

EBS/84/91

CONFIDENTIAL

April 24, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Review of the Fund's Income Position
for the Financial Years 1984 and 1985

Attached for consideration by the Executive Directors is a paper reviewing the Fund's income position for the financial years 1984 and 1985.

It is proposed to bring this subject to the agenda for discussion on Monday, May 14, 1984.

Att: (1)

INTERNATIONAL MONETARY FUND

Review of the Fund's Income Position for the Financial Years 1984 and 1985

Prepared by the Treasurer's Department

Approved by W. O. Habermeier

April 23, 1984

I. Introduction

The Rules of the Fund provide for a review of the Fund's income position shortly after the end of each financial year and for consideration by the Executive Board of the disposition of any net income in excess of the target amount of income for the year. The Rules also provide that the rate of charge shall be determined at the beginning of each financial year on the basis of the estimated income and expense of the Fund during the year and the target amount of income for the year. In addition, the Fund shall review the rate of interest on holdings of SDRs at the conclusion of each financial year. The rate of remuneration has recently been reviewed and a new method for determining that rate has been adopted. 1/ The operation of that method will be reviewed on the occasion of the next annual review of the Fund's income position in accordance with paragraph (c) of the revised Rule I-10. 2/

This paper presents in Section II income and expense of the Fund expected for the current financial year ending April 30, 1984 and projections of the Fund's income and expense for the financial year ending April 30, 1985. 3/ The possible disposition of the net income for 1984 as well as the rate of charge for 1985 are discussed in Section III. Section IV describes the impact on the Fund's income position of the method of calculating charges on enlarged access when purchases under the enlarged access are partly financed by ordinary resources. A staff paper discussing this matter is being issued separately. A summary of Conclusions and Recommendations for the consideration by Executive Directors are set out in Section V.

The review of the Fund's income position for 1984 is based on actual results for the ten months ended February 29, 1984 and estimates for the last two months of the financial year. A supplement to this paper will be issued when the results for the full year are known.

1/ See "The Rate of Remuneration and the Fund's Income Position" (EBS/83/237, 11/2/83) and Executive Board Decision No. 7603-(84/3).

2/ Rules I-6(4), I-10 and T-1(d) are reproduced in the Appendix.

3/ Unless otherwise stated, references in the paper to 1984 and 1985 are to the financial years ending April 30, 1984 and April 30, 1985.

II. Income Position in 1984 and 1985

A. Financial Year 1984

The Fund's net income for the year 1984, which had initially been projected to range from SDR 63 million to SDR 93 million depending on the timing of payments for the quota increase, 1/ was last reviewed by the Executive Board in December 1983. At that time, net income for the six months ended October 31, 1983 amounted to SDR 24 million and net income for the year as a whole was estimated at SDR 52 million, based on revised estimates of members' use of the Fund's resources and assuming no further changes in market interest rates and thus the rate of remuneration. 2/ As a result of this mid-term review, the Executive Board agreed that there should be no further adjustment either in the rate of charge or in the rate of remuneration for 1984. 3/

It is now estimated that net income for the year will amount to about SDR 69 million (Table 1). 4/ The improvement in the projected net income position since the mid-year review has been due largely to a shortfall below projections in members' use of unremunerated reserve tranche positions and, to a much smaller extent, the fact that average holdings of SDRs in the General Department were somewhat higher than had been estimated earlier.

(i) Use of reserve tranche positions and of Fund credit

Earlier income estimates were based on the assumption that members' use of unremunerated reserve tranche positions, on which the Fund does not earn income but which increases remuneration expense (or reduces income from SDR holdings) would be in the order of SDR 1,750 million, of which about SDR 1 billion were expected to be drawn in connection with payments for the quota increases. In the event, reserve tranche purchases following the quota payments amounted to about SDR 800 million, of which SDR 700 million were in the unremunerated reserve tranche. Based on actual results through end-February, purchases in the unremunerated reserve tranche are now expected to amount to about SDR 800 million for the year as a whole, or about SDR 950 million less than had been estimated previously.

1/ See "Review of the Fund's Income Position for Financial Years 1983 and 1984" (EBS/83/75, 4/18/83).

2/ See "Review of the Fund's Income Position" (EBS/83/248, 11/21/83) and Correction 1 (12/12/83).

3/ Minutes of Executive Board Meetings 83/172 and 83/173, December 14, 1983.

4/ Actual projected net income for 1984 of SDR 69 million is SDR 24 million lower than the original estimate one year ago of SDR 93 million on the assumption that the quota increase would be paid by the end of calendar year 1983, which was materially realized. Because of the uncertainties surrounding the estimates and the risk that net income could be lower than estimated, the Board decided not to reduce the rate of charge or increase the rate of remuneration at that time.

Table 1. Estimated Income and Expense
for the Financial Years 1984 and 1985

(In millions of SDRs)

	1984				1985
	Actual	Preliminary		Revised	Preliminary
	Ten Months	Estimates		Estimates	Estimates <u>3/</u>
	February 29, 1984	April 1983 <u>1/</u>	November 1983 <u>2/</u>		
<hr/>					
1. <u>Operational Income</u>					
a. Periodic charges					
Regular facilities	917	1,297	1,154	1,121	1,411
SFF	637	728	776	778	776
Enlarged Access	<u>358</u>	<u>559</u>	<u>507</u>	<u>471</u>	<u>972</u>
Total charges	1,912	2,584	2,437	2,370	3,159
b. Interest on SDR holdings	271	341	342	369	459
c. Other income					
Regular facilities	23	46	36	29	32
SFF	5	6	6	5	--
Enlarged Access	<u>17</u>	<u>30</u>	<u>28</u>	<u>22</u>	<u>24</u>
Total other income	45	82	70	56	56
Total operational income	2,228	3,007	2,849	2,795	3,674
2. <u>Operational Expense</u>					
a. Remuneration	1,021	1,454	1,327	1,289	1,877
b. Interest expense					
GAB	16	16	16	16	--
SFF	625	714	762	764	758
Enlarged Access <u>4/</u>	<u>352</u>	<u>548</u>	<u>497</u>	<u>462</u>	<u>896</u>
Total interest expense	993	1,278	1,275	1,242	1,654
Total operational expense	2,014	2,732	2,602	2,531	3,531
3. Net operational income	214	275	247	264	143
4. Administrative expense	<u>158</u>	<u>182</u>	<u>195</u>	<u>195</u>	<u>211</u>
5. Net income (deficit)	56	93	52	69	(68)
Pro memoria <u>5/</u>					
SFF	17	20	20	19	17
Enlarged Access	23	41	38	31	56 <u>6/</u>

1/ See "Review of the Fund's Income Position for the Financial Years 1983 and 1984" (EBS/83/75, 4/18/83).

2/ See "Review of the Fund's Income Position" (EBS/83/248, 11/21/83).

3/ On the basis of the assumptions set out in Table 2 and assuming that the method of setting charges for purchases outstanding under the policy on enlarged access are modified as proposed in "Charges on Holdings Outstanding Under the Policy on Enlarged Access" to be issued shortly.

4/ Less net income from temporary investments held in the Borrowed Resources Suspense Account.

5/ Net income including "other income" from the service charge of 0.5 percent.

6/ After deducting remuneration expense (SDR 44 million) attributable to the substitution of ordinary for borrowed resources.

The cancellation of some stand-by and extended arrangements, and the postponement of some purchases until a later date, also affected the income estimates. Members' use of Fund credit had been projected at SDR 13.9 billion, of which SDR 7.2 billion were to be financed from ordinary resources and about 6.7 billion from borrowed resources. Based on the latest indications for financial year 1984, total use of Fund resources in 1984 will approximate SDR 11.1 billion (SDR 5.7 billion from ordinary resources and about SDR 5.5 billion from borrowed resources) (Table 2). As a result of this lower than expected use of the Fund's resources, balances subject to the basic rate of charge will average about SDR 500 million less than estimated at mid-year; average balances financed from borrowed resources will be about SDR 390 million less than estimated, and remunerated positions will average about SDR 605 million less than that projected in November 1983. 1/

(ii) Holdings of SDRs

At the time of the mid-year income review, it had been assumed that SDR holdings of the Fund over the year would average SDR 3.9 billion, taking into account subscription payments for the quota increases under the Eighth Review. By end-February, a total of SDR 7.0 billion had been received in the form of reserve asset payments in connection with the quota increases, of which SDR 6.1 billion was received in SDRs and the remainder in the form of currencies of other members prescribed by the Fund. Since end December, the Fund's SDR holdings have remained in the range of SDR 7 billion and for the year as a whole are expected to average about SDR 4.2 billion, or about SDR 290 million more than had been estimated earlier. The slight increase in average holdings above the level projected at mid-year reflects primarily a delay of projected purchases by members beyond the dates anticipated at mid-year.

(iii) Interest rates

Interest rates did not change markedly from the average level of the first half of the financial year (Chart 1). Over the four months from November 1983 through end-February 1984, the SDR interest rate and the rate of remuneration averaged 8.64 and 7.34 percent, respectively; for the ten months ended February 29, 1984 the average of these rates were 8.65 and 7.35 percent, compared with mid-year estimates of 8.66 percent for the average SDR interest rate and of 7.36 percent for the average rate of remuneration. Consequently, and in contrast to previous years, the revision of the income estimates for the year as a whole has been only marginally affected by movements in interest rates.

The effects of these development on the Fund's income position for 1984 compared to the estimates made at the time of the mid-year review are summarized in Table 3.

1/ Estimated average balances are shown in Appendix Table 1.

CHART 1
 RATE OF CHARGE, SDR INTEREST RATE AND RATE OF REMUNERATION
 (In per cent per annum)

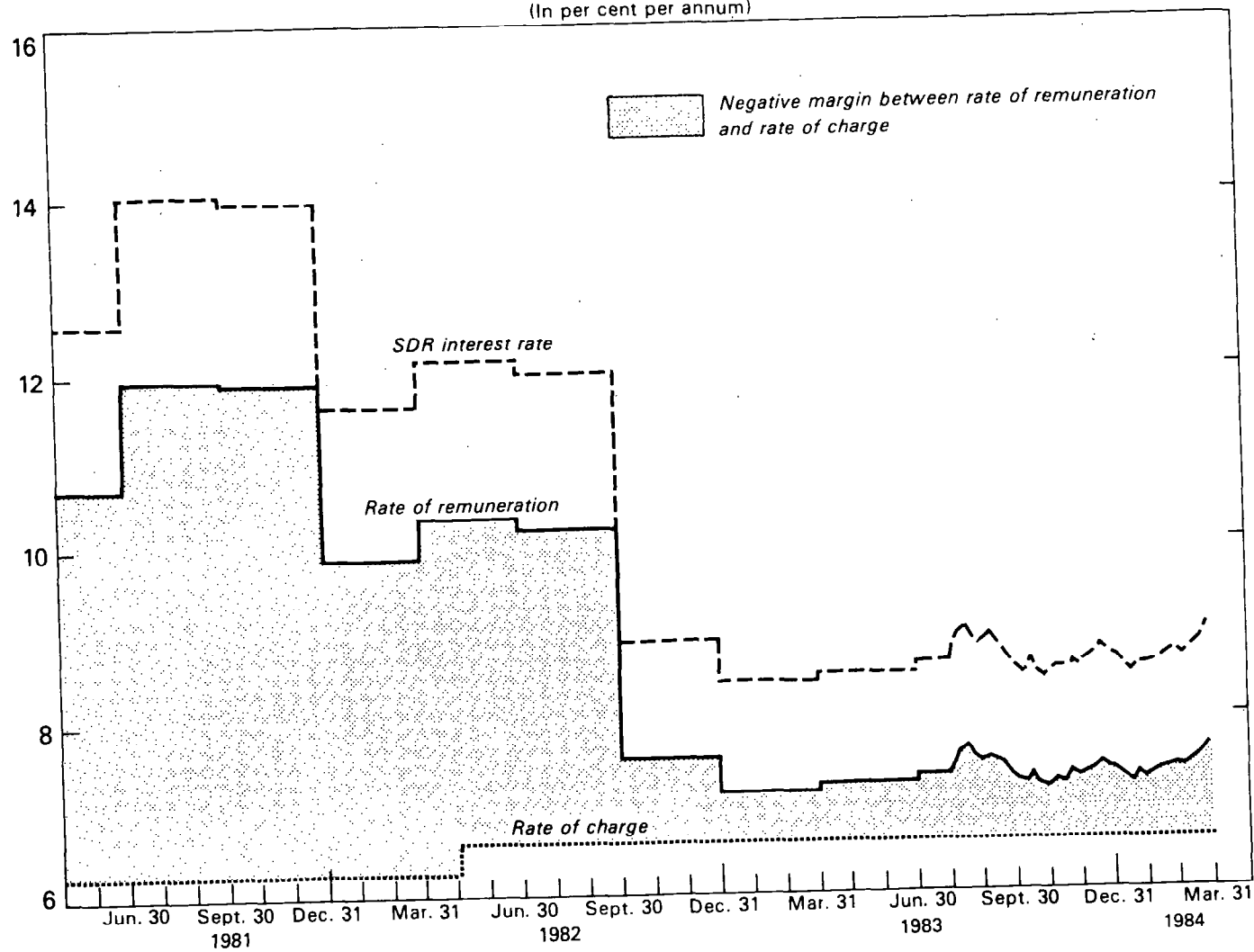




Table 2. Assumptions Underlying the Estimates
for Financial Years 1984 and 1985

(In millions of SDRs)

	1984				1985
	Actual	Preliminary		Revised	Preliminary
	Ten Months	Estimates		Estimates	Estimates
	February 29, 1984	April 1983 <u>1/</u>	November 1983 <u>2/</u>		
<hr/>					
A. <u>Ordinary Resources</u>					
1. Purchases					
Unremunerated reserve tranche <u>3/</u>	789	1,750	1,750	800	500
Credit tranches	3,109	7,100	5,435	4,050	4,520
Compensatory financing and Buffer Stock	<u>1,282</u>	<u>2,000</u>	<u>1,815</u>	<u>1,600</u>	<u>1,780</u>
Total	5,180	10,850	9,000	6,450	6,800
2. Repurchases other than SFF and Enlarged Access <u>4/</u>	1,591	1,265	1,765	1,815	2,005
3. Average SDR holdings	3,758	4,000	3,945	4,235	5,100
B. <u>Borrowed Resources</u>					
1. SFF:					
Purchases	1,083	1,200	1,120	1,083	--
Repayments of borrowing <u>5/</u>	165	205	205	205	675
Repurchases	158	200	200	200	640
2. Enlarged Access:					
Purchases	3,380	6,100	5,570	4,410	4,880
Repayments of borrowing <u>5/</u>	--	--	--	10	1,190
Repurchases	--	--	--	--	45
C. <u>Interest Rates</u>					
1. Average SDR interest rate (percent)	8.65	8.52	8.66	8.71	9.00
2. Average rate of remuneration (percent)	7.35	7.24	7.36	7.40	7.95
3. Average rate of charge (percent)	6.6	6.6	6.6	6.6	6.6
4. Average SFF interest rate (percent)	11.43	10.25	11.41	11.44	11.50
5. Average net cost of borrowing under enlarged access policy (percent)	10.51	10.34	10.37	10.49	10.44

1/ See "Review of the Fund's Income Position for the Financial Years 1983 and 1984" (EBS/83/75, 4/18/83).

2/ See "Review of the Fund's Income Position" (EBS/83/248, 11/21/83).

3/ Only purchases in the unremunerated reserve tranche affect the Fund's income position. Purchases in the remunerated reserve tranche represent a shift of a remunerated position from the purchasing member to the members whose currencies are sold by the Fund and have no effect on the Fund's income position. If SDRs are used by the Fund to finance such purchases there would be a net fall in income because the rate of remuneration (and hence remuneration expense) is lower than the SDR rate of interest (and hence income foregone).

4/ The difference of SDR 550 million between the initial and revised estimates reflects early repurchases, mainly by Australia, China and South Africa.

5/ Does not include repayments of borrowing refinanced by calls on other lenders.

Table 3. Effects on Net Income for 1984
of Differences between Mid-year Estimates and Revised Estimates

(In millions of SDRs)

	Mid-year Estimates November 1983	Revised Estimates	Difference	Explanation of Difference between Mid-year and Revised Estimates						
				Less than estimated use of				Higher than Estimated Average		
				Reserve Tranche	Credit Tranche	C.F.	Borrowed Resources	SDR Interest Rate	Rate of Remun- eration	SDR Holdings
1. <u>Operational income</u>										
a. Periodic charges	2,437	2,370	-67	--	-29	-4	-34	--	--	--
b. Interest on SDR holdings	342	369	+27	--	--	--	--	+2	--	+25
c. Service charges	70	56	-14	--	-6	-1	-7	--	--	--
Total	2,849	2,795	-54	--	-35	-5	-41	+2	--	+25
2. <u>Operational expense</u>										
a. Remuneration	1,327	1,289	-38	-29	-32	-5	--	--	+7	+21
b. Interest expense, net of income from tem- porary investments held in the Borrowed Resources Suspense Account	1,275	1,242	-33	--	--	--	-33	--	--	--
Total	2,602	2,531	-71	-29	-32	-5	-33	--	+7	+21
3. Net operational income	247	264	+17	+29	-3	--	-8	+2	-7	+4
4. Administrative expense	195	195	--	--	--	--	--	--	--	--
5. Net income	52	69	+17	+29	-3	--	-8	+2	-7	+4

B. Estimates for Financial Year 1985

As indicated in the review of the Fund's liquidity position, the demand for Fund credit in the months ahead is expected to continue on a substantial scale. 1/ Total purchases in 1985 are estimated to be in the order of SDR 11.2 billion, of which about SDR 6.3 billion would be financed from the Fund's ordinary resources, and the remainder from borrowed resources (Chart 2). These estimates take into account the projections of commitments and disbursements over the next twelve months presented in the staff paper reviewing the Fund's liquidity position, and are based on the following assumptions: 2/

- (i) purchases in the unremunerated reserve tranche will amount to SDR 500 million;
- (ii) purchases under stand-by and extended arrangements will amount to SDR 4.5 billion and will be made in accordance with agreed (or estimated) phasing;
- (iii) compensatory financing and buffer stock purchases will amount to SDR 1.8 billion and will be made in proportion to the estimates for CY 1984 and CY 1985;
- (iv) repurchases of SDR 2.0 billion and repayments to lenders will be made in the amounts and on the dates scheduled;
- (v) repayments of short-term borrowings will be made with ordinary resources, and the method of determining EAR charges adapted accordingly; 3/
- (vi) the Fund's holdings of SDRs will be reduced to a level of about SDR 4.2 billion by end-April 1985 and are projected to average about SDR 5.1 billion for the year as a whole;
- (vii) the SDR interest rate will average 9.00 percent and the rate of remuneration, at 88.33 percent of the SDR interest rate, will average 7.95 percent. 4/

1/ See "The Fund's Liquidity and Financing Needs" (EBS/84/44, 3/7/84).

2/ These projections, the impact on outstanding use of Fund resources, and the effect on projected income for 1984-85 are summarized in Tables 1 and 2 above, and Appendix Table 1.

3/ The need for a rule to determine charges on holdings under the Policy on Enlarged Access when outstanding purchases are partly financed from ordinary resources instead of borrowed resources is discussed in a separate paper. See "Charges on Holdings Outstanding Under the Policy on Enlarged Access" to be issued shortly.

4/ The SDR interest rate has been projected over the coming year to average the rate in effect when the calculations were made, rounded to the nearest quarter percent.

The projections do not include any assumptions regarding use of the enlarged GAB and associated arrangements. If these arrangements were to be utilized, the cost to the Fund would be equal to the SDR interest rate; and the effect on the Fund's net income position would depend on whether GAB resources were used to finance purchases in the credit tranches or under special facilities which would result in lower Fund income compared to use of ordinary resources for this purpose, or whether they replaced other borrowing necessary to finance enlarged access purchases.

Based on these projections and assumptions, average income producing balances (currency holdings subject to charges plus SDR holdings) are estimated to rise from SDR 21.2 billion in 1984 to SDR 26.5 billion in 1985, interest costing balances (reserve tranche position and GAB borrowing) are expected to rise, on average, from SDR 17.8 billion to SDR 23.6 billion, and the average balance of outstanding borrowing is expected to rise to SDR 15.2 billion. At current interest rates the projected increase in the cost of resources in combination with the extent of the use of Fund credit is expected to lead to a sharp deterioration in the Fund's income position. Assuming that market interest rates and the SDR rate of interest were to remain at the present level of about 9 percent, the present rate of charge on the use of the Fund's ordinary resources of 6.6 percent would remain in effect, total expenses 1/ would be projected to exceed total revenue by SDR 68 million. 2/

C. The Impact of Deviations from the Projections for Major Variables

The target amount of net income of 3 percent of the Fund's reserves, or SDR 32 million at present, represents a very small proportion of less than one percent of total expenditures and receipts (of about SDR 3.7 billion). In these circumstances, the net income target can easily be overwhelmed by even small changes in market rates of interest. As can be seen from the following table, the impact on the Fund's net income of an increase in market rates of interest has risen sharply in the last two years:

1/ These calculations are based on administrative expenses of SDR 211 million. They do not include provision for a general salary adjustment or for anticipated capital expenditures for a computer center, as they remain to be decided by the Executive Board.

2/ The effect on the projected deficit of the method to determine charges on holdings under the Policy on Enlarged Access is discussed further in Section IV below.

CHART 2
USE OF FUND RESOURCES

(In millions of SDRs)

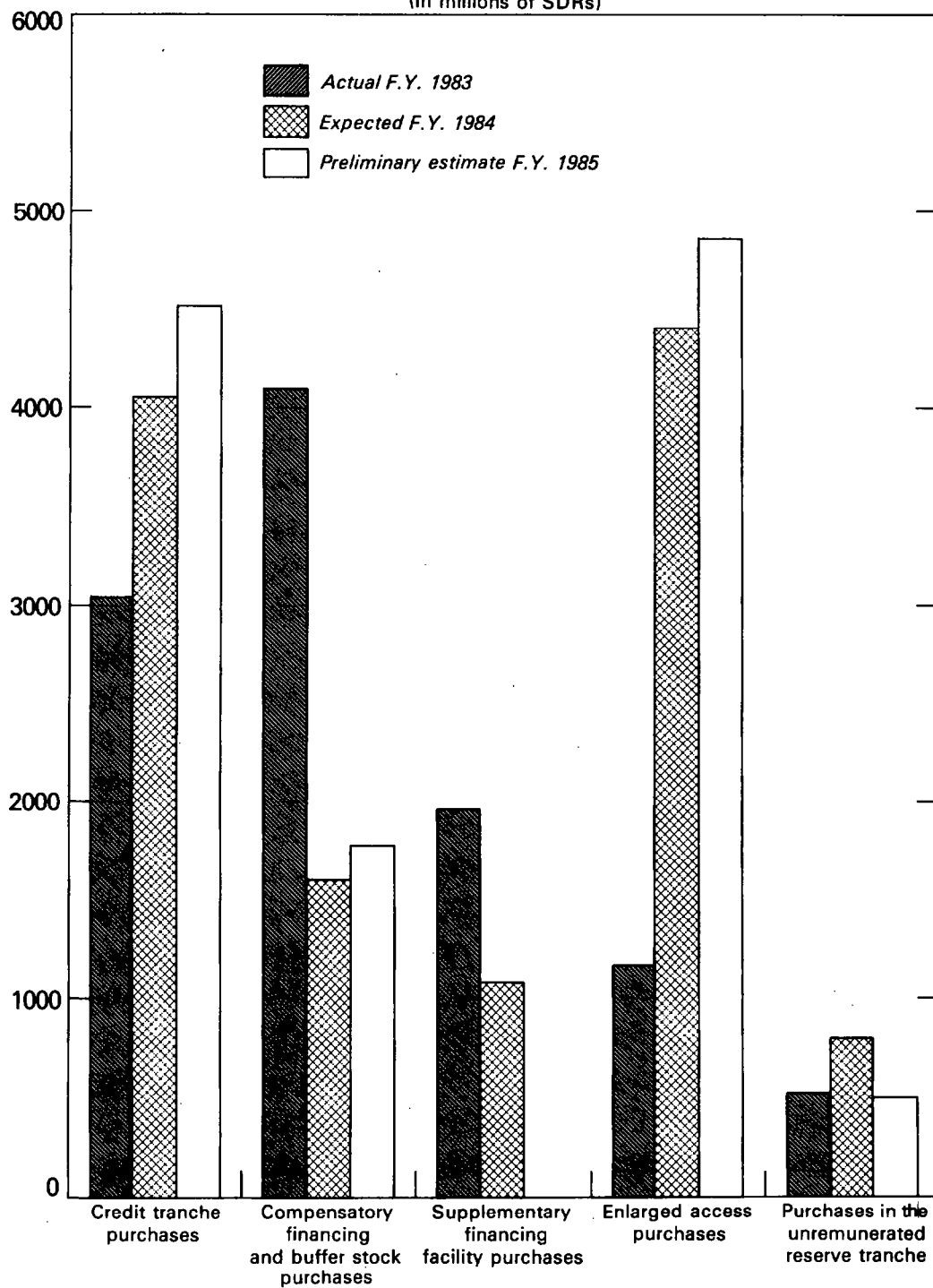


Table 4. Average Remunerated Positions and Effect
on the Fund's Net Income of an Increase in
Market Interest Rates 1/

Financial Year	Average Remunerated Positions (SDR billions)	Effect on net income resulting from a one percentage point increase in the SDR interest rate (SDR millions)
1981	4.3	10
1982	8.2	20
1983	11.6	55
1984 est.	17.0	105
1985 est.	23.7	160

1/ The effect of a decline in the interest rate would be the same except for the increase in the remuneration coefficient prescribed by the amended Rule I-10 for any decline in the SDR interest rate below the rate at end-April 1984. A decline would lead to an increase in the remuneration coefficient of one percentage point for each further fall in the SDR rate of one-sixth of a percentage point in excess of 0.56 percentage point by the end of a quarter (up to a maximum level of the coefficient during 1984 of 90.83 percent).

The impact of deviations from projections in purchases or in the Fund's average holdings of SDRs would be much smaller but still have an effect on net income relative to the agreed target. If purchases in the unremunerated reserve tranche--which generate no income but give rise to increased remuneration payments (or reduce interest earnings on SDR holdings)--were lower by, say, SDR 250 million, the Fund's net income would be higher by SDR 10 million or vice versa. 1/ A delay or cancellation of projected purchases in the credit tranches or under special facilities would have a less sharp effect on net income, as the service charge collected at the time of the purchase partially offsets the excess of the cost to the Fund of the resources over the income from periodic charges; the net effect of a shortfall or increase of such purchases of SDR 1 billion from projected levels would be about SDR 1-2 million at present interest rates. Similar effects would result from a shortfall or excess of purchases under the policy of enlarged access, or from deviation of the average holdings of SDRs; these effects are summarized in Table 5.

1/ This assumes present interest rates and that the members making use of their unremunerated reserve position purchased the currencies of other members. If the purchasing member bought SDRs instead, the effect on the Fund's net income would be somewhat larger.

Table 5. Effect on Net Income for 1985 of Various Combinations
of Deviations from Projections Underlying the
Projection of Fund Income

(In millions of SDRs)

Deviation	At Projected SDR Interest Rate	Increase in Average SDR Rate by One Percentage Point	Decrease in Average SDR Rate by One Percentage Point <u>1/</u>
Projected use of resources and average SDR holdings		-162	+127
Purchases in the unremunerated reserve tranche higher or lower by SDR 250 million <u>2/</u>	<u>+10</u>	<u>+11</u>	<u>+9</u>
Purchases financed with ordinary resources			
a. higher by SDR 1 billion <u>3/</u>	-2	-6	+3
b. lower by SDR 1 billion <u>3/</u>	+1	+6	-2
EAR purchases higher or lower by SDR 1 billion <u>3/</u>	<u>+6</u>	<u>+6</u>	<u>+6</u>
Average holdings of SDRs higher or lower by SDR 500 million	<u>+5</u>	<u>+6</u>	<u>+4</u>

1/ The SDR interest rate would be lower by one percentage point on average if, for example, the rate would fall from nine percent on April 30, 1984 to 7.86 percent on July 31, 1984 and would stay at this level during the remainder of the financial year. The remuneration coefficient in these circumstances would be 90.83 percent as from August 1, 1984.

2/ This implies that average use of the unremunerated reserve tranche during the year would increase or decrease by SDR 125 million.

3/ This implies that average balances subject to the charges levied on the use of ordinary resources during the year would increase or decrease by SDR 500 million.

D. The Rate of Charge for 1985

Rule I-6(4)(a) calls for the determination of the rate of charge for the use of the Fund's ordinary resources for a financial year on the basis of the estimated income and expense of the Fund during that year, and the target amount of income. Experience shows that actual net income for reasons explained above, will differ from the estimates to some extent. Although these net differences have been very small relative to total income and expense and the other magnitudes involved in the estimation, they can be significant in relation to the target increase of 3 percent of the Fund's reserves. Since May 1, 1981 when the present rules for reviewing the Fund's financial position and determining the rate of periodic charges became effective, the estimates of the Fund's income and expenses were based on the SDR rate of interest in effect at the time the estimate was made, and on the projected use of Fund resources.

As indicated above, a deficit of SDR 68 million is projected for the next financial year. To avoid such a deficit and to attain net income equivalent to 3 percent of reserves the rate of charge on the use of the Fund's ordinary resources would need to be increased to 7.07 percent per annum from May 1, 1984. 1/2/

The deficit could be significantly higher if market rates of interest were to move up markedly from present levels. The exact impact of rising interest rates would, of course, depend on the extent and timing. For example, if the average SDR interest rate would turn out to be 9.5 percent rather than 9 percent, as assumed in the estimates, it would raise the projected deficit to SDR 149 million and require a rate of charge of 7.45 percent to reach the income target; if the average SDR rate would be 8.5 percent, this would result in net income of SDR 15 million, which corresponds to a rate of charge of

1/ As indicated, the projected deficit assumes a rate of interest on the SDR of 9 percent and a rate of remuneration of 7.95 percent (or 88.33 percent of the SDR interest rate). Of the increase in the rate of charge of 0.47 percent, 0.33 percent is attributable to the increase in the remuneration coefficient from 85 percent to 88.33 percent.

2/ The deficit of SDR 68 million estimated for 1985 is based on the assumption that the method of setting the rate of charge for purchases outstanding under the policy of enlarged access will be modified as proposed in "Charges on Holdings Outstanding Under the Policy on Enlarged Access" to be issued shortly. As discussed in that paper, the other alternatives suggested for consideration could increase the estimated deficit in 1985 in a range of from SDR 8 million to SDR 14 million and would require a further adjustment in the rate of charge of 0.04 to 0.07 percentage point in order to achieve the net income target.

6.68 percent. 1/ More generally, Table 6 illustrates a number of different combinations about future interest rates, higher and lower use of Fund resources than projected in Table 2, and the rate of charge needed to achieve the net income target of 3 percent of reserves. The data in the table confirm the earlier observation that a shortfall (or excess) of purchases would have only a marginal effect on the rate of charge required to meet the net income target and would be easily swamped by interest rate movements.

In view of the great sensitivity of the Fund's net income position, and hence of the rate of charge needed for FY 1985 in order to achieve the net income target, to the accuracy of the underlying assumptions, the staff has considered again whether it would be desirable to depart from the practices so far, and in particular whether an attempt should be made to forecast the average SDR interest rate and the average rate of remuneration that might be applicable in the forthcoming year. 2/ On balance, the staff considers it preferable to continue relying on the past practice of basing income projections on recent SDR interest rate levels. On present assumptions and projections, the rate of charge applicable from May 1, 1984 for the use of ordinary resources would need to be set at 7.07 percent in order to achieve the net income target of 3 percent of reserves. If at the time of the mid-year review of the Fund's income large revisions of the Fund's net income would be indicated, the possibility would exist to adjust the rate of charge for the remainder of the financial year in such a manner so as to more closely achieve the net income target. This conclusion is subject to two qualifications: (i) a decision on the determination of the rate of charge on purchases outstanding under enlarged access mentioned earlier and (ii) a decision on the disposition of the income in excess of target in 1984.

1/ In contrast to changes in the average SDR rate from the present level, a shortfall of purchases below projections within the range of past experience would not have a very marked impact on Fund income: it would reduce the deficit by an amount in the range of SDR 8-12 million, which would allow meeting the net income target with a rate of periodic charge in the range of 7.01-7.03 percent, i.e., lower by 0.04-0.06 percentage point than the rate indicated above.

2/ The method of determining the rate of charge, including the method of estimation was last considered by the Executive Board in December 1983, at which time it was decided that the present method of calculating the rate of charge should continue to apply. See "The Level and Growth of Fund Reserves and the Determination of Fund Charges" (EBS/83/251, 11/25/83).

Table 6. Effect of Different Assumptions
on the Fund's Income Position and the Rate of Charge
Financial Year 1985

(In millions of SDRs)

	Average Annual SDR Rate of Interest <u>1/</u> (In percent)				
	8.00	8.50	9.00	9.50	10.00
Purchases in the unremunerated reserve tranche and in the credit tranches (including special facilities):					
1. As projected in Table 2					
Net income <u>2/</u>	59	15	-68	-149	-230
Rate of charge <u>3/</u>	6.47	6.68	7.07	7.45	7.83
2. Purchases in the unremunerated reserve tranche, higher by SDR 250 million					
Net income <u>2/</u>	50	5	-78	-160	-241
Rate of charge <u>3/</u>	6.52	6.73	7.12	7.50	7.88
3. Purchases in the unremunerated reserve tranche, lower by SDR 250 million					
Net income <u>2/</u>	68	24	-58	-138	-219
Rate of charge <u>3/</u>	6.43	6.63	7.02	7.40	7.78
4. Credit tranche purchases, higher by SDR 1,000 million					
Net income <u>2/</u>	62	16	-70	-153	-236
Rate of charge <u>3/</u>	6.46	6.67	7.08	7.47	7.85
5. Credit tranche purchases, lower by SDR 1,000 million					
Net income <u>2/</u>	57	14	-67	-145	-224
Rate of charge <u>3/</u>	6.48	6.68	7.06	7.43	7.80

1/ Assumes SDR rate of interest to be at 9 percent on April 30, 1984.

2/ Net income at the present rate of charge (6.6 percent), assuming charges on enlarged access based on imputed borrowing cost, as proposed in "Charges on Holdings Outstanding Under the Policy on Enlarged Access" to be issued shortly.

3/ Rate of charge necessary to produce the target net income of SDR 32 million, calculated on the assumption stated in the preceding footnote.

III. Disposition of 1984 Net Income and Determination
of the Rate of Charge for 1985

The projected net income of the Fund for 1984 of SDR 69 million, is about 7 percent of the Fund's reserves at April 30, 1983 and exceeds the target income for the year of SDR 30 million, or three percent of the Fund's reserves at the beginning of the year, by SDR 39 million.

The disposition of the income in excess of the target is for consideration by the Executive Board. The options provided by Rule I-6(4)(c) for that purpose are as follows: (i) a retroactive reduction in the rate of charge; (ii) a retroactive increase in the rate of remuneration; (iii) a combination of a retroactive reduction in the rate of charge and a retroactive increase in the rate of remuneration; (iv) addition of the income in excess of target to the Fund's reserves. Placing income in excess of target to Fund reserves could be combined with deeming of part or all of the excess as income for the next financial year for the determination of the rate of charge and for setting the net income target in that year. These options are discussed in the following paragraphs.

A. Reduction in the Rate of Charge for 1984

As mentioned, net income in 1984 is now projected to reach SDR 69 million, and would exceed the target income equivalent of three percent of reserves at the beginning of the year by SDR 39 million. Assuming that any changes during the last two months of the financial year would result in not more than minor revisions of these projections, the income in excess of target would allow a retroactive reduction in the rate of charge applicable in 1984 from 6.6 percent to 6.37 percent. However, a retroactive reduction in the rate of charge for 1984 would not appear desirable in view of the increase in the rate of charge required for 1985 to meet the target growth of reserves in that year.

B. Increase in the Rate of Remuneration for 1984

Net income in excess of the target would allow an additional payment of remuneration for 1984 which would be equivalent to a retroactive increase in the rate of remuneration from the equivalent of 85 percent to 87.57 percent of the SDR interest rate. Remuneration payments for 1984 would then approach--but not quite reach--the payment of remuneration in relation to the SDR interest rate of 88.33 percent that has been agreed to apply from May 1, 1984 in accordance with the revised Rule I-10 adopted by the Executive Board in January 1984. 1/

1/ Retroactive increase in the rate of remuneration in accordance with the provision of Rule I-6(4)(c) would not signify a retroactive increase of the remuneration coefficient in effect on January 1, 1984 which is to be increased by 3.33 percentage points on May 1, 1984 under the revised Rule I-10, and thus would not imply that the coefficient would increase beyond 88.33 percent on that date.

If it were agreed that there should not be a retroactive decrease of the rate of charge, it would also be undesirable to raise the rate of remuneration retroactively.

C. Deeming 1984 Income as Income in 1985 for the
Determination of Rate of Charge

Rule I-6 (4)(d) allows that the excess of income above target in 1984 of SDR 39 million be deemed as income of 1985 for the purpose of determining the rate of charge, which would allow a somewhat smaller increase in charges than otherwise would be required. If all of the 1984 income above target were deemed as 1985 income for the purpose of determining the rate of charge, the 1985 rate could be set at about 6.89 percent rather than a rate of about 7.07 percent mentioned earlier. However, it should be noted that the 1984 income in excess of target (of SDR 39 million) exceeds the 1985 net income target (of SDR 32 million). In effect, the Fund would be planning to run an operating deficit equal to the difference between the 1984 income in excess of target and the 1985 net income target, i.e. a deficit of SDR 7 million. For reasons of principle, it would not seem desirable for the Fund actually to plan an operating deficit. Any "deeming" for the purpose of setting 1985 charges should therefore not exceed the amount of reserves accumulation called for in 1985, i.e., the net income target stipulated in Rule I-6(4)(a) or SDR 32 million. With "deeming" to the extent of the net income target, the rate of charge on the use of the Fund's ordinary resources for 1985 would have to be set at 6.92 percent (presuming continuation during 1985, on average, of the SDR rate of interest around 9.0 percent). This possibility could be examined in the light of the likelihood of a further upward adjustment of the rate of charge in the course of financial year 1985 for interest rate reasons.

D. Placing Income to Reserves

At a time when both the use of the Fund's resources and the Fund's borrowing to finance the increased demands are continuing to expand, it is also for consideration whether the Fund's reserves should also increase. Reserves provide a means to absorb potential losses and they reflect a source of interest-free liquid resources that can be utilized in the Fund's operations and transactions. In present circumstances, the staff would consider it good policy to accept the fortuitous, though small, excess of income over the target and to place it to reserves. This would strengthen the Fund's reserves and slow down the decline of reserves relative to quotas, outstanding purchases and liquid claims on the Fund. Executive Directors could examine that suggestion taking into consideration the fact that the level and growth of the Fund's reserves are still low compared to the amount and the rate of increase in Fund credit outstanding and also relative to Fund borrowing.

IV. The Rate of Charge on Purchases under the Policy on Enlarged Access

As mentioned above, Rule I-6(5) which sets out the method of determining charges on holdings outstanding under the Policy on Enlarged Access does not refer to the repayment from the Fund's ordinary resources of short-term enlarged access borrowing. Proposals to deal with this matter are made in a separate paper. ^{1/} The deficit of SDR 68 million discussed above has been projected on the basis of the staff proposal in that paper, i.e., that the cost of borrowing be also imputed to that part of resources used to finance outstanding purchases under the Policy on Enlarged Access that involves ordinary resources.

Two other possibilities to determine charges on holdings under the Policy on Enlarged Access when ordinary resources are involved in the financing of credits under that policy are discussed in the above staff memorandum (i) using the rate of interest on the SDR for this purpose or (ii) using the rate of remuneration. Since both of these rates are assumed to be lower than the imputed borrowing rate, their use would reduce the income expected in 1985. Use of the first of these two indicators of the cost of ordinary resources to the Fund would reduce the estimated income by SDR 8 million, resulting in a deficit of about SDR 76 million; the rate of charge required to meet the target rate of income would increase to 7.11 percent. Use of the rate of remuneration would reduce estimated income by SDR 14 million resulting in a deficit of about SDR 82 million, and require a rate of charge of 7.14 percent to meet the income target.

V. Conclusions and Recommendations

1. Net income in FY 1984 is expected to be in the order of SDR 69 million. For FY 1985 a deficit of the order of SDR 68 million is projected with the present rate of charge on the use of ordinary resources of 6.6 percent, based on the present SDR rate of interest and estimated use of Fund resources. The projected deficit is, however, very sensitive to interest rate assumptions.

2. The Rules provide a number of options for the disposition of 1984 income in excess (probably about SDR 39 million) of the target: a retroactive decrease in the rate of charge, a retroactive increase in the rate of remuneration, a combination of these retroactive adjustments, or addition to the Fund's reserves. There is also a provision in the Rules that an excess of income over target income in a year may be deemed income for the subsequent financial year for the purpose of setting charges and determining the income target. In circumstances where the projected deficit in the Fund's income position calls for an increase in the rate of charge, the staff considers undesirable a retroactive decrease in the rate of charge or a retroactive increase in the payment of remuneration.

^{1/} See "Charges on Holdings Outstanding Under the Policy on Enlarged Access" to be issued shortly.

3. It would be possible to moderate the projected rise in the rate of charge on use of the Fund's ordinary resources by deeming part of the income in excess of target in FY 1984 to meet target income for the subsequent financial year, in accordance with Rule I-6(4)(d). On the assumption that the Fund would not wish to deliberately plan for a deficit and thus confine the "deeming" to reach the target increase in reserves of 3 percent, the increase in the rate of charge necessary to cover the prospective deficit would be 6.92 percent.

4. Notwithstanding the decisions to place all of net income each year since 1978 to the Fund's reserves, these have increased at a very much slower rate than the increase in liquid claims on the Fund, outstanding purchases and the Fund's gross income and expenses. In these circumstances, the staff would have a preference to accept a somewhat faster increase in the Fund's reserves and to place all of the net income of the current year to the Fund's special reserves.

5. The Fund's income position has become extremely sensitive to trends in market rates of interest and hence the SDR interest rate and the rate of remuneration. An increase or decrease in the average over the year of the SDR interest rate of one-half of one percentage point from the level presently prevailing (i.e., from 9 percent to 9.5 percent or 8.5 percent) will increase or decrease the projected deficit of SDR 68 million by about SDR 82 million. The net income position will be affected much less sharply by a deviation of purchases from projected levels, but the variance in income would still be sizeable in relation to the net income target of 3 percent of reserves.

6. In the light of the foregoing, Executive Directors may wish to consider action along the following lines:

(i) to place net income for 1984 to the special reserve;

(ii) to increase the rate of charge on the use of ordinary resources to a level that would, on present projections, permit the Fund to reach the net income target of 3 percent of reserves. In this case, the rate of charge on the use of the Fund's ordinary resources would need to be set at 7.07 percent per annum;

(iii) to maintain the SDR rate of interest at 100 percent of the combined market rate of interest; and

(iv) to hold a further review of the Fund's charges not later than at the time of the mid-year review of the Fund's net income position.

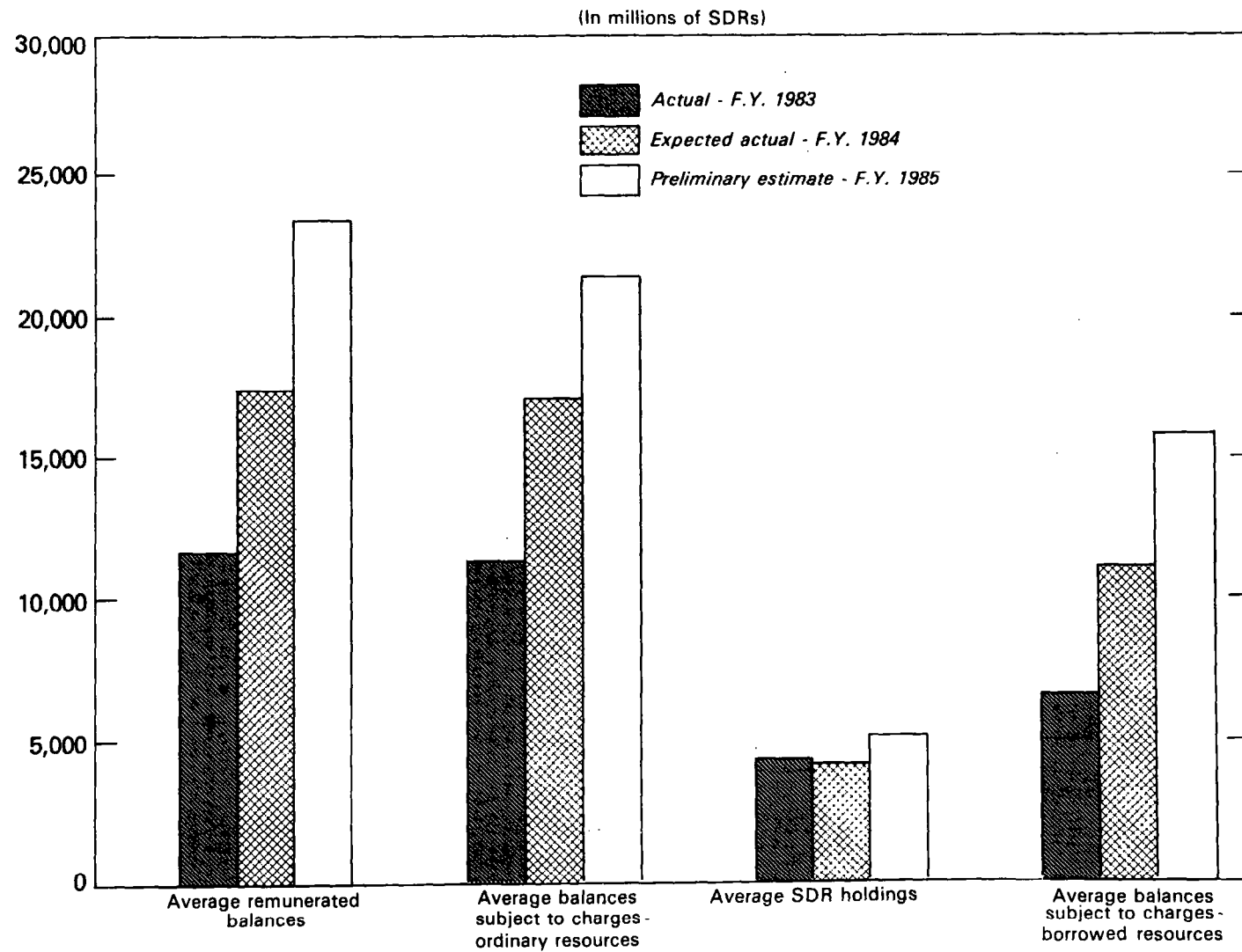
APPENDIX

Rule I-6(4):

(4) The rate of charge on holdings acquired as a result of a purchase (i) in the credit tranches, or (ii) under the Extended Fund Facility (Executive Board Decision No. 4377-(74/114), as amended), or (iii) under the Facility for the Compensatory Financing of Export Fluctuations (Executive Board Decision No. 4912-(75/207), as amended), or (iv) under the Facility for the Problem of Stabilization of Prices of Primary Products (Executive Board Decision No. 2772-(69/47), as amended), or (v) under the Facility for Compensatory Financing of Fluctuations in the Cost of Cereal Imports (Executive Board Decision No. 6860-(81/81)), shall be determined in accordance with (a), (b), and (c) below.

- (a) The rate of charge shall be determined at the beginning of each financial year on the basis of the estimated income and expense of the Fund during the year and the target amount of net income for the year. The latter shall be 3 percent of the Fund's reserves at the beginning of the year or such other percentage as the Executive Board may determine particularly in the light of the results in the previous financial year.
- (b) A mid-year review of the Fund's income position shall be held shortly after October 31 of each year. If actual net income for the first six months of the financial year, on an annual basis, is below the target amount for the year by an amount equal to, or greater than, two percent of the Fund's reserves at the beginning of the financial year, the Executive Board will consider how to deal with the situation. If on December 15 no agreement has been reached as a result of this consideration, the rate determined under (a) at the beginning of the year shall be increased as of November 1 to the level necessary to reach the target amount of net income for the year.
- (c) A review of the Fund's income position shall be held shortly after the end of each financial year. If the net income for the year just ended is in excess of the target amount for the year, the Executive Board will consider whether the whole or a part of the excess should be used to reduce the rate of charge, or increase the rate of remuneration to not more than the rate of interest of the SDR, retroactively for the year just ended, or both, or to place all or part of the excess to reserve.
- (d) If the Fund's net income for a financial year is in excess of the target amount for that year, the Executive Board may for the purposes of the determinations and estimates referred to in (a) and (b) above in respect of the immediately subsequent financial year, decide to deem any part of the excess over the target amount that has been placed to reserve as income for that subsequent financial year.

CHART 3
 AVERAGE REMUNERATED POSITIONS, BALANCES SUBJECT TO CHARGES,
 AND HOLDINGS OF SDRs





Rule I-10:

(a) The rate of remuneration shall be equal to 85 percent of the rate of interest on holdings of SDRs under Rule T-1 (hereafter referred to as the "SDR interest rate"). The relationship of the rate of remuneration to the SDR interest rate will be referred to as the "remuneration coefficient".

(b) Beginning April 30, 1984, the remuneration coefficient during each quarter shall be at the level determined under (1), (2), (3), and (4) below, but no higher than permitted by Article V, Section 9(a):

- (1) During the period May 1, 1984 to April 30, 1987, the remuneration coefficient shall be the higher of (i) or (ii) below:
 - (i) The remuneration coefficient in effect on January 1, 1984 increased by 3.33 percentage points in each of the three financial years beginning May 1, 1984, May 1, 1985, and May 1, 1986;
 - (ii) The remuneration coefficient in effect on January 1, 1984, increased or decreased on the first day of each quarter by one percentage point for each 1/6 of one percentage point that the SDR interest rate on the day before the beginning of the quarter is below or above the SDR interest rate in effect on April 30, 1984, provided that the remuneration coefficient in any quarter in each of these three financial years shall not be more than 2.5 percentage points above the amount of the coefficient for that year as determined under (i) above.
- (2) Following the adjustment in the remuneration coefficient on May 1, 1986, the rate of remuneration shall be reviewed before May 1, 1987. This review shall be conducted in the light of all the relevant considerations, including, in particular, the SDR interest rate and the rate of charge.
- (3) Beginning May 1, 1987, the remuneration coefficient shall be the higher of (i) or (ii) below:
 - (i) The remuneration coefficient existing at the end of the preceding financial year;
 - (ii) A remuneration coefficient of 95 percent, increased or decreased on the first day of each quarter by one percentage point for each 1/6 of one percentage point that the SDR interest rate on the day before the beginning of a quarter is below or above the

SDR interest rate on April 30, 1987, provided that the remuneration coefficient in any quarter of a financial year shall not be more than 2.5 percentage points above the level at the end of the preceding year.

- (4) The rate of remuneration, while less than 100 percent of the SDR interest rate, shall be rounded to the nearest two decimal places.

(c) The operation of (b) above shall be reviewed on the occasion of the reviews of the rate of charge under Rule I-6(4) and the SDR interest rate under Rule T-1(d).

(d) If the rate of charge on holdings specified in Rule I-6(4) should exceed the SDR interest rate, the Executive Board shall review the remuneration coefficient, and, in particular, will consider whether the remuneration coefficient should be set, within the range in Article V, Section 9(a), at such a level as would permit the rate of charge to be set under Rule I-6(4)(a) or (b) at the same level as the SDR interest rate referred to above and still meet the target amount of net income for the financial year.

* * *

Rule T-1(d):

(d) The Fund will review the rate of interest on holdings of SDRs at the conclusion of each financial year.

OF DEPARTMENT OF THE TREASURY

CHART 4
RATE OF REMUNERATION, SDR INTEREST RATE, AND RATE OF CHARGE

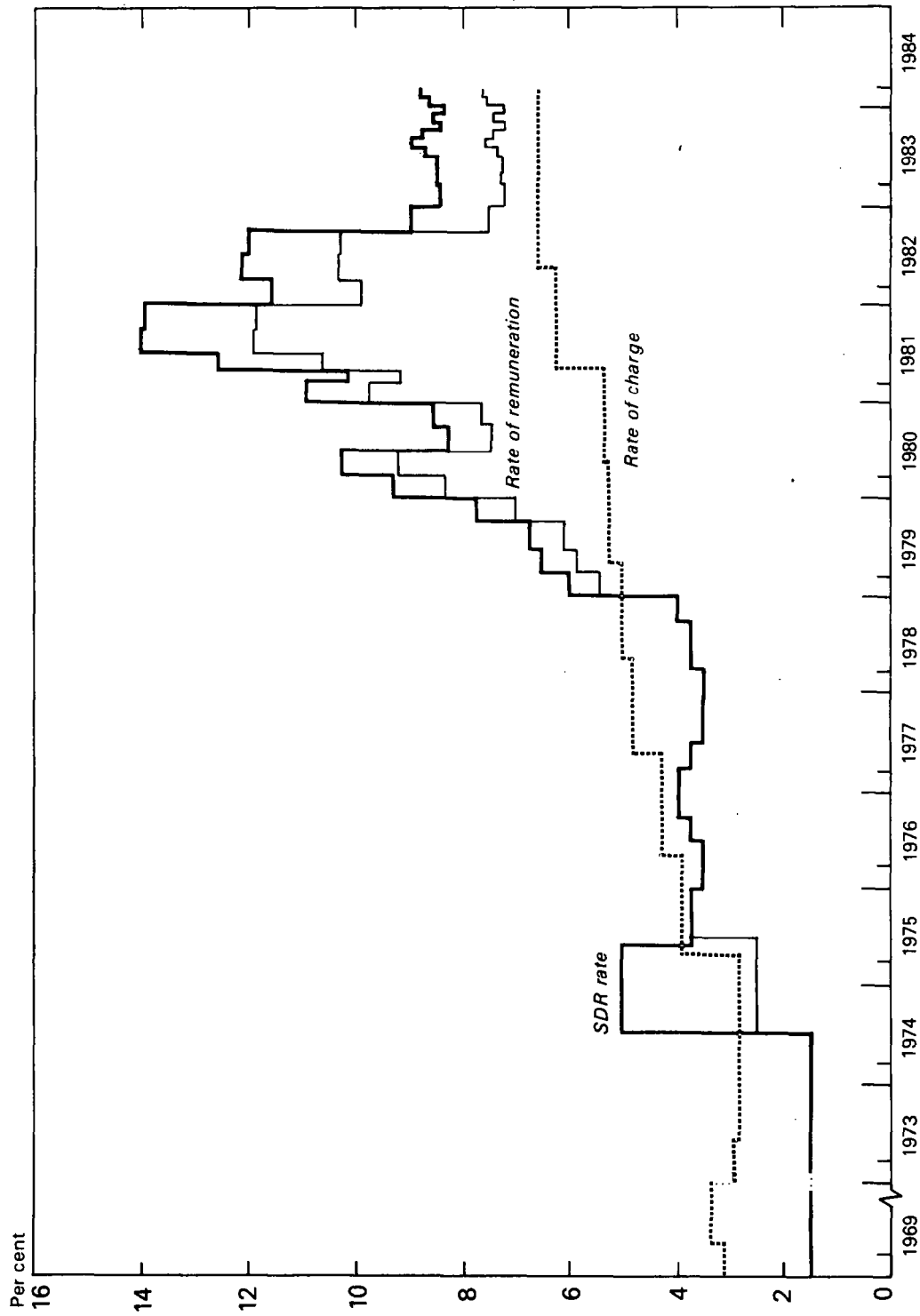


Table 1. Estimates of Average Daily Balances and Rates of Periodic Charges,
SDR Interest, Remuneration, and Interest on Borrowing
Financial Years 1984 and 1985

(In millions of SDRs)

	Actual Ten Months February 29, 1984	1984		Revised Estimates	1985 Preliminary Estimates
		Preliminary Estimates			
		April 1983 <u>1/</u>	November 1983 <u>2/</u>		
A. Ordinary Resources and GAB Borrowing					
1. Balances subject to periodic charges	16,622	19,645	17,485	16,985	21,380
Average rate of charge	6.6	6.6	6.6	6.6	6.6
2. Holdings of SDRs in the General Resources Account	3,758	4,000	3,945	4,235	5,100
Average rate of interest	8.65	8.52	8.66	8.71	9.00
3. Revenue-producing balances	20,380	23,645	21,430	21,220	26,480
Weighted average rate of revenue	6.98	6.92	6.98	7.02	7.06
4. Remunerated positions	16,662	20,085	18,030	17,425	23,610
Average rate of remuneration	7.35	7.24	7.36	7.40	7.95
5. Borrowings under the GAB <u>3/</u>	487	390	390	405	--
Average rate of interest	4.00	4.00	4.00	4.00	--
6. Expense-producing balances	17,149	20,475	18,420	17,830	23,610
Weighted average rate of expense	7.25	7.18	7.29	7.32	7.95
7. Pro memoria					
Margin between rate of charge and the average rate of remuneration	-0.75	-0.64	-0.76	-0.80	-1.35
B. Borrowed Resources					
1. Balances subject to periodic charges					
SFF	6,624	6,970	6,680	6,680	6,610
Enlarged Access	4,019	5,280	4,795	4,405	9,140
Total	10,643	12,250	11,475	11,085	15,750
Average rate of charge					
SFF	11.63	10.45	11.61	11.64	11.73
Enlarged Access	10.71	10.54	10.57	10.69	10.64
Combined	11.28	10.49	11.18	11.26	11.10
2. Borrowings					
SFF	6,624	6,970	6,680	6,680	6,590
Enlarged Access <u>3/</u>	5,518	5,500	6,300	5,725	8,585
Total	12,142	12,470	12,980	12,405	15,175
Average rate of interest					
SFF	11.43	10.25	11.41	11.44	11.50
Enlarged Access <u>4/</u>	10.51	10.34	10.37	10.49	10.44
Combined	11.08	10.29	10.98	11.06	10.90
3. Pro memoria					
Excess of average balances subject to periodic charges over average borrowings					
SFF	--	--	--	--	20
Enlarged Access	--	--	--	5	555
Total	--	--	--	5	575

^{1/} See "Review of the Fund's Income Position for the Financial Years 1983 and 1984," EBS/83/75 (4/18/83).

^{2/} See "Review of the Fund's Income Position," EBS/83/248 (11/21/83).

^{3/} Balances held in the Borrowed Resources Suspense Account averaged SDR 1,499 million during the ten month period ended February 29, 1983 and are estimated to average SDR 1,315 million during financial year 1984. The estimates for 1985 assume no balances in the Borrowed Resources Suspense Account.

^{4/} Net cost of borrowing after deducting net income from investments.

APPENDIX

Table 2. Factors Explaining the Difference Between
the Rate of Remuneration and the Rate of Charge Under Rule I-6(4)
for 1984 and 1985

	1984 <u>1/</u>	1985	
		Present Rate	Proposed Rate
1. Rate of remuneration	7.24	7.95	7.95
2. Rate of charge under Rule I-6(4):	<u>6.60</u>	<u>6.60</u>	<u>7.07</u>
3. Difference	<u>0.64</u>	<u>1.35</u>	<u>0.88</u>
Explained by:			
Rate of remuneration x $\frac{\text{Interest-free resources}}{\text{Use of Fund credit}}$	1.17	1.27	1.27
Difference between SDR interest rate and rate of remuneration x $\frac{\text{SDR holdings}}{\text{Use of Fund credit}}$	0.26	0.25	0.25
Difference between GAB interest rate and rate of remuneration x $\frac{\text{GAB Borrowing}}{\text{Use of Fund credit}}$	0.06	--	--
$\frac{\text{Income from service charges}}{\text{Use of Fund credit}} \times 100$	0.42	0.26	0.26
$\frac{\text{Income from margins on oil facility, SFF and Enlarged Access}}{\text{Use of Fund credit}} \times 100$ <u>2/</u>	0.13	0.24	0.24
Less:			
$\frac{\text{Administrative expense}}{\text{Use of Fund credit}} \times 100$	-0.93	-0.99	-0.99
$\frac{\text{Target income}}{\text{Use of Fund credit}} \times 100$	<u>-0.47</u>	<u>+0.32</u>	<u>-0.15</u>
	0.64	1.35	0.88

1/ Based on original estimates made in April 1983. See "Review of the Fund's Income Position for the Financial Years 1983 and 1984," EBS/83/75 (4/18/83).

2/ Income from margins, net of remuneration expense resulting from the substitution of ordinary for borrowed resources.