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November 2, 1983

To: Members of the Executive Board

From: The Secretary

Subject: The Rate of Remuneration and the Fund's Income Position

The attached paper on the rate of remuneration and the Fund's income position has been scheduled for discussion by the Executive Board on Wednesday, November 23, 1983.

Att: (1)

INTERNATIONAL MONETARY FUND

The Rate of Remuneration and the Fund's Income Position

Prepared by the Treasurer's Department

(In consultation with Other Departments)

Approved by W.O. Habermeier

November 2, 1983

I. Introduction

At the conclusion of the Executive Board discussion reviewing the Fund's income position, it was decided that a further review of the rate of remuneration and of the Fund's charges be undertaken not later than the mid-year review of the Fund's net income position. 1/ A number of Executive Directors asked that this review include an analysis of the effects of raising the rate of remuneration in relation to the SDR interest rate. This paper has been prepared to serve as the basis of a review by the Executive Board of the rate of remuneration relative to the SDR interest rate; it also discusses the financial implications of eliminating the differential which now exists between these two rates.

The memorandum is organized as follows: Section II reviews the relationship between the rate of remuneration and the rate of interest on the SDR and factors bearing on this relationship; Section III explores the implications for the Fund's financial position of proposals which would set the rate of remuneration at a level equal to or closer to the SDR interest rate. A summary of conclusions is presented in Section IV.

Executive Directors also considered it desirable to review the methods used to set the rate of charge on the use of the Fund's ordinary resources with the purpose of achieving more closely the net income target of the Fund than has been the case in the last two years; in addition, a number of Directors felt that the adequacy of that target rate of growth of the Fund's reserves also deserved further consideration. A separate memorandum is being prepared reviewing the present methods of determining the rate of periodic charges in the light of the Fund's target growth in its reserves. That memorandum will also include a further consideration of the factors relevant in judging the adequacy of the Fund's reserves and of the target rate of growth of reserves.

1/ See "Review of the Fund's Income Position for the Financial Years 1983 and 1984" (EBS/83/75, 4/18/83) and Executive Board Meeting 83/70 (5/16/83).

II. The Rate of Remuneration and the SDR Interest Rate

1. Evolution of remuneration

Table 1 (and Chart 1) shows the evolution of the rate of remuneration since July 1969, the date of the coming into effect of the First Amendment of the Articles, and its relationship with the SDR interest rate. Prior to July 1969, there was no provision for the Fund to pay remuneration on the credit that members extended to other members through the Fund. 1/

As can be seen from Table 1, remuneration (and the SDR interest rate) was initially paid at the rate of 1.5 percent per annum. This rate prevailed until the introduction of the basket valuation of the SDR in July 1974, when the rate of remuneration began to be set by reference to a combined market rate. The SDR rate was set at 5 percent and a split rate for remuneration was introduced with the higher rate of 5 percent applicable on the amount by which currency holdings were less than 50 percent of quota (a rate of remuneration of 2.5 percent applied to creditor positions on currency holdings falling below 75 percent of quota and in excess of 50 percent). The split rate was unified in July 1975 and in July 1976 the rate was calculated on a quarterly basis, rather than, as hitherto, on a semiannual basis and set at 60 percent of the combined market rate.

From July 1976 to January 1979 the rate of remuneration and the SDR interest rate were equal, when, following the coming into effect of the Second Amendment of the Articles, the SDR rate was raised to 80 percent of the combined market rate and the rate of remuneration was set at 90 percent of the SDR interest rate. When the SDR interest rate was raised to the full combined market rate of interest with effect from May 1, 1981, the rate of remuneration was maintained at a discount to the SDR interest rate and was set at 85 percent of the SDR rate; consequently, in terms of the combined market rate, the rate of remuneration increased from 72 percent to 85 percent.

2. The reserve tranche and other Fund related assets

Over the last 20 years the Fund has instituted major improvements--most notably in connection with the First Amendment of the Articles--in the liquidity and usability of the reserve (formerly "gold") tranche. 2/ Furthermore, significant steps have been taken over time to improve the return on the reserve tranche:

1/ Appendix I provides a brief chronology on the developments affecting the payment of remuneration.

2/ For example, as a result of the First Amendment, use of the reserve ("gold") tranche became legally automatic, not subject to challenge, and available for meeting capital transfers. It may now also be retained when use is made of Fund resources under any of its facilities.

CHART 1

RATE OF REMUNERATION, SDR INTEREST RATE, RATE OF CHARGE AND COMBINED MARKET RATE

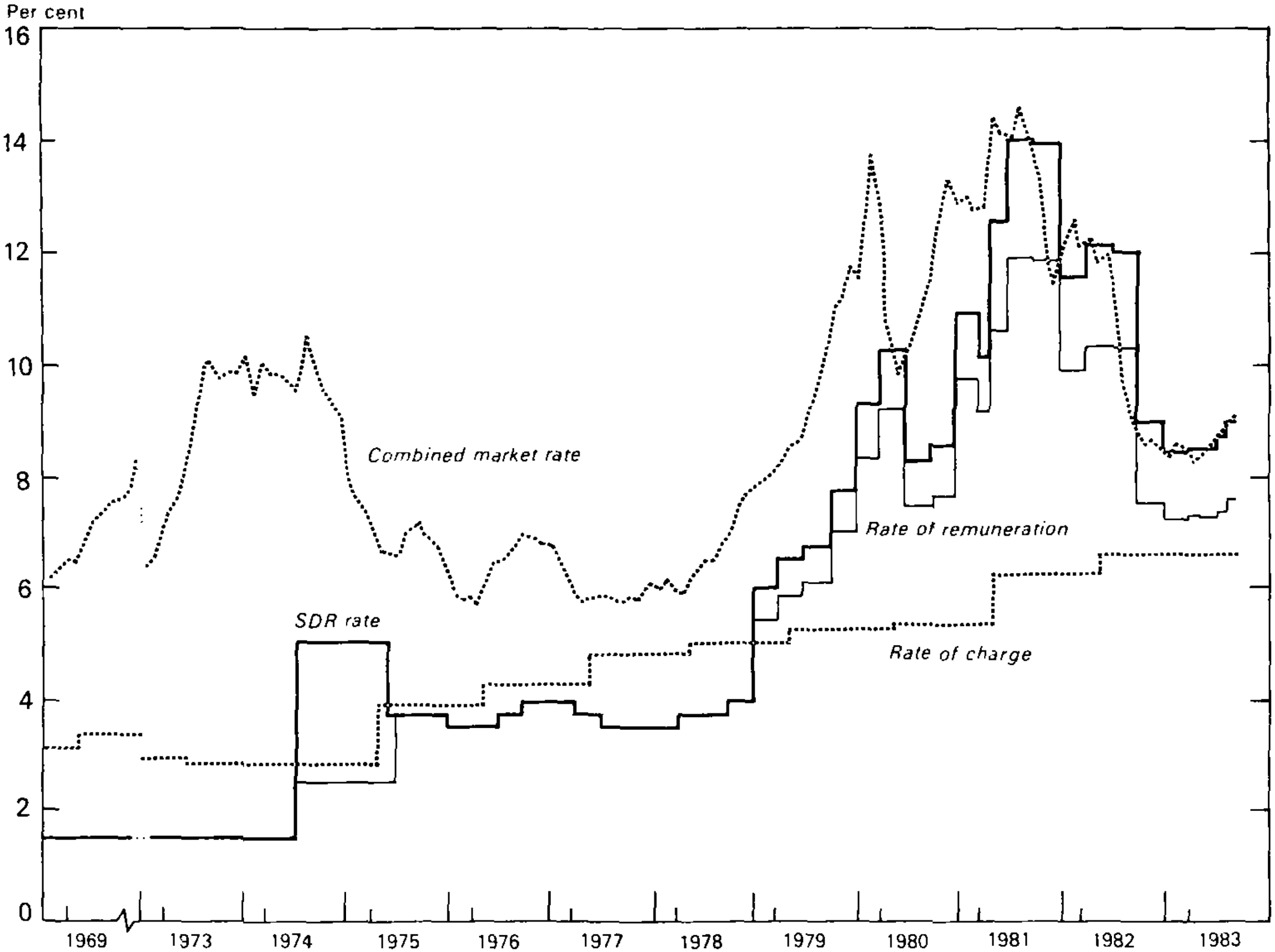


Table 1. The Rate of Remuneration and the SDR Interest Rate

Effective Date		Rate of Remuneration	SDR Interest Rate	Combined Market Rate (Reference Rate 1/)	Rate of Remuneration as a percentage of the SDR Rate	Rate of Remuneration as a percentage of the Combined Market Rate 1/
1969	July 28	1.5	1.5	...	--	--
1974	July 1	2.5 and 5.0	5.0	9.86	100	35
1975	July 8	3.75	3.75	6.86	100	55
1976	January 1	3.50	3.50	6.68	100	52
	July 1 2/	3.75	3.75	5.95	100	60
	October 1	4.00	4.00	6.59	100	60
1977	April 1	3.75	3.75	6.38	100	60
	July 1	3.50	3.50	5.71	100	60
1978	April 1 3/	3.75	3.75	6.10	100	60
	October 1	4.00	4.00	6.57	100	60
1979	January 1 4/	5.40	6.00	7.54	90	72
	April 1	5.85	6.50	8.04	90	72
	July 1	6.075	6.75	8.51	90	72
	October 1	6.975	7.75	9.64	90	72
1980	January 1	8.325	9.25	11.56	90	72
	April 1	9.225	10.25	12.73	90	72
	July 1	7.425	8.25	10.38	90	72
	October 1	7.65	8.50	10.54	90	72
1981	January 1	9.7875	10.875	13.590	90	72
	April 1	9.1125	10.125	12.583	90	72
	May 1 5/	10.69	12.58	12.58	85	85
	July 1	11.93	14.03	14.03	85	85
	October 1	11.89	13.99	13.99	85	85
1982	January 1	9.89	11.63	11.63	85	85
	April 1	10.33	12.15	12.15	85	85
	July 1	10.21	12.01	12.01	85	85
	October 1	7.57	8.90	8.90	85	85
1983	January 1	7.20	8.47	8.47	85	85
	April 1	7.24	8.52	8.52	85	85
	July 1	7.35	8.65	8.65	85	85
	August 1 6/	7.49	8.81	8.81	85	85
	August 8	7.62	8.96	8.96	85	85
	August 15	7.68	9.03	9.03	85	85
	August 22	7.56	8.89	8.89	85	85
	August 29	7.51	8.84	8.84	85	85
	September 5	7.59	8.93	8.93	85	85
	September 12	7.51	8.84	8.84	85	85
	September 19	7.47	8.79	8.79	85	85
	September 26	7.34	8.64	8.64	85	85
	October 3	7.28	8.56	8.56	85	85
	October 10	7.25	8.53	8.53	85	85
	October 17	7.34	8.63	8.63	85	85

1/ The reference rate is the combined market rate used to determine the SDR interest rate. The actual percentage of the rate of remuneration to the combined market rate is slightly different from the one shown because of the rounding in the setting of the SDR rate.

2/ Change from semi-annual to quarterly determination of rates and the rate of remuneration was set at 60 percent the combined market rate.

3/ SDR rate set at 60 percent of the combined market rate.

4/ SDR rate set at 80 percent of the combined market rate and the rate of remuneration set at 90 percent of SDR interest rate.

5/ SDR interest rate set at 100 percent of the combined market rate and the rate of remuneration set at 85 percent of the SDR interest rate.

6/ SDR interest rate and rate of remuneration determined on a weekly basis.

(1) There has been a considerable increase in the proportion of the reserve tranche which now bears remuneration by inclusion of subscription payments made in connection with quota increases. The norm for remuneration has been raised from 75 percent of quota in 1977 to an average of 87.9 percent of quota now, and will rise further when the quotas agreed under the Eighth General Review become effective.

(2) The rate of remuneration has been progressively adjusted closer to market rates, though its relationship with the rate of return on other Fund related assets has varied. In terms of the combined market rate, remuneration has been raised from 35 percent in 1974 to 85 percent in 1983. In relation to the SDR interest rate, the rate of remuneration was equal to the SDR rate for a number of years--albeit when the latter rate was below market rates--but is now at a discount of 15 percent of the SDR rate. The frequency of determining the rate of remuneration--from annually to semiannually to quarterly and, since August 1983, to a weekly basis--and the frequency of payment--from annually to quarterly--have been brought more in line with market practice in step with the SDR interest rate.

While there are a number of different Fund related assets--reserve tranche positions, SDRs, GAB, SFF and EAR loan claims--which bear different rates of interest, they all have certain similar characteristics. 1/ In view of these similar characteristics, differences in yield on these assets might be expected largely to reflect specific features or characteristics in which these individual assets differ from others--e.g., their encashability, transferability, and maturity. One important common feature of all Fund-related assets is that the currency value of the assets is determined by the same method. Secondly, these assets can be mobilized at par by the member holding them in the event the holder represents to the Fund it has a balance of payments need to use the assets. Thirdly, Fund-related assets can be transferred or sold to other official institutions (and, in the case of some EAR claims, also to private holders) under certain conditions. This, however, is not the case for reserve tranche positions.

A reserve tranche position differs in two other ways from other Fund-related assets: while members can add to their SDR holdings through bilateral transactions, and, if there is a willing seller, add Fund loan claims to their reserves, members cannot, at their own initiative, increase their reserve tranche positions in the Fund nor, except within broad limits, determine the rate at which such positions could be increased; rather, a creditor member's reserve tranche position in the Fund may be reduced by repurchases made by other members indebted to the Fund. To a considerable extent, the size of a member's reserve

1/ Similarities and differences between these assets were discussed more fully in "Review of the Fund's Charges" (SM/80/282, 12/24/80) pp. 22-23. See also "Special Drawing Rights--A Discussion Paper" (SM/78/153, Supp. 1, 6/29/78) and "The Effects of Separating the Rate of Remuneration from the Interest Rate on the SDR" (SM/78/20, 1/18/78).

tranche position in the Fund fluctuates at the discretion of the Fund, rather than that of the member, and the fluctuations reflect variations in the scale of the Fund's operations and transactions. Assets with a lesser degree of usability or transferability might normally be expected to carry a somewhat higher rate of return than more liquid assets. 1/ Secondly, as noted earlier, remuneration is paid on only a part of a member's reserve tranche position. At present, the total of unremunerated reserve tranches amounts to SDR 5.5 billion, which effectively reduces the amount of remuneration paid to creditors by 27 percent below what it would be if remuneration were paid on the total of reserve tranche positions. The revised and enlarged General Arrangements to Borrow provide for GAB claims to bear interest equal to the combined market rate. The reserve tranche positions subject to payment of remuneration will then represent the only creditor claims on the Fund with a yield that is below some market-related rate of interest, despite the less advantageous liquidity characteristics of the positions. Thus reserve tranche positions may be regarded as somewhat less liquid than other Fund-related assets and as less well remunerated.

3. Rate of remuneration and extension of Fund credit

In view of these characteristics, an increase in a member's reserve tranche position implies a shift from a higher yielding reserve asset invested in official liquid instruments or in the private markets (or even in SDRs) to one with a lower return as well as a shift from a more liquid asset to a somewhat less liquid asset. These effects may not be the most conducive to facilitate financing of the Fund from subscriptions on the scale that is likely to be needed in the period ahead. The extension of credit through the Fund has expanded sharply in the last three years, more than doubling from an average level of SDR 5.3 billion in FY 1981 to SDR 11.4 billion in FY 1983, and a further significant expansion of credit can be expected over the next one or two years. The expansion of Fund credit is, of course, reflected in a sharp expansion of reserve positions in the Fund (see Chart 2) and if the further increase in Fund credit to members is to materialize, it will need to be financed in large part by an expansion of members' reserve positions in the Fund. Table 2 sets out the expansion of the reserve tranche positions of creditor members in relation to their total reserves over the last decade. A further expansion of these positions would imply a substantial diversification of members' reserves into reserve tranche positions in the Fund, particularly in the event that growth of other reserves would continue to be small or stagnate at current levels. If the members concerned would perceive the rate of return on reserve positions to be too low, the diversification could, however, be an uneasy process which may not only show up in some reluctance of countries to accept the increase in reserve tranche positions to which they would

1/ An argument could be made that in view of the differences in transferability and usability between reserve tranche positions in the Fund and the SDR, the rate of remuneration might exceed the SDR interest rate, but the Articles do not provide for this possibility.

be obligated, but also in a reduced willingness to agree to a further expansion of the credit activities of the Fund.

Table 2. Reserve Tranche Positions and Total Reserves of Creditor Members, 1973-1983

(Amounts in billions of SDRs)

Financial Years Ended April 30,	Reserve Tranche Positions	Reserve Positions (including loan claims on the Fund)	Total Reserves 1/	Reserve Tranche Position	Reserve Position
				Percent of total reserves	
1973	6.2	6.2	136.5	4.5	4.5
1974	6.2	6.2	143.0	4.3	4.3
1975	7.3	10.0	155.3	4.7	6.4
1976	8.3	14.8	170.3	4.9	8.7
1977	10.8	18.5	186.5	5.8	9.9
1978	9.0	17.0	231.2	3.9	7.4
1979	8.3	13.3	264.1	3.1	5.0
1980	8.4	12.1	300.4	2.8	4.0
1981	13.1	17.4	353.4	3.7	4.9
1982	15.6	22.3	328.2	4.8	6.8
1983	20.6	30.9	331.5	6.2	9.3
1984 (est.)	32.3	49.6	331.5 2/	9.7	15.0

Source: IFS

1/ Including holdings of foreign exchange; gold, valued at SDR 35 per fine ounce, SDR holdings, reserve tranche positions; and loan claims on the Fund.

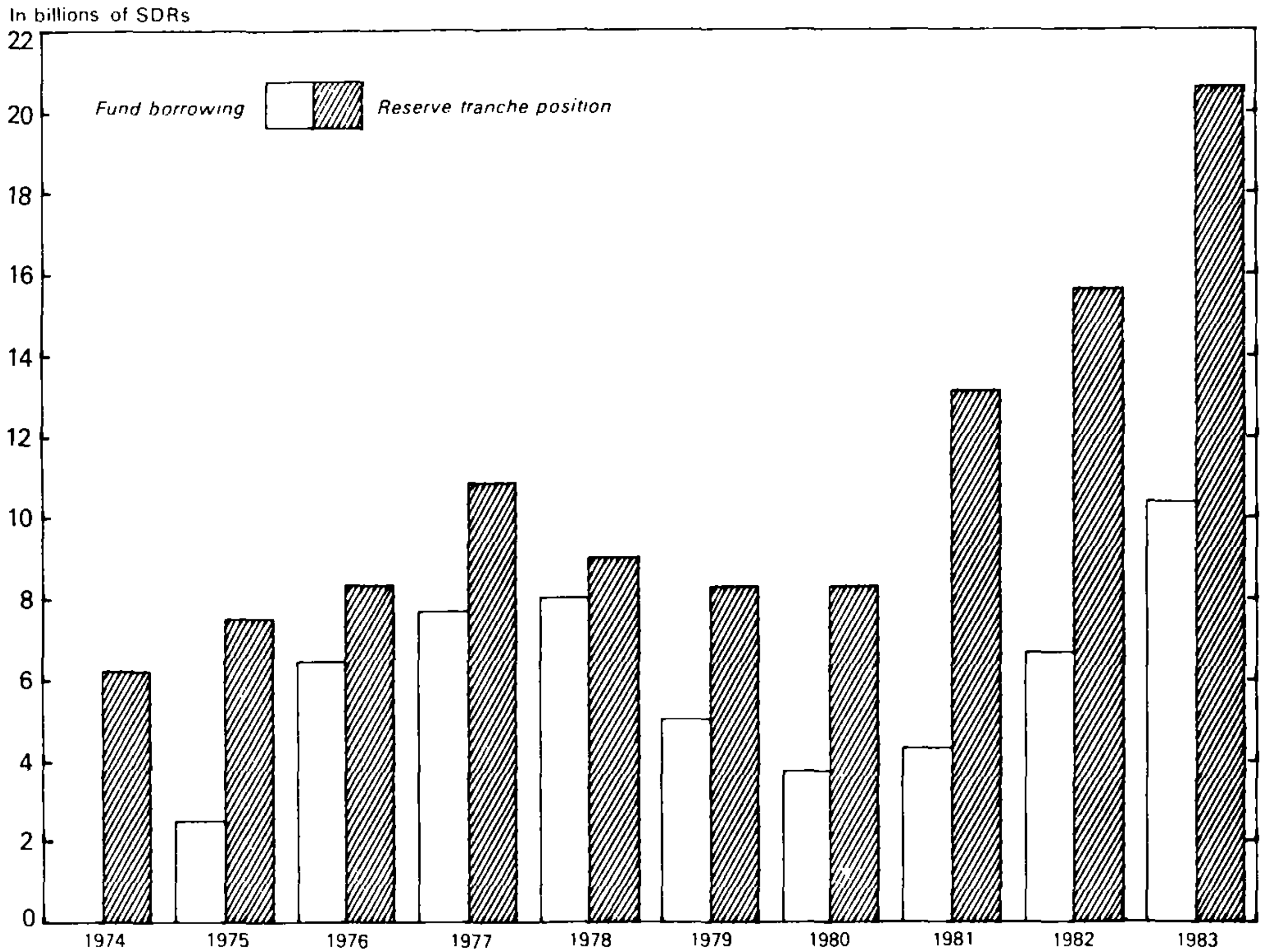
2/ Assumed unchanged from 1983.

4. Frequent changes in the level of the rate of remuneration

For the reasons discussed in the foregoing paragraphs, it may be desirable to bring the rate of remuneration into closer harmony with other Fund-related assets, in particular the SDR interest rate. Should an increase in the rate of remuneration relative to the SDR interest rate be decided upon, it would be desirable at the same time to consider carefully whether and under what conditions such an increase could be sustained. A frequent variation in the level of the rate of remuneration relative to the SDR may not improve the standing of the remunerated reserve tranche as an attractive investment for a significant proportion of members' reserves. A stable relation between the rate of remuneration and the SDR rate would also appear desirable to assure holders of reserve tranche positions that the Fund would not lower the rate of return on this asset for reasons of its income position. It would, therefore, be

CHART 2

RESERVE TRANCHE POSITION AND FUND BORROWING



for consideration that an understanding be reached when an increase in the rate of remuneration is approved to keep subsequent changes in the relationship to the SDR to the minimum. This would mean that, as a matter of policy, primary reliance might have to be placed on more frequent variations in the actual rate at which the Fund's reserves are to grow or in changes in charges as a consequence of changes in both the rate of remuneration and the amounts of remuneration payments. Thus the rate of remuneration would not normally be regarded as an element which would be varied from time to time in relation to the SDR interest rate or market interest rates in order to protect the Fund's financial position.

III. Implications for Charges and the Fund's Income Position

1. Possible impact on charges

Remuneration paid by the Fund to creditor members is in present circumstances a main determinant of the Fund's operational expense. Any increase in the rate of remuneration will thus have an important impact on the Fund's net income position. Unless market rates of interest decline, an increase in the rate of remuneration would require an increase in the rate of periodic charges in order to ensure that the Fund would be able to achieve the net income target that has been agreed by the Executive Board.

To gauge the likely impact on Fund charges of raising the level of the rate of remuneration, calculations have been made of the Fund's net income position at the present rate of charge, and of the rates of charge that would be needed in FY 1985 to achieve the target rate of growth of reserves of 3 percent per annum if the rate of remuneration were raised to the SDR interest rate. As is customary, the calculations are based on the current SDR rate in order to obviate the need for projections of developments in market interest rates, and hence the SDR interest rate. 1/ In view of the weekly fluctuation of the SDR rate of interest since August 1, the average rate since that date (rounded to the nearest quarter percent) of 8.75 percent has been used in the calculations.

These calculations indicate a deficit of SDR 48 million with the rate of remuneration at 85 percent of the SDR interest rate, and of SDR 387 million if the rate of remuneration were raised to the level of the combined market rate and the present rate of charge maintained unchanged, and the present level of interest rates continued. In order

1/ The calculations are based on projections of the use of Fund resources in "Review of the Policy on Access to the Fund's Resources--Financial Considerations" (EBS/83/133, 6/28/83). Projected demand for the use of Fund resources and their effect on the Fund's income position will be reviewed in the forthcoming Review of the Fund's Income Position.

to avoid the deficit but maintaining the target income of 3 percent of reserves, the rate of charge would need to be raised to 6.93 percent with the present relation between the rate of remuneration and the SDR interest rate, and to 8.33 percent with a rate of remuneration equal to the SDR interest rate.

The estimates are, of course, highly sensitive to developments in market interest rates and hence the interest rate on the SDR. For example, if the combined market rate and SDR interest rate were to average 1 percentage point lower than the 8.75 percent assumed in the calculations, the rate of charge required to produce a balanced income position with the rate of remuneration equal to the SDR interest rate would be 7.30 percent; if market interest rates during FY 1985 averaged about 1.9 percentage points below the present rate, it would be possible to raise the rate of remuneration to the level of the SDR rate without having to raise the present rate of charge of 6.6 percent in order to safeguard the Fund's income position. The projected deficit at the present rate of charge and the rate of charge required to avoid a deficit in the Fund's income position at various hypothetical combined market rates of interest are shown in Table 3:

Table 3. Effect of Market Rates of Interest and the Fund's Income Position and Charges, FY 1985

SDR Interest rate = rate of remuneration (In percent)	Projected deficit with rate of charge of 6.6 percent (SDR million)	Rate of charge required for balanced income position (In percent)
6	+213	5.72
7	-5	6.62
8	-223	7.53
9	-441	8.43
10	-659	9.33
11	-877	10.24
12	-1,095	11.14

Divergences from projected values may, of course, also occur for some of the other variables on which the estimates are based, such as, e.g., the volume of credit extended by the Fund. However, likelihood of large differences between projected and actual values, and hence of a sharp effect on the Fund's income position, is a much smaller order of magnitude than that of substantial fluctuations in market rates of interest.

2. Concessionality of charges

Consideration will also have to be given to the concessionality in Fund charges. The periodic charges presently levied by the Fund on the use of its subscribed (i.e. "ordinary") resources contain an important element of concessionality which would be reduced, other things remaining equal, by an increase in the rate of remuneration relative to the SDR interest rate and thus in relation to market rates of interest.

The size of a concessional element in, and the need for concessionality of, Fund charges has been long debated, but there remain differences of view on the criteria that should determine the level and structure of charges, which are determined from time to time in the light of circumstances. Market interest rates have been an important element in the determination of Fund charges in two somewhat countervailing directions: the level of charges should be such as to encourage--and certainly not discourage--members to make early use of the Fund's resources to finance balance of payments disequilibrium, but charges should also not be so low as to discourage members from making repurchases or to induce members to finance an undue share of their deficit from the Fund. In fact, the effective level of Fund charges for long periods in the past was not much different from comparable U.S. interest rates. 1/ It was also recognized that the Fund's operating revenues should be large enough, over a reasonable period, to pay its way. More recently, importance came to be attached to the view the Fund ought to avoid deficits in order to inspire confidence in the good management of its affairs and to strengthen the Fund's financial standing.

At the outset of Fund operations and for some years afterwards, the effective rate of charge was relatively high "compared to rates then prevailing in the markets of the potential capital exporting countries." 2/ Following the return to active monetary policies in the early 1950s, and the consequential rise in interest rates, the Fund's charges were periodically raised in the light of increases in interest rates in the major money markets: for example, the 1951 increase in charges on outstanding balances "made them [charges] equivalent to prevailing rates on two-year or three-year paper in New York and London"; the 1953 increase in the schedule of charges was "a reaction to the marked rise in the costs of international financing between 1951 and 1953, and, in less degree, to the continuing Fund deficit." 3/ Subsequent increases in charges, if not directly motivated by, were certainly

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1/ A case was sometimes made in the past for keeping the Fund's level of charges somewhat below the levels of interest rates in the major capital markets on the basis that a purchase from the Fund involved a repurchase commitment expressed in terms of gold whereas borrowing in the capital market did not. The same argument based on the gold value character of a creditor's claim against the Fund also justified, to some extent, the nonpayment of a return on its creditor position.

2/ See "Schedule of Fund Charges" (SM/66/39, 3/24/66), p. 4.

3/ *Ibid.*, p. 6.

made in the light of increases in interest rates in the leading international financial centers. However, because the Fund did not pay remuneration on creditor positions until the First Amendment, the level of operating expense was relatively small which made it possible that the effective rate of charge was increased much less sharply than the trend in market rates and as a consequence, could be kept relatively low in comparison to these rates. This resulted in an increasing concessional element in Fund charges during the 1960s which, however, varied markedly over time in view of fluctuations in market rates of interest and the relative fixity of charges. From 1969 onwards, the obligation for the Fund to pay remuneration, particularly following the establishment of a direct link between the market interest rate and the rate of remuneration in 1974, has become an increasingly dominant consideration in the determination of charges, in view of the impact of the payment of remuneration on the Fund's income position.

The Fund's ability to provide its resources on a concessional basis derives primarily from (a) the amount of interest-free resources at its disposal and (b) the extent to which the rate of remuneration is lower than the combined market rate, after taking into account the contribution from interest-free resources. 1/

(a) The amount of interest-free resources--i.e., resources on the use of which the Fund does not pay remuneration--normally does not vary substantially from month to month. 2/ The total of such resources at present amounts to SDR 2.9 billion, and is equal to the total of unremunerated reserve tranche positions plus reserves less gold holdings. The contribution of these resources in reducing operational expense is relatively the larger the lower the outstanding use of the Fund's ordinary resources, and vice versa. The existence of interest-free resources at present rates of use of Fund resources permits the rate of charge to be about 1.3 percentage points lower than it otherwise would be.

1/ Other factors affecting the Fund's income position and its ability to provide resources on a concessional basis include the income from the Fund's SDR holdings, from service charges, and from the margin on borrowed resources, offset by administrative expenditures and reserve accretion. Determinants of the Fund's income position will be discussed more fully in the forthcoming staff memorandum on the determination of Fund charges and the level of reserves.

2/ Interest-free resources essentially derive from the proceeds of sales from the Fund's gold holdings and the accumulation of reserves, and also reflect the use of unremunerated reserve tranche positions. Interest-free resources decrease (increase) to the extent of purchases (sales) in the unremunerated reserve tranche, and increase by the accumulation of net income placed to reserves and from the proceeds of additional gold sales. Payments of additional subscription for quota increases also provide additional interest-free resources equal to any increase in unremunerated reserve tranche positions that derive from the quota payments.

(b) The other main contribution to the concessional element in Fund charges stems from the payment to members of a rate of return on credits extended through the Fund that is substantially below the rate of return on their other reserves. At present the rate of remuneration is about 1.3 percentage points below the combined market rate, and considerably further below rates in the individual currency markets in which members invest a large portion of their reserves. 1/

Although an increase in the rate of remuneration, unless offset by a decline in market interest rates, would result in a need to increase the rate of charge, this does not necessarily mean that the concessional element in the cost of resources provided by the Fund would be eliminated. While there is no single established way of measuring the concessional element in Fund charges--some possible measures are presented in Table 4--it is clear that in view of the relative stability of the rate of charge in the face of fluctuating market interest rates the concessional element in Fund charges has varied markedly over the years, as has already been mentioned. The comparatively high concessional element during periods of high market rates since 1980 clearly has reduced the financing cost to members associated with stabilization programs and thus facilitated the adjustment process. It is less clear, however, whether there exists a level of concessionality that is optimal from the point of view of providing incentives to adopt adjustment policies, or in the sense of contributing to their success.

As noted earlier, the major element of the concessionality in present Fund charges derives from the availability of interest-free resources, and depends on the extent of use of Fund resources relative to the volume of such interest-free resources. 2/ It is not self-evident that the advantages of the additional element of concessionality that is the result of a rate of remuneration below market rates of interest and the rate of interest on other Fund-related assets outweigh the disadvantages presented by the potential effect on the financing of the Fund's transactions. Indeed, in present circumstances of a relatively large total of outstanding reserve tranche positions and a pressing need to finance further increases of Fund credit through expanding the total of these positions, it would seem that some increase in the rate of remuneration relative to other Fund-related assets could be justified, notwithstanding its effect on the concessionality of Fund charges, in order to facilitate the provision by the Fund of balance of payments finance derived from quota subscriptions.

1/ These indications of the contribution to the concessional element in Fund charges are approximate as they do not take into account other income and cost elements, such as administrative expenditures and reserve accretion mentioned above.

2/ For example, the increase in charges for FY 1985 mentioned on page 7 was based on projected use of Fund resources (i.e., balances subject to charges) of SDR 24.1 billion. Interest-free resources would permit avoidance of an increase in the present rate of charge only if outstanding use of Fund credit did not exceed SDR 3.2 billion.

Table 4. *Fund Charges and Market Rates of Interest*

(In percent; annual averages)

Financial Year	Rate of Charge 2/	Market Interest Rates 1/		Rate of charge as a percentage of market interest rates		Grant Element 3/	
		Domestic	Euro-deposits	Domestic	Euro-deposits	Domestic	Euro-deposits
1969	3.16	5.68	7.07	55.6	44.7	10.0	15.0
1970	3.31	6.99	10.11	47.4	32.7	14.1	24.2
1971	3.67	5.36	7.34	68.5	50.0	6.7	14.0
1972	3.84	4.23	6.45	90.8	59.5	1.6	10.2
1973	2.98	4.83	6.23	61.7	47.8	7.5	12.7
1974	2.85	9.49	9.85	30.0	28.9	24.0	25.0
1975	3.19	9.00	10.35	35.4	30.8	21.2	25.3
1976	3.90	6.44	6.34	60.6	61.5	9.9	9.5
1977	4.26	6.50	5.45	65.5	78.2	8.7	4.8
1978	4.77	5.86	6.73	81.4	70.9	4.3	7.6
1979	5.04	7.21	9.89	69.9	51.0	8.3	17.3
1980	5.25	10.84	13.80	48.4	38.0	19.5	27.9
1981	5.30	11.72	14.42	45.2	36.8	22.0	29.3
1982	6.25	13.11	16.00	47.7	39.1	22.7	30.3
1983	6.60	9.41	11.19	70.1	59.0	10.2	15.9
1984*	6.60	8.70	9.59	75.9	72.8	7.7	9.0

*May-September 1983.

1/ Market interest rates are three-month U.S. Treasury bill rates and three-month euro-dollar deposit rates through 1973, and the combined market rate used for the calculation of the SDR interest rate, based on domestic and euro-deposit rates, respectively, from 1974 onwards.

2/ Refers to average rate of charge on use of Fund's ordinary resources only. Prior to 1982, rates of charges are average rates levied by the Fund taking into account the progression of rates then incorporated in the schedules of charges.

3/ The "grant element" in this table is calculated as the face value of a commitment less the discounted present value of the future flow of payments of principal and interest expressed as a percentage of the face value, using the combined market rates and euro-deposit rates as discount rates.

3. Timing of a change in the rate of remuneration

An increase in the rate of remuneration in relation to the SDR interest rate must take into account the size of the possible increase in charges that is likely to be required to safeguard the Fund's income position. This raises the issue of the timing of any such increase in relation to the Fund income position, and also in relation to developments in interest rates in the leading money markets which, of course, determine the level of the SDR interest rate. Raising the rate of remuneration at a time when market rates might be continuing their recent fall or remain stable might appear unjustified although there would, of course, be a lesser immediate impact on the Fund's income position and thus on the level of charges. On the other hand, delaying an increase in the rate of remuneration to a time when market rates were rising would tend to magnify the impact of market interest rates on the Fund's income. The recent very high level of market rates was, in fact, one reason for delaying a proposal to adopt an increase in the rate of remuneration that in principle might have been thought desirable.

A number of possibilities could be considered that would tend to lessen the short-run impact on the rate of charge as a result of equalizing the rate of remuneration with the SDR interest rate. These measures could include the following:

(i) Instead of increasing charges concomitantly with an increase in the ratio of the rate of remuneration to the SDR interest rate, an increase in the rate of charge could be delayed until a shortfall in the target income actually occurred. A delay in raising charges should avoid any increase in the rate of charge if future interest rates were to turn out lower than had been projected. However, in the converse case of actual interest rates exceeding projected levels, the delay would eventually result in the rate of charge needing to be raised more sharply later than would have been required had the change been made earlier. While an adjustment in the rate of charge might be delayed to reduce the likelihood of increases that subsequently prove not to have been necessary, its character and application could be established at the outset in line with the safeguard mechanism of the present Rules. For example, if at the time of the mid-year review of the Fund's income position actual net income for the first six months were found to be below the target by a specified amount, the rate of charge could automatically be increased to the level necessary to reach the target amount of net income for the financial year as a whole.

(ii) Net income in FY 1982 and FY 1983 substantially exceeded the amounts necessary to finance a 3 percent per annum increase in reserves, and the amount in excess of target during these years might be deemed to meet the desired growth of reserves at the agreed rate for the immediate future. 1/ An increase in the rate of charge that might be required as a consequence of an increase in the rate of remuneration could therefore be delayed, provided that projections of the Fund's net income position showed, as a minimum, a balance of income and expenditures. Consequently, any increase in the rate of charge resulting in a

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1/ If the total amount of net income in excess of target during FYs 1982 and 1983 were deemed to satisfy a target increase in reserves of 3 percent (compound) at the end of FY 1981, further reserve accumulation would be unnecessary for 3.8 years.

further accumulation of reserves at the agreed level might be avoided for some time. However, whenever projections of the Fund's income position threatened an actual deficit, the rate of charge would be raised sufficiently to bring about a balance in the Fund's net income position. 1/ The drawback of this solution is that 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. Besides, a slow-down in reserve accumulation at this point would not seem to be desirable.

(iii) The impact on Fund charges could be temporarily mitigated if the rate of remuneration were raised to the level of the SDR interest rate in stages over a limited period of time, rather than in one step. A progressive rise in the rate of remuneration (relative to the SDR interest rate) would initially permit a smaller increase in charges than would otherwise be the case. For example, if the rate of remuneration were raised in two steps, say to 92.5 percent of the SDR rate at the beginning of the next financial year and to 100 percent half a year later, the consequent deficit at the present rate of charge would be SDR 306 million and the increase that would be required in the rate of charge to avoid a deficit would be to 7.87 percent, rather than to 8.33 percent as mentioned earlier. Alternatively, the rate of remuneration could be raised to a level somewhat below the full SDR interest rate in FY 1985, with a further increase being scheduled for the following year. Table 5 shows the financial implication of raising the rate of remuneration to different proportions of the SDR interest rate. The required rate of charge would, of course, be lower than those shown in Table 5 if the method of progressively raising the rate of remuneration was combined with an attribution to subsequent financial years of some of the reserves accumulated in excess of target in FY 1981 and FY 1982, as discussed above.

(iv) Consideration could be given to measures that would improve the Fund's income on some of its assets. The Fund has the authority to make investments up to the level of its reserves, and the income from such investments could be used to meet the Fund's expenditures, thereby offsetting in part the additional cost that would arise from raising the rate of remuneration to the level of the SDR interest rate. Any investment would, of course, commensurately reduce the Fund's currency holdings in the General Resources Account, thereby expanding remunerated positions and adding to remuneration costs. The rate of return on the

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1/ The offset to the required increase in charges would be much more substantial if the whole of the income above targ[illegible] [illegible]ere deemed available to mitigate the increase in the rate of charge. This would, however, require that the Fund would be willing to accept an operating deficit, rather than aiming, as a minimum, at balanced net income position. As anticipation of a deficit would not appear compatible with the prudent management of the Fund's resources--which would preclude planning for or acceptance of an operating deficit--this possibility is not pursued further.

investment would therefore need to be significantly greater than the rate of remuneration in order to provide additional income of appreciable magnitude. 1/

Table 5. Financial Implication of an Increase in the Rate of Remuneration to Different Proportions of the SDR Interest Rate

Financial Year 1985

	Rate of Remuneration as a Percent of SDR Interest Rate					
	85	90	92.5	95	97.5	100
SDR interest rate	8.75	8.75	8.75	8.75	8.75	8.75
Rate of remuneration	7.44	7.88	8.09	8.31	8.53	8.75
Estimated deficit with rate of charge at 6.6 percent	-48	-162	-216	-273	-330	-387
Rate of charge required to attain target income	6.93	7.40	7.62	7.86	8.10	8.33
Rate of charge as a percent of SDR interest rate	79.2	84.6	87.1	89.8	92.6	95.2

The choice among these various measures would depend on the importance attached to the effect they have on the timing of an increase in the rate of remuneration, the rate of charge, the required degree of change in the rate of charge, and the desired rate of growth of the Fund's reserves. In addition, it would need to be kept in mind that although these methods may help to reduce or delay an increase in

1/ Investment of currency would not create additional remunerated positions to the extent that it is financed from the proceeds of the sale of gold. If gold were sold at market prices, the capital value of the proceeds would flow to the General Resources Account and, if not invested, reduce remunerated positions. Any profit could be transferred to the Investment Account, and the income from investment used for meeting the expenses of conducting the business of the Fund. Possible sales of gold are not pursued further here. See "Statement by the Managing Director on the Fund's Gold Holdings" (Buff Document 79/243 12/21/79) and "The Use of the Fund's Gold for Improving the Fund's Income Position and for Lowering the Costs of Using the Supplementary Financing Facility" (EBS/80/48, 2/29/80).

charges that may become necessary, they could not ensure that an increase in charges would in fact be more gradual than that resulting from an immediate adoption of a rate of remuneration equal to the SDR interest rate, as the degree of required adjustment in the rate of charge would also depend on the trend in market interest rates.

IV. Summary and Conclusions

The following are the main points made in the preceding analysis:

1. Despite very considerable improvements in the characteristics of reserve tranche positions that resulted from the First Amendment of the Articles and subsequently, reserve tranche positions can be viewed as somewhat less liquid than other Fund-related assets. In particular, reserve tranche positions cannot be transferred to other official holders. Although the rate of return could not offset differences in transferability, one might normally expect assets with a lower degree of usability to carry a higher return than otherwise similar assets that are more liquid.

2. With the large-scale expansion of Fund credit the total of reserve tranche positions has increased sharply, both in absolute amounts (from SDR 8.4 billion to SDR 20.6 billion between 1980 and 1983 and a projected SDR 32.3 billion in 1984) and also as a proportion of members' reserves (from 2.8 percent to 6.2 percent over the same period, and a projected 9.7 percent in 1984). The volume of credit extended by the Fund is estimated to continue to increase at a rapid pace in the period ahead, which will imply a further expansion of reserve tranche positions. However, some creditor countries seem to be showing some reluctance to support policies that would result in their continuing to acquire reserve tranche positions on the scale of recent years. One element that seems to be contributing to such a reluctance is the relatively low rate of remuneration on reserve tranche positions, implying an increasing amount of income forgone as reserve tranche positions increase in absolute amount and as a proportion to total reserves.

3. The Articles provide that the rate of remuneration paid by the Fund may be not greater than the SDR interest rate, and shall be not less than four-fifths of that rate. At present, the rate of remuneration is 85 percent of the SDR interest rate. The effective yield on the reserve tranche is lower than indicated by the relationship to the SDR interest rate because members earn remuneration only when the Fund's holdings of their currency falls below the norm for remuneration. Since 1974, the rate of remuneration has increased from approximately 35 percent of the combined market rate to 85 percent today, and the norm for remuneration has increased from 75 percent of quota to, on average, 87.9 percent of quota.

4. Despite these improvements in the return on reserve tranche positions, the reserve tranche positions will, after the revised and and enlarged GAB enter into effect, represent the only creditor claims on the Fund which yield a rate of return (remuneration) that is significantly below market-related rates of interest, even though they do not possess the same degree of liquidity that is associated with other Fund-related assets. In view of present circumstances in which the Fund needs to strengthen its liquidity position, it would seem justified to raise the yield on reserve tranche positions relative to other Fund-related assets.

5. If the rate of remuneration were raised, it may be desirable in line with the reserve character of remunerated positions, to avoid frequent variation in the rate of remuneration as a means of protecting the Fund's financial position or to increase the concessionality in the Fund's rate of charge. Consequently, greater variation in the Fund's reserves target, in the level of charges, or in both, might be expected in the event that measures were needed to be taken to safeguard the Fund's financial position.

6. An increase in the rate of remuneration to the level of the SDR interest rate would, in present circumstances and on the projections indicated earlier, necessitate an increase in the rate of charge on the use of the Fund's ordinary resources in order to avoid the emergence of a significant deficit in the Fund's income position.

7. An increase in the rate of remuneration and in the rate of charge would have an impact on the present concessional element in Fund charges. Fund charges have not always been concessional in relation to market rates and the concessional element, which derives most importantly from the interest-free resources in the Fund and from the discount of the rate of remuneration to the SDR interest rate, has fluctuated widely over time in view of the comparative stability of charges in the face of sharp movements of market interest rates. The level of concessionality which might be considered optimal from the point of view of inducing member countries to adopt policies corrective of their balance of payments problems is difficult to judge. The same is true regarding the effect of an increase in the rate of charge, if it became necessary to safeguard the Fund's income position, on members' willingness to adopt such policies. The effect of any reduction of the present level of concessionality must be balanced against the potential effect on the financing of Fund transactions of the difference between yields on various Fund-related assets.

8. In view of the impact of an increase in the rate of remuneration on the Fund's income, the Executive Board would have to consider whether charges should be increased to offset that impact fully and immediately, or whether the increase in charges should be mitigated temporarily in one of the ways described in the paper.

Evolution of the Payment of Remuneration--Chronology

1. First Amendment of the Articles

As indicated in Section II above, the Fund was required to pay remuneration on the credit that members extended to other members through the Fund only after the First Amendment of the Articles, which came into effect in July 1969. However, the original Articles provided for a discretionary distribution of net income, both preferential and nonpreferential, to its members. A distribution of net income was first to be made to an extent of up to 2 percent on average net creditor positions, i.e., the amount by which 75 percent of a member's quota exceeded the Fund's average holdings of that member's currency during the year (preferential distribution); 1/ the balance of any net income distribution was to be made to all members in proportion to their quotas (non-preferential distribution). The Fund made the first (preferential) distributions of net income to members for the financial years 1968 and 1969, in amounts equal to 1 1/2 percent of creditor positions.

The concept of remuneration was introduced with the First Amendment of the Articles, which provided for the payment of remuneration at a rate of 1 1/2 percent per annum on net creditor positions. The Fund could vary the rate of remuneration between 1 to 2 percent per annum by a decision of the Executive Directors taken by a majority of the votes cast. The Executive Board was also given the power to increase or decrease the rate of remuneration outside that range by a decision taken by three-fourths majority of the total voting power. 2/

The First Amendment established the SDR Account and provided for charges and interest to be paid on SDR allocations and holdings at a rate of 1 1/2 percent per annum, i.e., the same rate as the rate of remuneration. However, the Fund in its discretion could increase or

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1/ The level of 75 percent of currency holdings was the mark against which the extension of credit by a member through the sale of its currency to other members was measured. The reserve asset payment, which normally amounted to 25 percent of quota and was payable in gold, was not regarded as credit extended and the resulting reserve (gold) tranche therefore did not bear remuneration.

2/ At the same time, the provisions of (the original) Article XII, Section 6(b) were amended to provide that if there were to be a distribution of the net income of any year, there should first be distributed to members eligible to receive remuneration for that year an amount by which 2 percent per annum exceeded any remuneration that had been paid for that year, and any distributions beyond that amount would be paid to all members in proportion to their quota. Distributions of net income of the financial years 1970 and 1971 were made to members eligible to receive remuneration in amounts by which 2 percent per annum exceeded remuneration paid at the rate of 1 1/2 percent per annum.

decrease the SDR interest rate provided that it could not be greater than 2 percent or the rate of remuneration, whichever was higher, nor could it be less than 1 percent or the rate of remuneration, whichever was lower. This linkage of the SDR interest rate to the rate of remuneration reflected the view that the yields on various Fund-related reserve assets, including reserve tranche positions, SDR holdings, and claims on the Fund under the GAB, should not be substantially different. (By the time of the First Amendment, the rate of interest paid by the Fund on borrowings under the General Arrangements to Borrow had been fixed at 1 1/2 percent and this also suggested an equivalent initial rate of return on reserve tranche positions.)

As a consequence of the First Amendment, then, the Fund was required to pay remuneration which came to be accepted as a return on the credit extended through the Fund by member countries in comparatively strong balance of payments position to those needing balance of payments finance, rather than being considered, as formerly, a distribution of income to be made only if the Fund's financial position at the end of the financial year allowed such a distribution. Furthermore, the First Amendment enabled the Fund to vary the rate at which remuneration could be paid to creditors, by a 75 percent majority of the total voting power, even though it was not expected that a change in the rate would be made "unless it were necessary in the light of developments in international monetary markets." 1/

2. 1974-78

As noted earlier, the rates of charge and interest on SDRs could not go above 2 percent per annum unless remuneration was increased above 2 percent per annum. However, upon the introduction of the basket valuation of the SDR in July 1974, the rate of remuneration was also set by reference to a combined market rate based on short-term market interest rates in each of the five countries whose currencies had the largest weights in the then 16-currency valuation basket. This change in the method of determination of the rate of remuneration would have resulted in a sharp increase in the amount of remuneration paid to creditors, with adverse consequences on the Fund's financial position unless charges on the use of Fund resources were sharply raised. To overcome this difficulty, a schedule of rates of remuneration was adopted under which the basic rate of remuneration that was paid on large creditor positions (in relation to quota) was higher than the average rate of remuneration on net creditor positions, and thus permitted a higher rate of interest on the SDR, with the result of reducing

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1/ "Proposed Amendment of the Articles of Agreement", A Report by the Executive Directors to the Board of Governors, Washington, D.C. (April 1968), p. 28.

operational costs of the Fund that needed to be covered by charges on purchases. 1/

More specifically, the rate of remuneration was set at 5 percent per annum on the amount by which currency holdings were less than 50 percent of quota while a rate of one-half the basic rate (or 2.5 percent) applied to amounts between 75 percent and 50 percent of quotas. The graduation made it possible to introduce a smaller increase in the schedule of charges than would otherwise have been necessary, the initial rate being raised from from 2 percent to 4 percent. The SDR interest rate was set at 5 percent per annum equal to the basic (or higher) rate of remuneration.

3. Second Amendment of the Articles

The Second Amendment of the Articles introduced a number of changes regarding the payment of remuneration, of which three are of particular relevance in the present context: (i) the rate of remuneration must now be the same (rather than simply uniform) for all members and for all portions of a member's reserve tranche position on which remuneration is paid; (ii) the rate of remuneration may not be more than the rate of interest on SDR holdings, nor less than four-fifths of that rate; and (iii) remuneration is payable on the amount by which a specified part of a member's quota, the "norm", exceeds the average daily balances of a member's currency held in the General Resources Account (after making provision for excluded balances). The norm is influenced by a member's subscription payments subsequent to the Second Amendment, and can be an amount between 75 and 100 percent of quota. 2/ The Fund may also prescribe 100 percent of quota as the norm applicable for all members, but the Fund cannot lower the norm from the level ruling at any given time.

The Second Amendment thus directly linked the rate of remuneration to the SDR rate, which itself was a market-related rate, and also extended the size of the reserve tranche on which remuneration was to be paid. The linking of the rate of remuneration to the SDR rate of interest assured that the rates of return on the two reserve assets should be closely related. In the discussions on the Second Amendment the view was expressed that it would be desirable for the rates of

1/ See "Interim Valuation of the SDR" (SM/74/59, 3/8/74) and "Uniformity in Relation to Remuneration" (SM/74/56, 3/7/74) regarding the establishment of split rates of remuneration for different brackets of net creditor positions.

2/ Specifically, for a member at the time the Second Amendment entered into effect, the norm is an amount equivalent to 75 percent of the member's quota at that time plus the full amount of any quota increase since then. For a member that joined the Fund after the Second Amendment, the norm is an amount equivalent to the weighted average of norms for all members at the time of joining, plus the amount of any subsequent quota increase for that member.

interest on the two assets to be equal, with the possibility of some divergence as there could be occasions when equality between the rate of remuneration and the SDR interest rate would have a substantial and undesirable effect on the Fund's income position and on the rate of charge of the use of the Fund's resources.