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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 84/83

10:00 a.m., May 30, 1984

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	L. K. Doe, Temporary
	L. E. J. M. Coene, Temporary
	X. Blandin
A. Donoso	M. Teijeiro
R. D. Erb	M. K. Bush
M. Finaish	T. Alhaimus
T. Hirao	T. Yamashita
J. E. Ismael	Jaafar A.
R. K. Joyce	L. Leonard
	C. Robalino
G. Laske	G. Grosche
	N. Coumbis
	G. Gomel, Temporary
	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
	A. A. Agah, Temporary
	E. I. M. Mtei
M. A. Senior	J. L. Feito
J. Tvedt	A. Lindå
N. Wicks	T. A. Clark
Zhang Z.	Wang E.

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

Administration Department: H. Wiesner. European Department: B. E. Rose, Deputy Director; J. T. Boorman, L. Hansen, V. Marie. External Relations Department: H. P. Puentes. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; G. F. Rea, Deputy General Counsel. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; D. Williams, Deputy Treasurer; D. H. Brown, W. L. Coats, D. S. Cutler, R. B. Hicks, B. E. Keuppens, T. Leddy, J. T. McDonald, M. A. Tareen, G. Wittich. Western Hemisphere Department: E. Wiesner, Director. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, C. J. Batliwalla, S. E. Conrado, J. Delgadillo, S. El-Khouri, H.-S. Lee, W. Moerke, G. E. L. Nguyen, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: E. M. Ainley, H. Alaoui-Abdallaoui, I. Angeloni, J. Bulloch, M. B. Chatah, G. Ercel, I. Fridriksson, V. Govindarajan, D. Hammann, A. K. Juusela, H. Kobayashi, M. J. Kooymans, E. Landis, J. A. K. Munthali, G. W. K. Pickering, M. Rasyid, J. Reddy, C. A. Salinas, A. A. Scholten, S. Sornyanyontr, Wang C. Y.

1. ENLARGED ACCESS POLICY - CHARGES ON HOLDINGS OUTSTANDING - AMENDMENT OF RULE I-6(5)

The Executive Directors considered a staff paper on charges on holdings outstanding under the policy on enlarged access (SM/84/97, 5/1/84).

Mr. Jayawardena noted that the paper discussed two issues: the inclusion of ordinary resources employed in the financing of purchases under the policy on enlarged access in the calculation of charges to be levied on members' purchases under that policy, and the interest rate to be applied to the ordinary resources so used. The use of ordinary resources to finance a part of purchases under the enlarged access policy was a temporary phenomenon caused by cashflow mismatches between outstanding purchases and borrowed resources. For the first time, the Executive Board had to decide on the rate of charge that should be applied to the segment of purchases under the enlarged access policy financed by ordinary resources. The staff had proposed various charges based on six different rates of interest, namely, the rate of charge applied to ordinary resources, the rate of remuneration, the SDR rate of interest, the rate of interest applicable to borrowing under the General Arrangements to Borrow (GAB), the rate on outstanding borrowing, and the rate on borrowing under the agreement with the Saudi Arabian Monetary Authority (SAMA).

In estimating the Fund's operational income under enlarged access in its paper reviewing the Fund's income position for financial years 1984 and 1985 (EBS/84/91, 4/24/84, Table 1; EBM/84/83, 5/30/84, Item 2), the staff had assumed a rate of charge that was equal to the rate on outstanding borrowing, Mr. Jayawardena went on. The staff proposed to base the cost of ordinary resources used in financing a part of purchases under the enlarged access policy on the rate of interest to be paid by the Fund on its borrowing from SAMA under the 1981 loan agreement, a rate that could be slightly higher than assumed in Table 1 of EBS/84/91. He could accept the staff proposals, which might have a beneficial impact on the Fund's income position, on the condition that any income generated above the estimate in EBS/84/91 would be used for moderating the rate of charge in 1985.

Mr. Gomel indicated his broad agreement with the staff proposals, in particular that the cost of ordinary resources should be included in the calculation of charges levied on purchases under the enlarged access policy when such resources were used to finance purchases of borrowed currency, given the mismatch between borrowing and corresponding purchases under the enlarged access policy. The modalities for determining the appropriate cost of ordinary resources used in such circumstances were complicated and required careful consideration. He would prefer that an imputed borrowing cost be applied to the use of the Fund's ordinary resources, as under the second approach suggested by the staff. He therefore supported the staff's recommendation to use a market interest rate that was representative of the cost of borrowing by the Fund to finance enlarged access purchases. Unlike the staff, however, he sugggested that, in the quest for a reasonable compromise and to keep the cost of resources available under the enlarged access policy as low as possible, the interest rate applicable to borrowing under the GAB should be adopted as an appropriate indicator.

Mr. Ismael stated that he had no difficulty in accepting the staff's recommendations and could support the proposed amendments to Rule I-6(5).

Ms. Bush indicated her support for the proposed decision to amend Rule I-6(5) that would base the cost of ordinary resources used in financing purchases under the enlarged access policy in the case of mismatches between sources and uses of funds on the imputed rate of interest to be paid by the Fund on borrowing from SAMA under the 1981 loan agreement. The immediate problem reflected a more fundamental difficulty: the Fund was lending under the enlarged access policy at maturities that were longer than the repayment periods on its borrowing. The present proposal to substitute ordinary resources for borrowed resources resulted from too little attention having been paid to the problem of mismatching of maturities. Various solutions were theoretically possible. For example, the Fund could seek additional borrowed resources to replace those that would be repaid before the corresponding repurchases were made, or the original repurchase schedule could be revised to shorten the member's repayment period to correspond to the Fund's own repayment obligations. She did not recommend either of those courses of action but cited them merely to highlight the fundamental problem.

If the Fund were to substitute ordinary resources for borrowed resources, it should do so in a way that did not create an unfair advantage for one borrower over another and that did not break the link between the extraordinary nature of enlarged access arrangements and the Fund borrowing supporting them, Ms. Bush went on. It was important that that link be strong in order to ensure that the financial consequences of the enlarged access policy would remain clear. Conversely, it would be unwise to create an incentive for drawings under the enlarged access policy by making the cost of such purchases lower, to the extent that ordinary resources were substituted for borrowed resources. It was worth recalling that the higher cost associated with enlarged access had its counterpart in longer repayment terms. Creating such an incentive for additional enlarged access drawings could be contrary to the principle, as expressed in the Articles of Agreement, that use of Fund resources should be temporary.

It would be anomalous to reduce the rate of charge as a result of the substitution for borrowed or ordinary resources while retaining the original long repayment schedule of drawings under the enlarged access policy, Ms. Bush commented. Similarly, if the Fund were to assess a reduced rate of charge for the use of ordinary resources on a case-by-case basis, depending on the accident of mismatching, it would be treating individual borrowers unfairly and arbitrarily. However, to try to generalize the effect of substituting ordinary resources on the rate of charge to all borrowers, rather than dealing with the problem on a case-by-case basis, would introduce an unnecessary degree of complexity. It would be more appropriate to determine the procedure for assessing charges from the outset, by retaining the cost of Fund borrowing as the basis for the rate of charge throughout the entire repurchase period.

Finally, her authorities were becoming increasingly concerned about the net income and reserve position of the Fund, Ms. Bush indicated. It seemed appropriate to strengthen the Fund's income position by basing the rate of charge on the cost of borrowing, rather than on the remuneration rate or the SDR rate. Additionally, as the staff pointed out, such a decision would help to limit the extent to which the rate of charge would have to be increased in the future.

Mr. Polak said that the two subjects under discussion at the present meeting--charges on holdings outstanding under the policy on enlarged access, and a review of the Fund's income position for financial years 1984 and 1985--were interrelated. In general, established Fund policy determined that users of the Fund's resources, whether borrowed or ordinary, would be charged the cost of that money, plus a small amount necessary to build up the Fund's reserves. In the past, the Fund had made a sharp division between the cost of ordinary resources and borrowed resources; users of the Fund's ordinary resources were charged a much lower rate. The difference in charges was even larger than the difference between the cost to the Fund of borrowed money--the rate of interest paid to SAMA--and the cost to the Fund of the use of ordinary resources--the rate of remuneration. The Fund gave virtually all the breaks to the users of its own money. The transaction charge was used to reduce the cost of ordinary resources--the interest-free reserves were used for that purpose--and the Fund even levied an extra charge of 0.2 percent on borrowed money to subsidize further the Fund's own money. That extra charge, which the staff referred to as "a small margin," was not so small when compared with the margin that would be discussed heatedly when Executive Directors reviewed the Fund's income position for financial years 1984 and 1985.

The Executive Board paid great attention to a modest increase in the charge applied to ordinary resources, but little attention to the charges on borrowed money, Mr. Polak observed. In fact, the staff had proposed various rates of charge for the use of borrowed money that differed by more than 0.5 percent. The time had come perhaps for the Fund to consider charging a single rate for a pool of resources made up of both borrowed and ordinary resources. As such a change was not practical at present, he would address the proposal put forward by the staff in SM/84/97.

Since some ordinary resources would have to be used to finance enlarged access purchases that had originally been financed with borrowed resources, the Fund should base the charge for those ordinary resources on the net cost of borrowing by the Fund, Mr. Polak continued. However, the staff proposed the use of a medium-term rate that "would also provide the Fund with some net income compared with the rate that would reflect the cost to the Fund of the use of ordinary resources. This net income would help mitigate the increase in the rate of charge on members' use of ordinary resources that is otherwise required" (SM/84/97, page 7). There was no good reason for increasing the rate for that purpose. Rather, the rate of charge on ordinary resources should be based on the cost of those resources to the Fund: the rate of remuneration for the use of currencies

and the SDR rate for the use of SDRs. Since the net use of SDRs was determined by other considerations, the marginal cost to the Fund was the rate of remuneration, which, in his view, was the relevant cost. The rate of remuneration was the lowest of all the rates proposed by the staff as the basis for charges, but, in charging more, the Fund would be subsidizing the already low cost of the use of ordinary resources by adding to the cost of using borrowed money.

The staff had proposed to include a margin of 0.2 percent a year in the rate of charge for using ordinary resources under the enlarged access policy; that special fee on borrowed money was, he supposed, the cost of having agreed to borrow from BIS and Saudi Arabia, Mr. Polak remarked. He could not support that suggestion. He favored basing the rate of charge on the ordinary resources used to finance enlarged access purchases on the rate of remuneration, without the 0.2 percent margin. According to the staff, a decision not to include the margin would make no difference to the income projections; any change would be lost in rounding. Nevertheless, for reasons of principle, it would be better to eliminate the margin from the proposal.

Mr. Blandin agreed that the cost of ordinary resources used in financing purchases under the enlarged access policy should be added to the net cost of borrowing. The rate of charge on the resources so used should be based on the five-year SDR rate applied to the Fund's borrowing from SAMA. If the rate of charge were based on the rate of remuneration, present users of resources under the policy of enlarged access would have an unjustified advantage over any future users.

Mr. Hirao stated that the decision to be taken by the Board should be consistent with the original intention that the rate of charge on enlarged access purchases should reflect the net cost of borrowing. Therefore, the calculation of the rate of charge should not be affected by the fact that ordinary resources were employed. The rate proposed by the staff would provide the Fund with some additional net income that would help to mitigate any future increase in the rate of charge; he could therefore support the staff's proposal.

Mr. Laske remarked that he could support the staff proposals for the reasons put forward by other speakers.

Mr. Tvedt noted that a mismatch between Fund borrowing and lending under the policy on enlarged access would arise in the current year. Fortunately, the Fund was in a position at present to cover that financing gap by use of its ordinary resources.

As for the charges to be applied to enlarged access purchases during the mismatch period, he shared the view that the five-year SDR rate paid by the Fund to SAMA seemed appropriate for determining the cost of ordinary resources, Mr. Tvedt continued. The principle of equality of treatment would be maintained, and no member would be worse off than if purchases and borrowing by the Fund had been matched. Moreover, the use

of the SAMA rate would provide the Fund with some net income that would help to mitigate any future increase in the rate of charge. Consequently, he could support the draft amendment of Rule I-6(5).

Mr. Joyce agreed with the proposal to amend Rule I-6(5) as indicated in SM/84/97. The staff had proposed the most equitable solution to the problem for the reasons set out by earlier speakers. While the rate of interest on borrowing from SAMA under the 1981 agreement was perhaps the most appropriate at present, it might be necessary to review Rule I-6(5) at a future date, since the question of mismatching maturities would also arise with respect to the use of resources acquired under the new borrowing agreements.

Mr. Clark indicated his support for the proposals in the staff paper. However, he shared to some extent the views presented by Mr. Polak, particularly that the Fund seemed to be moving away from the "cost-plus" approach to charges.

Mr. Morrell stated that he too could go along with the staff proposals. However, could the problem of mismatching be solved by the Fund drawing on its new borrowing lines? By structuring charges in such a way that it was more profitable for the Fund to use ordinary resources to finance enlarged access purchases, the Fund would seem to be promoting the option of using ordinary resources to finance drawings under the enlarged access policy rather than drawing on its borrowing lines. The staff appeared to be suggesting a strategy of reducing the use of borrowed resources to finance purchases under the enlarged access policy.

The actual wording of the decision appeared incorrect, Mr. Morrell stated, inasmuch as it mentioned first "the charge on holdings of a member's currency" and then "the total of" the net cost of borrowing by the Fund.

Mr. Donoso noted that the staff recommended that an imputed borrowing cost should be applied to the ordinary resources used to finance purchases under the policy on enlarged access in the case of mismatching. He saw an advantage in the simplicity of the proposal and a disadvantage for extended arrangements. The staff had indicated that the use of the proposed rate of charge would provide the Fund with some net income that would help to mitigate the increase in the rate of charge on members' use of ordinary resources. He had two reservations with respect to that suggestion. First, when the net income position of the Fund had improved in the past, the Executive Board had, in fact, recommended that the net income should be placed to reserve, rather than used to mitigate the increase in the rate of charge. Second, even if the net income were used to reduce the rate of charge, those countries using ordinary resources would have an advantage over those members purchasing borrowed resources. Nevertheless, he could still support the proposed decision on the understanding that the present policy was designed to address a minor, short-term deviation during a period of mismatching of maturities, and that net income should be used to reduce any future increase in the rate of charge.

Mr. Agah expressed his agreement with the thrust of the staff analysis and recommendations. While there seemed to be various choices for the calculation of the interest rate on ordinary resources used in financing purchases under the enlarged access policy, the staff recommendation was clearly the least disadvantageous from the point of view of the Fund's net income position and of members that did not make purchases under the enlarged access policy. He could support the proposed amendment to Rule I-6(5), on the condition that any additional income would be used to moderate the rate of charge.

Mr. Mtei remarked that it was important for the Executive Board to bear in mind the need to keep the rate of charge for the use of Fund resources as concessional as possible in order to uphold the spirit of the Articles of Agreement. For the time being, however, he had no objection to the proposed amendment to Rule I-6(5), which would permit the use of ordinary resources to finance purchases under the policy on enlarged access. The staff had recommended that the rate of charge for the resources so used should be imputed at the rate of interest to be paid by the Fund on its borrowing from SAMA, a rate that was representative of the cost of borrowing under the enlarged access policy. The staff had also noted that that rate would provide the Fund with some net income that could help to mitigate the increase in the rate of charge on members' use of ordinary resources. Could the staff elaborate on the mechanism for moderating the rate of charge?

The income generated as a result of using the proposed rate of charge would constitute part of the overall income of the Fund, Mr. Mtei observed. He therefore supported the view that any excess income should be used to moderate the rate of charge for financial year 1985. Although the use of ordinary resources in financing enlarged access purchases was a temporary phenomenon caused by mismatching, the same mechanism should be adopted if a similar situation recurred in the future.

Mr. Doe stated that he had no difficulty with the proposal to apply ordinary resources to the financing of purchases under the enlarged access policy. He was uncertain whether or not the mismatching problem might become more important in the future; he hoped that it would remain manageable. He endorsed the decision to base the cost of the ordinary resources used in financing enlarged access purchases on the rate of interest to be paid by the Fund on its borrowing from SAMA under the 1981 loan agreement.

Mr. Zhang, Mr. Nimatallah, Mr. Senior, and Mr. Finaish indicated agreement with the proposed amendment to Rule I-6(5).

Mr. Coene stated that he could support the proposed decision, although, like Mr. Polak, he was not fully convinced of the need to deviate from the traditional system of basing the rate of charge on the actual cost incurred by the Fund.

The Treasurer confirmed that the use of ordinary resources to finance purchases under the enlarged access policy did produce net income for the Fund and, therefore, had an influence on the rate of charge that would be required to achieve a reserve target of 3 percent. Table 1 of EBS/84/91 had been based on the assumption that the Executive Board would adopt the staff proposal to impute the cost of ordinary resources at the rate of interest to be paid by the Fund on its borrowing under the 1981 loan agreement. If the Executive Board had not accepted the staff's suggestion, the calculated rate of charge on the use of ordinary resources would have been 7.14 percent, rather than 7.07 percent. The application of an imputed borrowing cost would lower the cost of using the Fund's ordinary resources. The present guidelines on charges to be levied under the enlarged access policy were not based only on cost considerations. Purchases under the enlarged access policy were different from other purchases of ordinary resources. Furthermore, the Fund lent under the enlarged access policy at maturities that were longer than the repayment periods on its borrowing.

In the past, the rate of charge on Fund resources had borne little relationship to the cost of borrowing, the Treasurer remarked. While there had been some link between the cost of borrowing and the charges to be levied on resources available under the supplementary financing facility, there had been no guarantee in the decision on charges that the Fund would, in fact, recover costs. The margin of 0.2 percent included in the rate of charge on purchases under the enlarged access policy was based on the administrative costs of borrowing and lending by the Fund under the policy. The margin was also intended to make some contribution to the reserves of the Fund. Because of the additional volume of lending and borrowing incurred under the policy on enlarged access, the Fund was exposed to greater income and capital risks. Consequently, it had been felt by the staff and Executive Board that a stronger reserve position in relation to the large expansion of the Fund's credit activities would be desirable.

In the past year, the Fund had used new lines of credit when the first payments on its borrowing had become due, the Treasurer indicated. However, the Executive Board had agreed to repay maturing obligations under the policy on enlarged access from ordinary resources; that method of repayment had necessitated the decisions proposed at the present meeting. If the Fund were to call on the new lines of credit with the BIS, Belgium, Japan, and SAMA, the Fund's borrowing needs would be increased.

He wished to dispel the notion that there was a deliberate attempt on the part of the staff to reduce the level of borrowing by the Fund, the Treasurer stated. It had been the staff's understanding that the Executive Board was not in favor of increasing the Fund's borrowing needs. The proposed decision, as formulated, left open the possibility of using borrowed resources to repay maturing obligations should the Executive Board decide at any time that it was desirable to do so.

Mr. Morrell recalled that at the time of the Executive Board's decision to use ordinary resources to repay its loans, there had been no other lines of credit. The new lines of credit had been available for only about a month.

Mr. Polak noted that the Fund currently based the rate of charge for use of borrowed resources on a cost-plus and cost-minus principle. The staff had not proposed any deviation from that practice.

Mr. Coene said that it was his understanding that the interest rate on borrowed resources was determined by reference to the interest rate charged by the lenders to the Fund and not by reference to the characteristics of the purchases made by Fund members. It would be dangerous to set a rate of charge for borrowed resources that was not linked to the cost to the Fund of borrowing.

The Chairman considered that it would be appropriate to base the rate of charge for ordinary resources used in the financing of purchases under the enlarged access policy on the rate of interest to be paid by the Fund on its borrowing from SAMA under the 1981 loan agreement. The inclusion of a margin in the rate of charge was a way of improving the Fund's income position, thereby mitigating any future increase in the rate of charge.

Mr. Polak stated that the Fund should not charge its borrowing members the full cost to the Fund of its borrowing from SAMA, but should deduct any interest earned on investing those resources. The difference between the rate of interest paid to SAMA and the rate of remuneration was equal to the net benefit to the Fund.

The Treasurer remarked that the Fund normally incurred a loss on its investments. While he agreed that the rate of remuneration was the major cost to the Fund, at times when the interest rate on the SDR was higher than the rate of remuneration--which it would be for some time to come--the highest marginal cost to the Fund was the SDR rate.

The Deputy General Counsel stated that a redraft of the proposed decision would be circulated to Executive Directors for later consideration. 1/

2. INCOME POSITION FOR FINANCIAL YEARS 1984 AND 1985 - REVIEW

The Executive Directors considered a staff paper reviewing the Fund's income position for the financial years 1984 and 1985 (EBS/84/91, 4/24/84; and Sup. 1, 5/21/84).

1/ See EBM/84/84, 5/30/84.

Mr. Jayawardena remarked that the Fund's net income in financial year 1984 was expected to be in the order of SDR 69 million, about SDR 39 million in excess of the net income target for 1984. A deficit of about SDR 68 million was projected for 1985/86 based on the present rate of charge of 6.6 percent on the use of ordinary resources, the present SDR rate of interest, and estimated use of Fund resources.

The Rules of the Fund provided a number of options for disposing of 1984 income in excess of target: it could be used to decrease the rate of charge or to increase the rate of remuneration retroactively, or both in combination, or alterntively it could be added to the Fund's reserves, Mr. Jayawardena noted. There was also a provision in the Rules that allowed the income in excess of target to be deemed income for the subsequent financial year for the purpose of setting charges. The staff had expressed the view that given the projected deficit in the Fund's income position in financial year 1985 and the need for an increase in the rate of charge, it would be undesirable to retroactively decrease the rate of charge or increase the rate of remuneration. Although the staff had stated that it would be possible to moderate the rise in the rate of charge on the use of ordinary resources that would otherwise be necessary to cover the target income for 1985/86, it had suggested that the entire net income for 1984 should be placed to the special reserve. Furthermore, the staff had stated that the rate of charge would need to be set at 7.07 percent a year, instead of the present rate of 6.6 percent a year, in order to reach the net income target of 3 percent of reserves for 1984/85.

It was necessary to note a number of facts in order to place the issues in the right perspective, Mr. Jayawardena considered. First, the Board had repeatedly adopted a net income target of 3 percent of reserves. The Fund's need for reserves had been discussed at great length in December 1983, at which time it had been decided that an annual increase of 3 percent in reserves would be appropriate. However, over the past seven years, with the exception of 1980, net income had been significantly higher than 3 percent, and the entire excess income had been placed in reserves. As a result, reserves had grown at an annual average rate of about 7 percent from 1978 to 1983.

Second, staff estimates of the Fund's net income during the past several years had been highly conservative, Mr. Jayawardena noted. As charges were calculated on a "residual" basis, they had been overpitched, to the detriment of borrowers. Against that background, the most rational and fair disposition of excess income for financial year 1985 would be to reduce retroactively the rate of charge. Borrowers that had been overcharged, owing to erroneous estimates, would thereby be duly compensated. However, he found some force in the staff view that a retroactive reduction in the rate of charge or increase in the rate of remuneration would be undesirable because of the prospective increase in the rate of charge to meet the net income target for 1985/86. He saw no justification for the staff proposal that the net income of financial year 1984 should be placed in the special reserve.

To continue to increase reserves at the rate of the past several years, would render meaningless the Executive Board's decision to increase reserves by 3 percent a year, Mr. Jayawardena said, and would be against the interest of borrowers. The impact of any increase in the rate of charge should be moderated by deeming the excess income of 1984 as income for 1985. The Executive Board should bear in mind that the present rate of charge was not very concessional, and the Board's recent decision to increase the rate of remuneration would reduce concessionality even further. The excess income of 1984 should therefore be deemed as income for 1985 in order to moderate the projected rise in the rate of charge from 6.6 percent to 6.89 percent a year. He could not accept the staff argument that, in deeming the entire excess income of 1984 as income for 1985, the Executive Board would be planning for a deficit, because there was a proposal for increasing the rate of charge in order to cover the estimated deficit.

He was aware of the difficulties in making precise estimates because of the variability of the relevant factors, Mr. Jayawardena added, but the tendency of the staff to err in its estimates in one direction was a matter of concern. The Executive Board should consider the matter further and adopt policies and practices that would not place unnecessary and unfair burdens on borrowers, who by all accounts were facing a most difficult situation. Members that had been overcharged owing to errors of estimation should be compensated when such estimates resulted in excess income above the target. Such action had become all the more necessary because of the Executive Board's decision to increase the rate of remuneration over the next several years, a development that would have an adverse impact on the rate of charge. Finally, he agreed that the SDR rate of interest should be maintained at 100 percent of the combined market rate of interest and that a further review of charges should be made not later than the midyear review of the Fund's net income position.

Mr. Gomel commented that, like the staff, he did not favor a retroactive change in the rate of charge or rate of remuneration. His authorities would be willing to see part of the 1984 excess income above target deemed to be income for 1985 for the purpose of setting the rate of charge, which would not need to exceed 6.92 percent to cover the projected income deficit and to reach the net income target.

He was unconvinced by the staff proposal to place all of the 1984 net income to the special reserve, Mr. Gomel went on. As his chair had stated on previous occasions, his authorities had some qualms about the analysis offered by the staff thus far on the adequacy of reserves in relation to their use. In the present and previous reviews of the Fund's income position, indicators of the adequacy of reserves had been described in a rather loose manner, and no conclusive evidence had yet been put forward to confirm the view that the level and growth rate of reserves were still too low. Finally, he could agree with the staff proposals on the SDR rate of interest and the review of the Fund's charges.

Mr. Ismael remarked that the staff had put forward four possible options for disposing of the excess net income in 1984, but had favored placing the entire excess to reserves. On previous occasions, some Directors had been in favor of retroactively reducing the rate of charge. They had argued that as excess income had resulted from a higher than necessary increase in charges, net income in excess of target should logically be applied toward reducing charges. Other Directors, however, had preferred a different course of action. They had argued that as the rate of remuneration had been below the SDR rate, any excess in net income should be used to increase the rate of remuneration retroactively. Directors representing those opposing viewpoints had seen a compromise in the staff proposal to place the entire net income to reserves.

He was not in favor of that compromise, Mr. Ismael stated. There seemed to be a strong case for deeming the excess income in 1984 to be income for 1985 for the purpose of determining the rate of charge. First, the wishes of those Directors who favored an increase in the rate of remuneration had been met. The staff had allowed in its projection for an increase in the rate of remuneration, and there was no longer any need to use the excess net income to raise the rate of remuneration retroactively.

Second, the proposal to apply the excess income toward a retroactive reduction in charges had some merit, Mr. Ismael considered. It could, for example, be argued that excess income was the result of the increase in charges resulting from errors in estimation and that, therefore, any excess income should be applied first toward reducing charges. But he recognized that the retroactive application of either an increase in remuneration, or a decrease in charges, could be administratively cumbersome, and he did not favor such a course of action.

Third, the entire excess income could be placed in reserves, the course favored by the staff, Mr. Ismael noted. Although he agreed with the staff's statement that reserves were "a source of interest-free liquid resources that can be utilized in the Fund's operations and transactions," he had difficulty with its proposal to raise charges in 1985 in order to meet the operating deficit and to generate a surplus, which would be in line with past practice.

The world financial community and the debtor countries in particular were extremely concerned about the debt servicing problem, Mr. Ismael observed. Various proposals were being considered to alleviate that problem. At the same time, the Executive Board was considering proposals that would, in effect, require the debtor countries to contribute to the accumulation of Fund reserves. In the past six years, reserves had been growing at an average annual rate of about 8 percent, far above the 3 percent target. The Executive Board had also taken a decision to raise the rate of remuneration. In those circumstances, it was only fair that the burden of reserve accumulation should be shared more equitably by the Fund membership. The issue should be examined further, but, in the meantime, his preference would be to deem the 1984 excess income to be income for 1985 for the purpose of setting charges in 1985. In view of the rapid

rate of accumulation of reserves in the past six years and of the uncertainties surrounding the staff projections for 1985, he would prefer to leave the rate of charge for 1985 unchanged. But, if necessary, he was prepared to accept an increase in the rate of charge to 6.89 percent a year.

Ms. Bush said that she strongly supported the staff proposals. Her authorities were particularly concerned about the need to strengthen the net income and reserve position of the Fund. The package of measures proposed by the staff--placing all of the net income for 1984 in the special reserve and increasing the rate of charge to 7.07 percent, while maintaining the SDR interest rate at 100 percent of the combined market rate--was consistent with that objective. A modest increase in the rate of charge by less than 0.5 percentage point was necessary owing to the present level of the SDR interest rate, which reflected world economic developments, the earlier decision of the Executive Board to increase gradually the rate of remuneration in order to compensate more appropriately the creditors of the Fund, and also the need to reach the 3 percent net income target. It was worth noting that even a rate of charge of 7.07 percent was substantially concessional. The maintenance of the present 6.6 percent rate of charge would result in an ex ante net deficit of SDR 68 million, a figure that did not include any provision for a general salary increase, should one be approved, or for the $13 million in capital expenditures for the computer center. In addition, the Executive Board had increasingly been faced with problems of some members' overdue obligations to the Fund. It was evident that the countries that had recently opened lines of credit to the Fund were concerned about the soundness of the institution's financial position.

Over the longer term, it was necessary to have higher reserves as a cushion for the period when the lending activity of the Fund abated and when administrative expenditures did not decline correspondingly, Ms. Bush considered. Consequently, the Executive Board should take decisions that would help to preserve and strengthen the Fund's financial position at a time when the net income of the Fund had increased at a much slower rate than liquid claims on the Fund, outstanding purchases, and the gross income and expenses of the institution. She did not support the option of deeming any of the excess income in 1984 to be income for 1985.

Finally, according to Rule I-6(4)(b), if the Fund's net income in the first six months of financial year 1985 on an annual basis were below the target amount for the year by an amount equal to or greater than 2 percent of the Fund's reserves at the beginning of the financial year, the Board would have to consider how to deal with the situation at the midyear review of the Fund's income position, Ms. Bush observed. If no agreement had been reached by December 15, 1984, the rate of charge would automatically be increased to the point necessary to reach the net income target for the year. Such a pattern of events might result in a more abrupt change in the rate of charge than if the Executive Board were to take the prudent course at present and accept the proposed increase in the rate of charge to 7.07 percent.

Mr. Wicks said that three considerations had to be borne in mind in deciding on the disposition of the 1984 net income: the policy on accumulation of Fund reserves, the staff's income projection for financial year 1985, and recent developments with respect to the Fund's financial relations with its members. First, on reserve accumulation, his view had not changed since December 1983, when he had supported the staff's conclusion that it would be reasonable to accept for the next three years an actual increase in reserves that was greater than the target of 3 percent. Moreover, he still felt that an important purpose of maintaining reserves was to enable the Fund to meet contingent operating deficits.

Second, Mr. Wicks went on, the staff had projected a deficit of SDR 68 million in financial year 1985. A good deal of uncertainty surrounded that estimate, which was very sensitive to the assumptions on which it was based, particularly the level of interest rates. The staff's calculation that a 0.5 percent change in the average SDR rate for the year could cause a swing of SDR 82 million in the projected deficit was a very persuasive argument for prudence in disposing of the excess net income of financial year 1984.

Third, the late payment of charges by some members, which added further uncertainty to the Fund's income position, reinforced the arguments in favor of increasing reserves as a buffer against contingent operating deficits, Mr. Wicks continued. Those three considerations had led his authorities to choose the most prudent course in disposing of the 1984 excess income. They would once again refrain from pressing for a retroactive increase in the rate of remuneration in the expectation that those members that might wish for a retroactive decrease in the rate of charges would take an equally cautious view. His authorities supported the staff's recommendation that the SDR 39 million be placed to the special reserve.

It had been suggested by some Directors that charges should be held down by deeming net income from one year as income for the following year, as permitted under the Rules, Mr. Wicks recalled. The staff paper raised the question whether the SDR 39 million net income from financial year 1984 should be used in that way. His view on the use of net income was closely related to his view on the policy on reserves. It was perhaps worth recalling that higher reserves made a not insignificant contribution to the concessionality of charges by adding to the cost-free resources of the Fund; apart from the importance he attached to increasing reserves, he did see a drawback in the use of net income to hold down charges. As the staff had stated in an earlier paper: "Once the excess surpluses have been absorbed, charges might have to be steeply increased, depending on the level of market interest rates at the time, which could be difficult to achieve." For all those reasons, he could go along with the staff's recommendation to increase the rate of charge to 7.07 percent and to hold a further review in six months.

It was clear from the present discussion that some Directors might be reluctant to accede to an increase in charges because it might prove unnecessary, Mr. Wicks observed. If the deficit projected for financial year 1985 in fact turned out to be a surplus, the Executive Board could consider the position at the midyear review of the Fund's income position.

One way of eliminating uncertainty over the Fund's income position would be to change the method of determining charges, Mr. Wicks continued. He recognized that the Executive Board had looked at that issue in December 1983, and he regretted that the suggestions put forward by the staff had been rejected; he continued to see merit in relating charges to past use of Fund resources. Fixing charges quarterly would help to bring the timing of adjustment of charges into line with the frequency of repurchases. He hoped that the Executive Board could look again at the method of determining charges in the near future.

On three related points, Mr. Wicks said, first, that his chair had suggested in the past that it might be wise to invest some of the Fund's currency holdings in order to improve the institution's income position. Unless that suggestion were impractical, he would welcome some confirmation that it might be reviewed. Second, he agreed that it was timely to reconsider the Fund's policy on reserves, given the changing economic situation. Third, what would happen to the 1984 excess net income and the rate of charge if the Executive Board could not come to a satisfactory decision at the present meeting? Finally, he could accept the staff's recommendation to maintain the SDR interest rate at 100 percent of the combined market rate.

Mr. Agah remarked that, while the staff had appropriately analyzed the factors responsible for the excess over the 1984 net income target, he had some doubts about the desirability of endorsing the staff's recommendations regarding the disposition of net income in excess of that target and the rate of charge in the financial year 1985. A number of factors deserved consideration by Executive Directors before the review was concluded. First, it should be noted that since financial year 1978, the Fund's net income had almost consistently been in excess of 3 percent, largely owing to erroneous or conservative assumptions and estimates with respect to the Fund's operational income and expenses. It was only fair to recognize, however, that that period had been characterized by a number of major unforeseen developments that had made accurate forecasts almost impossible. Nevertheless, such estimates had consistently led to unnecessarily high charges for users of the Fund's resources, mostly the developing countries, although they had also resulted in an appreciable strengthening of the Fund's special reserve.

Second, the recent decision to increase gradually the rate of remuneration would put significant pressure on the Fund's operational expenses and would further increase the sensitivity of its net income position to interest rate variations, Mr. Agah went on. As the decision to increase the rate of remuneration would inevitably lead to an increase in the rate of charge, it would be desirable to find ways to moderate that increase as much as possible. Of all the options, the staff proposal would result in the largest increase in the rate of charge.

Third, the difficulties facing the non-oil developing countries had hardly abated in recent months, despite a relative recovery in world trade, Mr. Agah noted. The recent rise in international interest rates had offset all potential gains from the modest expansion of world trade and had made it particularly difficult for the developing countries to adjust to the changing circumstances and to pay their external debt.

Those factors should be prominent in a consideration of the two decisions relating to the disposition of income in excess of target and to the rate of charge for 1985, Mr. Agah stated. He agreed that, in view of the recent decision on remuneration and the projected operational deficit for 1985, it would be undesirable to decrease retroactively the rate of charge or increase the rate of remuneration. However, it would be equally undesirable to place all of the 1984 net income in the special reserve and to ignore the impact of a maximum increase in the rate of charge on the users of the Fund's resources. The decision to set a 3 percent target net income had been discussed extensively by the Executive Board before its adoption; there seemed to be no satisfactory reason for the staff to make recommendations that went beyond that decision.

He strongly supported the option to deem all 1984 income to be income in 1985 for the determination of the rate of charge, Mr. Agah continued. That option would appreciably cushion the effects of the recent revision in the rate of remuneration and was preferable to the staff's proposal, since the rate of charge might have to be increased further in financial year 1985 if international interest rates remained at their present high level.

He had no difficulty in going along with the staff's recommendations to maintain the SDR interest rate at 100 percent of the combined market rate and to review the rate of charge not later than the time of the mid-year review, Mr. Agah went on. Finally, there was an inconsistency in the Executive Board's decision relating to the rate of charge. While a shortfall from the Fund's net income target almost automatically resulted in an increase in the rate of charge at the time of the midyear review of the Fund's income position, there was no comparable provision for reducing the rate of charge at the midyear review if the target were exceeded. That matter deserved careful consideration by the Executive Board.

Mr. Laske welcomed the fact that the Fund's net income for financial year 1984 had been above the established target for the increase in reserves. There were various options available for dealing with the surplus in net income, some of which he would consider inappropriate under current circumstances. The staff had made a convincing case for placing the total net income in 1984 to the Fund's special reserve, a proposal that he strongly supported. The increased lending of the Fund made an increase in reserves seem necessary, as did the increased incidences of overdue payments to the Fund. In past discussions, his chair had supported a higher target than 3 percent for the increase in reserves, and he joined Mr. Wicks in suggesting that the Executive Board review its decision. In the present uncertain world economic situation, the Fund should follow a prudent course.

The staff had projected a sizable net deficit for the Fund in financial year 1985, based on assumptions of stable interest rates and charges, Mr. Laske noted. Owing to the high sensitivity of the Fund's net income position to changes in market interest rates, the deficit might well be larger if interest rates were to increase further. A deterioration in the income position of the Fund should not be tolerated, and an increase in the Fund's rate of charge was therefore unavoidable. He strongly supported the staff's proposal to increase the rate of charge to 7.07 percent. Finally, he supported the other proposals in the draft decision.

Mr. Hirao said, that a retroactive decrease in the rate of charge or increase in the rate of remuneration would not be an appropriate way to dispose of the 1984 net income in excess of target, because of the deficit projected for the financial year 1985. One option was to deem part of the net income in excess of target to be income for 1985, thereby moderating the projected rise in the rate of charge. While he could understand the desirability of maintaining a relatively stable rate of charge, it should be noted that in recent years the Fund's reserves had increased at a much slower pace than the increase in outstanding purchases and in liquid claims on the Fund. The ratio of reserves to outstanding purchases had declined from 8.6 percent at the end of the 1980 financial year to 4.2 percent in financial year 1983. At the time of the Executive Board's discussion of the midyear review in December 1983, the staff had expressed the view that net income should be allowed to exceed the target on occasion, in view of the Fund's relatively low reserves. He had endorsed that view. The excess net income of SDR 39 million might be relatively large in relation to the target of a 3 percent increase of reserves, but it was small relative to total Fund income and expense. The staff paper showed that a deviation of such magnitude could easily be caused by only a small change in the SDR interest rate. His preference, therefore, was to place the small, incidental excess net income to the special reserve. On the basis of those considerations, he supported the proposal to set the rate of charge for financial year 1985 at 7.07 percent. Finally, he agreed that the SDR interest rate should be maintained at 100 percent of the combined market rate.

Mr. Senior indicated agreement with Mr. Jayawardena and Mr. Ismael. His authorities' views on the Fund's income position had been expressed in great detail at previous discussions on the subject. The present review of the Fund's income position made patently clear the difficulties of estimating the Fund's income with any degree of accuracy. The original estimate for 1984 net income of SDR 93 million had been revised to SDR 52 million in November, and at present was reported to be SDR 69 million. While that outcome was not completely unexpected, the deviation from the original projection was quite significant when compared with the outcome in the past few years, as interest rates had not changed markedly in 1984 from the average figure of the first half of the financial year. In the past, interest rate movements had explained the difference between initial estimates and the actual outturn of net income; the absence of that factor in 1984 underscored the importance of other factors in explaining the final outturn.

The staff was estimating a deficit of about SDR 68 million in 1985, based on the present rate of charge on the use of ordinary resources, the present SDR rate of interest, and the estimated use of Fund resources, Mr. Senior observed. No doubt the staff had again been conservative in its estimates. However, he agreed with the staff that, there was no justification for a retroactive decrease in charges. In addition, the recent decision to increase gradually the rate of remuneration provided no justification for a retroactive increase in the rate of remuneration.

Nevertheless, he could not accept the staff proposal that excess net income in 1984 should be placed in the special reserve, Mr. Senior stated. The Executive Board's decision on the appropriate rate of reserve accumulation should not be changed in a roundabout way by increasing reserves faster than the 3 percent target through the transfer of excess income to the special reserve. That option seemed even less justified in view of the estimate of negative net income for 1985. It would be much more appropriate to deem the excess income to be income for 1985, as the Rules allowed. Charges could then be increased by less than the staff proposed, or not at all. He strongly agreed with those Directors who proposed that the present rate of charge should be maintained until the midyear review. Assuming that the additional income in 1984 would be deemed income in 1985 and assuming a certain margin of error in the staff's estimates, there might be no need for an increase in the rate of charge. Finally, he agreed with the staff's proposal to maintain the SDR rate of interest at 100 percent of the combined market rate.

Mr. Blandin remarked that his position would be similar to the one taken by his chair at the December 1983 discussion of the Fund's income position. His authorities considered that the 3 percent target for an annual increase in reserves remained appropriate to preserve the Fund's reserve position and financial soundness. The net income of the Fund for 1984 was estimated at SDR 69 million, about 7 percent of the Fund's total reserves. The excess of income over target for 1984 should be deemed income of 1985 so that the rate of charge could be kept at the lowest possible level. However, for the reasons put forward by the staff on page 15 of EBS/84/91, he would be ready to accept a rate of charge of 6.92 percent for financial year 1985, and to deem part of 1984 excess income to be income for 1985. At the time of the midyear review, it might be possible to adjust the rate of charge for the remainder of the financial year.

Mr. Joyce agreed that it was difficult, if not impossible, to achieve the targeted net income of 3 percent, given the unpredictable variations in market interest rates and in the use of Fund resources. The role of reserves in a cooperative intergovernmental institution such as the Fund could be looked at in many ways. Clearly, the main guarantee of the Fund's financial viability was the continued commitment of its members. But the staff and the Executive Board must also make certain that the institution pursued sound and responsible financial management practices and policies. They should ensure that access to Fund credit did not strain available resources and that there was a high probability that all

repurchases would be made on time. For those reasons, he did not wish to overemphasize the role of reserves. While reserves had an important role to play in offsetting potential losses arising from unexpected developments, the primary focus should be on ensuring that the budget was constructed and reviewed in such a way that the Fund could take early action to prevent deficits from arising. The midyear budget review was therefore important.

The proposal to place the 1984 net income to reserves was the only prudent course of action, given the possibility that rising interest rates could have an adverse effect on the Fund's financial position, Mr. Joyce concluded. The net income target should continue to be set at 3 percent of reserves; the Fund's policy on reserves did not need to be reviewed at present. The excess of net income above the 3 percent reserve target should not be deemed net income for financial year 1985 in order to reduce the rate of charge. The rate of charge for financial year 1985 should, at a minimum, be set at 7.07 percent, the rate required to achieve a net income equal to 3 percent of reserves. He had some doubts whether that rate of charge would, in fact, be sufficient to meet the 3 percent target, in the light of recent interest rate movements, but he was prepared to take that risk so as not to compound the financial problems of borrowing members. The appropriateness of a 7.07 percent rate of charge should be reconsidered at the midyear review of the Fund's income position.

Mr. Mtei recalled that at EBM/83/172 and EBM/83/173 (12/14/83), Directors had agreed to accept the staff's recommendations, because a favorable outcome for the Fund's income position for financial year 1984 had been projected. The final figures submitted in EBS/84/91 confirmed that the Fund's net income position was even better than estimated in December 1983. However, the projected outcome for financial year 1985 was quite different, showing a sizable deficit that had obvious implications for the cost of ordinary resources used by members with balance of payments needs.

Over the years it had become apparent that the staff had encountered problems in making precise estimates of net income for any financial year, Mr. Mtei continued. As Mr. Jayawardena had pointed out, since 1978 the final outcome had almost always been better than the original projections, suggesting a certain measure of conservatism in staff estimates. He realized that the underlying assumptions were clouded by many uncertainties, but when the deviations from the projections went in one direction only, questions were likely to be raised and doubts cast on the conclusions to be drawn from future projections. How could the estimates be improved? The importance of reducing the discrepancies, particularly to the users of Fund resources, could not be overemphasized. The pressure to raise the rate of charge stemmed not only from the pessimistic estimates of the Fund's income position, but from the recent decision to increase the rate of remuneration.

His authorities considered that it was important to undertake as soon as possible an exercise to improve the methods of estimation, since the pessimistic estimates of the Fund's net income position had tended to

place a heavier burden on the users of Fund resources, Mr. Mtei went on. The Board had thus far accepted the argument that excess income should be placed to reserves, rather than used to reduce the rate of charge. Consequently, the rate of growth of reserves since 1978 had averaged 7 percent a year, against the Executive Board's target of 3 percent a year. He shared Mr. Jayawardena's and Mr. Ismael's comments on that matter.

The staff had set out some of the various options for the disposal of the Fund's excess income, Mr. Mtei noted. His chair supported the proposal to deem all of the excess income for 1984 to be income for 1985 for the purpose of determining the rate of charge for that financial year. There was a need to maintain the concessional and cooperative character of Fund assistance. The Fund's exposure in many developing countries, particularly low-income countries, had increased, and any slight rise in the rate of charge would aggravate their debt service burden. If the 1984 excess income was deemed income for financial year 1985, the rate of charge would need to be increased only from 6.6 percent to 6.89 percent.

The staff had indicated that to deem the whole of the excess to be income for 1985 would imply that the Fund was planning for a deficit amounting to the difference between the net income target for 1985 of SDR 32 million and the 1984 excess income of SDR 39 million, Mr. Mtei observed. To deem the entire excess income in 1984 to be income in 1985 would not be at variance with sound financial planning, particularly as the final outturn might prove to be better than forecast, based on the staff's forecasting record. He could not support the proposal to place net income in excess of target in 1984 to the special reserve. Consequently, the proposal to set the rate of charge at 7.07 percent was not acceptable to him; he would favor a rate of charge that did not exceed 6.89 percent. Finally, he had no problem with the proposals to maintain the SDR rate at 100 percent of the combined market rate of interest and to hold a further review of the Fund's charges not later than at the time of the midyear review of the Fund's net income position.

Mr. Doe said that the staff's explanation for the better than expected net income position in 1984 was plausible. Given the large number of variables that affected the Fund's income and expenses and the uncertainties surrounding their evolution, he could understand how a deviation between the forecast and actual outcome might arise. However, the projections of the Fund's net income position might have been too conservative during the past few years. From 1981 to 1984, with the exception of 1983, there had been a substantial gap between the midyear estimate of net income and the actual outcome that had reached a high of SDR 39 million in 1982, reflecting an income position consistently better than projected. He was fully aware of the difficulties that the staff faced in preparing the forecasts. However, since the rate of charge was determined on the basis of the estimated income and expenses of the Fund, the staff should try to make less conservative estimates.

As for the disposition of the excess net income in 1984, he agreed with the staff that a retroactive decrease in the rate of charge or increase in the rate of remuneration might be inappropriate, Mr. Doe went on. However, he had reservations about the proposal to place the full amount of the excess of SDR 39 million to the special reserve. He had some difficulty with the implication that Fund reserves in relation to borrowed resources were low. What did the staff mean by low? Unless major losses were foreseen, the need for drawing down the reserves in the near future was small. Furthermore, as indicated by other Directors, reserves had grown at a much faster rate than had been targeted by the Board. If the staff considered that a 3 percent annual increase in reserves was too low, a case should be made for increasing the target and recommendations put forward regarding the appropriate rates of charge and remuneration. Otherwise, the impression could be given that detours were being taken in order to circumvent the 3 percent target for growth of reserves.

His views should not be misinterpreted as lack of support for the objective of increasing reserves, Mr. Doe continued. On the contrary, he favored a strong reserve position for the Fund so that it could withstand adverse developments. In that context, he would support an arrangement whereby part of the excess income would be placed in reserves and the remainder applied toward income in 1985 with the aim of moderating the rise in charges to 6.92 percent. Finally, he supported the other suggestions made by the staff regarding the SDR rate and the timing of the midterm review.

Mr. Polak noted that the rates of charge supported by Executive Directors ranged from 6.89 percent to 7.07 percent. That difference of 0.18 percent was less than the "small margin" of 0.2 percent referred to in the staff paper on charges on holdings outstanding under the policy on enlarged access. He would be brief, as he agreed with most of the points made by Ms. Bush and Mr. Wicks. In view of the Executive Board's concern about the level of the Fund's reserves, he supported the staff's proposal for placing all of the net income of 1984 in the Fund's special reserve. An increase in reserves was good for the Fund in the long term and was neutral for the debtors of the Fund because the reserves constituted a base for the concessionality of charges in the future. As the Executive Board had recently decided to maintain the present method of determining the rate of charge, he could support the proposed rate of charge of 7.07 percent. In conclusion, he agreed with the other proposals put forward in the staff paper.

Mr. Zhang said that the Executive Board should adopt the option of deeming the excess income of 1984 to be income in 1985 for the determination of the rate of charge, for a variety of reasons. First, the staff's proposal to place 1984 net income into the special reserve was not warranted; the Executive Board had decided to increase the Fund's reserves by 3 percent a year, and, in fact, during the past several years a substantial amount of excess income had already been placed in the reserve. Second, he could accept the staff's argument that a retroactive reduction in the rate of charge or an increase in the rate of remuneration in 1984

would be undesirable because of the higher rate of charge that would be necessary to meet the net income target of 1985. Third, by deeming the excess income of 1984 to be income of 1985, the Fund would find it possible to moderate the increase in the rate of charge from 6.6 percent to only 6.89 percent in 1985.

He could accept the staff's proposal to maintain the SDR rate of interest at 100 percent of the combined market rate of interest and to hold a further review of the rate of charge not later than the midyear review of the Fund's net income position, Mr. Zhang continued. Finally, could the staff explain why it had underestimated the Fund's income over the past several years? What had prompted the staff to make such conservative projections?

Mr. Arias stated that the Executive Board had taken the decision to increase the Fund's reserves by 3 percent a year. Therefore, the entire net income of SDR 39 million in 1984 should be deemed as income for 1985, and the rate of charge adjusted accordingly. Finally, he could agree to the remaining staff proposals.

Mr. Donoso stated that he agreed with the arguments presented by Mr. Senior, Mr. Ismael, and Mr. Jayawardena. The Fund's net income for the financial year 1984 had been estimated at SDR 60 million, a figure that was within the range of the initial staff projections and well above the figure presented on the occasion of the midterm review in December 1983. The projections for the Fund's income position in financial year 1985 were based on a set of assumptions regarding demand for Fund credit, the rates of remuneration and charge, and the expected level of the SDR interest rate. It was projected that, at the current SDR interest rate and rate of charge for the use of the Fund's ordinary resources of 6.6 percent, there would be a net deficit of SDR 68 million in financial year 1985.

Under the assumptions presented by the staff, the achievement of the net income target for 1985 would require an increase in the rate of charge on the use of the Fund's ordinary resources to 7.07 percent a year, Mr. Donoso observed. However, the magnitude of the deficit expected for 1984/85 could be reduced by deeming the excess of income in 1984 to be income for 1985; the rate of charge necessary to achieve the income target in financial year 1985 would then be 6.89 percent rather than 7.07 percent. He supported an increase in the rate of charge to a level that would, based on the present projections, permit the Fund to reach a net income target of 3 percent of reserves in 1985 after deeming the excess income of 1984 as income in financial year 1985, namely, a rate of charge of 6.89 percent in 1985.

Mr. Coene said that his chair considered that the present policy on reserve accumulation was appropriate and that, under the present circumstances, it was important to try to limit the increase in the rate of charge. He would agree to deem either part or all of the net income of 1984 to be income of 1985. He supported the proposal to maintain the SDR interest rate at 100 percent of the combined market interest rate and to hold a further review at midyear.

Mr. Morrell commented that his chair had always expressed the need for a strong and financially sound Fund, and it was with that in mind that he had considered the proposals before the Executive Board. His authorities supported the staff's decision for the reasons put forward by a number of other Directors. A variety of factors--including increased borrowing by the Fund, overdue obligations by some members, and variations in interest rates--suggested that there was a need for prudence with respect to the Fund's income position. He supported the staff proposal to place the entire excess income of 1984 to the special reserve.

Perhaps the 3 percent increase in reserves should be considered a guideline rather than a target, Mr. Morrell continued. The disposition of the Fund's income should be considered at the midyear review of the Fund's income position and at the end of the financial year. Given the many uncertainties, it was inappropriate to regard the 3 percent increase in reserves as a target. In the present year, reserve growth of 3 percent was too low. Even the average growth of reserves of about 7 percent a year over the past few years did not seem to be sufficient, given the increase in the lending activities of the Fund.

Mr. Finaish observed that the staff projections of the Fund's income position had been subject to a certain margin of error, owing to the inherent difficulties of the exercise and perhaps also to cautious estimates of use of Fund's resources; consequently, there had been a tendency to underestimate net income. The scope for error was greatly compounded by the uncertainties surrounding the future interest rate of the SDR. A 0.5 percent increase or decrease in the present assumption of a 9 percent SDR rate would make a difference of about SDR 82 million for net income, causing either a possible doubling of the projected deficit for 1985 or a surplus of SDR 14 million. An alternative to the present method of basing estimates on prevailing interest rates was to forecast interest rates. Unfortunately, that was a difficult and potentially counterproductive exercise; therefore, the present staff projections of net income had to be accepted despite their inevitable limitations.

Nevertheless, he was not totally convinced by the arguments in favor of placing all the surplus income in 1984 to the special reserve, Mr. Finaish continued. Certainly, reserve augmentation was a desirable objective that was being met through the annual increase of 3 percent as agreed by the Executive Board. The question under consideration was how to dispose of the excess income in accordance with the Fund's Rules. The case had been made for deeming at least part of the SDR 39 million excess income in 1984 to be income in 1985 for the purpose of setting the rate of charge, an option that would allow a more moderate increase in the rate of charge and would, therefore, be more appropriate in view of the already heavy burden of debt service obligations of many members. Moreover, some Executive Directors had argued during the discussion on the rate of remuneration in December 1983 that the effect of the increase in the rate of remuneration on the rate of charge should be mitigated by the use of excess income above the 3 percent target. The staff pointed out in EBS/84/91 that, of the 0.47 percent increase in the rate of charge

proposed by the staff, about two thirds was attributable to the increase in the rate of remuneration. It seemed reasonable therefore for the rate of charge to be set lower than the 7.07 percent suggested by the staff. Finally, he could go along with the proposal to maintain the SDR rate of interest at 100 percent of the combined market rate.

Mr. Tvedt indicated that he had come to the present meeting without holding any firm position on the issues being addressed. The staff's arguments in support of its recommendations were rather convincing, as were the many interventions by Directors in support of the staff's proposals. However, other Directors had been in favor of deeming excess income in financial year 1984 to be income in 1985, thus limiting the needed increase in the rate of charge. On balance, he could support the idea of a smaller upward adjustment on the rate of charge than that proposed by the staff, without jeopardizing the net income target for the financial year 1985 and without planning to run an operating deficit.

Mr. Nimatallah remarked that it was encouraging that the reserve target for 1984 had been met comfortably, as it was in the interest of all members to ensure that the Fund remained financially strong. He could go along with the main projections for financial year 1985. The estimates were extremely sensitive to changes in market interest rates, but he agreed that it would be difficult for the Fund to make accurate forecasts of interest rate movements. He had an open mind about the disposition of excess income of the Fund in financial year 1984. The staff's suggestion to place the excess in the special reserve would further strengthen the Fund's financial position and its credit standing, thereby benefiting all members. However, in the light of present circumstances and until the Executive Board reviewed the question of Fund reserves, he was in favor of the option to deem SDR 32 million of excess income in 1984 to be income in the financial year 1985 and to place SDR 7 million to reserves. The staff had outlined the arguments supporting the proposal, in particular, that the increase in charges could be limited to 6.92 percent and that it would be an equitable way of covering the projected deficit. There were several ways of dividing the 1984 excess income; a combination that would result in a rate of charge of 7 percent might be appropriate.

The Treasurer noted that a number of Directors had expressed the view that the staff estimates had erred consistently in one direction and that the staff had based its estimates on conservative assumptions. The staff would continue to try to be as accurate and objective as possible; he assured Directors that the staff was cautious, but not conservative or biased in any direction. The staff's overestimation of SDR 39 million was relatively minor in proportion to the Fund's total income of SDR 5.5 billion in 1984. If the Fund's actual income in 1985, projected to be SDR 7.1 billion, deviated from the forecast by only 0.5 percent, the reserve target of 3 percent would not be met. Furthermore, if the absolute level of the SDR rate of interest changed by only 0.5 percent, there would be a swing in the Fund's net income position about 2.5 times larger than the reserve target of 3 percent. The errors in estimation were extremely small in relation to the Fund's total income and expense, and were not in one direction only.

It would be possible to strengthen the Fund's net income position by investing the Fund's reserves if the Executive Board so agreed, the Treasurer indicated. On several occasions in the past, however, the Executive Board had not favored such action, for two reasons. First, the income that could be derived from such investment was equal to the margin between the rate of remuneration or the SDR interest rate and whatever could be obtained in the market. That difference was small and depended on the maturity of the investment and the risk that the Fund would be willing to take in making such investments. As it would be advisable to hold liquid investments and as the Fund would want to minimize the capital risks, the margin that could be obtained between the SDR rate or the rate of remuneration, which would be converging in the next few years, and market rates of interest was extremely small and would not contribute significantly to strengthening the Fund's income position.

Second, the Fund, by investing some of its assets, would be giving up extremely liquid resources that might be needed to expand credit and to meet loan claims, the Treasurer remarked. Third, one objection raised had been that such investment would indirectly support the currency and benefit the balance of payments position of those countries in which the Fund would invest.

According to the Articles of Agreement, the Executive Directors should decide on the disposition of the Fund's net income at the end of the financial year, the Treasurer went on. Directors could choose to place the net income in the general reserve or in the special reserve, or they could decide to distribute it to the membership in proportion to quotas. The staff was suggesting that the net income should be placed to the special reserve because the special reserve could not be distributed to the membership, but would be used to pay any deficit in the Fund's income position. If Executive Directors decided to deem all or part of the 1984 excess income to be income in 1985, the Fund would be planning for a deficit in the next financial year.

The Chairman observed that Directors agreed that there should be no retroactive decrease in the rate of charge or retroactive increase in the rate of remuneration. Furthermore, Directors were in favor of maintaining the SDR rate of interest at 100 percent of the combined market rate of interest and of holding a further review of the rate of charge not later than at the time of the midyear review of the Fund's income position.

In the absence of a distribution to member countries or of a retroactive reduction in the rate of charge or a retroactive increase in the rate of remuneration, 1984 net income would be placed to the special reserve, the Chairman continued. That left the question of whether to deem all or part of 1984 income in excess of target to be 1985 income for the purpose of setting charges. Seven Executive Directors, representing something less than 49 percent of the voting power, were in favor of not deeming any of 1984 excess income to be income in 1985, which would require that the rate of charge be set at 7.07 percent in 1985. Ten Executive Directors, representing something less than 32 percent of the voting

power, were in favor of deeming all of the excess of income in 1984 to be income in 1985 for the purpose of determining the rate of charge, which could then be set at 6.89 percent. Seven Executive Directors, representing some 26 percent of the voting power, could agree to deem part of the excess in 1984 to be income in 1985. Of the Directors favoring that option, some could accept a rate of charge of 6.92 percent, and others preferred a rate of charge of 6.89 percent. One Director, representing somewhat less than 5 percent of the voting power, preferred to keep the present rate of charge and to reappraise the situation at the midyear review of the Fund's income position.

Some Directors' positions overlapped, the Chairman indicated. Fourteen Executive Directors, representing some 45 percent of the voting power, could accept a proposal to deem either the whole or part of the 1984 excess income. A 70 percent majority was required for any decision on a change in the rate of charge.

The Director of the Legal Department stated that, in order to deem any of the excess income in 1984 to be income in 1985, the entire net income must first be placed to reserve. However, the change in the rate of charge that was under consideration as a result of the deeming required a majority of 70 percent. If no compromise decision could be reached with respect to deeming part or all of the excess income or to a change in the rate of charge, the present rate of charge would remain. If it appeared at the time of the midyear review that the 3 percent reserve target could not be reached by the end of financial year 1985, the charges would automatically be adjusted in order to meet that target, unless the Board decided otherwise at that time.

Responding to a question from Mr. Wicks, the Director explained that if no decision were reached at the present meeting, and the rate of charge were automatically increased at the midyear review, it would stay at that figure unless and until a further decision had been taken, by a 70 percent majority, to adjust the rate.

The Treasurer, in response to a question by Mr. Wicks, confirmed that if no decision were taken at the present meeting to increase the rate of charge, the level required to meet the income target at the time of the midyear review was likely to be higher than the 7.07 percent currently proposed by the staff.

Mr. Polak noted that, assuming the staff's projections were accurate, the increase in the rate of charge at the time of the midyear review would be double the increase proposed at present, as there would only be six months to raise the Fund's income to the target level.

The Chairman stated that the situation would be even worse if international interest rates were to increase further. He encouraged the Executive Directors to reach a compromise solution, as it would be inadvisable to maintain the rate of charge at the present level with the presumption that it would have to increase significantly at the time of

the midyear review. The Executive Directors could choose either not to deem any 1984 excess income to be income in 1985, and to set the rate of charge at 7.07 percent, or to deem part of 1984 income to be income in 1985 in order to limit the increase in the rate of charge to about 6.92 percent.

Mr. Senior indicated that he could go along with an increase in the rate of charge to 6.89 percent after deeming the entire excess income in 1984 to be income in financial year 1985.

Mr. Laske inquired what the rate of charge would be if one half of the excess net income--about SDR 20 million--were to be deemed income for 1985.

The Treasurer indicated that the rate of charge could then be set at about 6.97 percent.

Mr. Polak inquired about the proportion of net income that would have to be deemed in order to set the rate of charge at 7 percent.

The Treasurer stated that SDR 15 million of the excess income would have to be deemed in order to set the rate of charge at 7 percent.

Mr. Zhang inquired whether the Executive Board could decide at the present meeting that, if net income turned out to be in excess of target in the financial year 1985, as a result of an increase in charges, the rate of charge could be reduced retroactively.

The Director of the Legal Department remarked that such a decision would be possible from a legal point of view, although it should be noted that some of the other provisions in the Rules called for a decision to determine the rate of charge to be made at the beginning of the financial year and at the midyear review of the Fund's income position.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/84/82 (5/29/84) and EBM/84/83 (5/30/84).

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to an Executive Director as set forth in EBAP/84/111 (5/25/84) is approved.

APPROVED: December 10, 1984

LEO VAN HOUTVEN
Secretary