FOR AGENDA

EBS/83/75

CONFIDENTIAL

April 18, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Review of the Fund's Income Position for the Financial Years 1983 and 1984

Attached for consideration by the Executive Directors is a paper on a review of the Fund's income position for the financial years 1983 and 1984. Recommendations appear on page 21.

It is proposed to bring this subject, together with the paper on a review of the sales of SDRs and proposal on the level of the Fund's SDR holdings (SM/83/63, 4/18/83), to the agenda for discussion on Monday, May 16, 1983.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. D. H. Brown (Division Chief, ext. 73288).

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Review of the Fund's Income Position for the Financial Years 1983 and 1984

Prepared by the Treasurer's Department

Approved by W. O. Habermeier

April 18, 1983

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 that the Executive Board will consider the disposition of any net income in excess of the target amount of income for the year. 1/ 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 and on the same occasion review the rate of remuneration.

This paper presents in Section II the income and expense of the Fund that are expected for the current financial year ending April 30, 1983 and some estimates of the Fund's income and expense for the financial year ending April 30, 1984. 2/ The possible disposition of the net income for 1983 as well as the rate of charge, the rate of interest on the SDR and the rate of remuneration proposed for 1984 are discussed in Section III. As requested by some Executive Directors a note on the Fund's reserves is provided in Appendix II.

The review of the Fund's income position for 1983 is based on actual results for the ten months ended February 28, 1983 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. A paper providing information on the operations and income derived from the temporary investments in the Borrowed Resources Suspense Accounts is being circulated separately.

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

2/ Unless otherwise stated, references in the paper to 1983 and 1984 are to the financial years ending April 30, 1983 and April 30, 1984.

II. Income Positions in 1983 and 1984

A. Financial year 1983

When the Fund's income position for 1983 was estimated in April 1982, the outlook was for a deficit in the order of SDR 100 million. 1/ In the light of this expected deficit, the Executive Board agreed a number of measures involving 1982 and 1983 income, including the following: 2/

(i) to place the net income amounting to SDR 92 million for the financial year 1982 to the special reserve;

(ii) to amend Rule I-6(4) to enable the Executive Board to deem any part of net income earned in excess of the target amount for the year, and that had been placed to reserve, as net income of the subsequent financial year for the purpose of setting the rate of charge in that year and for the automatic revision, if necessary, on the basis of the mid-year review; and

(iii) for 1983, it was decided:

- to adhere to the target amount of an increase of 3 per cent in the Fund's reserves at the beginning of 1983,

- to raise the rate of charge for the use of the Fund's ordinary resources from 6.25 per cent to 6.6 per cent per annum with effect from May 1, 1982,

- to maintain the rate of remuneration at 85 per cent of the SDR interest rate,

- to reduce the level of the Fund's SDR holdings over the period to end-May 1983 to a level of about SDR 4 billion, implying an average level of holdings over the financial year of about SDR 4.25 billion, 3/ and

- to place the entire net income earned in 1982 to the special reserve and to deem it to be net income for 1983 for the purpose of determining the 1983 rate of charge. This was done in order to avoid a sharper increase in the rate of charge that would have been

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1/ See "Review of the Fund's Income Position for the Financial Years 1982 and 1983," EBS/82/75 (4/29/82), and Supplement 1 (5/21/82).

2/ See "Statement by the Managing Director on the Fund's Income Position for Financial Years 1982-83 and Proposed Decisions," Buff Document 82/87 (6/4/82) and EBS/82/75, Supplement 2 (6/10/82).

3/ Since average holdings of about SDR 4.5 billion had been assumed in preparing the estimates of the 1983 income position, this downward adjustment in the average holdings had the effect of increasing the estimated deficit from SDR 100 million to SDR 105 million.

necessary to achieve the target increase in reserves in 1983 and which, because of the uncertainties surrounding the estimates for 1983, might have proved excessive.

Despite the increase in charges, it was estimated that for 1983 a deficit of SDR 63 million would be incurred. 1/

The Fund's income position was last reviewed by the Executive Board in December 1982 in connection with the mid-year review as provided by Rule I-6(4)(b). 2/ At that time, net income for the six months ended October 31, 1982 amounted to SDR 3 million and net income for the year as a whole, assuming no further change in interest rates, was estimated at SDR 61 million. The Executive Board agreed that there should be no adjustment at that time either of the rate of charge or of the rate of remuneration. 3/

Since the mid-year review, the outlook for the Fund's net income position has improved further. It is now estimated that net income for 1983 will amount to SDR 57 million, after taking into account the adjustment discussed below, as compared with an estimated net income of SDR 61 million made in October 1982 (Table 1). The improvement in the net income position of the Fund since mid-1982 has been due largely to two factors: (i) the sharp, and until the end of February 1983, virtually continuous fall in interest rates which resulted in a large decline in the amount of remuneration paid by the Fund, and (ii) a smaller than estimated average use of the Fund's resources taking the year as a whole.

(i) The SDR interest rate eased from 12.15 per cent in May 1982 to 8.47 per cent in the quarter to March 31, 1983; the rate of remuneration accordingly declined from 10.33 per cent to 7.20 per cent. For the quarter beginning April 1, 1983, the SDR interest rate and the rate of remuneration increased marginally to 8.52 per cent and 7.24 per cent, respectively. As can be seen from Table 2 the fall in interest rates since the beginning of the Fund's financial year has had the effect of improving the Fund's net income position by SDR 136 million from the estimates presented in April 1982 and explains virtually all of the improvement in the Fund's net income as compared with the original estimate a year ago.

(ii) Another factor which helped to improve the Fund's net income in a minor way was a slightly smaller average use of the Fund's ordinary resources than had been originally estimated because some purchases were made later than had been expected so that the average daily balances, to

1/ The estimated deficit of SDR 105 million reduced by SDR 42 million expected to derive from the increase in the rate of charge from 6.25 per cent to 6.6 per cent as from May 1, 1982.

2/ See "Review of the Fund's Income Position," EBS/82/210 (11/23/82), discussed at Executive Board Meeting 82/160, December 15, 1982.

3/ Minutes Executive Board Meeting 82/160, December 15, 1982.

Table 1. Estimated Income and Expense
For the Financial Years 1983 and 1984

(In millions of SDRs)

	Actual Ten Months Feb. 28, 1983	FY 1983 Estimates: Preliminary Estimates April 1982 1/	FY 1983 Estimates: Preliminary Estimates November 1982	FY 1983 Estimates: Revised Estimates	Preliminary FY 1984 Estimates: With Quota Increases 2/	Preliminary FY 1984 Estimates: Without Quota Increases
1. Operational Income						
a. Periodic charges						
Regular facilities	587	792	735	752	1,297	1,297
Oil Facility	19	21	20	20	--	--
SFF	494	805	670	597	728	728
Enlarged Access	140	330	201	178	559	559
Total charges	1,240	1,948	1,626	1,547	2,584	2,584
b. Interest on SDR holdings	389	516	440	445	341	199
c. Other income						
Regular facilities	32	32	36	41	46	46
SFF	8	11	11	10	6	6
Enlarged Access	4	15	7	6	30	30
Total	1,673	2,522	2,120	2,049	3,007	2,865
2. Operational Expense						
a. Remuneration	802	1,246	970	981	1,454	1,342
b. Interest expense						
GAB	26	31	31	31	16	16
Oil Facility	16	18	17	17	--	--
SFF	487	794	659	587	714	714
Enlarged Access 3/	137	325	198	175	548	548
Total	1,468	2,414	1,875	1,791	2,732	2,620
3. Net operational income	205	108	245	258	275	245
4. Administrative expense	148	171	184	201 4/	182 4/	182 4/
5. Net income	57	-63	61	57	93	63
Pro memoria 5/						
Oil Facility	3	3	3	3	--	--
SFF	15	22	22	20	20	20
Enlarged Access	7	20	10	9	41	41

1/ Original estimate of SDR 100 million adjusted for the decision to reduce the Fund's holdings of SDRs to SDR 4 billion over the year and to increase the rate of charge to 6.6 per cent.
2/ Assuming the quota increases are effective as from December 31, 1983; no assumptions are made on the use of credit tranches and CFF as a result of higher quotas.
3/ Less net income from temporary investments held in the Borrowed Resources Suspense Account.
4/ Administrative expense includes recognition of the value of accumulated annual leave and earned separation grants.
5/ Net income including "other income" from the service charge of 0.5 per cent.

Table 2. Revision of the Estimates
For the Financial Year 1983 and
Explanation of Changes

(In millions of SDRs)

	Estimates: Original	Estimates: Revised	Change	Revisions to Estimated Income and Expense as a Result of Changes in Estimates: Average Balances	Revisions to Estimated Income and Expense as a Result of Changes in Estimates: Interest Rates
1. Operational Income					
a. Periodic charges:					
Regular facilities	792	752	-40	-40	--
Oil Facility	21	20	-1	-1	--
SFF	805	597	-208	-52	-156
Enlarged Access	330	178	-152	-116	-36
Total charges	1,948	1,547	-401	-209	-192
b. Interest on SDR holdings	516	445	-71	13	-84
c. Other income:					
Regular facilities	32	41	9	9	
SFF	11	10	-1	-1	--
Enlarged Access	15	6	-9	-9	--
Total	2,522	2,049	-473	-197	-276
2. Operational Expense					
a. Remuneration	1,246	981	-265	-42	-223
b. Interest expense:					
GAB	31	31	--	--	--
Oil Facility	18	17	-1	-1	--
SFF	794	587	-207	-52	-155
Enlarged Access	325	175	-150	-116	-34
Total	2,414	1,791	-623	-211	-412
3. Net operational income	108	258	150	14	136
4. Administrative expense 1/	171	201	30	-30	--
5. Net income	-63	57	120	-16	136
Pro memoria					
Net income from:					
Ordinary resources	-108	25	133	-6	139
Borrowed resources (Oil Facility, SFF, and Enlarged Access)	45	32	-13	-10	-3
	-63	57	120	-16	136

1/ The variance of SDR 30 million in administrative expense is due to changes in the US$/SDR exchange rate (SDR 5 million), a change in the administrative budget for increased salaries (SDR 5 million) and the recognition of the accumulated annual leave and earned separation grant (SDR 20 million).

which the rates of charge and remuneration are applied, are slightly smaller than originally estimated. The positive impact on net income of the smaller average use of resources was, however, much less pronounced than in earlier years since the negative margin between the rate of charge and the rate of remuneration declined significantly. 1/ As can be seen from Table 4, it is now estimated that the margin between the two rates will average 1.82 per cent in 1983. This compares with an estimate of 3.73 per cent made in April 1982 when it was assumed that the rate of remuneration (10.33 per cent) effective as from April 1, 1982 would remain unchanged through 1983. Due to the fall of market interest rates which determine the rate of remuneration, the apparent anomaly that an expansion of the Fund's volume of lending leads to a rising deficit is no longer as striking as before.

In addition, average SDR holdings are somewhat higher than originally targeted for reasons explained in "Review of the Policy on Sales of SDRs and Proposal on the Level of the Fund's SDR Holdings" (SM/83/63, 4/18/83).

(iii) The staff has reviewed current accounting and financial reporting standards in order to assure that the Fund is in compliance with generally accepted accounting principles. Recent standards issued by the Financial Accounting Standards Board in the United States require that where benefits for compensated absences (accrued leave) exist, the benefits vest or accumulate and they can reasonably be determined, then the employer shall accrue such liabilities in its accounts. Other standards also require that deferred compensation benefits (separation grants) should also be accrued as liabilities in the accounts of the employer. Similar requirements for recognizing and disclosing such liabilities exist in Canada and a number of countries in Western Europe. To bring the Fund's practices into compliance with generally accepted accounting principles, the Fund should give recognition to the value of accumulated annual leave and earned separation grants. 2/

1/ More precisely, the negative margin is the excess of the weighted average cost of ordinary resources (remuneration and interest on GAB borrowing) over the weighted average rates earned on income-earning balances (currency holdings subject to charges and SDR holdings). While the SDR interest rate and the rate of remuneration have fallen during 1982/83, the rate of charge has remained constant since May 1982.

2/ It will be recalled that since July 1979 staff members who separate from the Fund after at least five years' continous service on a regular or fixed-term appointment are eligible for a separation grant, calculated as two weeks' net salary for each full year of service up to a maximum full-rate grant of fifty-two weeks' net salary for twenty-six years or more of service. The grant is based on a staff member's salary at the time of separation. In addition, staff members may accumulate annual leave to a maximum of sixty days. At the time of separation, a staff member is paid for any accumulated annual leave up to the maximum accumulation.

Estimates of the value of accumulated annual leave and earned separation grants at the end of this financial year are US$10.0 million and US$11.2 million, respectively, and it will be necessary to give recognition to these amounts totaling US$21.2 million (about SDR 20 million) in the Fund's accounts this year. 1/ Thereafter, the annual charge against income will be measured as the difference between the accrual from one year to the next. The annual increment in the accrual for accumulated annual leave is not expected to change very much from that between the end of 1982 to the end of 1983 (about SDR 1 million). The change would depend, of course, on the rate at which staff members would accumulate additional days of leave and on salary increases during the year. 2/ The rate at which earned separation grants are accruing is expected to increase over time as staff now eligible for this grant accumulate additional benefits at current salary levels and as the newer staff members reach five years' continuous service and begin to earn the grant.

The total of accrued benefits is not very large in relation to the total liabilities of the Fund; however, the amount is material in relation to net income (about 35 per cent in 1983), administrative expense (about 10 per cent) and reserves (about 2 per cent). These liabilities are now being taken into account because they have become material and are likely to increase in the future. 3/ In view of this, and in accordance with generally accepted accounting principles, the initial liability is to be charged against the income of the current year. Year-to-year changes in the liabilities are to be accounted for as an administrative expense. As a result, estimated net income for 1983 is now expected to be about SDR 57 million, or SDR 29 million in excess of the target increase in reserves for the year.

B. Estimates for financial year 1984

Estimates of the Fund's income position made more than a year in advance are subject to a considerable margin of uncertainty, as most of the Fund's income and expense is determined by factors over which the Fund has no control. The uncertainties surrounding the estimates are those of the timing and the amounts of members' use of the Fund's resources, the level of members' use of their unremunerated reserve tranche positions on which the Fund does not earn income but on which it must pay the rate of remuneration (or forego the interest on SDR holdings), and the level of market rates of interest which are used to determine the level of the SDR interest rate and the rate of remuneration. The most important determinants of the Fund's net income are the volume of

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1/ It is not a generally accepted practice to spread the charge in recognizing such liabilities over the next several years.

2/ A decrease in the accrual is possible should more leave be used by the staff than would be accumulated from one year to the next.

3/ The recognition of these liabilities in the Fund's accounts does not represent a correction of errors in past accounting periods nor the granting of retroactive benefits.

use of the Fund's ordinary resources and the rates of charges and the rate of remuneration.

It is expected that members' use of the Fund's resources will continue to expand strongly in the coming financial year. Total purchases are estimated to be in the order of SDR 18.1 billion, of which about SDR 10.8 billion will be financed from the Fund's ordinary resources. These estimates are the same as the estimates presented in the staff paper reviewing the Fund's liquidity position. 1/ In addition, the following assumptions have been made in estimating the net income position for 1984. The assumptions on which the 1984 estimates are based are quantified in Table 3.

(i) it is assumed that use of unremunerated reserve tranche positions will be SDR 750 million if the quota increases do not come into effect, and will be made in proportional monthly amounts throughout the year; if the quota increases are completed it is assumed that an additional SDR 1 billion of unremunerated reserve tranche positions will be drawn immediately after the quota payments are made;

(ii) purchases of SDR 7.1 billion in the credit tranches will be in accordance with agreed (or estimated) phasing;

(iii) compensatory financing and buffer stock purchases will amount to SDR 2 billion and will be made in proportional monthly amounts throughout the year;

(iv) repurchases of SDR 1.5 billion and repayments to lenders totaling SDR 218 million will be made in the amounts and on the dates scheduled; 2/

(v) outstanding GAB borrowing of SDR 777 million will be repaid from the Fund's ordinary resources in November 1983;

(vi) the Fund's holdings of SDRs will be reduced to a level of about SDR 1.5 billion by end-December 1983; and

(vii) the SDR interest rate (8.52 per cent) and the rate of remuneration (7.24 per cent) applicable for the quarter beginning April 1, 1983 will remain unchanged through 1984.

The estimates do not take account of short-term loans contracted with the BIS and central banks in the amount of SDR 100 million that will be due for repayment in 1984, and which are not matched by scheduled repurchases. There will be no impact on the Fund's income

1/ See the "Fund's Liquidity Position and Financing Needs," EBS/83/59, (3/18/83).

2/ Repurchases do not include an expected early repurchase by China equivalent to SDR 450 million, which if made early in 1984 could have a positive impact on net income of about SDR 2 million.

CHART 1

RATE OF CHARGE, SDR INTEREST RATE AND RATE OF REMUNERATION

(In per cent per annum)

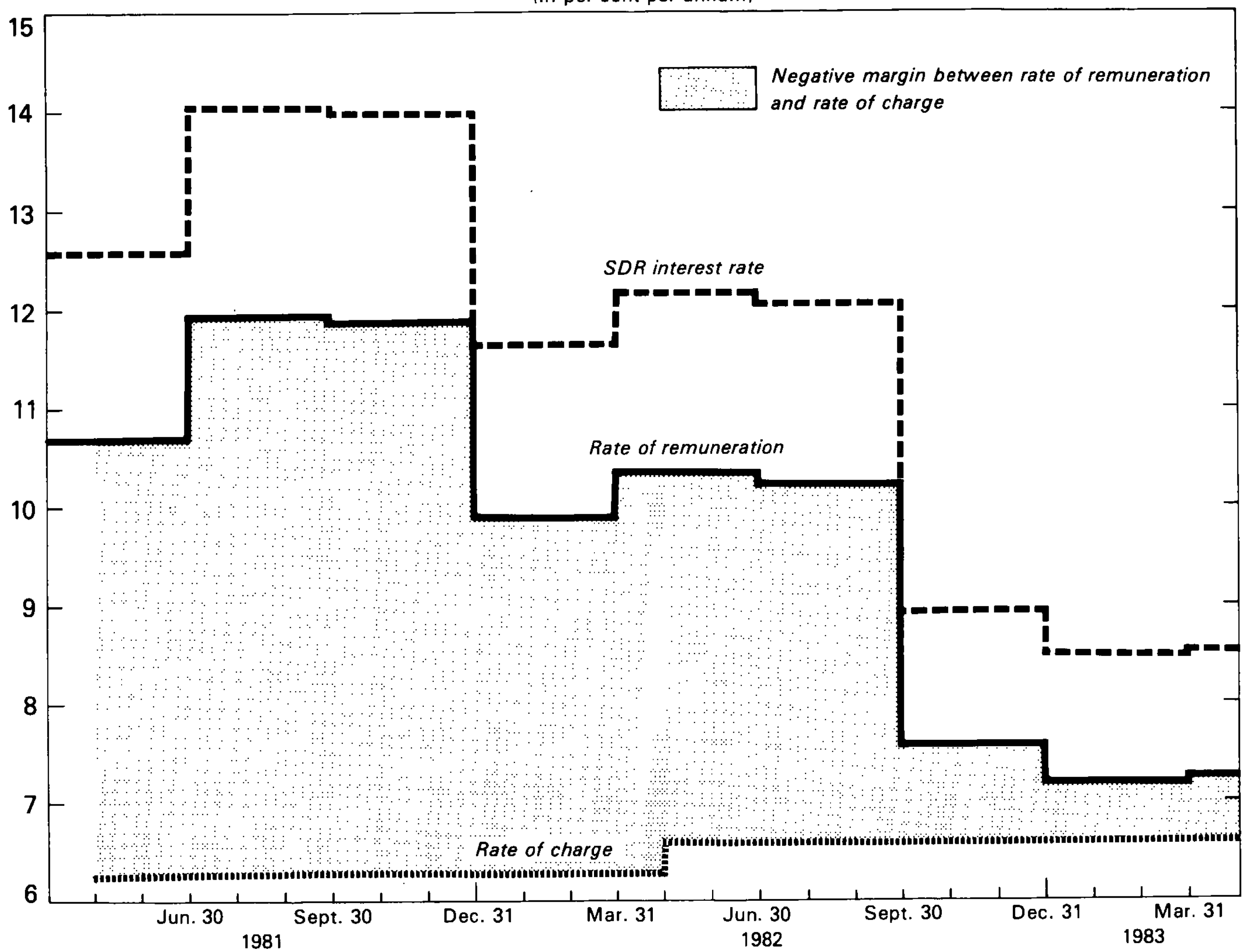

Table 3. Assumptions on Which Estimates for Financial Years 1983 and 1984 are Based

(In millions of SDRs)

	Ten Months Feb. 28 1983	FY 1983 Estimates: Preliminary Estimates April 1982 1/	FY 1983 Estimates: Preliminary Estimates November 1982 2/	FY 1983 Estimates: Revised Estimate	Preliminary FY 1984 Estimates: With Quota Increases 3/	Preliminary FY 1984 Estimates: Without Quota Increases
A. Ordinary Resources						
1. Purchases (absolute amounts):						
Unremunerated reserve tranche 4/	467	500	500	500	1,750	750
Credit tranches	2,405	3,600	3,200	3,125	7,100	7,100
Compensatory financing and Buffer Stock	3,197	2,800	3,500	4,265	2,000	2,000
Total	6,069	6,900	7,200	7,890	10,850	9,850
2. Scheduled repurchases (absolute amounts) other than Oil Facility and SFF	782	860	875	916	1,265	1,265
3. Excess of purchases over repurchases (absolute amounts)	5,287	6,040	6,325	6,976	9,585	8,585
4. Average SDR holdings	4,444	4,250	4,250	4,360	3,330	2,000
B. Borrowed Resources						
1. Oil Facility repurchases	512	571	538	538	27	27
and repayment of borrowing (scheduled)	487	541	508	508	18	18
2. Use of borrowed resources						
a. SFF						
Purchases	1,684	2,300	2,200	2,050	1,200	1,200
Repurchases	31	35	35	35	200	200
Average balances	4,883	5,430	5,140	5,060	6,970	6,970
b. Enlarged Access						
Purchases	807	3,000	1,400	1,260	6,100	6,100
Average balances	1,382	2,500	1,595	1,525	5,280	5,280
C. Interest Rates						
1. Average SDR interest rate (per cent)	10.50	12.15	10.35	10.20	8.52	8.52
2. Average rate of remuneration (per cent)	8.74	10.33	8.60	8.42	7.24	7.24
3. Average SFF interest rate (per cent)	11.94	14.625	12.83	11.61	10.25	10.25
4. Average net cost of borrowing under enlarged access policy (per cent)	11.93	13.13	12.39	11.44	10.34	10.34

1/ See EBS/82/75 (4/29/82).
2/ See EBS/82/210 (11/23/82).
3/ Assuming the quota increases are effective as from December 31, 1983.
4/ For the purposes of financial analysis, only those purchases in the unremunerated reserve tranche are taken into consideration. Purchases in the remunerated reserve tranche represent an exchange of a remunerated position between the purchasing member and the members whose currencies are sold by the Fund and have no effect on the Fund's income position. If SDRs were used by the Fund to finance such use there would be a net loss of income because the rate of remuneration is below the SDR rate of interest.

position resulting from these repayments to the extent that other borrowings are arranged to refinance those maturing short-term claims. To the extent that they would be paid from the Fund's ordinary resources, the Fund's income position would be improved by a minor amount.

The effect of increases in quotas and the revised and enlarged GAB

A major element that will significantly affect the Fund's income position in 1984 is the timing of subscription payments for the quota increases agreed under the Eighth General Review of Quotas, and the media used to make the reserve asset payments. While no assumptions have been made with respect to additional use of credit tranches and other facilities as a result of increased quotas prior to a review of access policies, the effects of the quota payments on the Fund's income have been examined. Since the timing of the quota payments is uncertain, two income estimates are presented. The first estimate is based on the assumption that all the increases in quotas will be fully paid and effective as from December 31, 1983. Although reserve asset payments in connection with the quota increases will be in the order of SDR 7.2 billion, it is assumed that SDR 1.2 billion of the increase will be reversed immediately by reserve tranche purchases (of which SDR 1 billion will represent use of the unremunerated reserve tranche) by members with insufficient reserves to make the reserve asset payment and by those members that are also experiencing balance of payments difficulties. 1/ It is further assumed that SDR 6.0 billion (almost 85 per cent) of the reserve asset payments will be made in SDRs and the balance in the currencies of other members prescribed by the Fund. This estimate is based on a member-by-member assessment of present SDR

1/ Unlike under previous quota reviews all reserve asset payments for quota increases under the Eighth Review will result *pro tanto* in a reserve tranche position and the balances on which the Fund levies charges will not be reduced. In 1981, the Fund decided that, for the purpose of calculating a member's reserve tranche position, purchases in the credit tranches or under extended arrangements should be excluded under Article XXX(c). As a result, all holdings on which the Fund now levies charges have been acquired under policies that are the subject of an exclusion under Article XXX(c) and charges on these holdings are no longer a function of the level of holdings in relation to quota. It should be noted that not all of the reserve tranche positions resulting from the quota payments will be remunerated positions. Although the norm for each member (the level of holdings below which remuneration is payable) will increase by the full amount of the quota increase, holdings of individual member currencies will rise by an amount equal to 75 per cent of the quota increase. For most members that do not now have a remunerated reserve tranche position, particularly those who have fully utilized their reserve tranche, the increase in the norm will not be sufficient to create a remunerated position. It should be noted also that the quota increases when completed will raise the norm from the present average of 87.9 per cent of quotas to 91.8 per cent.

holdings, taking into account obligations to the Fund that are likely to be settled in SDRs until the end of the calendar year 1983. For the purpose of estimating the Fund's 1984 income position it has been assumed that the quota payments will give rise to a net addition to the Fund's SDR holdings of about SDR 5 billion and enlarged remunerated reserve tranche positions of about SDR 4.7 billion. Because the SDR holdings on which it is assumed a higher rate of interest is earned by the Fund will increase by an amount greater than reserve tranche positions on which the Fund pays the lower rate of remuneration, it is estimated that the net income that will accrue to the Fund in 1984 as a result of the quota payments will be in the order of SDR 30 million. On this basis, it is estimated that total net income for 1984 could amount to the order of SDR 93 million. If the effective date of the quota increases is delayed beyond December 31, 1983, the net income in 1984 would be correspondingly lower.

It is also recognized that not all of the quota increases will be effective at the same time. If 70 per cent of the increases were to be in effect by the end of calendar year 1983 and the remaining 30 per cent were to come into effect over the succeeding months, depending upon decisions the Fund might take with respect to extending the period for consents, the estimate of additional income resulting from the quota increases would be reduced. Should the effective date of the quota increases be delayed until after April 30, 1984, the net income for 1984 would be estimated at SDR 63 million.

In preparing the estimates for 1984, no assumption has been made as to when the enlarged GAB will become effective and to what extent, if any, it might be utilized in the coming year. The cost of the enlarged GAB will be higher than that of the existing GAB. At present, charges received from purchases financed from the activation of the GAB are passed through to the lenders. If no charges are earned by the Fund, as in the use of the GAB to finance purchases in the reserve tranche, then the minimum rate of interest payable by the Fund is 4 per cent per annum. In contrast, under the enlarged GAB, the cost to the Fund is in effect equivalent to the SDR interest rate. 1/

Over the last four years the use of the GAB to finance a large reserve tranche purchase has implied a significant financial advantage for the Fund because the interest rate paid by the Fund has been less than the rate of remuneration which would have been payable if the Fund had had to use its currency holdings. 2/ This financial advantage will

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1/ Under the enlarged GAB, the rate of interest to be paid by the Fund on amounts borrowed is equal to the combined market interest rate computed for the purpose of determining the SDR interest rate.

2/ In part a lower rate of charge has been sustainable by the Fund because of the differential between the GAB interest rate at 4 per cent and the rate of remuneration (see Appendix III, Table 2 for an example). If the Fund would have had to pay the SDR rate of interest, as it will be in the future, on the GAB borrowing in 1982 and 1983, then its expenses would have been higher by SDR 70 million and SDR 48 million, respectively.

Table 4. Estimates of Average Daily Balances
and Rates of SDR Interest, Remuneration, and Interest
(excluding Oil Facility, SFF and Enlarged Access)
Financial Years 1983 and 1984

(In millions of SDRs)

	Ten Months Feb. 28 1983	FY 1983 Estimates: Preliminary Estimates: April 1982	FY 1983 Estimates: Preliminary Estimates: November 1982	FY 1983 Estimates: Revised Estimate	Preliminary FY 1984 Estimates: With Quota Increases 1/	Preliminary FY 1984 Estimates: Without Quota Increases
1. Balances subject to periodic charges 2/	10,673	12,000	11,135	11,390	19,645	19,645
Average rate of charge	6.6	6.6	6.6	6.6	6.6	6.6
2. Holdings of SDRs in the General Resources Account	4,444	4,250	4,250	4,360	4,000	2,335
Average rate of interest	10.50	12.15	10.35	10.20	8.52	8.52
3. Income-earning balances	15,117	16,250	15,385	15,750	23,645	21,980
Weighted average rate of income	7.75	8.05	7.64	7.60	6.92	6.80
4. Remunerated positions	11,018	12,060	11,285	11,645	20,085	18,540
Average rate of remuneration	8.74	10.33	8.60	8.42	7.24	7.24
5. Borrowings under the GAB 2/	775	775	775	775	390	390
Average rate of interest	4.00	4.00	4.00	4.00	4.00	4.00
6. Interest-costing balances	11,793	12,835	12,060	12,420	20,475	18,930
Weighted average rate of expense	8.43	9.95	8.30	8.14	7.18	7.17
7. Net income-earning balances	3,324	3,415	3,325	3,330	3,170	3,050
Margin between weighted average rates of income and expense	-0.68	-1.90	-0.66	-0.54	-0.26	-0.37
8. Pro memoria						
Margin between rate of charge and the average rate of remuneration	-2.14	-3.73	-2.00	-1.82	-0.64	-0.64
Margin between average SDR rate and average rate of remuneration	1.76	1.82	1.75	1.78	1.28	1.28

1/ Assuming the quota increases are effective as from December 31, 1983. No assumptions are made on the use of credit tranches and CFF as a result of higher quotas.

2/ Holdings subject to charges and amounts of borrowing under the Oil Facility and the SFF as well as borrowing to finance purchases under the policy of enlarged access are excluded from this table because the rates of interest and of charges for the SFF and EAR are determined only at the end of six month periods ending June 30 and December 31. The rate of charge on supplementary financing provides the Fund with a basic constant margin of net income equal to 0.20 percentage point over the rate of interest, which progresses to 0.325 percentage point after 3-1/2 years after the date of purchase. The income from progression in the rate in 1983 and 1984 is estimated to be minimal. The rate of charge under the policy of enlarged access provides the Fund with a constant margin of net income equal to 0.20 percentage point over the average coat of borrowing. The Oil Facility provides the Fund with a fixed margin of income over the rate of interest of 0.625 percentage point.

be reduced when the outstanding GAB claims are repaid later this year and will not exist at all if, and when, the enlarged GAB is activated. This higher cost of financing will need to be taken into account in determining the rate of charge that would be required to cover the Fund's expenses and to provide for the target increase in reserves.

It is proposed that the effect on the Fund's income position resulting from increased quotas and any activation of the GAB be examined later in this year, but in any event at the time of the mid-year review of the Fund's income position which is scheduled for December 1983. By that time, more should be known with respect to the policies on members' access to the Fund's resources under the increased quotas, and the financing of this access.

Estimates of income-producing and interest-costing balances

Under the assumptions outlined above, the average daily balances and the related interest rates on these balances will be those that are presented in Table 4. As can be seen from that table, income-producing ordinary balances (line 3) are estimated to rise from SDR 15.75 billion to SDR 23.65 billion (with the quota increases) and the weighted average rate of income is estimated to fall by 0.68 percentage point to 6.92 per cent. However, though the interest-costing balances are estimated to rise by over SDR 8.0 billion, the weighted average rate of expense is estimated to fall by almost 1 percentage point to 7.18 per cent. As a consequence, the margin between weighted average rates of income and expense (the "negative" margin) is estimated to fall to -0.26 per cent. If the relatively small negative margin prevails in 1984, its impact on balances resulting from purchases during 1984 will be more than offset by the one-time service charge of 0.5 per cent received at the time of purchase. An expansion in the use of the Fund's resources will thus result in net income to the Fund in the year in which the service charge is received, unlike previous years when the gap between the rate of charge and rate of remuneration was comparatively large.

Changes in the SDR interest rate and in the rate of remuneration significantly influence the Fund's net income position. As is illustrated in Table 5, a change of one percentage point in the average SDR interest rate assumed for 1984 will change the estimates in the order of SDR 130 million to SDR 135 million. The impact of a change in interest rates on the Fund's net income position is now much greater than before. The main reason for this is the very large absolute expansion of remunerated positions. 1/

The following table illustrates the sharp changes in average remunerated positions over the four-year period 1981-84 and the effects on the Fund's income resulting from a change of one percentage

1/ The level of the Fund's SDR holdings mitigate the effects of interest rate changes but to a lesser extent as these holdings have tended to remain somewhat more stable.

Table 5. Effect on Net Income for 1984
of Various Combinations of Variances

(In millions of SDRs)

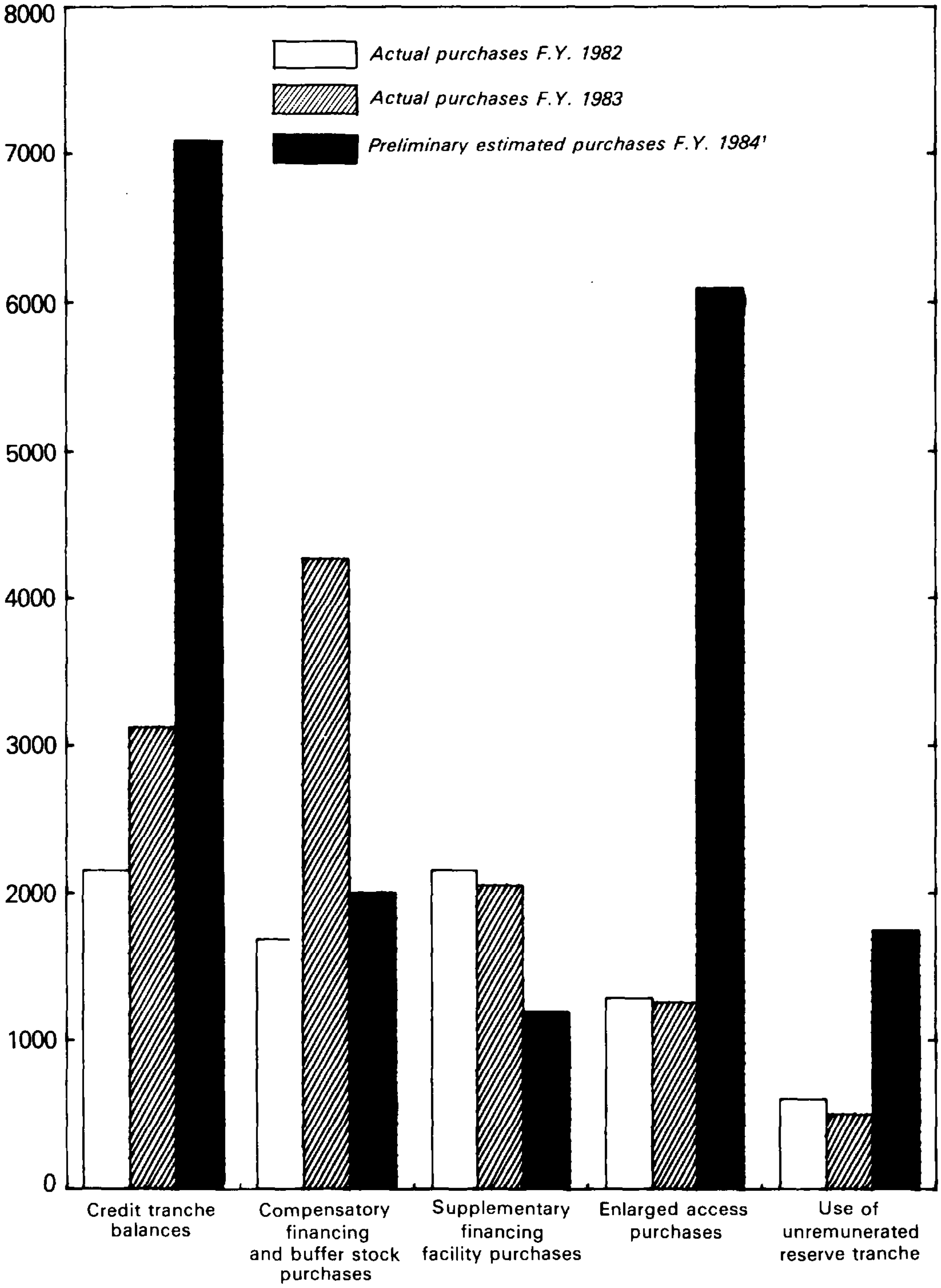
	With Quota Increase			Without Quota Increase		
	At assumed rates 1/	Increase in average SDR rate by 1 percentage point	Decrease in average SDR rate by 1 percentage point	At assumed rates 1/	Increase in average SDR rate by 1 percentage point	Decrease in average SDR rate by 1 percentage point
No change in estimated use of resources and in average SDR holdings		-130.7	+130.7		-134.2	+134.2
Average lead or lag of one month in timing of purchases in the unremunerated reserve tranche	±10.6	±11.8	±9.3	±4.5	±5.1	±4.0
Average lead or lag of one month in timing of credit tranche purchases	±4.9	±11.3	±1.6	±4.9	±11.3	±1.6
Average lead or lag of one month in timing of purchases financed with borrowed resources	±1.2	±1.2	±1.2	±1.2	±1.2	±1.2

1/ Assumed rates of charges, SDR interest rate and rate of remuneration.

CHART 2

USE OF FUND RESOURCES

(In millions of SDRs)



[1] Preliminary estimates for F.Y. 1984 are based on the assumption that the quota increases will be effective as from Dec. 31, 1983

point in the SDR interest rate (0.85 percentage point in the rate of remuneration).

Table 6. Average Remunerated Positions and Income Effects Resulting from Interest Rate Changes

Financial Year	Average Remunerated Positions (SDR billions)	Effect on income resulting from a one percentage point change in the SDR interest rate (SDR millions)
1981	4.3	10
1982	8.2	20
1983 est.	11.6	55
1984 est.	18.5 to 20.1	130 to 135

The target growth rate of reserves of 3 per cent each year is very small in comparison to such potential swings, and the standard assumption that the level of the combined market interest rate which is used to determine the SDR interest rate and the rate of remuneration will remain unchanged is therefore the most crucial element in estimating the Fund's net income position. The much larger balances on which the Fund pays remuneration and on which income is earned imply also that a small change in these balances will have a lesser impact on the Fund's net income than interest rate changes. The likelihood of achieving a net income target as precise as 3 per cent of reserves (about SDR 30 million) or about 1 per cent of combined gross income and expense, when this volume is approaching SDR 3 billion, is relatively small. Apart from the effects of changes in the level of interest rates, the leads and more often the lags in the timing of large purchases by a few members can create substantial shifts in average balances on which the Fund levies charges and, perhaps more significantly at present, on balances on which the Fund pays remuneration. Though not as significant as the effects of interest rate movements, these timing changes can also lead to significant changes in actual net income compared to estimated net income.

These regular uncertainties are in 1984 compounded by other important developments, including the effects on the Fund's net income resulting from the reconsideration of the frequency of fixing the SDR interest rate and the rate of remuneration, the frequency of paying SDR interest and remuneration, and the limits to access to the Fund's resources and the means of financing this access.

Although 1984 net income, based on the assumptions discussed earlier, is expected to be in a range of SDR 63 million to SDR 93 million, and thus considerably in excess of a target income of 3 per cent of reserves, the uncertainties surrounding these estimates, especially the uncertainty about interest rates, the timing of the quota increases and activation of the enlarged and revised GAB, are such that it would not seem prudent to base on this consideration alone any changes in the rate of charge or a reduction in the differential between the rate of remuneration and the SDR interest rate as from May 1, 1983. An increase in the rate of remuneration to a level equal to the SDR interest rate would impose additional expense on the Fund ranging from SDR 235 million to SDR 255 million so that a substantial deficit would be in prospect. Therefore, such a change should be considered on its own merits rather than in the light of the Fund's income position for a particular year as it would inevitably entail an increase in the rate of charge.

III. Disposition of 1983 Net Income and Determination of the Rate of Charge and Rate of Remuneration for 1984

As mentioned above, the estimated net income for 1983 is SDR 57 million, equivalent to 6 per cent of the Fund's reserves at April 30, 1982. This is SDR 29 million in excess of the target income of SDR 28 million for the year.

It is for consideration of the Executive Board how the income in excess of the target should now be used. In accordance with Rule I-6(4)(c) and (d), 1/ the options available for the disposition of the income in excess of the target amount for the year are as follows: (i) a retroactive reduction in the rate of charge; (ii) a retroactive increase in the rate of remuneration; (iii) a retroactive reduction in the rate of charge and increase in the rate of remuneration; (iv) to deem any part of the excess as income for the next financial year for the determination of the 1984 rate of charge (and implicitly the rate of remuneration), or (v) to place the excess income to reserves. These options are discussed in the following paragraphs.

A. Reduction in the rate of charge for 1983

The amount of income in excess of the target increase in reserves (SDR 29 million) would allow a lowering of the rate of charge retroactively from 6.6 per cent to 6.35 per cent. This would still be slightly higher than the rate of 6.25 per cent that prevailed prior to May 1982 (see Table 7). If that reduced rate of charge were to be carried forward in 1984, estimated net income in 1984 would be lowered to about SDR 43 million. However, lowering the rate of charge to 6.35 per cent would increase somewhat the degree of concessionality in the Fund's charges at a time when market rates are falling, as the rate of charge is still below the market rates. This might give an

1/ See Appendix I.

incentive for members to continue to use the Fund's resources purely on the basis of cost, which could be to the detriment of strengthening the Fund's liquidity position through voluntary early repurchases. Also, the fact that it is not possible to raise the rate of remuneration by any significant amount by using the income in excess of target (see below) does not imply that for this reason the rate of charge should be lowered retroactively.

B. Increase in the rate of remuneration for 1983

Net income earned by the Fund in 1983 in excess of the target would allow some upward adjustment in the rate of remuneration retroactively from 85 per cent to 87.51 per cent of the SDR interest rate (Table 7). However, it is doubtful whether a relatively stable rate of remuneration in terms of the SDR interest rate could be maintained once the differential between the two rates were narrowed, considering the uncertainties facing the movement of interest rates in the next few years and in the event these rates should rise.

If the rate of remuneration were raised retroactively to equal the SDR rate in 1983, estimated expense would increase by SDR 173 million so that the estimated net income result for the year would be changed to a deficit of SDR 116 million. As discussed earlier, to bring the rate of remuneration in 1984 to a level equal to the SDR interest rate would mean that a deficit would be in prospect unless the rate of charge were to be increased also (estimated to be about one percentage point). In addition, there are also various income aspects involved in the reexamination of the SDR interest rate which is currently underway. For example, quarterly payments of SDR interest and remuneration would reduce the Fund's income in 1984 by about SDR 30 million.

C. Deeming 1983 income as income in 1984 for the determination of rate of charge and rate of remuneration

The effect of deeming the excess income of 1983 of SDR 29 million as income of 1984 for the purpose of determining the rate of charge or the rate of remuneration, or both, would have only a small effect on either rate. If all of the 1983 excess income were deemed as 1984 income for the purpose of determining the rate of charge, this rate could be set at 6.29 per cent without the increased quotas, or at 6.13 per cent taking into account the estimated net income effect resulting from the quota increases. If 1983 excess income were deemed as 1984 income in order to raise the rate of remuneration without an increase in the rate of charge, the rate of remuneration could only be increased to 88.9 per cent of the SDR rate without the increased quotas, though it could be increased to 90.4 per cent after taking into account the likely effect of the payments of quota increases.

Table 7. Possible Use of 1983 Net Income in Excess of the Target Amount for Decreasing the Rate of Charge or Increasing the Rate of Remuneration

(In per cent)

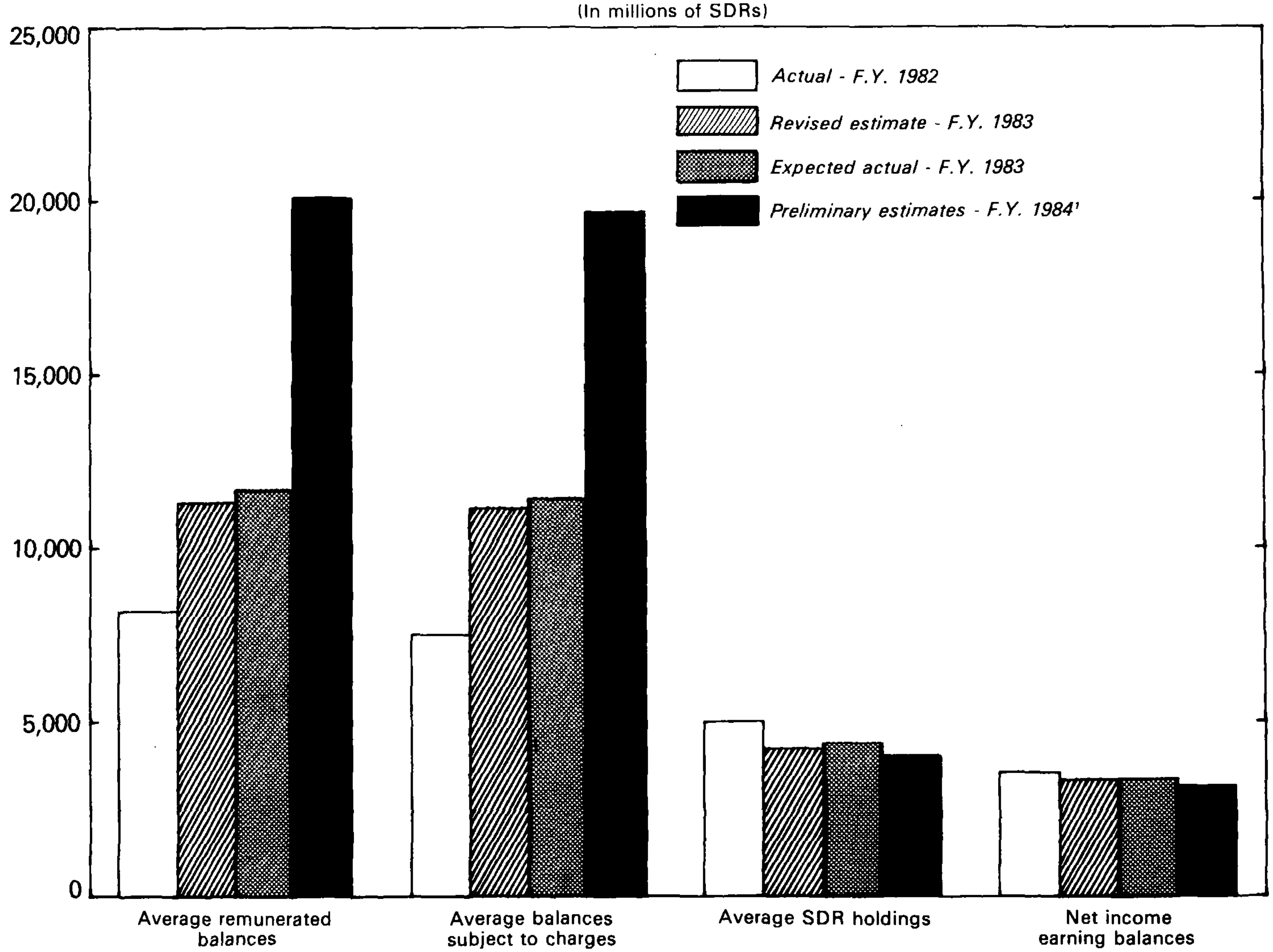
	Estimated Retroactive Decrease in Rate of Charge	Estimated Retroactive Increase in Average Rate of Remuneration	Adjusted Rates		
				Remuneration	
			Charges	Average Rate	As Per Cent of SDR Interest Rate
1. Use full amount of net income in excess of the target to retroactively:					
a. reduce the rate of charge	0.25	--	6.35	8.42	85
b. increase the rate of remuneration	--	0.25	6.60	8.67	87.51
2. Use one-half of net income in excess of the target amount to retroactively reduce the rate of charge and one-half to retroactively increase the rate of remuneration	0.13	0.12	6.47	8.54	86.26

1/ Possible use of SDR 29 million based on estimated average rates and balances set out in Table 4.

CHART 3

AVERAGE REMUNERATED POSITIONS, BALANCES SUBJECT TO CHARGES, HOLDINGS OF SDRs AND NET INCOME EARNING BALANCES

(In millions of SDRs)



[1]Preliminary estimates for F.Y. 1984 are based on the assumption that the quota increases will be effective as from Dec. 31, 1983.

D. Place 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 expanding rapidly in relation to quotas, it is also for consideration whether the Fund's reserves should also increase. The evolution of the Fund's reserves, the contribution they make to the Fund's liquidity, and earning power as well as its credit standing, are discussed in Appendix II. It is worth noting that the reserves of a central institution like the Fund are of great importance, especially at a time when its financial strength is under scrutiny by its actual and potential creditors, in particular also by private investors. Furthermore, the accumulation of reserves provides 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. Although the Fund's reserves have increased in absolute amounts since 1978, they have declined as a proportion of quotas, outstanding purchases, borrowing, operational income and total liquid claims on the Fund (see Table 8). In present circumstances, it may be appropriate to slow down, if not arrest, the decline.

IV. Conclusions and Recommendations

1. Net income in 1983 is expected to be in the order of SDR 57 million, or SDR 29 million in excess of the target amount of 3 per cent of reserves set at the beginning of the 1983 financial year.

2. Net income in a range from SDR 63 million to SDR 93 million is expected in 1984 depending on the timing of the payment of the quota increases. The estimate of net income is subject to uncertainties, most especially the significant swings in income that could result from changes in the combined market rate of interest, and a number of pending policy issues relating to members' access to the Fund and to the SDR interest rate which will come before the Executive Board for consideration in the coming weeks.

3. Of the number of options available for the disposition of the 1983 net income, it is not recommended to retroactively adjust either the rate of charge for use of ordinary resources or the rate of remuneration. The retroactive adjustment that could be made either to the rate of charge or to the rate of remuneration (or both) would be relatively small; nor are retroactive adjustments recommended at a time when lending by the Fund is increasing rapidly and when the level of the Fund's rate of charge remains concessional in comparison to market rates.

4. In the light of the considerable uncertainties (as explained in paragraph 2 of these conclusions) with respect to timing and to matters of policy, it is not considered prudent that these tentative estimates

Table 8. The Fund's Reserves 1974-1983

(In millions of SDRs)

Year Ending April 30	Net Income (Deficit)	Operational Income	Total Reserves	Per cent increase (decrease) over previous year	Total Reserves as a Percentage of: Quotas	Outstanding Purchases	Borrowing	Liquid Claims 1/	Operational Income
1974	(37.2)	38.5	717.3	(4.9)	2.5	20.7	--	11.5	1,863.1
1975	(9.7)	166.5	707.6	(1.4)	2.4	10.7	28.3	7.1	425.0
1976	(2.9)	455.9	704.7	(0.4)	2.4	5.8	10.9	4.8	154.6
1977	(18.2)	774.6	686.5	(2.6)	2.3	4.3	8.9	3.7	88.6
1978	27.5	839.6	714.0	4.0	2.2	5.1	8.9	4.3	85.0
1979	46.1	753.3	760.1	6.5	1.9	7.4	15.1	5.7	100.8
1980	3.1	614.2	763.2	0.4	2.0	8.6	20.3	6.2	124.3
1981	80.1	882.3	843.3	10.5	1.4	8.6	19.3	4.8	95.6
1982	92.0	1,788.9	935.3	10.9	1.4	6.2	13.8	4.1	52.3
1983 2/	57.0	2,049.0	992.3	6.1	1.6	6.4	8.9	3.1	48.4
1984 est. 3/	93.0	3,007.0	1,085.3	9.4	1.2	3.6	6.7	2.2	36.1

1/ Liquid claims equal reserve tranche positions and outstanding borrowing.
2/ Based on the assumption of full appropriation of net income to reserves.
3/ Based on the assumption of full appropriation of net income to reserves, and omitting the activation of the enlarged GAB in 1984.

of net income be used as a basis for an increase in the rate of remuneration, or for a reduction in the rate of charge in 1984. However, it may be useful to review these matters again once the review on the policy of access to the Fund's resources is completed, the additional demands and financing will be clearer than at present, and also in the light of any conclusions that may be reached on the various aspects of the SDR interest rate.

5. The Fund's reserves, even with the addition of net income since 1978, have decreased steadily in relation to quotas, to members' outstanding use of the Fund's resources, to Fund borrowing, to other liquid claims on the Fund, and to the volume of the Fund's gross income and expense. It may be opportune, therefore, to strengthen the Fund's special reserve, which can be used for all purposes except a general distribution to members in proportion to quotas.

6. In the light of the foregoing, the following recommendations are made for consideration by the Executive Board:

a. That the net income for 1983 be placed to the special reserve;

b. That the SDR interest rate be maintained at 100 per cent of the combined market interest rate;

c. That the rate of remuneration be continued at 85 per cent of the SDR interest rate;

d. That the rate of charge levied by the Fund under Rule I-6(4)(a) be continued at 6.6 per cent per annum; and

e. That a further review of the Fund's charges and of the rate of remuneration be made not later than the time of the mid-year review of the Fund's net income position.

Rule I-6(4) as amended on June 9, 1982

(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 three per cent 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 per cent 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 on 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.

Rule I-10 (a) The rate of remuneration shall be equal to 85 per cent of the rate of interest on the special drawing right under T-1(b), rounded to the two nearest decimal places,

(b) The Fund shall review the rate of remuneration on the occasion of the annual review of the rate of interest on holdings of special drawing rights under Rule T-1(d).

Rule T-1 (d) The Fund will review the rate of interest on holdings of special drawing rights at the conclusion of each financial year.

The Fund's Reserves

As used in the Fund's accounts, the term "reserve" refers to the combined total of the General Reserve and the Special Reserve and represents the cumulative undistributed excess of Fund income over expenses. The reserves are also the measure of the proprietary equity which the Fund, as an independent entity, has in the total assets of the organization, i.e., the residual of the total assets not derived from capital contributions of members and from borrowing. Inasmuch as each of the Fund's assets is not segregated by origin, the Fund's reserves are not represented by specific identifiable assets. Rather, they are represented by a part of the Fund's fungible resources and net amounts owed to the Fund.

1. Origin of reserves

a. Special Reserve

Except in the financial year 1948, when the net income of the Fund amounted to SDR 1,538,380, the Fund incurred a deficit in each financial year through April 1956. The cumulative deficits appeared in the Fund's balance sheets as "Excess of Expenditures over Income" and were shown as deductions from members' subscriptions. Thus, in those years, the costs of conducting the operations of the Fund were financed from the capital subscriptions paid to the Fund by its members.

In January 1956, the Fund decided to initiate an investment program and the income from investments was used to reduce the deficits which through October 31, 1957 amounted to SDR 8.4 million. In the second half of financial year 1958, the Fund began to earn net income from its operations and by decision of the Executive Board, the income from investment was placed directly to the Special Reserve. 1/ Because the possibility existed that the Fund might in future have excesses of expenditure over income, it was considered appropriate to raise additional amounts of income to provide a reserve to meet these possible deficits and the investment program was continued until February 1972 when it was terminated. From 1972 through 1977 net deficits amounting to SDR 103.0 million were written off against the Special Reserve and since 1978, net income totaling SDR 248.8 million has been placed to the Special Reserve. The balance of this reserve, amounting to SDR 569.7 million, is comprised as follows:

1/ The relevant part of the Executive Board Decision No. 708-(57/57), adopted November 27, 1957 reads as follows:

> The income of the investment earned after October 31, 1957 shall be placed to a Special Reserve, and any administrative deficit for any fiscal year of the Fund shall be written off first against this reserve.

	Millions of SDRs
Income from investment	432.3
Investment income used to offset deficits through October 1957	-8.4
Deficits charged to reserve 1972-77	-103.0
Income placed to reserve 1978-82	248.8
	569.7

b. General Reserve

The Fund began to earn net income from its operations in the second half of financial year 1957 and in accordance with Executive Board Decision No. 753-(58/17), adopted April 14, 1958 a General Reserve was established by transfer of the 1958 net income, which after absorbing the remainder of accumulated deficits through April 30, 1957 of SDR 6.3 million amounted to SDR 6.0 million. In the memorandum recommending the establishment of the General Reserve 1/ it was stated:

> If in the future the Fund should have net income as a result of the excess of its ordinary earnings over its expenditures and should decide to place that net income to reserve, this could constitute a second and separate reserve. It would be of a general character; that is to say, it would provide for purposes wider than the one for which the Special Reserve was intended. For example, it could be used to meet or offset possible losses of a capital or principal character, as contrasted with the meeting of possible future administrative (i.e., income) deficits which would be provided for by the Special Reserve. It would also be available as a second source for meeting administrative deficits should the Special Reserve ever be exhausted.

In each of the financial years 1958 through 1967, the Board of Governors, acting on recommendations made by the Executive Directors, decided to place the net income of each year to the General Reserve. In the financial years 1968 through 1971, it was decided that a part of the net income of each year should be distributed to members with creditor positions in those years. For financial years 1968 and 1969 the distribution was at the rate of one and one-half per cent on the amount by which 75 per cent of each member's quota exceeded the average of the Fund's holdings of the member's currency during each financial year. For financial years 1970 and 1971, the distribution was made to effect a return on creditor positions of 2 per cent after taking account

1/ See SM/57/93 (11/4/57) and SM/58/28 (4/4/58).

of remuneration that was paid at the rate of one and one-half per cent per annum. 1/

The General Reserve has at times been used to absorb transfers of additional resources to the Staff Retirement Plan to fund the costs of past service liabilities resulting from amendments to the Staff Retirement Plan 2/ and to absorb refunds to certain members in connection with stand-by arrangements relating to prior financial years following decisions adopted by the Executive Board that had a retroactive application. Other charges and credits have been made to the General Reserve in connection with the settlement of accounts with a country which had withdrawn from membership and to close out minor accounts that earlier had been established as contingencies for costs which the Fund might incur.

The balance of the General Reserve stands at SDR 365.6 million and is comprised as follows:

	Millions of SDRs
Cumulative deficits - inception through October 31, 1957	-14.4
Investment income transferred to cover deficits	8.4
Net income since 1958	474.5
Distribution of net income 1968-72	-99.4
Transfers to Staff Retirement Plan	-3.5
Other credits and charges - net 3/	0.0
	365.6

1/ In accordance with Article XII, Section 6(b) as amended with effect from July 28, 1969 which provided that if a distribution were made of the income of any year, it would first be distributed to members eligible to receive remuneration in an amount by which 2 per cent exceeded any remuneration paid for that year.

2/ It should be noted that this is no longer a generally accepted accounting practice. Although the determination of past service liabilities is based in part on service rendered by employees in the past, the added pension costs based on such service are incurred in contemplation of present and future service following the date of a plan amendment. Pension costs based on elements of past service are now allocated to current and future periods. This practice was followed by the Fund for past service costs associated with the 1976 Plan amendments.

3/ Less than SDR 20,000.

2. Purposes and adequacy of reserves

The total of the Fund's reserves, without taking account of the 1983 net income, is SDR 935.3 million. The two reserves have been established for different purposes.

The Special Reserve was originally established for a specific and limited purpose, to provide a reserve against which deficits of the Fund could be charged without diminishing the capital contributions made by members through their subscription payments. The General Reserve was established for purposes broader than that for which the Special Reserve was intended, including serving as a second source to meet deficits should the Special Reserve be exhausted. Certain changes affecting the use of the Fund's reserves were incorporated into the Articles of Agreement with the entry into force of the Second Amendment on April 1, 1978. Under the provisions of the pre-amendment Article XII, Section 6(c), the Fund could make transfers from any Special Reserve to the General Reserve. That provision was deleted from the amended Articles. In addition, the preferential right of members to receive a distribution of the net income of any particular year should a later distribution be made was not retained under the amended Articles; 1/ decisions regarding the disposition of net income or a distribution of the General Reserve are no longer reserved to the Board of Governors but are within the authority of the Executive Board; and Article XII, Section 6(b) was added to clarify that the Fund may use the Special Reserve for any purpose for which it may use the General Reserve, except distribution.

An earlier paper on the Fund's reserves 2/ cited a number of purposes served by reserves. They are summarized and updated below:

a. The absorption of losses and special charges.

The Special Reserve was used to absorb the Fund's deficits between 1972 and 1977. As was also noted, the General Reserve has on some occasions been charged for transfers of resources to the Staff Retirement Plan to fund past service costs resulting from amendments made to the Staff Retirement Plan. The reserves are also available to meet other risks of the Fund's assets. As regards exchange risks, the maintenance of value provisions of the Articles of Agreement protect the SDR value of the Fund's currency holdings in the General Resources Account. These maintenance of value provisions do not extend to currencies which may be held by the Fund in Borrowed Resources Suspense Accounts, the Special Disbursement Account or the Investment Account, which also are a part of the General Department, but the Fund has adopted practices to

1/ Prior to the Second Amendment, if the Fund distributed net income of any year, it first had to distribute to members eligible to receive remuneration for that year an amount by which 2 per cent per annum exceeded any remuneration paid for that year.

2/ "Fund's Reserves--General and Special," SM/69/140 (9/11/69), pp. 5-8.

minimize exchange risks that might affect the SDR value of resources held in the Borrowed Resources Suspense Accounts pending their use in operations and transactions. Breaches of obligations of members to repurchase the Fund's holdings of their currencies, or the failure of a withdrawing member to settle its obligations to the Fund are other possible examples of capital losses. There is one example where a member has not fulfilled its obligations to the Fund for a prolonged period. Democratic Kampuchea is not meeting its obligations to repurchase a part of the Fund's holdings of its currency or to pay charges on currency balances held by the Fund. These outstanding obligations amount to more than SDR 24 million and are accounted for at their full SDR value in the Fund's balance sheet, but it should be noted that the charges owing to the Fund by this member are regarded as a deferred credit item and have been removed from the Fund's income until further decision.

b. A source of additional liquidity

The expansion of the Fund's activity and the growth of its income, and hence in its reserves, represented by a corresponding increase in its usable assets has helped to provide the Fund with a modest amount of additional interest-free resources which it can use in its operations and transactions.

c. Psychological impact

It has been stated in earlier discussions of the desirability of the Fund adding to its reserves that the psychological aspect of reserves should not be overlooked. 1/ The fact that the Fund has reserves does have an effect on its members, its creditors and the public in general. As an institution exerting an effective influence on international monetary affairs, it is appropriate that the Fund conduct its activities in a manner that does not impair its resources, but rather in a manner that adds an element of strength to its financial position through increases in its reserves as its operations expand.

It should be noted also that under the provisions of the Articles of Agreement governing the administration of the Fund in the event of liquidation, the assets of the Fund, after meeting its liabilities, are to be apportioned and distributed to the Fund's members. To the extent that the Fund's assets include amounts equal to its accumulated reserves at the time of liquidation, they would ultimately be distributed to the members.

There are valid reasons why the Fund should have reserves and it is important also that these reserves should grow over time although there may be no precise manner in which their adequacy at a given point in time can be determined. When the Fund's investment program was discussed

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1/ "Distribution of Net Income--Policy Aspects," SM/66/131, Revision 1 (7/3/67), p.4.

in 1957 1/ it was suggested that income to be produced by the investment should be related to the amount of the Fund's administrative expenditure, and that while the amount to be invested need not be related to the Fund's administrative expenditure, the size of the Special Reserve certainly should be; again, when the matter of reserves was discussed in 1969, 2/ it was pointed out that it would be prudent to increase the level of reserves at a time when the level of reserves was then equal to about 3 per cent of the Fund's total assets--a level that was viewed as adequate but not excessive. 3/ When the Fund's income position and level of reserves were discussed in 1981, it was felt desirable that the Fund's reserves should increase modestly from year to year, and a target increase of 3 per cent was considered to be appropriate. However, the Rules adopted at that time provide that the Executive Board may determine some other percentage.

If the 1983 income is placed to reserve, the Fund's reserves will have expanded at an annual average rate of 2.8 per cent over the last ten years. However, the level of reserves has diminished substantially in relation to quotas, to members' repurchase obligations and to Fund borrowing. Furthermore, the increase in the Fund's reserves has occurred at a time when members' demands for Fund resources are expanding at a more rapid pace than at any time in the past and when its creditworthiness is under scrutiny by its existing and potential creditors.

1/ Executive Board Meeting 57/57, November 27, 1957.
2/ Executive Board Meeting 69/90, September 19, 1969.
3/ Based on these criteria, the Fund's reserves would have to be raised substantially.

Table 1. Estimates of Sources and Uses of Resources for 1983 and 1984 1/

(In millions of SDRs)

	1984	1983
Sources		
Interest-free		
Sales of gold	2,975	2,975
Subscription payments above the "norms" for remuneration 2/	785	765
Reserves	1,040	960
Excess of sundry liabilities over sundry assets 3/	380	150
	5,180	4,850
Less - Use of unremunerated reserve tranche	2,010	1,500
	3,170	3,350
Interest-costing		
Borrowings:		
GAB	390	775
Special facilities 4/	12,250	6,565
Remunerated positions	20,085	11,645
	32,725	18,985
Total Sources	35,895	22,335
Uses		
Purchases subject to charges financed with:		
Ordinary resources	19,645	11,390
Borrowed resources	12,250	6,585
SDR holdings 5/	4,000	4,360
Total Uses	35,895	22,335

1/ Estimates of average daily balances.
2/ Excluding payments in gold in past years of up to 25 per cent of quota as such payments added to the Fund's gold holdings.
3/ Mainly accrued interest and remuneration not yet paid that exceeds the amount of accrued charges and interest on SDR holdings not yet due.
4/ Net of borrowed resources held in suspense accounts.
5/ SDR holdings are a use in the sense that they yield interest income.

Table 2. Factors Explaining the Difference between the Rate of Remuneration and the Rate of Charge under Rule I-6(4) For 1983 and 1984

			1984 1/	1983 2/
1. Rate of remuneration			7.24	10.33
2. Rate of charge under Rule I-6(4):			6.60	6.60
3. Difference			0.64	3.73
Explained by:				
Rate of remuneration x	Interest-free resources 3/ / Use of Fund credit		1.17	2.98
Difference between SDR interest rate and rate of remuneration	x	SDR holdings / Use of Fund credit	0.26	0.64
Difference between GAB interest rate and rate of remuneration	x	GAB borrowing / Use of Fund credit	0.06	0.41
Income from service charges / Use of Fund credit	x	100	0.42	0.48
Income from margins on oil facility, SFF and Enlarged Access / Use of Fund credit 4/	x	100	0.13	0.12
Less:				
Administrative expense / Use of Fund credit	x	100	-0.93	-1.43
Target income / Use of Fund credit	x	100	-0.47	+0.53
			0.64	3.73

1/ Based on estimates set out in Table 4.
2/ Based on original estimates made in April 1982 adjusted for the decision to reduce the Fund's holdings of SDRs to SDR 4 billion over the year (see EBS/82/75, 4/29/82).
3/ Interest-free resources net of use of the unremunerated reserve tranche (see Appendix Table 1).
4/ Income from margins, net of remuneration expense resulting from the excess of outstanding oil facility purchases over outstanding borrowing.