of the different opinions. In that context, in redrafting the document for publication, it should be made clear that the Board had not discussed the optimal value of minimum reserves, but rather the methodological issues which needed further consideration; and that, while those were being considered further, on a prudential basis, the Board had suggested using the SDR 40 billion as an average.

The Acting Chair (Mr. Sugisaki) remarked that the staff did not intend to publish the paper under discussion. What would be published was the number itself, with an explanatory note on the new approach—the forward commitment capacity.

Mr. von Kleist stated that he agreed with the Acting Chair, and with Mr. Padoan. Quotas should be discussed during the quota discussion, access limits during the access limits discussion, and PSI during the PSI discussion, rather than hide all of that in some sort of demand issue. Moreover, if the new number was published with a minimum of comments, then it would not be necessary to explain lengthily at a later stage why the methodology might be changed again in light of the three discussions he had just mentioned.

Mr. Yanase said that he shared the comment made by Mr. von Kleist. It would perhaps take several months, if not years, to complete the discussions on PSI, access limits, and also the demand side. Therefore, for the interim period, it would be desirable to proceed as the Acting Chair had suggested.

Messrs. Campos and Wei noted that they agreed with the Acting Chair's conclusions, and supported the views expressed by Messrs. Duquesne, Shaalan, Low, Portugal, and Yanase.

Mr. Melhem said that he agreed with Messrs. Baukol, Lushin, Josz, and Vermaeten. There was no rush to decide, and it would be preferable to wait until the paper was revised.

The Acting Chair (Mr. Sugisaki)—after some further discussion during which Messrs. Brooke, Baukol, Cippà, Vermaeten, Nijse, and Josz reiterated that they could not agree to committing to the level of SDR 40 billion before the methodology itself was further discussed—made the following summing up:

Our meeting today provided a useful opportunity for a discussion on conceptual and policy issues relating to the measurement of the supply of Fund liquidity, the demand for Fund resources, and the outlook for the Fund's liquidity position.

Directors welcomed and agreed to the staff's proposal to introduce a measure of forward capacity to commit General Resources Account (GRA) resources over one year as the primary measure of the supply of Fund's liquidity. They noted that the forward-looking nature of this measure provides a useful framework for transparent decision making by offering a clear indication of the amount of resources available for new commitments (derived from published financial data) and incorporates a transparent judgment on the prudential minimum level of uncommitted usable resources. Most Directors agreed that these characteristics of the forward commitment capacity (FCC) make it superior to the traditional liquidity ratio, which fails to provide a direct indication of the Fund's ability to undertake new commitments; uses categorizations that are not fully transparent; and relies on a number of judgmental adjustments. Several Directors, however, suggested that the traditional liquidity ratio still be used, at least for a limited period, as an additional indicator.

Directors had a wide ranging discussion on the considerations and methodology that should underpin the determination of an appropriate level for the prudential minimum for uncommitted usable resources, which is a key element in the calculation of the forward commitment capacity. They noted that the staff proposal for a minimum prudential amount of SDR 40 billion, derived as the mid-point of a range from SDR 35 to 45 billion, is intended to strike a balance between the need to safeguard creditors' positions in the Fund, the need to take account of possible erosion of the resource base if participation in the Financial Transactions Plan declines, and efficient use of the Fund's available resource base. Some Directors, however, thought that a lower level may be justified because some commitments would not be disbursed fully, and because it has become increasingly unlikely that some of the major creditors, with ready access to capital markets, would need to encash their reserve positions; while some other Directors suggested that a higher level would be preferable, as the situation in the fall of 1998 on which calculations for the SDR 40 billion have been based, represented an overly tight liquidity situation that should be avoided in the future and in view of the potential erosion of the resource base. A few Directors felt that they were not yet in a position to support any specific level for minimum prudential level and requested that the staff conduct further analysis on the appropriate

minimum level. Directors also discussed a proposal to express the minimum prudential amount of uncommitted resources as a percentage of the Fund's resource base, noting that this approach would provide an automatic adjustment of the minimum amount to changes in the size of the Fund's resource base. Furthermore, such a ratio might also make the FCC easier to communicate to the public. On balance, the general range of SDR 35-45 billion proposed by the staff could probably garner the support of most Directors, as that level would constitute the average/midpoint of the various views expressed. Directors will have a further opportunity to consider a methodology and underlying considerations for determining the prudential minimum of uncommitted usable resources at the time of the next regular review of the Fund's liquidity position.

Directors agreed in principle that the one-year forward capacity should be regularly published in the weekly and monthly information posted on the Fund's Web site, to maintain the transparency of Fund operations and its financial position. They noted, however, that further careful consideration is needed of how to describe this measure, and explain its principal components and calculation (in particular for the minimum prudential level of uncommitted usable resources) to the public. The staff will make a detailed proposal regarding publication at the time of the next regular review of the Fund's liquidity position.

Directors noted the staff's assessment of the Fund's current and prospective liquidity position. They also noted that after weakening considerably between the spring and fall of 2001, the Fund's liquidity position has since remained broadly unchanged. Barring emergence of new large demands, the projected demand under Stand-By Arrangements and EFF arrangements can be readily accommodated within the one-year forward commitment capacity, which can also accommodate possible commitments under the SRF and CCL.

During the past few years experience has shown that demand projections have become increasingly difficult and need to be treated with considerable caution. In the event of an unexpected downturn in economic conditions, and/or crises or widespread contagion reappeared, the Fund could face large new and/or additional commitments. If commitments were similar to the crisis levels of the period 1997-98, this level of demand would exhaust the forward capacity to commit GRA resources from own resources, but could be met by drawing on the NAB/GAB. Directors encouraged staff to carry out further work on demand projections and underlined the need to monitor closely the liquidity position of the Fund. They looked forward to a discussion of the size and distribution of quotas in the context of the Twelfth General Review of Quotas in the Fund.

2. DENMARK—2002 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2002 Article IV Consultation (SM/02/115, 4/16/02; Cor. 1, 5/3/02; and Cor. 2, 5/6/02); and Selected Issues (SM/02/123, 4/22/02)

Staff: Corker, EU1; Fetherston, PDR

Length: 1 hour, 20 minutes

Mr. Andersen submitted the following statement:

My Danish authorities welcome the staff report, which provides a fair and balanced description of the consultation discussions in Copenhagen and developments in the Danish economy. They find themselves in broad agreement with the staff's policy recommendations in areas where further improvements are necessary.

The new liberal-conservative government took office shortly after the general election in late November 2001. The government has stated that it will pursue a tight fiscal policy and continue the stability-oriented policy, which has been conducted since 1982, based on the fixed krone exchange rate vis-à-vis continental European currencies, and since 1999 vis-à-vis the euro. The overall macroeconomic targets in the medium term are:

- Continued fiscal surpluses in the order of 2 percent of GDP on average, thereby lowering public debt levels in order to enhance the sustainability of public finances and further prepare for the impact of future demographic changes.
- A tax freeze to be followed by lower tax on earned income.
- Real annual growth in public consumption of up to 1 percent on average during 2002-2005.
- Outsourcing and improved efficiency in the public sector.
- Increased employment through higher participation rates and lower unemployment.
- Low and stable inflation of just below 2 percent a year.
- Favorable conditions for private savings, which, in conjunction with the surplus on general government finances, pave the way for gradual repayment of foreign debt.

The Danish economy has weathered the effects of the international slowdown well, with a relatively small downward revision of the Danish growth forecasts. The estimated GDP growth of 0.9 percent in 2001, in fact, overstates the apparent deceleration in the pace of economic activity, since growth had been unexpectedly strong in 2000—in part due to hurricane repair works—leading to the re-emergence of wage pressures in the Danish economy with wage increases accelerating somewhat around late 2000. The slowdown in activity should act to weaken these pressures. Denmark meets all four EU convergence criteria by a broad margin, unemployment remains around its lowest level for 25 years, there is a strong and robust surplus on the current account, and public finances likewise show a strong and sustained surplus. With the prospect of an international recovery, the main challenge in the short-term is to forestall an intensification of pressures in the economy. In the medium term perspective, maintaining public surpluses and achieving an expansion of the labor force whilst ensuring adequate skill levels constitute important policy challenges.

Economic Policies

The new government presented the budget for 2002, which had been delayed due to the election, at the end of January. The fiscal impact and the surplus provided for in the budget correspond closely to the proposal put forward by the former government in the autumn 2001, but the new government rearranged expenditures and taxes reflecting new priorities, and among other things, a number of planned tax increases was left out. With minor amendments, the budget was approved in parliament in the beginning of March. Furthermore, new policy initiatives are being developed in accordance with the new government's platform.

An important part of the new government's economic policy is a so-called "tax freeze", which broadly speaking means that both tax rates and taxes that are expressed as an amount in Danish krone will not be increased. The tax freeze also applies to local government taxes as a whole. In its work program the government has announced that it will follow a tight expenditure policy, and the tax freeze implies an increased commitment to exercise expenditure control as it deliberately shifts attention to the prioritization of expenditures. Moreover, the budget for 2002 includes cuts across ministries in expenditures for subsidies and administrative functions, including advisory bodies. The staff report suggests that ensuring sufficient expenditure control and preventing expenditure overruns may prove difficult. The Danish authorities acknowledge that expenditure overruns have been a problem in the past, especially at the local government level. In late February, the government signed a letter of agreement with the Association of Municipalities ("Kommunernes Landsforening") regarding the tax freeze and targets for expenditure growth. If contrary to these objectives budgets for

municipalities and counties turn out to display an actual increase in average tax rates, the government intends to neutralize the effect hereof.

As noted by the staff, the budget includes a reform of the compulsory pension scheme known as the Special Pensions Fund, whereby the scheme will be rearranged from a redistributive tax scheme into an individual scheme based on actuarially fair principles. The Special Pensions Fund is, therefore, no longer included in the public finances, and the present surpluses in the Fund of around $\frac{1}{2}$ percent of GDP (as well as future payments from the Fund) are no longer included in the fiscal surplus. Obviously, this technical modification does not affect the long-term sustainability of public finances, but technically the budgetary surplus will be reduced by $\frac{1}{2}$ percent of GDP to an estimated 1.9 percent of GDP in 2002 and the medium-term target range for public finance surpluses reduced to $1\frac{1}{2}$ – $2\frac{1}{2}$ percent of GDP, instead of the previous target range of 2–3 percent of GDP.

The staff report seems to suggest that Denmark may not be able to maintain its, admittedly, high level of taxes in the medium term due to increased pressures that erode the tax base. The Danish authorities share this concern to some extent, but the challenge needs to be put into perspective. The government has stated its intention to lower the taxation on labor as of 2004, provided the necessary fiscal room for maneuver is available in terms of public debt reduction, fiscal sustainability, and the cyclical position of the economy. In this context, it is perhaps worth noting that the fiscal challenge resulting from ageing not only limits the scope for tax reductions in Denmark, but also in other countries, of which many have made much less preparation for the consequences of population ageing. Moreover, as a technical matter, comparisons of taxation of labor across countries should take the level of employers' social contributions into account. Such contributions are low in Denmark compared to many other OECD countries. Whilst not disputing that taxation of labor—and the redistribution through taxes and public expenditures—is higher in Denmark than in most other OECD countries, this is less so when taking social contributions into account. As noted by the staff, for all practical purposes, erosion of the tax base due to migration of high-income earners is not yet appearing as a significant problem. Furthermore, the effects of lower taxes should not be exaggerated. With reference to targeted tax reductions, it is the authorities' assessment that the labor supply response would only partly—and with a costly lag—compensate the immediate loss of revenue.

The Danish authorities fully share the staff's assessment of the monetary arrangements, which continue to work well without any apparent strains. The fixed exchange rate policy has been a cornerstone in the Danish economic policy during the past two decades. The objective of the policy is to keep the Danish krone stable against the euro, which is formally being pursued within the framework of the EU exchange rate mechanism, ERM II.

Since 1997, the Danish krone rate has remained close to the central parity of the exchange rate mechanism and day-to-day fluctuations in the krone rate have been small. The fixed exchange rate policy constitutes a strong foundation for price stability in Denmark and the conditions for maintaining it are well understood by wage negotiators and fiscal authorities. The fixed exchange rate policy implies that monetary policy can only be directed at maintaining the fixed exchange rate vis-à-vis the euro. Normally, Denmark's official interest rates are adjusted in step with the ECB's adjustments of its interest rate with small independent steps being triggered by capital flows. Consequently, the implicit monetary policy stance can sometimes be more accommodative than warranted from a cyclical perspective. During these periods, other economic policies, in particular fiscal policy, must play a larger role as an instrument in stabilizing the economy. The experience with this policy is very good, thereby also sheltering the real economy from random exchange rate fluctuations and currency speculation.

With respect to labor markets, continued structural reforms have been essential factors in ensuring a further reduction of unemployment and further gains in employment. Among other things, benefit periods have been reduced and various schemes of early retirement have been reformed. The staff has expressed concerns whether current policy initiatives will prove sufficient to achieve the targeted growth in labor supply. The Danish authorities recognize that a major challenge now is to increase labor supply and provide incentives to stay longer in the labor force. In this respect, it is encouraging to see that reforms of early retirement schemes in the late 1990s have reduced inflow rates into these schemes markedly, and this will contribute significantly to the labor supply in the coming years. Looking ahead, active labor market policy is set to be more efficient, with greater focus on activation directly qualifying a person for a job and more people receiving private job training. The mediation of jobs will be made more efficient, and the successful special initiatives aimed at young people will be extended to people aged 25–29. Furthermore, the government has put focus on improving the weak employment record of immigrants and refugees.

In the product markets—as noted by the staff—further deregulation and privatization is planned. The affected sectors include natural gas, electricity, railways, and postal services.

The Danish banks continued to present sound earnings with substantial profits for the seventh consecutive year, although losses and provisions have increased somewhat in view of the slowdown in the economy. The staff notes that Danish insurance companies and pension funds are vulnerable to falling stock prices or long-term yields. This is due to their guarantees to pay a minimum nominal interest rate for many years into the future. However, since mid-2001, a number of insurance companies and pension funds have used the option market to hedge against interest rates falling below an agreed

threshold. In 2001, structural improvements in the taxation of capital income in pension institutions has made the taxation neutral in relation to changes in asset prices over the business cycle. Moreover, problems within Danish pension and insurance companies are not expected to result in systemic risks. In spite of the high concentration ratios in the banking sector, competition increasingly has to be seen in an international and, especially, a Nordic context. In Denmark, there are banks in almost every city and compared to other countries, the number of branches is relatively high. The total number of Danish banks is 190.

Denmark is implementing all U.N. Security Council resolutions on financing of terrorism through the relevant European Council Regulations. Furthermore, the government has presented a legislative package to Parliament containing a broad range of initiatives aimed at combating money laundering and the financing of terrorism. It is expected that the package will be adopted within the next month. The Danish Financial Intelligence Unit (FIU) is a mixed police/judicial unit organized within the office of the Public Prosecutor for Serious Economic Crime. The Danish FIU is in charge of the collection, registration, coordination, analysis, and dissemination of all information concerning money laundering and the financing of terrorism. The Danish FIU is authorized to share information with all foreign FIUs.

Recent Developments

Presently, the Danish economy is running close to its potential. This should be seen in the context of a rebalancing of demand through a slowdown in domestic demand following the so-called Whitsun package, which was decided in 1998 amidst fears of overheating and implemented over the period 1999 to 2002.

Since the mission took place, a number of statistics have been published. National account figures for the fourth quarter of 2001 and revised figures for 1999 to 2001 were published at the end of March. GDP growth slowed to 0.3 percent year-on-year as stock adjustment in the fourth quarter contributed negatively to GDP growth. However, non-residential private investments and public consumption growth was quite strong in the fourth quarter.

The latest figures for unemployment and consumer prices confirms the impression that pressures in the economy remain a source of some concern, despite the lower pace in the economy. In March, the seasonally adjusted rate of unemployment was 5.1 percent and, unlike what has been the case in many other countries, there has hardly been any increase. Consumer prices increased more than expected in the first months of 2002. In March, consumer price inflation stood at 2½ percent—the euro area average—among other things reflecting international increases in food and vegetable prices. The annual

increases in wages have moderated slightly, although wage increases remain above those of Denmark's main trading partners. The continuing wage pressures reflect that unemployment is below structural unemployment.

Consumer confidence has increased in recent months and is now above the 2001 level. Car sales, which during the last couple of years have fallen to their lowest level in 8 years, in March showed an increase of 8 percent, whilst retail sales increased 2.4 percent in real terms year-on-year in the first two months of 2002. The strong performance in the housing market has continued throughout 2001, supported by lower interest rates and increasing use of floating rate mortgages where interest rates are about 2 percentage points lower than for long-term fixed rate mortgages. Nonetheless, the latest figures support the impression of a gradual leveling off. The number of forced sales of owner-occupied houses has increased somewhat during the latest months, though they remain at historically low levels. Also, the increase in house prices fell to 4.6 percent year-on-year in the first quarter of 2002, compared to 7½ percent in the first half of 2001. Business confidence has improved markedly in the first months of 2002—and presently the level of confidence corresponds to its average over the last 10 years.

On the currency market, the Danish krone rate has remained a little stronger than its central parity in ERM II. During the first four months of 2002, Danmarks Nationalbank's net purchase of foreign exchange amounted to DKK 25 billion. On February 1, the National bank lowered the lending rate by 0.05 percent, thereby narrowing the differential to the ECB's minimum bid rate to 0.3 percent.

In conclusion, recent statistical information supports the view that the slowdown during 2001 has helped to mitigate the price and wage pressures. The outlook for 2002 and 2003 appears reasonably balanced, but price and wage pressures remain a source of concern, particularly if the expected pickup in growth turns out to be stronger than expected.

Mr. Varela submitted the following statement:

At the outset, I would like to thank the staff for the detailed report on Denmark's Article IV consultation, and, particularly, for the Selected Issues paper on the Danish fiscal framework that I have found especially illuminating. I also thank Mr. Andersen for his clear and concise statement.

Since the mid-1990s, Denmark has achieved excellent economic results. The country has enjoyed a high growth level, above that of the largest European countries, with subdued inflation, very low unemployment, high labor market participation—among the highest in Europe—and twin current account and fiscal surpluses.

After a soft landing during 2001, the recovery is now well underway. To consolidate this recovery and to further increase the economy's potential growth, the authorities should focus now on three main challenges ahead: to continue complying with the medium-term fiscal framework commitments, while further strengthening control on public expenditures; to reduce the existing labor supply constraints; and finally, to reinforce the competition in the private sector, as well as the efficiency in some areas of the public sector.

It is reassuring that the new government, elected in November 2001, has decided to continue the same basic approach of implementing a stable macroeconomic policy mix and to move forward on structural reforms in the areas that still need attention. The targets indicated in Mr. Andersen's statement, are well selected and they provide a strong policy framework to cope with the above mentioned challenges.

Economic Performance and Outlook

Like other economies, Denmark slowed down in 2001 reflecting a weakening domestic demand and the deterioration in the international environment. The situation was further aggravated due to the fading away of investments in residential housing, as noted by the staff. We concur, however, with Mr. Andersen that the drop to 0.9 percent growth in 2001 might overstate the deceleration with respect to year 2000 (3 percent growth rate) due to this latter factor. In any case, the economic slowdown might not be totally unwelcome, as it has helped to diminish price and wage pressures in an economy that was increasingly suffering from overheating.

The Danish economy is expected to recover in 2002 and to continue growing at a good pace in 2003. The staff's projection for 2002 growth rate is 1.3 percent, which coincides with that of the authorities. In its spring forecast, the European Commission points to a 1.7 percent growth. May the staff comment on this difference, taking into account recent developments in the world economy and, particularly, strong growth data in the United States.

As indicated by Mr. Andersen, wage pressures continue to be a matter of some concern. Recent data confirm the expectation that there will not be significant reductions in unemployment during 2002, given the already tight labor market. Although labor productivity growth has been so far close to the euro area average, in case labor costs continue to increase at a faster speed than in other partner countries, it might create some difficulties for the Danish economy in the long run. This situation emphasizes the need to make further progress in the liberalization of the labor market.

Although inflation has moved a bit upwards recently, it remains at the euro area average. I concur with the staff that monetary conditions are on the easy side, so authorities should remain vigilant as to the evolution of prices.

Monetary policy has been very successful in attaining the objective of keeping the Danish krone within the ERM II band, even during the testing period of the referendum on EMU participation in September 2000.

Fiscal Policy

Denmark's fiscal framework has been developed in different steps since the early 1990s. The various elements of that framework are well designed and are serving well the country's objectives of achieving a budget surplus and reducing the debt-to-GDP ratio. Excellent results have been attained in both areas and the authorities must be commended for it. Nevertheless, this framework could be further reinforced by making it more binding and we encourage the government to explore different possibilities in this regard. There are several experiences in Europe that could be useful as a reference. A more formal fiscal framework could also help to promote further involvement and internalization of the overall fiscal targets at the local level, which will also be beneficial.

We concur with the staff that the broadly neutral stance of 2002 budget is appropriate in the current circumstances. The envisaged budget surplus for 2002 and subsequent years provide sufficient room for maneuver in case of an unexpected cyclical downturn. On the other hand, if the current forecast for GDP growth is confirmed, fiscal targets will be comfortably achieved, provided that proper attention is paid to avoid spending overruns.

On the revenue side, the tax freeze decided by the new government is a significant step towards the objective of reducing the tax burden. Yet, more ambitious measures might be needed in the future to reach a situation more in line with other EU countries. I do not think that the current tax level is creating significant distortions in Denmark, or that it is affecting in a meaningful way economic efficiency. However, a tax burden closer to other EU countries will be beneficial for the Danish economy in the long run. We encourage the government to study carefully further measures to achieve this goal and to adopt further steps to control expenditure accordingly.

We concur with the staff that the government should give careful consideration to lowering the labor income tax. It is encouraging to know that the government is taken on board this issue, as stated in Mr. Andersen's statement.

The government should remain vigilant as to the volatility of revenues brought about by the modification of the pension fund yield tax, as it is now more dependent on the stock market evolution. At the same time, any windfall gain from this tax should not be used to increase public spending, but to reduce debt or tax burden, as we understand it is the government's intention.

On the expenditure side, it is reassuring that the new government has limited real annual public consumption growth to 1 percent from 2002 to 2005. This target should be strictly adhered to, particularly now that the tax freeze is in place.

We welcome the agreement reached with the Association of Municipalities, as indicated by Mr. Andersen. It is a significant step that goes in the right direction. Coordination of fiscal policy with the local authorities is certainly very important given that about 70 percent of government consumption and provision of public services is made at the local level. It is precisely in this regard that the establishment of a more formally binding fiscal framework becomes even more relevant.

As for the long-term sustainability of the public accounts, the current level of public finances and the fiscal framework envisaged for the medium run, provides, in our opinion, a sufficient cushion for handling the expenditure rises due to the aging of population. The relative position of Denmark vis-à-vis other countries is significantly better in this regard. However, the government should remain vigilant in order to achieve the envisaged budget structural surpluses and to implement measures that increase the labor participation rate, as these two factors are particularly relevant to stabilize the public accounts.

Structural Reforms

Denmark ranks among the leading countries in Europe regarding employment performance. The Lisbon targets for employment rates set for the whole EU for 2010 have been already achieved by Denmark. Yet, there continue to be some constraints in the labor market that need to be addressed. We welcome the measures that the new government is designing to increase the effectiveness of the active labor market policies, to facilitate the mediation of jobs, and to foster the employment of immigrants and refugees. However, we concur with the staff that additional incentives for later retirement and a review of the benefit and tax systems should be considered by the government.

On product markets, we encourage the government to continue strengthening the enforcement of competition rules in the private sector, to carry on opening up network sectors, and to further increase competition in public procurement, along the lines contained in the 2002 budget. We concur with the staff that designing a strong regulatory framework, in order to minimize distortions, should precede the governmental privatization and deregulation plans.

Financial Sector

We note that bank capitalization ratios, provisions, and profitability remain at comfortable levels. It is reassuring to know that supervisors are aware of developments regarding insurance companies and pension funds and that appropriate action is being taken. We welcome the agreement reached by the FSA to reinforce cross-border supervision, and also the efforts made to consolidate different regulations in a single act that will facilitate compliance among financial institutions. We welcome the interest expressed by the authorities to undertake a Financial Sector Assessment Program.

Other Issues

We welcome the measures taken by Denmark to implement the U.N. Security Council Resolutions on anti-money laundering and financing of terrorism, and further steps that will be approved by Parliament next month, as indicated in Mr. Andersen's statement.

Denmark must be commended for its outstanding official development assistance record. We encourage the government to continue providing similar high aid levels.

I note that the last time Denmark was discussed in the Board was in August 1999, 33 months ago. This period, almost three years, is too long, even for a country under a 24-month cycle. We encourage the staff to adhere as strictly as possible to the determined schedule under the consultation cycle.

With these remarks, we wish the authorities success in their future endeavors.

Mr. Callaghan submitted the following statement:

Key Points

- Denmark's economic performance remains impressive, outperforming many of its European neighbors. This is a testament to sound economic policies.
- The main challenge is meeting the fiscal costs of an aging population. Notwithstanding Denmark's overall impressive economic performance and existing preparations to meet demographic changes, more decisive steps are necessary.
- With limited scope to increase labor market participation, the priority should be to introduce more formalized measures to control spending across all levels of the government. Ultimately, it may not be possible

to safeguard the existing welfare state and accommodate the fiscal costs of an aging population.

Encouraging Short-Term Outlook

Denmark has shown the benefit of sound economic policies, continuing to achieve a growth performance, which is good relative to European standards. The recent modest slowdown in growth was in many respects necessary, given earlier concerns of possible overheating. The current stance of policy appears appropriate and growth should strengthen over the course of 2002.

Preparing for Demographic Change

The interesting aspect of the Danish economy is meeting the challenge of an aging population, as well as maintaining a welfare state and an already very high tax structure. In this respect, the selected issues paper is very interesting.

The strong impression from the report is that, notwithstanding Denmark's impressive economic performance over the past decade, its commendable progress in reducing its public debt ratio, and its preparations to meet the challenges of an ageing population, more decisive steps will be necessary.

The illustrative scenarios in the selected issues paper are revealing. For the reasons outlined in the staff report, it is difficult to see scenario 1, namely, "reform success" being achieved in its entirety. For example: it is questionable whether the existing labor market initiatives will achieve the assumed increase in the participation rate (there are currently labor market pressures, notwithstanding the slowdown in the economy); the high tax base is likely to come under considerable pressure (moreover, a sizeable reduction in the overall tax burden is probably necessary simply to prevent a deterioration in labor supply); and with an ever-increasing proportion of government spending being accounted for by local governments, which have a history of over-spending, the chances of observing the assumed expenditure ceiling appear questionable. Furthermore, with around half of the fiscal consolidation over the 1990s the result of cyclical factors, any change to the benign growth assumptions would have a significant impact on the debt dynamics. Hence, it is difficult to see the "reform success" scenario as being the central case outcome.

The telling aspect of the alternative scenarios is that relatively small slippages in achieving greater labor market reform progress (scenario 2), or a slightly lower than assumed revenue-to-GDP ratio (scenario 3), or an overshooting of the spending target (scenario 4), could push fiscal surpluses

into deficit and result in an unsustainable public debt path. What may eventuate, however, is a combination of scenarios 2, 3, and 4.

It would be interesting if the staff have modeled such a scenario, namely, not achieving the labor market outcome in full, slightly greater than assumed erosion of the tax base, and somewhat higher public consumption spending.

What appears clear is that Denmark needs to take decisive steps to boost labor market participation (although given the already high levels, the scope for a meaningful increase would appear limited) and perhaps, most importantly, introduce more robust measures to control spending—particularly local government spending. Perhaps this is the most pressing issue facing Denmark: the introduction of more formalized arrangements to ensure expenditure control over all levels of government.

The agreement with the Association of Municipalities regarding a tax freeze and targets for expenditure is a positive step, but if past experience is anything to go on, the authorities should start planning to introduce measures to “neutralize” any failure by the municipalities and counties to stick to the agreement, as foreshadowed in Mr. Anderson’s statement.

The bottom line would appear to be that with limited scope to increase labor market participation, and likely increasing pressure to reduce the tax burden, Denmark will have no option but to reduce the size of social transfers. In short, is it realistic to assume that the existing welfare state can be maintained while accommodating the fiscal costs of an ageing population and reducing the tax burden?

Mr. Wijnholds submitted the following statement:

Key points:

- Denmark’s economic performance has been impressive, but challenges remain. In the area of budgetary consolidation, for instance, Denmark could benefit from more comprehensive fiscal rules.
- The current high tax burden on the economy seems difficult to maintain in the environment of an ever further integrating European Union.
- The share of mortgages with adjustable interest rates has risen substantially, which increases the financial risks for the household sector. Especially given the potential use of the interest rate to maintain a stable exchange rate with the euro, this should be a reason for concern.

- The staff report would have benefited from a more extensive discussion of the economic consequences of the current exchange rate system.

Denmark shows many of the similarities with my own country, the Netherlands. Not only does it recognize the economic opportunities presented by windmills, but it has also managed to turn around a rigid, over-regulated, and heavily taxed economy into a competitive, well performing welfare state. The economic challenges are also similar to the ones my own country faces: how to increase labor participation in certain segments of the labor market (older workers and immigrants), how to pay for the costs of the ageing of the population without returning to high fiscal deficits, and how to prevent erosion of the tax base in a globalizing economy.

The economic policy performance of the authorities has really been impressive: few European countries managed to combine economic growth with a budget surplus and low inflation in 2001. I concur with what Mr. Varela wrote in his statement on this point.

In order to continue this positive track record, it is important that the Danish authorities adhere to the public expenditure growth targets, particularly in light of the announced tax freeze. I would especially like to draw attention to the fact that the Danish authorities have only set a norm for the real growth of public consumption (which, as staff notes, was breached in most of the last several years), but not for public investment. Somewhat stricter and more comprehensive fiscal rules would be appropriate. This would be supported by the staff paper, which shows that small deviations from the projected spending path can have large medium term consequences for the budget balance. Like Mr. Varela in his statement, I welcome the agreement with the Association of Municipalities on the tax freeze and on targets for expenditure growth. This is a first step in the right direction of better spending discipline at the lower levels of government.

The tax burden in Denmark remains one of the highest in the world. Although the Danish government provides a high level of public services in return, the high tax level causes serious distortions in the economy. Work incentives at the marginal rate are low, thus limiting the labor supply. Furthermore, it will be quite a challenge to maintain substantially higher tax rates than in neighboring countries, being part of an ever further integrating European Union.

With regard to the financial sector, I am less comfortable than the staff as concerns a potential deterioration in credit quality. Although the staff is right that the risks of a possible increase in nonperforming mortgage loans in combination with declining housing prices would be borne to a large extent by mortgage bond holders instead of by the banks, there is reason for concern about the increased financial risks for the household sector. Table 4 of the

staff paper shows that the share of adjustable rate mortgages in total mortgage lending has risen rapidly from 5.7 percent in 1999 to an estimated 22.4 percent at the beginning of this year. Mortgage credit institutions have started to offer fixed rate mortgages in 1999 and, as a reaction, many households have redeemed their fixed rate mortgage in order to profit from falling short term bond rates. It would be important to know to what extent this has made Danish households much more vulnerable to an increase in interest rates, especially if it were combined with an economic slowdown and rising unemployment. This could become a major problem if the 'interest weapon' would have to be used to maintain the stability of the exchange rate with the euro.

The attention paid in the staff report to the exchange rate regime is somewhat disappointing. Especially in a country which is on a 24-month Article IV cycle, but which has a pegged exchange rate regime in place, I would have expected a thorough analysis of the adequacy of the current regime and the potential future risks of pressures on the krone. Even though I admit that the fact that the Danish National Bank managed to cut interest rates even somewhat more than the ECB over the last year proved that the participation in ERM II remained a credible strategy.

In that context, I very much support Mr. Varela's remark that, although there should be some flexibility to shift Article IV consultation dates in cooperation with the authorities, planning an Article IV consultation beyond the 24 month period for a country participating in an exchange rate mechanism like ERM II is unacceptable.

Mr. Mirakhor submitted the following statement:

Key Points:

- Looming demographic strains necessitate more decisive progress in consolidating public finances and in structural reform. In this context, renewed commitment to budgetary surpluses and lowering debt levels is welcome. Progress should continue in labor and product market reforms.
- Denmark's outstanding record of providing ODA is praiseworthy.

The concise and well-written staff report, the high-quality Selected Issues paper, and the informative statement of Mr. Andersen provide a comprehensive account of Denmark's recent economic performance, as well as the policy options and challenges in the period ahead. Denmark's economic expansion since 1993 is a clear evidence of the benefits of sustained implementation of fiscal discipline and structural reform.

In 2001, in the context of global downturn, the real economy continued to expand, albeit at a slower pace, in a subdued inflation environment, while unemployment reached a 25-year low. There was a higher structural fiscal surplus; public debt ratio continued to trend downward; the external position strengthened; and the decline in official reserves was reversed. The authorities deserve praise for their skilful macroeconomic management, which has enhanced investor confidence and market perception, as evidenced by a further narrowing of already-low spreads with Germany. We agree with the thrust of the staff appraisal and share the view that the looming demographic strains necessitate further progress in consolidating the public finances, as well as more determined structural reforms.

The 2002 budget maintains a broadly neutral stance, with fiscal surplus expected to remain within the medium-term target range. This policy stance seems appropriate, given that the somewhat easy monetary conditions could support a firming of growth in light of still weak global conditions, on the one hand, and the fact that relatively strong wage growth and high capacity utilization in some industries argue against a more active fiscal policy response, on the other. In case activity turns out to be markedly weaker than foreseen, the automatic stabilizers, considered quite powerful in Denmark, should be allowed to operate freely, while avoiding spending overruns of recent years, especially at the local government level. The staff report makes a compelling case for enhanced competitiveness through wage moderation. While the current monetary and exchange rate arrangements are working well, in light of recent opinion polls and calls by political parties, we welcome Mr. Andersen's or staff's comments on prospects for a new EU referendum.

On the medium-term fiscal strategy, the renewed commitment to budgetary surpluses and lower debt levels in preparation for the coming demographic change augurs well for the strength of public finances. This, however, is a challenging task, given the continued tendency toward public consumption overruns, as well as the need to gradually reduce Denmark's high tax ratio toward the EU average. Lowering the income tax rates, and raising tax thresholds could prevent a tax base erosion due to increased factor mobility and counter the brain drain phenomenon, as well as pressure for shorter working hours. The tax freeze, in line with the political commitment of the new government, provides a useful start, but there is a need for better targeting. On the expenditure side, the staff suggestion to bring forward the planned reduction to 0.5 percent of the targeted growth rate for real public consumption and to widen the expenditure target to cover social transfers merits careful consideration. Strengthening expenditure discipline at the local authority level should help avoid the reemergence of fiscal deficits and rising debt levels. In this context, notwithstanding the previously failed attempts, recent evidence in the case of disability payment points to usefulness of offering rewards and imposing penalties in exerting a degree of spending

discipline. We welcome the authorities' increased attention to improved public management and their consideration of the scope for user fees and outsourcing of provision of public services.

The perceptive remarks of Mr. Callaghan on the illustrative medium-term scenarios point to the importance of the observation that ensuring sustained growth and increased employment in the face of future demographic pressures is predicated on firm expenditure control and further advances in structural reforms. Notwithstanding Denmark's remarkable progress to date in enhancing the functioning of the labor market, efforts should continue to increase labor supply by providing incentives to labor to stay longer in the work force, as well as strengthening training and integration for immigrants and refugees. With product market reforms trailing behind other structural adjustments, we welcome the steps taken to enhance competition policy, as well as planned deregulation and privatization in natural gas, electricity, railway and postal sectors, are welcome. We also support the view that a strong regulatory framework is an important prerequisite for successful privatization of network industries.

On the financial sector, we are pleased to note that, despite some expected deterioration in the credit quality, the Danish banks remain well-capitalized and profitable. Outside the banking system, however, the situation faced by some insurance companies and pension funds highlights the need for improved risk management systems. Given new challenges posed by increasing conglomeration and cross-border mergers, there is merit in providing consistent consolidated supervision through planned unification of the financial supervisory acts, and the authorities are encouraged to undertake a Financial Sector Assessment Program.

Finally, the authorities are to be commended for their outstanding record of providing official development assistance, which has turned Denmark into a worthy role model. Accordingly, it is hoped that the authorities' unwavering commitment to development aid will prevent any further scaling back of the aid budget, thus safeguarding Denmark's enviable top-rank position among OECD countries.

Mr. Junguito and Mr. Rambarran submitted the following statement:

We thank the staff for the reports and Mr. Andersen for a substantive statement.

We commend the Danish authorities for weathering the global slowdown and for easing the transition to a successful soft landing. This follows robust growth in domestic demand over most of the last ten years and the more recent adoption of policy measures to cool the economy. By the end of 2001, the economy slowed down to a more sustainable rate in line with

policy objectives directed to reduce the danger of overheating. Real GDP is expected to grow by only about 1¼ percent this year, leaving output below its potential level. With no major output gap expected in the short-term, price inflation should remain subdued, if wage settlements agreed in the coming negotiations adjust downwards. We, therefore, encourage the authorities to continue to steer the economy on its reasonably stable path, while advancing on efforts to deal with the major policy challenge of rapid population ageing.

Monetary policy remains geared to setting interest rates mainly with a view to maintaining the value of the Danish krone against the euro in the framework of the Exchange Rate Mechanism, as highlighted in Mr. Andersen's statement, and monetary conditions are effectively determined by the economic situation in Europe as a whole. Throughout most of the 1990s, the Danish economy was not in sync with the rest of Europe, leading to inappropriate monetary settings. Indeed, expansionary monetary conditions and insufficient fiscal tightening contributed to the overheating in past years. However, Danish interest rates have followed euro area rates down since last February, helping to support activity and to mitigate the adverse impact of the global slowdown. Now the soft landing may help to closer align the Danish business cycle with that of the euro area, and interest rates can play a more stabilizing role in determining the short-term outlook for Denmark.

Fiscal policy, nevertheless, remains Denmark's main instrument for macroeconomic stabilization in the short run. Given the cooling of the economy and with monetary conditions anticipated to be generally supportive of activity during the year, the present broadly neutral fiscal stance is appropriate. The overall general government surplus is projected to reach close to 2 percent of GDP this year. We share the staff's concern on the need to avoid spending overruns, while allowing the automatic stabilizers to work freely.

We agree that Denmark's fiscal framework is working well, and commend the authorities for the progress made in running structural budget surpluses and reducing public debt. Maintaining this fiscal strategy is important to help prepare for the spending pressures on pensions and health care associated with an ageing population that will arise from 2010 onwards. We welcome the government's commitment to reducing the tax burden, which, despite falling slightly in recent years, is around 48 percent of GDP, the second highest in the EU, but note that tax policy options may be constrained by pressures on the overall revenue base arising largely from growing integration and factor mobility, as well as international tax competition. Lowering the high tax rates on labor income is a priority. More than 40 percent of full-time workers face the highest marginal tax rate of 63 percent. We believe that the strengthening of incentives to work consequent on raising the threshold for the top tax rate would far compensate for the tax revenue foregone. Other tax distortions should also be addressed.

Given the magnitude of the welfare state—public expenditure stood at 53 percent of GDP in 2001, and public consumption remains at an internationally high level of 25 percent of GDP—this makes it difficult to reduce the overall tax burden without undermining the budget surplus. These potential risks reinforce the need for better control over public spending, especially at lower levels of government where the bulk of public consumption takes place and where expenditure slippages mainly occur. The “tax freeze” should improve spending control, if implemented effectively, but in light of the autonomy of counties and municipalities much more needs to be done. We note from the Selected Issues paper on the fiscal framework that the achievement of spending targets by the local government is based on a “gentleman’s agreement” and that it lacks a more formalized arrangement. Mr. Andersen’s statement indicated that in late February the government signed a Letter of Agreement with the Association of Municipalities regarding the freeze and targets on expenditure growth. Is this a means to reach a more formalized arrangement? What are the staff’s views and proposals on the subject?

Denmark has achieved a considerable reduction in unemployment mainly by improving active labor market policies and by tightening eligibility criteria for the early retirement pension scheme. However, like the staff, we wonder whether these policies are adequate to achieve the targeted growth in labor supply needed to enhance productive capacity and to cope with an aging population. Further reform of the benefit and tax system through a stronger reliance on economic incentives should be considered, if the authorities are to increase employment in areas of relatively low labor market participation such as older workers and immigrants. These measures would need to be complemented by tighter rules on social transfers that promote a return to the labor market, and by greater incentives to reduce the excessively long time spent in tertiary education and the corresponding high average age of entry into the workforce.

We welcome the recent measures to enhance competition in product markets, including by tightening merger control, and look forward to further changes in industries where anti-competitive problems have been identified. We encourage the authorities to deregulate energy markets in a manner consistent with environmental objectives for reducing greenhouse gas emissions in the least costly manner. The natural gas market, which is lagging among EU countries in terms of competitive behavior, should be opened up faster.

We are reassured that given the strong capitalization of the banking system, potential losses associated with the economic slowdown do not seem to pose significant systemic difficulties. From the table on Indicators on External and Financial Vulnerability, we note, however, that Denmark has a large share of mortgage credit institute lending in total lending. When this is

added to the fact that, since 1993, real house prices have risen by 70 percent, we wonder about the downside risks in the event of housing price declines on non-performing loans. Could the staff expand on the subject?

In conclusion, we wish the authorities well in their endeavors and take this opportunity to thank them for their outstanding record in providing official development assistance.

Mr. Shaalan and Ms. Farid submitted the following statement:

Sound economic policies have continued to be the hallmark of the economy in Denmark. Following the strong growth performance from 1993 through 2000, prudent macroeconomic policies, buttressed by important structural reforms implemented over the years, facilitated the achievement of a soft landing in 2001. Overheating concerns, which had surfaced in 1999, were ameliorated by the global economic slowdown and the effect of earlier interest rate increases. Growth slowed in 2001, price inflation remained subdued, and unemployment remained at its record low level. The current account also continued to show a healthy surplus, indicating that general competitiveness remained strong, despite the emergence of some wage pressures. Prospects over the near-term appear favorable, due to continued prudent macroeconomic policies, as well as the recently improved global prospects. Both monetary conditions and the relatively neutral stance of the 2002 budget appear to be appropriate at this stage, provided that the coming wage negotiations succeed in preserving wage moderation, and that slippages in budget implementation are avoided. On the other hand, if growth were to be weaker than projected, automatic stabilizers should be allowed to operate.

Denmark's long-term policy strategy to prepare for the coming demographic change also deserves much praise. The steadfast implementation of the policy of fiscal surpluses (reinforced by labor market reforms), and of reducing public debt levels has already achieved impressive results. Starting in 1997, fiscal deficits turned to surpluses and the government debt level dropped sharply. Nonetheless, the size of the government, as reflected in the very high tax burden and the very high public expenditure level, continues to be large in comparison to other European countries. While the analysis in the Appendix to the Selected Issues paper comes to a somewhat benign conclusion on the distortionary effect of Denmark's high taxes on economic efficiency at the present time, there is much merit to the view that high tax burdens and the accompanying high levels of expenditures are likely to have an increasingly adverse effect on growth in coming years. We, therefore, are reassured by Mr. Anderson's helpful statement, emphasizing the new government's commitment to continuing the existing medium-term fiscal strategy, centered around maintaining fiscal surpluses through 2010 and further reducing debt levels, while also accommodating a decline in Denmark's very high tax burden. Achieving the targeted fiscal surpluses,

however, is premised on lowering real annual public consumption growth to 0.5 percent in 2005–2010, from the current targeted increase of 1 percent. The strategy also assumes a growth in potential output based on achieving further annual increases in labor market participation rates. As the staff report notes, these assumptions, particularly of public consumption growth, are subject to some measure of uncertainty. Some adjustments in policy may, therefore, be needed to assure their realization. The well-written staff report and the Selected Issues paper rightly focus on how best to assure the attainment of these important targets, which are essential for the continued success of the authorities' sound medium-term strategy. We are in broad agreement with the appraisal and recommendations contained therein and will limit our remarks to brief comments, mainly for emphasis, on the issue of public expenditure discipline and the related issue of the high tax burden.

At the outset, it is important to commend the authorities for the impressive improvement in the budget balance achieved since 1996, the last year when the budget was in deficit. The balance moved from a deficit of 3 percent to a surplus of about 2.5 percent of GDP in 2000, largely through expenditure reductions at the central government level. The bulk of the expenditure decline was achieved through reductions in unemployment transfer payments, and to a lesser extent through lower interest payments. It is noteworthy that about half of the reduction in transfers resulted from a significant drop in structural unemployment following the implementation of labor market reform measures. These impressive achievements notwithstanding, public consumption remains very high by international standards. The targeted reduction of the annual real growth rate to 1 percent has been missed by a wide margin due to slippages at the local government level, where a good part of public service expenditure takes place. These slippages have meant that substantive progress toward the related objective of significantly reducing the overall tax burden has not been possible.

The staff's illustrative scenarios in the Selected Issues paper point to the sensitivity of the authorities' medium-term fiscal plan to even modest changes in the underlying assumptions. We note, in particular, that the strategy could be significantly derailed by continued slippages in public consumption growth. Strengthening control of local government finances, where the slippages have been prevalent, is, therefore, essential. As the staff note, this could be achieved by instituting a system of positive and negative incentives aimed at ensuring local government compliance with overall public finance targets. Here, while we welcome the authorities' letter of agreement with the Association of Municipalities, as noted by Mr. Anderson, we wonder whether it is sufficiently binding to assure compliance. Still on expenditure control, the authorities would also need to explore ways to contain the growth in expenditures on welfare services, including through limiting the relatively generous benefits. The outsourcing of services to improve efficiency and the imposition of user fees should also be considered. Additional benefit reform

aimed at encouraging older workers to stay longer in work force and better integrating immigrants into the labor force would also help assure the attainment of the labor supply targets assumed in the fiscal strategy.

Like the staff, we welcome the new emphasis being placed on reducing Denmark's high tax rates. However, given Denmark's very high tax burden, international tax competition could well require targeting a larger decline in the tax burden beyond the 2 percentage points of GDP by 2010, envisaged in the current medium-term plan. The questions surrounding the sustainability of the current high tax rates are likely to become increasingly pertinent as increasing factor mobility adversely affects the tax base and, more particularly, in view of plans by other EU countries to lower their own tax burdens. The imposition of a tax freeze by the Danish authorities is a first step that helps focus attention to the problem and also helps instill increased spending discipline, although we agree with the staff's concern with regard to the efficiency of an across the board freeze. In terms of efficiency, the adverse effects are not unlike those associated with across-the-board cuts in expenditures. It is, therefore, important that the tax freeze be followed by early action on more selective tax reforms aimed primarily at lowering the very high labor income tax rates. The need to reduce the high tax burden further underscores the importance of achieving the expenditure targets during the coming decade.

Finally, we commend the Danish authorities for their outstanding record of official development assistance (ODA). With ODA well in excess of the U.N. target, Denmark continues to rank at the top of OECD countries, providing a shining example to other industrial countries.

Once again, we congratulate the Danish authorities for their exemplary conduct of economic policies and wish them continued success.

Mr. Rustomjee submitted the following statement:

We thank the staff for the papers for today's discussion on Denmark and Mr. Andersen for a very helpful statement. We note from the staff report that the Danish economy grew at above average rates, compared to the largest economies of Europe during most of the 1990s. These favorable conditions, which were reinforced by labor market reforms, allowed for a substantial decline in unemployment and the build-up of fiscal surpluses, while the authorities managed to sustain the welfare system. Nevertheless, the Danish economy started to slow down during 2001 in synchrony with the global slowdown. Since we are in broad agreement with the overall thrust of the staff report, we will limit our comments to just a few issues.

Fiscal Policy

We commend the authorities for the implementation of fiscal policy over the last decade, particularly since 1997, when structural fiscal surpluses were being recorded, as a result of decreasing interest payments and lower social spending as unemployment progressively declined. The authorities have indicated that they would pursue the policy of building up fiscal surpluses over the medium term. We consider this policy stance appropriate, given the authorities' efforts to strengthen the country's long-run fiscal position, the later which is needed to address the changing demographics, as the population ages. This fiscal stance, nevertheless, contains some risk. We note that the overall government revenue-to-GDP rate remains high, notwithstanding the tax reforms implemented in 1998 to lower marginal income tax rates, since the lowering of income taxes was offset by an increase in local government taxes. We are also concerned that the still high marginal tax rates by European standards could increase the loss of skilled Danish workers, a view that is alluded to in the staff report. A sustained loss of skilled workers could, in our view, contribute to labor supply difficulties in the medium to long term, if the authorities fail to address the high tax burden and marginal tax rates effectively.

Monetary Policy

The Danish authorities took, in our view, appropriate measures to ease monetary policy by reducing interest rates in order to avoid a hard landing in the face of the synchronized global slowdown. We are pleased to note that authorities managed to keep the national currency stable against the euro, and that the widening of interest rate differentials in the run-up to the September 2000 referendum proved only temporary. The prevailing sound monetary and exchange rate conditions, of low inflation and a stable national currency underscore the appropriateness of the policy measures taken by the authorities within the overall macroeconomic policy framework.

Labor Policy

The high growth rate over the last decade, coupled with sustained labor market reforms, contributed significantly to the substantial decline in unemployment to the lowest levels recorded in 25 years. We commend the authorities on this truly remarkable achievement. Nevertheless, the authorities do not seem to be complacent regarding these achievements and we welcome their commitment to reduce the current NAIRU further from the already low level of 5½ percent. In addition, the authorities have identified a few areas for improving labor supply, including among older workers and immigrants. We would urge the authorities to implement the needed policies, particularly to strengthen the disincentives for early retirement. Finally, on labor issues, we are pleased to note that, notwithstanding the slightly higher unit cost of labor

compared to European standards, Danish labor productivity remained competitive in the euro area.

Commitment to Development Assistance

My authorities wish to record their gratitude to the Danish people for their undiminished commitment toward development assistance. Denmark remains among the top contributors among OECD countries in providing development assistance, and the budgeted contribution of official development assistance of 1 percent of GNP for 2002 remains exemplary. We would urge other industrial countries to follow this model.

We wish the Danish authorities every success with their future endeavors.

Mr. Wei submitted the following statement:

We thank the staff for their well-prepared report and the Selected Issues paper, and Mr. Andersen for his informative and insightful statement.

Denmark's economic performance over the past nine years has been very impressive. Real GDP growth from 1993–2000 outpaced that in the largest four European economies, national savings and investment ratios rose steadily, both the fiscal structural balance and the current account turned into surpluses, and the unemployment rate declined to 5 percent in 2000, the lowest in 25 years. Although economic growth in 2001 slowed against the backdrop of the global recession, it helped to mitigate the price and wage pressure and achieve a soft landing in the economy. All the abovementioned achievements have laid a solid footing for sustaining a healthy growth in the medium term and beyond.

Since I broadly concur with the staff appraisal, I would like to raise several points in contributing to the discussion, with one point on the short-term outlook and policy stance, and another three points on the medium-term strategy.

Short-Term Outlook and Policies

Domestic demand seems to be the major driving force for growth in 2002. It is encouraging to learn from Mr. Andersen's statement that consumer confidence is now above the level in 2001 and that business confidence has improved markedly over the past 10 years. Meanwhile, with the recovery of Denmark's major trading partners, especially Germany and other major EU countries, external demand may pick up gradually. In our view, the current ease in monetary policy and the neutral stance of fiscal policy are appropriate to further bolster domestic consumption and investment. At the same time, in

view of Denmark's declining market share within the euro area, we agree with staff that, although overall competitiveness appears healthy, the authorities need to focus on how it can be further strengthened, especially when the euro regains strength. In this regard, containing wage pressures remains a policy challenge.

Medium-Term Strategy

First, we have seen the new government's determination to reduce Denmark's tax burden over time and privatize state-owned assets. We agree with the staff that the tax freeze was the first step in curbing the tax burden and take Mr. Andersen's point that the effect of lower taxes on labor should not be exaggerated. However, the authorities need to give priority to lowering those taxes and surcharges that may have greater impact on economic incentives. Meanwhile, we hope to see improved efficiency and competition in those sectors undergoing privatization. To our understanding, the proceeds from privatization will be used to reduce the country's public sector debt. It would be appreciated if the staff could estimate the revenue implications of the above-mentioned privatization proceeds on the reduction of public sector debt and on the medium-term forecast for the fiscal account.

Second, I agree that a major policy challenge for the authorities in the medium term is to maintain fiscal sustainability in the face of an ageing population. The authorities have indicated a clear medium-term strategy for running fiscal surpluses. In this regard, expenditure restraint, particularly better expenditure control at the local government level, is important in reaching the surplus target. We welcome the Letter of Agreement signed between the government and the Association of Municipalities regarding the tax freeze and targets for expenditure growth. Furthermore, to establish a more flexible and multi-pillared pension system may be a good way to alleviate fiscal expenditure pressure, leave room for tax reduction and inject stimulus into the labor market. Therefore, the authorities' reform of the compulsory pension scheme, "Special Pensions Fund", is a very wise choice.

Third, we commend the authorities' leading position along with Norway in terms of past aid contributions to developing countries. We hope the authorities will continue to take the lead among developed countries in providing official development assistance (ODA) and play an active role in encouraging other developed countries to meet the ODA target of 0.7 percent of GNP set by the U.N.

In conclusion, I wish the new authorities every success in their efforts.

Mr. Ondo Mañe submitted the following statement:

As Mr. Andersen has pointed out in his helpful statement, it is reassuring to note that, despite the global economic slowdown, Denmark continues to experience positive economic growth consistent with a successful soft landing.

We commend the authorities for having made possible these developments through the implementation of sound economic policies. Looking ahead, the expected recovery in the global economy and supportive monetary policy are expected to boost growth. However, the key challenge facing the country is to safeguard the welfare state, while accommodating the fiscal costs of an ageing population. In this context, there is a need to maintain fiscal sustainability, while deepening structural reforms in the labor and product markets, so as to foster competitiveness and maintain an environment for sustainable growth.

Fiscal Policy

We commend the authorities for their steady efforts since the 1980s to achieve a budget surplus and reduce the debt-to-GDP ratio. In the context of low inflation and supportive monetary policy, we are of the view that the neutral policy stance adopted in 2002 is appropriate. For the medium term, we encourage the authorities to focus on providing a stable macroeconomic framework. In this context, we support the medium-term policy goals of maintaining fiscal surpluses of 1½-2½ percent of GDP through 2010. On the revenue side, we welcome the government emphasis on reducing the tax burden, as it will help focus more attention on expenditure control. Therefore, we encourage the authorities to strengthen their actions in lowering the public consumption growth target and to exercise a better expenditure control at the local government level. We also urge the authorities to explore methods to help make public service provision more efficient and to improve public management.

Structural Reforms in Labor and Product Markets

Accelerating structural reforms in labor and product markets is also critical for accelerating growth. We commend the authorities for the success of their labor market policies, as evidenced by low long-term and overall unemployment.

However, we encourage them to carry out additional reforms, so as to ease constraints on labor supply and promote work incentives. In this regard, reducing the labor income tax, while raising the tax thresholds are pressing priorities, as this will help provide an environment conducive to improving labor supply. Increasing employment in a few areas where there is still a low

labor market participation, such as older workers or immigrants is also important.

However, given the limited impact of the ongoing measures, we encourage the authorities to take additional financial disincentives for early retirement, in order to encourage older workers to stay longer in the labor force. As regards welfare traps and problems of high minimum wages, we believe that this matter hampers labor supply. Therefore, we urge the authorities to address this issue more broadly through the reform of the benefit and tax system. In this regard, we welcome the government's decision to reform the compulsory pension scheme, known as the Special Pension Fund, from a redistributive tax scheme into an individual scheme based on actuarially fair principles.

In the product markets, we welcome the recent steps to strengthen competition and encourage the authorities to accelerate the deregulation and privatization of a number of sectors, including electricity, railway, and postal sectors. We also call for the opening of network sectors and natural gas markets, which are lagging behind their EU partners, and to make sure that their commendable environmental protection does not obstruct competition in their energy market.

In the financial sector, we are encouraged by the soundness of the banking system and are confident that high capitalization of banks will help them weather the economic slowdown. Likewise, although the recent fall in stock prices has put some pressures on some insurance and pension funds, we are reassured that the risk is not systemic. However, we would like to bring to the attention of the authorities that the movement of these institutions into potentially more risky and complex securities and the increasing conglomeration and cross-border mergers not only require improved risk management systems, but they also pose new challenges to regulators and supervisors. In this regard, we commend the authorities for their intention to unify the financial supervisory acts and to establish a cross-border Memorandum of Understanding (MOU), as this would help improve consolidated supervision. We also appreciate the authorities' decision to conduct a Financial Sector Assessment Program as soon as possible.

Finally, we highly appreciate the commitment of the Danish authorities to official development assistance (ODA), despite the reduction in the ODA budget for this fiscal year. In the spirit of debt sustainability within the enhanced HIPC Initiative framework, we believe that the ongoing debt reduction efforts would be more helpful to low income countries if they were coupled with a further opening-up of markets to exports from low-income countries.

We wish every success to the authorities in their policy efforts.

Mr. Mozhin and Mr. Palei submitted the following statement:

We would like to thank the staff for a concise and well-focused report. The staff has found the right balance between the praise for the authorities' undeniable achievements and an appropriate emphasis on some of the structural weaknesses in the economy. The latter are not evident in the recent economic developments, but become more apparent when the staff entertains various assumptions in illustrative fiscal sustainability analysis. Being in broad agreement with the staff, we will make a few observations.

During the last ten years, the economic performance of Denmark has been exemplary. Public debt has declined to a respectable level; savings and investment ratios have strengthened; and unemployment rate is close to the level lowest in the last 25 years. The GDP growth compares favourably with the growth rates in larger European economies. In 2001, the global economic slowdown came just in time to cool an overheating in the country's economy. The authorities and the staff seem to agree that the current macroeconomic stance is broadly appropriate.

One issue of concern, as elaborated by Mr. Andersen in his statement, is related to continuing wage and price pressures. Mr. Andersen links these pressures to the fact that current unemployment is below structural, and he is probably right. This observation has additional implication, though. It seems to be quite possible that the currently slower growth, coupled with already tight labor market conditions, could complicate the upcoming wage negotiations. In this respect, we are somewhat less sanguine than the staff about the flexibility of wages in Denmark. The upcoming wage negotiations will take place in a different setting, since the labor market is very tight and Denmark went through a long period of relatively high growth. It would be reasonable to expect some inertia in wages, and it could be stronger than expected. For Denmark, the upcoming wage negotiations may negatively affect inflation, and are important from the competitiveness point of view. According to Figure 12, the unit labor costs in Denmark have been growing noticeably faster than unit labor costs in the euro area. A period of higher inflation and wage increases could put at risk the sequence of current account surpluses the country enjoyed in the recent years.

After a long period of economic growth and fiscal consolidation, now is a good time for the authorities to focus on medium-term issues, especially, as the staff did, on the labor supply and fiscal sustainability in the medium to long term. We tend to share the scepticism about the remaining room for improvements in the labor market. At about 5 percent, the unemployment rate is at its lowest level in a long period of time, and it is associated with already very high participation rates (Figures 14 and 15). Under the circumstances, it is not clear how productive the authorities' attempts to fine-tune the existing labor market conditions can be. We tend to agree with the staff that anything

short of a comprehensive review of the duration and generosity of benefits is unlikely to boost the labor supply.

Overall, significant changes in the labor markets over the last decade and continuing price and wage pressures, in our view, indicate that there is little room for further increasing the supply of labor in Denmark. The emphasis should now shift to a more ambitious and speedy reforms in the product markets and, to sustain the impressive growth rates of the past decade, the authorities should focus more on measures enhancing productivity. Here, we welcome the authorities' intentions to speed up the deregulation and liberalization of the product markets.

Given that the monetary conditions are largely predetermined by the developments in the euro area, it was appropriate for the staff to choose fiscal sustainability as the main area of policy discussions. We agree with the staff on the major risks to the fiscal developments in Denmark. On the revenue side, high effective taxation may lead to erosion of the tax base due to higher mobility of capital and labor in Europe. Similarly, the current structure of taxes may limit room for compensatory measures in the future. On the expenditure side, the degree of fiscal decentralization also calls for preventive steps in strengthening the expenditure controls. The current approach of freezing the tax rates at both central and local levels will make deviations from fiscal discipline more visible. We are still not certain to what extent the agreement with the Association of Municipalities is binding. In light of previous overruns in expenditures permitted by the local governments, the staff may have a point that more explicit incentives should be built into the system. The recommendations by the staff to explore introduction of penalties for over-spending and limits to local tax increases seem to be sensible.

The authorities' desire to subject the Danish financial sector to the scrutiny of the Financial Sector Assessment Program is commendable. Indeed, being on the 24-months consultations cycle, they are very prudent in the use of Fund's resources. The developments in the European financial sector in a broader sense certainly warrant additional advice from the Fund and the Bank.

We also join other Directors in praising the Danish authorities for the consistently high level of official development assistance, and wish the authorities success in their endeavours.

Mr. Kelkar and Mr. Jayatissa submitted the following statement:

We thank the staff for the well-written report and the useful Selected Issues paper, and Mr. Andersen for the insightful statement. We thank the authorities for their sound economic policies, which, together with the flexible labor markets, have enhanced the resilience of the economy. The staff report has clearly presented the short- and medium-term economic policy challenges

and we commend the authorities for their policy focus to address these challenges.

It is encouraging that earlier concerns of overheating have abated and that inflation is expected to be subdued, but, of course, under the assumption of subdued wage pressures. We see that in the context of more positive outlook for the world economy, the assumption of subdued wage pressures could be challenged if the growth recovers faster and labor supply constraints were slow to ease. Would not this be so, particularly given that labor market participation rate is already high and increase in labor market participation to additional incentives would come gradually over the medium term? We appreciate staff comments.

As the possible overheating concerns are not totally absent and given the somewhat expansionary bias in both fiscal and monetary policies at present, we also share the view that any spending overruns need to be avoided in 2002. In this regard, we would appreciate any update information on the status of fiscal policy stance this year, based on actual information so far.

While the staff has rightly questioned whether the authorities' current policy initiatives are sufficient towards the expected growth in labor supply, and agree with the staff's recommendation to provide added financial disincentives to discourage early retirements, the overall economic effects of such measures would depend on the interplay of number of factors, such as wage structure of the such early retirees, productivity and other costs, and benefits. Such disincentive schemes will have to be carefully designed so that it would not become an added burden.

We welcome the authorities' determination to make further progress on product market reforms and enhance competition. We also appreciate the authorities' efforts to improve expenditure management, particularly at the local administration level and the intentions to improve efficiency of the provision of public services.

It is encouraging that the financial sector is sound and risks are minimal. We welcome authorities' willingness to participate in the Financial Sector Assessment Program.

With these comments, we wish the authorities all success.

The staff representative from the European I Department (Mr. Corker), in response to questions and comments by Directors, made the following statement:

On Mr. Varela's question on the difference between the staff's 2002 growth forecast for Denmark and that of the European Commission (EC), the EC projection is more optimistic at 1.7 percent, compared to the staff

projection of 1.3 percent. The difference reflects the more optimistic view of the EC on Denmark's domestic demand growth—the EC expects stronger consumption and investment growth, and a small boost from inventory building. As mentioned in Mr. Andersen's statement, recent indicators provide some support for the view that domestic demand performed quite well in the first quarter, and is improving in the current second quarter. The difference between the forecasts of staff and the EC is, to some extent, whether demand will spill over into imports. For example, as Denmark is not a car producer, increased demand for automobiles does not add to its GDP growth. Furthermore, the average annual growth projection of the staff is sensitive to the timing of the recovery. In our forecast, we assume a fairly gradual recovery during the first half of 2002, with growth at an annualized rate of about 1 percent, but, thereafter, becoming quite strong in the second half of 2002. Were we to move the timing of the recovery slightly forward, we would have a stronger average growth projection. Note, we have a growth forecast of about 1.8 percent, fourth quarter on fourth quarter, which is not a particularly weak overall growth forecast. At present, the balance of risks to our forecast has tipped more to the upside; therefore, our current growth projection of 1.3 percent is slightly biased downward.

On Mr. Kelkar's and Mr. Jayatissa's question on the impact of stronger growth on wage pressures, faster growth could mean that wage pressures will be less subdued. However, this development is not a concern if the faster growth reflects higher productivity in Denmark. The implications for bilateral competitiveness would also depend on whether the Fund is underestimating the impact of wage pressures on the growth prospects of Denmark's trading partners. We may be underestimating some of the wage developments in continental Europe, particularly current wage pressures in Germany. Nonetheless, our policy advice to the authorities in these circumstances is to allow fiscal stabilizers to operate on the upside. Although the staff report discussed downside risks to growth, if upside risks were to materialize, fiscal stabilizers should also be permitted to operate symmetrically.

On Mr. Kelkar's request for an update on the current fiscal stance, unfortunately we do not yet have any new data for 2002. However, we have provided, via Correction 1 to the staff paper, an update on the fiscal outcome in 2001 and on the fiscal forecast for 2002. Revenue in 2001 performed surprisingly better than projected by staff and the authorities, and the surplus was about $\frac{1}{2}$ percent of GDP higher. A large proportion of that revenue bonus will be permanent, and will generate a higher surplus in 2002 of around 2 percent of GDP. However, this does not imply that fiscal policy has been tightened. The fiscal impulse between 2001 and 2002 remains at about $\frac{1}{4}$ percent of GDP, which is still regarded as broadly neutral.

Mr. Wijnholds asked whether the rise in the share of mortgages with adjustable interest rates would have an impact on household behavior, and, in this context, whether Danmarks Nationalbank might have some problems raising short-term rates as it would have an automatic effect on households' cashflow position. The fast-rising share of adjustable rate mortgages has rendered households, in some sense, more vulnerable to a rise in short-term rates. The Nationalbank has also issued public statements warning people that interest rates could go up, as well as down. However, there are some reasons not to be overly concerned. First, only 20 percent of mortgages have adjustable interest rates. The popularity of adjustable rate mortgages would probably start to diminish as the yield curve flattens out in the future. Adjustable rate mortgages are also based on one-year interest rates, which means that they would not be necessarily affected by hikes in overnight rates, should the central bank need to, for example, defend the krone against speculative attacks. In that sense, there is a cushion before an increase in short-term interest rates actually affects households with adjustable rate mortgages. The one-year interest rates are adjusted at the beginning of the year, and may cause a bunching problem; for example, there could be additional strains if the central bank had to increase short-term interest rates just before these one-year rates were due to change over.

On Mr. Junguito's and Mr. Rambarran's question on risks in the housing market, we agree that house prices are richly valued in Denmark—they have increased by about 70 percent in real terms over the past 8-9 years. A collapse in house prices would certainly place financial stress on households and have some repercussions of financial institutions, but there are some factors that we believe would help contain systemic risks. First, when house prices go down, insolvencies at the household level tend to be technical—a homeowner would have to have bought the house at a high price and then be selling it at a lower price before any default on the mortgage could occur. Note, average loan-to-value ratios for the household sector is still less than 50 percent. Second, there is an unusual feature of the Danish mortgage market in that mortgage loans tend to be securitized, and repackaged as mortgage bonds. This has the advantage of pooling risk; much of the risk is ultimately borne by the non-financial sector, which invests—through mutual funds—in mortgage bonds. Finally, the staff report notes that financial institutions in Denmark are overall well-capitalized at this stage. Obviously, if there were an increase in housing loan defaults, non-performing loans would rise. However, the current level of non-performing loans in Denmark is rather low.

Mr. von Kleist made the following statement:

We broadly share the staff's assessment of the Danish economy, we welcome Mr. Andersen's comments in his statement, and we support most of the points made in Mr. Varela's statement. The economic policies pursued

during the last couple of years in Denmark were highly successful. Continued relatively comfortable growth rates, historically low unemployment figures, a subdued inflation rate, and continued surpluses of the current account and the budget—all these leave the Danish economy very well-positioned to deal with upcoming challenges, not least also compared to other EU members. Given the existing fiscal cushion, the medium-term target of a balanced budget does not seem to be endangered, and the unrestricted play of the automatic stabilizers seems warranted under current circumstances. Budget surpluses achieved in the past and projected in the future, which did and will allow a further reduction of the stock of public debt, are vital to deal with the consequences of population ageing. We commend the authorities for their exemplary policy performance in this regard. The authorities are also addressing existing weaknesses in the policy framework, namely, certain features of Denmark's specific welfare system, the comparably high tax rates on labor income, as well as labor market rigidities, which potentially hamper labor supply.

Denmark is a shining success story of the continental European model of a welfare state made possible by a comparatively high tax burden. Of course, a broad consensus within the society as a whole is necessary to support this model over the longer term. Also, like with any other success story, there is no room for complacency and the soundness of the economic foundations carrying the weight of the welfare state has to be continuously reviewed. In this sense, I want to offer a few specific remarks.

Like the staff and the European Commission in its broad economic policy guidelines for 2001, we encourage the government to go beyond its current plans regarding the easing of the tax burden. The envisioned "tax freeze" will bring down the tax burden by only 2 percentage points to an internationally still-high figure of 46 percent of GDP. With an even higher average marginal effective tax rate on labor income and freely available generous social benefits in place, a possible impairment of the growth performance through disincentives to work can not be ruled out. More ambitious expenditure cuts could provide the necessary room for easing the tax burden further. At the same time, it is evident that a medium-term real reduction of the tax burden without jeopardizing the budget target requires not only a limitation of real public consumption growth, as envisaged by the authorities, but its reduction. Not least the effects of not-yet implemented expenditure cuts at the local level point to the need for more ambitious compensating cuts at the central level.

Efforts to improve labor market flexibility and to overcome the related impediments for higher potential growth could be strengthened beyond what is currently envisaged. As the staff pointed out, increasing the already high participation rate is of utmost importance and the available tools are listed in the staff report. In addition, we would recommend to review the potentially

distorting system of so-called “flexijobs”, which grants a compensation for employers in case their employees lack the required qualification profile. Finally, efforts aiming at improving the integration and qualification of immigrants will certainly promote a higher participation rate. On the other hand, given the increasing international labor mobility, those efforts could easily be undermined if the tax burden remained high.

While we support the staff’s view that expenditure control at the local level has to be improved markedly and that the penalizing of spending overruns should be institutionalized, the more general and important question, as mentioned before, is whether welfare benefits can be kept at their current level, or whether policies should focus on reducing the role which the state plays in the economy over time.

Denmark’s monetary regime, with the krone closely tied to the euro, has worked broadly without tension in the past. Given the low levels of inflation and interest rates, there is currently no evidence for inflationary pressure coming up, provided that wage moderation can be maintained. Like Mr. Wijnholds, I think that Denmark’s exchange rate system and its benefits and drawbacks would have deserved a much closer look in the staff paper, since Denmark is an EU, but not an EMU, member and its experience could offer some valuable insights for the so-called accession countries.

The high concentration ratios in the banking sector, as well as the potentially risky investment strategies of insurance companies and pension funds, are a matter of concern. Therefore, the FSA should remain vigilant and take the necessary remedies in a timely manner, if instabilities emerged. In that context, we welcome the authorities interest in undertaking a Financial Sector Assessment Program.

Finally, notwithstanding the continued surpluses of the trade balance and the current account, we concur with the staff that wage moderation, as well as an increased wage flexibility is needed, not least because Danish unit labor costs exceed the euro area average, by far its most important trading partners.

Mr. Dohlman made the following statement:

The most important reform issues in Denmark continue to center around long-term growth and fiscal challenges stemming from changing demographics and structural inefficiencies. The authorities have made important headway, such as the shift to fiscal surpluses. Looking forward, the authorities have broadly sound medium-term fiscal and structural reform goals that include important reductions in the tax and expenditure burdens and better labor market incentives.

The most immediate fiscal task is to establish stronger controls over expenditures. The recent tax and expenditure freeze agreement is a positive step, but as others have pointed out, this freeze is non-binding. More formal limits, particularly on expenditures at the local government level, are desirable, especially given the past track record of overspending. The authorities have pledged to “neutralize” any such overruns, but there are limits to such offsets, and in any event, such a guarantee provides a poor incentive.

We welcome the authorities’ near-term structural reform plans, including planned privatizations, enhancements to competition policy, and labor market reforms. With regard to labor market incentives, the Selected Issues paper cites empirical evidence that labor incentive problems are strongest among welfare recipients (“welfare trap”). It seems especially appropriate, therefore, to target this area. With respect to labor policies targeted on Denmark’s sizeable immigrant population, it is important to Denmark’s medium- to long-term prospects to follow through on associated pledges to enhance training and integration of this subgroup. To be successful, the specific costs of these efforts must be identified and resources reserved.

We read with interest the staff’s analysis that even small, but persistent, annual deviations from the planned reform path, such as small expenditure overruns, could shift Denmark towards a negative debt/GDP trajectory and hurt competitiveness. And as Mr. Mozhin points out, the deterioration resulting from such deviations could be even more rapid if they occur in combination. For example, it seems reasonable to assume that higher interest rates would emerge if expenditure targets are consistently missed. Given this sensitivity, we support the staff’s “risk management”-motivated recommendations for some additional reform measures to help reduce the probability of a negative outcome.

The staff report and the Selected Issues paper contain interesting discussions of the potential negative impact of “globalization” on Denmark’s fiscal balances and growth. The concerns expressed about the sustainability of high tax burdens and tax base erosion are logical and ring true—and have implications for the survival of the current social welfare system. It is interesting, however, that the empirical research cited by the staff suggests little evidence to date of significant negative effects, despite ongoing integration with Europe and beyond. For example, the data shows a low labor supply elasticity in Denmark. It leaves us wondering whether there are important countervailing factors, such as strong societal preferences and social cohesion in Denmark, that are mitigating the postulated effects from globalization—or whether the lack of empirical evidence just reflects a lagged response to still evolving integration. The possible existence of such countervailing factors seems important in answering Mr. Callaghan’s question of whether the welfare system can be sustained in the long term. This issue needs to be better understood.

Finally, we welcome Denmark's strong efforts in combating terrorist financing and money laundering.

Mr. Le Fort made the following statement:

We thank the staff for an excellent set of papers prepared for this Article IV discussion, and Mr. Andersen for his helpful statement. The Danish authorities are to be commended for a remarkable macroeconomic performance over the last years, underpinned by sustained growth, low inflation, falling unemployment and a succession of fiscal surpluses. The current economic slowdown and the need to further consolidate the fiscal position to preserve the welfare state in the face of demographic changes are presenting new challenges. Being in board agreement with the staff appraisal, I will limit my comments to a few issues for emphasis.

Under the existing exchange arrangement, monetary policy is in effect defined by that for the euro area. It is not clear, however, whether the prevailing monetary policy stance in the euro area is sufficiently demand-supportive for Danish conditions. Denmark is embarked in an aggressive fiscal consolidation effort process through continuous nominal and structural fiscal surpluses. A prolonged slowdown and the intensive use of automatic stabilizers may jeopardize these advances. The expected recovery in domestic demand justifies a certain optimism in this regard, however, I wonder what type of contingency is available in case that aggregate demand fails to recover?

The depreciated euro has favored external competitiveness in the Danish economy. Nevertheless, unit labor costs relative to partners in the euro area have increased continuously, and unit labor cost relative to other trading partners may increase in case the euro was to appreciate. I wonder whether there are basis for a more rapid increase in productivity in order to compensate the sustained wage pressures and preserve competitiveness. The tax structure contributes to create adverse incentives to work, reinforcing the effect of the compression of wage differentials in productivity. It appears that a reduction in the heavy tax burden would be a necessary condition for enhancing productivity growth.

Preserving the existing welfare system through the demographic changes with a falling tax burden and an already high rate of labor market participation will require fiscal consolidation, through strict enforcement of spending limits. Adequate spending control is required to avoid overruns at different levels of government and to prevent any decline in the effectiveness of the fiscal programs, and we applaud the authorities' commitment to maintaining a nominal expenditure ceiling. However, the necessary advances in fiscal consolidation could not by themselves confront the challenges of the aging of the population, and efforts should also be directed at improving the

incentives associated with the welfare system. Linking more closely benefits to contributions and eliminating incentives for early retirement should improve the financial soundness of the system.

In closing, we would like to, once again, commend the Danish authorities for the excellent macroeconomic performance over recent years. In addition, they also deserve praise for the technical assistance and financial support they provide to low-income countries. We wish them continuous success.

Mr. Alosaimi made the following statement:

Denmark's economic performance during the last year was relatively good. Facing the global slowdown, the authorities were able to engineer a soft landing, with unemployment close to a 25-year low and inflation subdued. However, in the long term, Denmark faces the challenge of safeguarding the welfare state, while accommodating the fiscal cost of an ageing population. As I broadly agree with the staff's appraisal, I will only add a few remarks for emphasis.

First, the authorities should be commended for the progress that has been made in consolidating public finances and reducing public debt. I agree with the staff that the 2002 budget is broadly appropriate. The authorities' medium-term strategy of maintaining fiscal surpluses is ambitious in view of the upcoming demographic change. This is underscored by the limited scope for raising the labor market participation rate, which is already high by international standards. Therefore, in view of the high tax burden, the success of the strategy depends mainly on the authorities' ability to control the growth of public expenditures. Like the staff, I encourage the authorities to look for a mechanism to ensure expenditure discipline at the local government level and explore methods to help make public services provision more efficient.

Second, I welcome the authorities' determination to continue structural reforms in the product market. The recent loss of market share in the euro area reinforces the need for continued efforts to strengthen competitiveness. Here, the ongoing efforts to improve the flexibility of the labor markets and the planned privatization and deregulation in a number of sectors should lead to cost savings, higher efficiency, and improved competitiveness.

Third, on the financial sector, I commend the authorities for their efforts in dealing with the reserves problem that some pension funds and insurance companies have been facing due to the fall in the stock market. The recent increase in mergers in the financial sector also need to be watched carefully to avoid a decline in competition at the retail level. Here, the planned unification of the financial supervisory act and the move to strengthen supervision over cross-border entities are encouraging steps. The Financial

Sector Assessment Program, which the authorities intend to undertake, should also help in this regard.

Fourth, given Denmark's outstanding record of providing foreign aid, I join the staff in encouraging the authorities not to further scale back the aid.

Finally, let me add that the staff report, which is well written and insightful, would have benefited from provision of more detailed data on the fiscal accounts.

With these remarks, I wish the authorities continued success.

Mr. Brooke made the following statement:

Like other Directors, I wish to commend the Danish authorities for their continued excellent macroeconomic management. I broadly agree with the staff's assessment and have only a few points to make.

As Mr. Andersen's helpful statement indicates, data released since the staff finalized their report shows a rebound in both consumer and business confidence, and an associated increase in growth. As a result, I agree with the staff representative's opening remarks that the upside risks to the staff's forecast for GDP and inflation have increased. This raises the possibility that monetary policy might perhaps be more accommodative than the authorities would desire, given Denmark's fixed exchange rate policy orientation. This would argue for some tightening in fiscal policy by allowing the government's automatic stabilizers to work. However, the authorities should be alert to the possibility that additional discretionary measures may be required if inflation pressures emerge.

In this regard, I welcome the information contained in Mr. Andersen's statement about the authorities' increased commitment to expenditure controls at the local government level. More generally, as I have mentioned in a number of other Article IV consultation discussions, I would like to see somewhat more comprehensive discussion of the risks surrounding the staff's short-term forecast, not because I do not feel that the staff are aware of these risks, but in terms of presenting this information to the general public, so that people do not become overly focused on point forecasts, particularly as it is difficult to prepare forecasts around a turning point. I have sympathy with the staff and the position they found themselves in this regard, therefore, a greater discussion of the risks would help to move tension away from the point forecasts. In this particular instance, the staff paper might have been facilitated by a fuller discussion on the determinants of consumer spending, investment, and net trade, as well as a brief discussion on the sectoral divergences between manufacturing and services.

On the medium-term framework for fiscal policy, I fully endorse the authorities' targets for maintaining fiscal surpluses of 2 percent of GDP over the course of the cycle. In line with the staff, I hope this will provide sufficient scope for considering greater reductions in income tax rates. Given how significant government spending is in the Danish economy, there must be considerable risks of inefficient expenditures. In this regard, I would urge the authorities to continually monitor and assess the value-for-money and efficiency of public spending.

I welcome the authorities' efforts to increase the competitive pressures in the Danish economy, and the plans for privatization and deregulation. Like the staff, I hope that complimentary regulatory frameworks will be put in place prior to the privatizations.

I support Denmark's Financial Sector Assessment Program application, and I welcome the authorities' decision to publish the mission chief's concluding remarks, as well as their intention to publish this Article IV report. I wish them every success in 2002.

Mr. Boitreaud made the following statement:

Let me thank the staff for this interesting report, and Mr. Andersen for his helpful statement. Since I broadly share Mr. Varela's views, I can be reasonably brief and just stress a few points for emphasis.

First, like other speakers, I would like to point out that it has been a long time since we last had an Article IV discussion on Denmark. Since our last discussion, which was focused on the risks of overheating for Denmark, the world economy has gone through a period of major slowdown, which could have had a major impact on the Danish economy, and is now on the way to a recovery. Clearly, such a long lapse of time between our discussions is not entirely satisfactory, and could potentially undermine the quality of our surveillance activity.

Turning now to the recent evolution, it is fair to say that Denmark weathered well the economic slowdown, and that it is facing the prospects of a worldwide recovery with strong fundamentals and, in particular, a low unemployment rate.

One of the potential risks that may exist for the Danish economy is that, despite some progress toward alleviating labor supply constraints, the situation in the labor market remains tight. The staff advocates additional measures to discourage early retirement and increase the level of employment. One other avenue, underlined by Mr. von Kleist and others, could be to strengthen integration of immigrant workers. Staff comment would be welcome on this issue. Given the wage pressures, the evolution of wages

should be monitored closely and should lead to maintain the monetary stance under close review. Indeed, Denmark, which is the only member of the European Union participating to the ERM II, has de facto monetary policy strongly influence by the ECB stances, and has seen a clear relaxation of the monetary conditions over recent months. Such an accommodating monetary policy put much of the adjustment burden on the fiscal policy. As stressed by Mr. Andersen, fiscal surpluses have helped to lower public debt and we welcome the intention to pursue this avenue. We also welcome the tax freeze, but encourage the authorities to be more ambitious.

Finally, let me wish the best to the Danish authorities in their endeavors.

The staff representative from the European I Department (Mr. Corker), in response to further questions and comments by Directors, made the following statement:

Mr. Junguito and Mr. Rambarran asked whether the agreement between the authorities and the Association of Municipalities was a precursor to a more formal fiscal framework. We welcome the agreement as it contains some good pledges for keeping expenditures lower than their targets for 2002, for having a lower spending growth target in 2003, and for keeping taxes, on average, unchanged throughout the municipalities. The agreement will also help raise the profile of spending targets and improve transparency and accountability. However, the agreement is still a “gentleman’s agreement,” so we would hesitate to read it as a precursor to a more formal framework. We are encouraging the authorities to explore more formal incentives to persuade municipalities to observe their tax and spending commitments. However, the authorities are treading warily in this area because they have previously tried, but failed, to impose incentives and disincentives on municipalities to control their spending and, in particular, to prevent overspending. Any incentives that the authorities have previously managed to secure political agreement on tended not to be symmetric; for example, they would have rewards for good behavior, but no punishment for bad behavior. However, as stated in the Selected Issues paper, the authorities have the scope to experiment with introducing more formal fiscal rules, as they provide a large part of financing to local authorities. For instance, they can make grants more conditional on fiscal performance and reduce the size of matching grants. The agreement with the Association of Municipalities is a good first step, but, over time, the authorities will probably need to try to implement a more formal fiscal framework.

On Mr. Wei’s question on the revenue implications of privatization proceeds in the medium term, we unfortunately do not have concrete estimates of future privatization receipts. The staff’s informal estimate is that future privatization revenues will not be large relative to projected debt stocks in the medium term. As a matter of principle, the staff does not factor in privatization receipts into medium-term scenarios. If privatization receipts are

used by the authorities to repay debt, as in the past, then the omission of privatization proceeds will not affect the qualitative analysis in the medium-term scenario, in the sense that the authorities will be receiving immediate resources, but will be giving up a longer-term income stream.

Several Directors asked whether it is realistic to assume that the welfare system can be maintained in its current form in the future. This question is difficult to answer. Scenarios 2, 3, and 4 in the Selected Issues paper are somewhat piecemeal—they present each of the different types of risk to the welfare system that could materialize. If all the different scenarios were to happen at the same time, the outcome would be much worse. Therefore, looking forward, there could be a potential problem in maintaining the welfare state. However, this is not a problem that is unique to Denmark. Whether the existing welfare system can be maintained in its current generous form depends, to some extent, on the future reaction of the authorities. They could react to the failure of structural reforms and implement new reforms, or they could react to expenditure overruns by being forced to implement more formal fiscal arrangements. However, going forward, it will become increasingly difficult to reform the welfare system, as political and economic changes are involved. For example, as the population grows older, the people whose benefits the authorities are trying to reduce will constitute the majority of the voters. Therefore, the next ten years will be a window of opportunity to reform the welfare state and protect it against longer-term fiscal risks.

Mr. Boitreaud asked about the prospects of integrating immigrants into the workforce. As a group, immigrants have not been well integrated into the labor market; their participation rate remains low, at about 40 percent, compared to the 80 percent for non-immigrants. The authorities have announced that they will cut welfare benefits, as there is much evidence that many immigrants are caught in welfare traps. At least 20 percent of immigrants would not benefit, in terms of higher remuneration, from working at all. Another large proportion of immigrants would only gain about \$50 a month if they were to work, as opposed to receiving welfare benefits. In addition, a much larger proportion of immigrants than Danes have remained longer on welfare benefits. In addition to their proposals to tackle welfare traps, the authorities have published on their Web site a document, which examines how some of the integration issues can be directly addressed through training and other measures.

Mr. Mirakhor stated that a sensitivity analysis by the staff on the possibility of a combination of scenarios 2, 3, and 4 materializing would be crucial for making future decisions on the welfare system. Although it was difficult to forecast the future, it was quite possible that the different scenarios of a slippage in achieving greater market reform, a slightly lower than assumed revenue-to-GDP ratio, and an overshooting of the spending target could all happen at the same time.

The staff representative from the European I Department (Mr. Corker) replied that, going forward, there would be an opportunity for the authorities to redress labor market policies to contain the downside risks to the welfare system. It was not a certain outcome that the authorities would have to abandon the welfare system on account of runaway deficits and debt. It was possible that public opinion could galvanize the authorities into considering a more serious approach toward expenditure control. Scenarios 2, 3, and 4 were quite useful in pointing out the sensitive nature of the current fiscal position—that missing expenditure targets even by small margins could have a large adverse impact.

Mr. Callaghan pointed out that, in terms of safeguarding the welfare state, addressing labor market policies to try to improve participation rates was difficult because the labor participation rate in Denmark was already at a high level. In addition, as Mr. von Kleist and other Directors had mentioned, the tax burden was also high, so it was questionable if it could be further raised in the future to maintain the existing welfare system. However, the authorities could still reduce public sector consumption. Therefore, the relevant policy offset for the authorities to consider was whether the existing welfare system could be maintained in light of such policy constraints and the possibility of a combination of scenarios 2, 3, and 4 materializing.

The staff representative from the European I Department (Mr. Corker) agreed with Mr. Callaghan, saying that transfers spending by the government constituted about 23 percent of GDP, while public consumption in Denmark was large by international standards. Perhaps other policy options would be to consider the indexing of benefits to wages in society, the indexing of pensions, or adjusting downward replacement ratios and replacement rates for either the unemployed or Pillar I pensions. All those options would have to be considered if the authorities failed to adhere to their expenditure targets over the medium term.

Mr. Bossone made the following statement:

Let me join all previous speakers in congratulating the Danish authorities for the enduring, excellent performance of their economy.

We fully support Mr. Varela's statement and do not have much to add to it.

We only wish to raise two points. First, although we commend the staff for the quality of their analysis, we think, like Mr. Wijnholds and Mr. von Kleist, that this consultation exercise was a missed opportunity to give full consideration to Denmark's exchange rate policy issues. In particular, it would have been useful to have an assessment of the potential costs and benefits of the current arrangement relative to the case of full-fledged participation in the European Monetary Union. In this respect, we deem it relevant to notice how remarkably well a country like Denmark has to perform in order to enjoy a small interest rate differential vis-à-vis the EU area. Spreads and relative interest rate volatility were somewhat high in the late 1990s, probably due to the higher uncertainty in the international financial

markets. Nothing dramatic, to be sure, but this suggests that Denmark remains exposed to external shocks that can easily feed into higher interest rates, in a way that monetary integration in the euro area would avoid.

Our second comment is on taxation. By international standards, taxes in Denmark—especially on labor income—are high. Yet, we would caution against drawing too easy a conclusion that major downward tax adjustments are called for. First, there is no clear-cut evidence that labor supply elasticities in Denmark are large enough to justify lower taxes on the grounds of market participation incentives. (In fact, the participation rate is so high that welfare trap arguments do sound quite tenuous, to say the least.) Second, assessing taxation in a country should be done having in mind the society's preferred mix of private and public consumption and the quality of local public goods. A high level of taxation is perfectly acceptable if the demand for high-quality public goods is large and if no significant distortions can be detected in the incentives to work, to save, and to select production technologies. This indeed seems to be the case in Denmark. And if one discards the fact that high taxation is the way to pay for high-quality public goods that the public sector is capable to deliver, the argument that the tax basis in Denmark will eventually be eroded by international tax competition is not compelling.

In a case like Denmark, it is likely that large tax corrections would produce limited efficiency gains, while they would imply major changes in the social compact underpinning the role of the public sector in the economy. Therefore, recommending large tax corrections would have to be considered in the context of this broader social picture. However, it would be interesting to assess whether the private sector could produce some of the wanted public goods more efficiently, while not disrupting the distributional equity and social consensus that characterize the Danish society.

Having said this, let us emphasize that there is indeed a need to control public spending across all levels of government, and there is room to increase the efficiency of spending. In this respect, we do not believe that the use of a tax freeze is an effective way to instill discipline, and we doubt that an agreement on spending limits with the municipalities can be effective if it is not supported by a legal enforcement mechanism.

With these remarks, I wish to reiterate our appreciation to the Danish authorities and wish them well.

Mr. Skurzewski made the following statement:

I agree with most of the views presented by the staff and other Directors, so let me contribute briefly, at this stage, at least to some aspects of the discussion.

Denmark's economy followed the global slowdown last year, but, nevertheless, continued to impress with other macroeconomic indicators, including very low unemployment, surpluses in the current account and state budget, and a low inflation rate. While the exchange rate regime is based on the continuation of the ERM II, and the monetary policy broadly follows the ECB's direction, focus of the authorities, and much of their future challenges, is in the fiscal and structural areas.

I support the authorities' goal of a broadly neutral fiscal policy, with the continuation of the budget surpluses in order to prepare for the long term pressures coming from the increased costs of pensions and healthcare due to demographic changes. However, I am not so convinced by the arguments on the need to further lower the taxation burden. Indeed, Denmark is featured by one of the highest revenue-to-GDP ratios in the world, similar to other Nordic countries. But it is closely associated with the equally high ratio of expenditure, including with the cost of rather generous social programs, which, for the time being, seems to be preferred by the policymakers. Also, as Mr. Anderson rightly points out, the taxation of labor should be considered together with the social security contributions, which themselves are set at a relatively moderate level. The arguments for lowering the taxation burden due to increasing international tax competition and the potential incentives for employment facilitation seem, therefore, rather hypothetical than actual, at least for now.

The European Commission estimates the future dependency ratio at 36 percent in 2050, which shall be the lowest level in the EU at that time, and it further proves that Denmark's situation is indeed quite comfortable compared to many other countries. And last but not least, Denmark is among the EU members who declared full opening of their labor markets to the new EU entrants. This might also affect the demographic situation and hence the pension system financing, but is probably too vague at the moment to be included in the forecasts.

However, the staff's long term scenarios presented in the excellent Selected Issues paper suggest that even small slippages may push fiscal surpluses into deficits much earlier than expected. With this in mind, I concur with the staff and other speakers who turn their concerns to the expenditure side of the budget. Because of the large share of local governments in the public spending, and the past experience with its overruns, I join Mr. Mozhin, Mr. Palei and others who opted for exploring more binding arrangements in the municipal financing sphere, and for some increase in the government's control over the public finance. There is also some room for increasing efficiency of the public services, with more outsourcing and involvement of the private sector. Revisiting the user charges for some services may also become necessary at some future point, as the staff and Mr. Mirakhor suggest.

With these remarks, I wish the authorities continued success.

Mr. Faircloth made the following statement:

I would like to begin by thanking the staff for their clear and succinct report, and Mr. Andersen for his helpful statement. At this late stage in the discussion, my comments can be fairly brief.

Denmark has a commendable economic track record of promoting growth and reducing the ratio of public debt, and is, therefore, well placed to face a number of difficult economic challenges. These challenges and their risks have been discussed at length in the staff's useful papers, particularly the Selected Issues paper. Instead, let me say that we are encouraged by the proactive nature of the authorities' medium-term strategy, but, as many chairs have already expressed, we believe that more decisive steps are needed to minimize economic risks.

In terms of policy implications, we see fiscal discipline as the overriding priority. Public expenditure growth targets must be adhered to, and, in fact, given the nature of the challenges to be faced, a tighter ceiling on real public consumption growth may be needed. We advise the authorities and the staff to clearly monitor this situation closely.

Like Mr. Varela, Mr. Wijnholds, Mr. Callaghan, and other chairs, we agree that comprehensive and prudent fiscal rules are needed at all levels of government, especially at the local level. The agreement with the Association of Municipalities is obviously a step in the right direction, but a formal and transparent internal stability pact may be needed.

Reform is also needed to address Denmark's high tax burden, so as to contain the risk of economic distortion. We agree with the staff that the emphasis should be placed on reducing income taxes through a combination of rate reductions and threshold increases. These reforms, however, would be usefully complemented by well-targeted reforms to the benefits system, particularly the welfare system, both to contain expenditures and reinforce labor market participation.

This brings me to my final point. Like Mr. Callaghan, we believe that there is a limited scope to maintain the existing welfare state, while accommodating the fiscal costs of an ageing population and reduced tax burden. The authorities should begin looking at innovative ways to preserve key social priorities by trimming the fat elsewhere. We fully support the staff's proposal that the authorities explore outsourcing public services as much as possible. Also, we support further consideration of the options outlined at the end of the paragraph 19 in the Selected Issues paper, related to the introduction of principles for effective welfare service provision and

public finance management in the transfer system, as well as changes in the reimbursement scheme.

With these remarks, I wish the authorities continued success.

Mr. Josz made the following statement:

Despite an almost three-year lapse in Denmark's Article IV consultations—much too long a gap—the Danish authorities continue to lead by example in almost every phase of their economic and social policies, including their generous official development assistance, which far exceeds the U.N. commitment level of 0.7 percent of GNP. The strong agreement between the authorities and the staff about the desirable course of future actions bodes well for a continued strong policy performance. But the authorities still need to pay particular attention to the following four issues.

First, they must watch wage developments closely. The deterioration of Denmark's cost competitiveness vis-à-vis the euro area has been noticeable since 1996, and its cost competitiveness in other major export markets will also worsen if the euro appreciates.

Second, the authorities must tighten their control of public spending if they are to meet their fiscal balance target and fulfill their pledge to freeze taxes. The staff convincingly argues that even a minor deviation from the ambitious path charted for the economy from now until 2010 would combine with population aging to put the fiscal position on an unsustainable long-term path. The 2002 budget anticipates that real government consumption will grow by 1.3 percent, exceeding the target of 1 percent on average for the period 2002-2005. To have a chance of meeting the public consumption growth target of 1 percent for the period 2002-2003, the growth of real government consumption must shrink to 0.7 percent in 2003. The central government should negotiate binding agreements with lower levels of government in order to attain the fiscal targets set for Denmark as a whole.

Third, the authorities should also build on the success of their policies aimed at the youth and the elderly by increasing the participation in the labor market of immigrants and older workers. This will increase the supply of labor and increase the economy's growth potential.

And finally, the authorities need to keep up with the challenges posed by the cross-industry and cross-border integration of their financial industry. The Financial Sector Assessment Program being considered by the authorities will very helpful toward achieving this goal.

The staff representative from the Policy Development and Review Department (Mr. Fetherston), on the consultation cycle, said that Denmark had been placed on the 24-

month cycle five years ago. The delay of nine months in concluding the current Article IV consultation had been initially due to staff constraints. In addition, when the staff had requested to reschedule the mission, the authorities had called a surprise early election, and a subsequent decision had been taken to further delay the mission in order to conduct the consultation with the new government.

Mr. Andersen made the following concluding statement:

I would like to thank my colleagues for their insightful contributions, advice, and comments, which I will, of course, report fully to my authorities. The staff has responded comprehensively to questions and issues raised during the discussion, which leaves me with all, but a few, remaining comments on some of the issues brought up.

First, on fiscal policy, many have underscored that Denmark could benefit from more comprehensive and binding fiscal policy rules. While there is always room for improvement, I think the staff is right in underscoring that the fiscal framework is quite transparent with clear quantitative targets, and it should not be forgotten that Denmark has managed to get strong and sustained surpluses on public finances within the present framework. Also, Denmark's fiscal policy is in full compliance with the EU Stability and Growth Pact. Nonetheless, I consider the Letter of Agreement between the government and the Association of Municipalities on the tax freeze and targets for expenditure growth to be an important strengthening of the fiscal policy framework. The letter can be seen on the web site, so it is transparent as well, and in the letter, not only the strong commitment from both parties is noteworthy, but the government has also declared that, if the tax freeze is not respected, the government will neutralize the effect hereof. So, I think this should be seen as a very important step.

On the tax freeze, I would only like to emphasize that it is very important for the government to put a halt to the traditional upward drift in the tax burden, and even though the marginal income tax rate has been lowered significantly—by about 10 percentage points, as compared to the mid 80s—a broadened tax base, hikes in local taxes, and new green taxes have over the years helped to keep the tax burden high and close to 50 percent of GDP, and my authorities very much hope to be able to lower income taxes, as from 2004. Some Directors have asked if the welfare state can be preserved in its present form in view of globalization, EU integration, and other developments. One could argue that in some areas, the most important challenges are behind us, for example with the EU internal market in place. There are important challenges looking forward as well, including the ageing of the population and the aim of lowering taxation, but with regard to the demographic challenges, Denmark is at least not lagging behind other countries in our preparations, as also emphasized during the discussion. It is indeed important to increase the labor supply, and on immigrants, the

government has presented a very comprehensive package with rather detailed proposals on how to better integrate immigrants into the labor market and employment.

Concerning the very significant increase in the use by households of adjustable-rate mortgage loans mentioned by Mr. Wijnholds and addressed by Mr. Corker at the outset of the discussion, let me offer a few remarks. The increased use of such financing, as well as some vulnerability assessments concerning households with regard to property prices and other factors, have indeed been subject for much attention in the central bank's macro-prudential work, including the annual financial stability report, of which a new version will soon be published by the way. The more widespread use of adjustable-rate mortgage financing was also covered extensively in the Governor's recent speech at the Annual Meeting of the Association of Danish mortgage banks in April. On that occasion, she reminded that, already in 1997, Danmarks Nationalbank had found it appropriate to point out that the ongoing adjustments to mortgage financing arrangements would not lead to any changes in monetary policy, as the fixed-exchange rate policy implies that the bank raises interest rates if the Danish krone comes under significant pressure due to speculation. This remark was intended to be an item of "consumer information" to mortgage-credit customers. It was naturally also influenced by the fact that, on several occasions during the 1990s, the bank had to counter speculative attacks on the krone by significantly raising monetary policy interest rates. This statement has been considered and debated in the media on numerous occasions since then, so this is hardly likely to be overlooked by any homebuyers or homeowners. Some have perhaps even misunderstood this and believe that this is the only risk presented by adjustable-rate mortgage loans denominated in krone. However, the bank has also emphasized the importance for the borrower to closely evaluate all risks he or she is exposed to, including, of course, that such loans will become more expensive if the interest rate is generally rising. Having said that the development is, of course, of interest as it does affect the monetary policy transmission mechanism. Still, the most serious risk to households appears to be falling property prices, which would particularly affect new home owners and owners with maximum loan-to-value ratios and terms to maturity.

Finally, on Denmark's position regarding the EMU, I was asked by Mr. Mirakhor for comments. As Directors will recall, a referendum was held as recently as in September 2000, where a majority of the population decided that Denmark should not join the euro area. My Danish authorities fully respect the outcome of this referendum and a new referendum is, accordingly, not part of the present political agenda. While one should always be careful about opinion polls, it could be noted that, according to the most recent opinion poll released just a few days ago, 57 percent is now in favor of Denmark joining the euro, with 35 percent against.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal, and commended the authorities for their sustained strategy of fiscal discipline and structural reforms. Unemployment is at a 25-year low, inflation is subdued, and Denmark's strong economic fundamentals have permitted the economy to weather the global slowdown reasonably well. Although growth slowed in 2001, conditions are in place for a pickup in the course of 2002.

Directors viewed the macroeconomic policy stance as appropriate at this juncture. Accommodative monetary conditions, consistent with Denmark's fixed exchange rate policy vis-à-vis the euro, are putting a protective floor under the economy in case downside risks to growth were to materialize. At the same time, strong wage growth and high capacity utilization in some industries argue against an active fiscal policy response to such risks, and it will be important to avoid public spending overruns while allowing for the operation of automatic stabilizers.

Directors judged overall competitiveness to be healthy, although the increase in unit labor costs relative to the euro area indicates that some wage moderation is needed to stem losses in market shares in continental Europe. They noted that efforts to improve the flexibility of labor markets and increase labor supply would be helpful in this regard.

Directors welcomed Denmark's progress in implementing a strong medium-term strategy to deal with the fiscal costs of an ageing population. While the goal of continuing to run fiscal surpluses is commendable, possible future pressures on the high level of taxation and the desire to maintain a comprehensive welfare system pose significant challenges for the medium term. Against this background, Directors agreed that improving public expenditure discipline, particularly at the lower levels of the government, should be a priority. They considered that a more formally binding fiscal framework would usefully support higher spending discipline, and they welcomed, in this regard, the recent agreement with the Association of Municipalities as a first step in the right direction. Directors also encouraged the authorities to pursue intentions to strengthen public management and outsource services where appropriate. While recognizing the high degree of social cohesion, a number of Directors recommended that the long-term viability of the present welfare system should be kept under close review by the Danish authorities.

Most Directors considered that high taxes might hamper efforts to increase labor supply. While welcoming the recent across-the-board tax freeze, they encouraged the authorities to aim for a more ambitious tax reform, that would focus on reducing high income tax rates and raising tax thresholds.

Directors commended Denmark's labor market reforms over the last several years, which have contributed to substantially lowering the structural unemployment rate. In view of labor supply constraints, additional reforms will, nevertheless, be needed. While Denmark's overall labor market participation rate is high by international standards, Directors saw scope to raise the participation of some groups, such as older workers and immigrants, and they welcomed, in this regard, the authorities' aim to increase the effectiveness of active labor market policies. They furthermore pointed out that problems of welfare traps and high minimum wages extend beyond these groups, and should be addressed more broadly through reform of the tax and benefit system.

Directors welcomed steps to strengthen competition policy. They encouraged the authorities to speed up the opening of the natural gas market and looked forward to the planned privatization and deregulation of network industries, supported by strong regulatory frameworks.

Directors considered that Denmark's financial sector appears sound, as evidenced by the high capitalization ratios of banks, although it was noted that the rapid increase in mortgages with adjustable interest rates should be monitored. The problems faced by some insurance companies and pension funds last year, in an environment of low interest rates and stock market returns, was also highlighted as an area requiring improved risk management. Directors commended the supervisory authorities for their attempts to improve consolidated financial sector supervision, most recently by unifying disparate financial supervisory acts and establishing cross-border memoranda of understanding. They also commended the authorities' firm stance on combating money laundering and the financing of terrorism, and looked forward to the early enactment of additional legislation in this area. Directors welcomed the authorities' interest in undertaking a Financial Sector Assessment Program.

Directors expressed their strong appreciation for Denmark's outstanding record on official development assistance, which sets an example for other industrial countries.

It is expected that the next Article IV consultation with Denmark will be held on the 24-month consultation cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/46 (5/6/02) and EBM/02/47 (5/8/02).

3. CHILE—REPRESENTATIVE RATE FOR CHILEAN PESO

1. The Fund determines, after consultation with the authorities of Chile, that the representative exchange rate for the Chilean peso against the United States dollar under Rule O-2, paragraph (b)(i) of the Fund's Rules and Regulations is the observed daily weighted average of quoted market rates of bank and financial institutions published by the Central Bank of Chile.

2. The Central Bank of Chile will inform the Fund of any changes affecting the definition of the representative exchange rate. (EBD/02/72, 4/29/02)

Decision No. 12740-(02/47), adopted
May 6, 2002

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 02/17 and 02/22 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/02/61 (5/3/02) and EBAM/02/64 (5/6/02), by Advisors to Executive Directors as set forth in EBAM/02/61 (5/3/02), and by Assistants to Executive Directors as set forth in EBAM/02/61 (5/3/02) and EBAM/02/64 (5/6/02) is approved.

APPROVAL: November 14, 2002

SHAIENDRA J. ANJARIA
Secretary