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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 83/70

10:00 a.m., May 16, 1983

J. de Larosière, Chairman
W. B. Dale, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	W. B. Tshishimbi
J. de Groote	H. G. Schneider
B. de Maulde	A. Le Lorier
A. Donoso	
R. D. Erb	C. Dallara
M. Finaish	
A. H. Habib	Jaafar A.
T. Hirao	T. Yamashita
	M. Casey
A. Kafka	
	G. Grosche
	C. P. Caranicas
R. N. Malhotra	A. S. Jayawardena
Y. A. Nimatallah	J. E. Suraisry
J. J. Polak	T. de Vries
	K. G. Morrell
	O. Kabbaj
F. Sangare	
	S. E. Conrado, Temporary
J. Tvedt	A. Lindø
N. Wicks	C. Taylor
Zhang Z.	Wang E.

L. Van Houtven, Secretary
R. S. Franklin, Assistant

1. EXECUTIVE DIRECTOR

The Chairman welcomed to the Executive Board Mr. Nigel Wicks, Executive Director for the United Kingdom.

2. SDRs - REVIEW OF SALES, AND PROPOSAL ON LEVEL OF FUND SDR HOLDINGS

The Executive Directors considered a staff paper on a review of the sales of SDRs and a proposal on the level of the Fund's SDR holdings (SM/83/63, 4/18/83).

Mr. Erb, Mr. Polak, Mr. Kafka, Mr. Grosche, Mr. Malhotra, Mr. Hirao, Mr. Kabbaj, Mr. Zhang, Mr. de Maulde, Mr. Morrell, Mr. Sangare, Mr. Tshishimbi, Mr. Habib, Mr. Portas, Mr. Nimatallah, and Mr. Caranicas supported the proposed decision.

Mr. Wicks noted that, while his authorities were also generally in favor of the decision, they wondered whether the Fund might not be somewhat bolder and aim to reduce its holdings of SDRs more toward SDR 1 billion by the end of 1983.

The Executive Board then adopted the following decision:

> In determining the amounts of SDRs to be transferred to members, the Fund will be guided by the aim of reducing the Fund's SDR holdings to approximately SDR 1.5 billion by the end of 1983. The level of the Fund's SDR holdings shall be reviewed again in the light of the progress made in implementing the increases in quotas authorized under the Eighth General Review of Quotas but not later than the end of December 1983.

Decision No. 7397-(83/70) S, adopted
May 16, 1983

3. FUND INCOME POSITION FOR FINANCIAL YEARS 1983 AND 1984 - REVIEW

The Executive Directors considered a staff paper and recommendations on a review of the Fund's income position for the financial years 1983 and 1984 (EBS/83/75, 4/18/83; and Sup. 1, 5/13/83).

Mr. Erb stated that his preference was to take a decision at the present meeting to move the rate of remuneration toward 100 per cent of the SDR interest rate because such a move would be helpful to many of those seeking parliamentary approval for the Fund's quota increase. In light of the large surplus registered for 1983, the rate of remuneration could be raised without the need for a significant increase in charges. However, he could go along with the proposed recommendations so long as it was agreed that the Executive Board would come back to the matter before the normal mid-year review--preferably sometime during the summer--to address some of the fundamental issues involved in setting the rates of remuneration and charges.

It was clear from EBS/83/75 that a more rational and more regular treatment of charges, remuneration, and reserves would be desirable, Mr. Erb continued. The staff was clearly faced by a number of uncertainties in estimating the Fund's income position a year in advance; the timing of the implementation of the quota increase obviously affected the assessment of the income position for 1984, and there were other elements, including the future course of interest rates, that would always be difficult to predict. In the circumstances, one issue deserving of consideration was the possibility of holding more frequent reviews of the Fund's income position, perhaps quarterly or semiannually.

It would also be important to consider more explicitly the role of reserves within the Fund's financial structure and the factors that should be taken into account in determining the appropriate growth in reserves, Mr. Erb observed. He tended to agree with the staff's suggestion that the current guideline for adding 3 per cent a year to reserves was inadequate, particularly if inflation remained above 3 per cent. In general, it would seem appropriate to work toward a real rate of increase in reserves over time.

Two minor questions should perhaps be looked at in the next review as well, Mr. Erb considered. The first was how the enlarged GAB should be treated if it were to be activated at some point in future. The staff had suggested that the resources under the enlarged GAB should be treated as ordinary resources, which was consistent with past practice, but it might be worthwhile looking at each case individually. If used in association with the policy of enlarged access, GAB resources could be treated as borrowed resources, in which case they would have no effect on the overall level of Fund charges; on the other hand, if they were not used in conjunction with the policy of enlarged access, it might be better to treat charges under the GAB as an expense of the Fund that was to be taken into account in setting the overall level of charges. Another matter deserving of consideration concerned the proposal to treat accumulated annual leave and earned separation grants as liabilities charged against income for the current year. It might be more appropriate if those items were charged against the reserves of the Fund, a move that would have implications for any decision on the appropriate level or growth of reserves.

Mr. Polak said that he could go along with the staff recommendations in EBS/83/75 on the grounds that the net income for FY 1983--properly reduced by an amount for quarterly payments of remuneration--was not so different from the target figure that it was necessary to make any adjustment in the rate of either charges or remuneration. He attached great importance to the move toward quarterly payments of remuneration and interest rates on SDRs, which he hoped would be adopted in the near future.

Like Mr. Erb, he had concluded that the present procedures for reviewing the Fund's income position were not satisfactory, and he urged reconsideration of some of those procedures no later than the mid-year review, Mr. Polak continued. Until recently, there had been a large gap between the rate of remuneration and the rate of charge, but that gap would all but disappear in 1984, as shown in Table 2 of Appendix III in EBS/83/75. Even the remaining 0.64 difference between the rate of remuneration and the rate of charge for 1984 was illusory because debtors paid service charges and the margins on borrowed money in addition to the base rate of charge. It could also be seen from Table 2 that the remainder of the Fund's income was roughly in balance with expenditure, the administrative expense of nearly 1 per cent on the use of Fund credit being roughly covered by the income earned on interest-free resources. The income arising from the differences between the SDR interest rate and the rate of remuneration and between the GAB interest rate and the rate of remuneration roughly equaled the Fund's addition to reserves. The effort in future should be directed toward a simple structure of the sort shown in Table 2; unfortunately, the present system for estimating the Fund's income position relied on estimates that could not be made accurately and that had indeed been wide of the mark in each of the past two years. The amount that had actually been added to reserves, for example, was approximately six times greater than that intended; by the same token, the system had led to charges that had been greater than originally envisaged. The real danger, however, was that the Fund might, on the basis of inaccurate estimates, set charges at a level that was too low, a development that could occur easily at a time of rising interest rates.

His proposal for reducing the risks of the estimation procedure was similar to that put forward by Mr. Erb, namely, a quarterly formula for the determination of the rate of remuneration--and thus the rate of charge--based on the known outstanding amounts at the beginning of a given quarter, Mr. Polak said. Then, if there were to be net repurchases during the quarter, the Fund would gain on the margin; if there were net drawings, the Fund might lose on the margin but would gain more on the service charge, which covered as much as a 2 per cent difference between the rate of charge and the rate of remuneration. With such a procedure, the only annual estimate necessary would be a rough calculation of target income.

Mr. Kafka stated that, like previous speakers, he could go along with the proposed recommendation so long as an early review of the entire policy on charges and remuneration was conducted. In that regard, it might be necessary to take an even more radical approach than that suggested by Mr. Polak, because it was clear from the latest paper on the policy of enlarged access that the Fund would continue to be a heavy borrower in future, even after the coming into effect of the Eighth General Review of Quotas. If so, it might make sense to unify charges on both borrowed and owned resources throughout the Fund's operations, except where unification was prevented by contractual obligations.

Mr. Morrell said that he too could generally support the proposed recommendations, albeit with a number of reservations. While he had no real difficulty with the 1984 projections for the Fund's income position, he was concerned about the treatment of the value of accumulated annual leave and earned separation grants. The paper proposed that the accumulated accrued amounts for those items should be charged to income in the present year and that the future charge should relate to the annual increment in the accumulation. He could agree to the proposal for the treatment of those items in future but had doubts about the handling of the accumulation of past charges.

Where the amounts were as material as those in question, there was a need to be careful about the accounting treatment chosen, Mr. Morrell remarked. The accounting standards issued by the Financial Accounting Standards Board indicated that a change from an accounting principle that was not generally accepted to one that was generally accepted was a correction of an error that should be reported as a prior period adjustment and excluded from the determination of net income for the current period. Whether or not the treatment previously used by the Fund had been in accordance with generally accepted accounting principles was a crucial issue and depended both on the nature of the accounting items and the extent to which they were considered material. The accounting standards were fairly unequivocal about the treatment of the two accrued employee expense items, and the issue was mainly related to their materiality; ultimately, the Fund's auditors would need to make a judgment on the matter. The impact of removing the accrued items from the current year's income would be to increase income in the present year from approximately SDR 61 million to SDR 80 million.

Another of his concerns was related to the treatment of the SDR 92 million that had in 1982 been deemed as income for FY 1983 for the purposes of computing the rates of remuneration and charges, Mr. Morrell continued. The move had probably been appropriate at the time, given the forecasts that had then been put forward for FY 1983; however, the fact that the results for 1983 had turned out far better than forecast called the move into question and underlined the need for a thorough review of the way in which the Fund dealt with rates of remuneration and charges. The Executive Board had stipulated in a decision that the target for addition to reserves should be 3 per cent a year, and it might be argued that the FY 1983 target of about SDR 29 million had already been met by virtue of the transfer of profits to reserves in the previous year. Hence, the entire amount of the FY 1983 profit could be regarded as "available" for transfer to reserves, to be deemed as income for 1984, or to be used to adjust current rates of remuneration and charges.

The issue of what constituted adequate reserves should not be addressed on an ad hoc basis depending on the outcome of the Fund's income position each year, Mr. Morrell commented. His preference was for guidelines that would enable the Executive Board to assess the adequacy of reserves in a consistent framework. If the assessment were based on profitability rather than liquidity, the main elements to be taken into consideration should be the level of outstanding purchases and borrowing in relation to quotas. Also, some measurement of risk concentration might be appropriate in considering the level of purchases, and the sensitivity of income to interest rate changes should be recognized.

It might be preferable to deal with the question of the rates of remuneration and charges later in the year under the rules set out in Appendix I of EBS/83/75, Mr. Morrell said; however, he noted that the scope of the mid-year review was limited to dealing with a situation in which income was below target. He wondered whether the proposed recommendation 6(e) would in any way supersede those rules; in particular, he would appreciate some assurance that the rates of remuneration and charges that might be set in an earlier review could be amended at the time of the mid-year review. Finally, since the Executive Board appeared reluctant to make retroactive adjustments to the rates of remuneration and charges when the Fund realized a reasonable profit, and since the Board was equally reluctant to amend future rates because of uncertainties about the projections, it might be be worthwhile carefully reviewing the rules that allowed for such changes. With that idea in mind, he could support the recommendations in EBS/83/75, but only if the mid-year review provided an opportunity for a full consideration of the rates of remuneration and charges.

The Director of the Legal Department observed in response to a question by Mr. Morrell that the Executive Board, which was responsible for the disposition of the Fund's income and for the setting of the rates of remuneration and charges, could at any time take a decision on those matters. When the decision related to charges, a 70 per cent majority of the total voting power was required.

The Treasurer wondered whether it was possible at the mid-year review, or at any time preceding the mid-year review, for the Board of Directors to increase the rate of charge.

The Director of the Legal Department replied that the Fund could not raise charges retroactively except as provided under Rule I-6(4)(b). However, the Executive Board could at any time, with a 70 per cent majority, change the rule or take any ad hoc decision on charges that it wished.

Mr. Grosche stated that he could go along with the staff's analysis and recommendations; at the same time, he could support Mr. Erb's proposal to increase the rate of remuneration toward 100 per cent of the interest rate on the SDR. He saw little difference between reserve tranche positions and SDR holdings, both of which were foreign reserves that could be activated on condition of balance of payments need. As foreign reserves of the same nature, those items should in principle yield the same interest rate.

Mr. Nimatallah said that he had an open mind about what to do with the excess income earned by the Fund in FY 1983. As an Executive Director who would like to see the Fund's financial position and its credit standing strengthened, his preference was to follow the staff's recommendation and place the excess income in the special reserve. That approach seemed a prudent one, particularly given the uncertainties surrounding the projections for FY 1984. On the other hand, partly because of an increase in charges in the previous year, the income target had been exceeded in 1983; it would thus be fair and logical to lower the rate of charge retroactively.

Assuming that the quota subscriptions were made on schedule, the reduced rate of charge--say, 6.35 per cent--could then be carried forward to 1984 without jeopardizing the target of a 3 per cent addition to reserves in that year.

There were of course other ways of dealing with the excess, Mr. Nimatallah continued. It might, for example, be worth exploring the possibility of using part of the excess to reduce charges and another part to raise the rate of remuneration. The only option about which he was not enthusiastic was that of deeming the excess income to be income for FY 1984. While that somewhat awkward approach might have been useful in the previous year, when a large deficit had been in prospect, it did not seem appropriate for the current review.

Mr. Tvedt observed that the difficulties involved in attempting accurately to forecast the Fund's income position might have been easier to overcome if the Executive Board had concluded its discussion of the Fund's policy on enlarged access before taking up the matter of the Fund's income position. He tended to agree with Mr. Erb on the need for a review of the Fund's charges and the rate of remuneration later in the summer; in preparing for such a review, the staff should pay close attention to the suggestions put forward by Mr. Polak. His authorities were generally in favor of an increase in the rate of remuneration relative to the SDR interest rate over the long term. However, given the prevailing economic circumstances, they believed that an increase in the rate of remuneration would not be appropriate at present. Also, the current level of charges made drawing on the Fund cheaper than most alternative sources of financing, and an increase in the element of subsidy through a reduction in charges could reduce the willingness of members to speed up their repurchases, even when their economic situation made such repurchases possible. Hence, his preference was for no change in the rate of remuneration or charges at present, and he could support the staff proposal to place the income in excess of target for FY 1983 to the special reserve, thereby postponing any decision on its final use. Finally, as noted by the staff, the Fund's reserves had recently decreased in relation to quotas, members' outstanding claims on the Fund, and Fund borrowing; placing the net income for FY 1983 to the special reserve would help to prevent further deterioration in those ratios.

Mr. Malhotra recalled that the Executive Board had, after lengthy discussion, reached agreement in April 1981 on a package of measures relating to the Fund's income. One purpose of the agreement had been to maintain an element of concessionality in charges for members using Fund resources while ensuring a reasonable return to lenders and adequate net income for the Fund. Accordingly, beginning in May 1981, a single rate of charge on the use of the Fund's ordinary resources had been fixed at 6.25 per cent. At the same time, the interest rate on the SDR had been raised to 100 per cent of the combined market interest rate, and the rate of remuneration was increased to 85 per cent of the combined rate. The target net income had been set at approximately 3 per cent of the Fund's reserves at the beginning of each year, although it had been accepted that targeting for such a net income would commence only from FY 1983. For FY 1982, it had been agreed that there would be a balance between net income and expenses.

The Fund's income performance in the first year following that decision had turned out better than anticipated, Mr. Malhotra continued. Instead of a balance between income and expense, there had been a surplus in FY 1982 of SDR 92 million, despite the increase in the rate of remuneration. The logical approach in the circumstances would have been to adjust the charges downward, but when the matter had come up for consideration, the Board had been confronted with the problem of handling a projected deficit of some SDR 105 million for FY 1983. It had therefore been decided that, instead of retroactively reducing charges, the surplus income in FY 1982 would be considered income for FY 1983 for the purpose of determining the rate of charge. The rate of charge had nonetheless been increased, effective May 1, 1982, from 6.25 per cent to 6.6 per cent in order to yield an additional SDR 42 million in FY 1983. Both those measures taken together, amounting to some SDR 134 million, had been considered necessary to cover the expected deficit of SDR 105 million in FY 1983 and to yield a surplus of SDR 29 million to meet the target of a 3 per cent addition to reserves.

For the current review, it was important to consider the set of interrelated decisions that had been taken in the two previous years, Mr. Malhotra remarked. In 1982, steps had been taken to raise charges on the basis of then available calculations and estimates of a likely deficit in FY 1983. In the event, however, there had been a surplus in FY 1983 of SDR 57 million, or SDR 28 million in excess of the needed net income, even without taking account of the surplus income of SDR 92 million in FY 1982. There were obvious difficulties involved in estimating the Fund's income, and mistakes could be made; however, when they were detected, the Executive Board should take account of actual developments and rectify the error. It was now clear that the increase in charges from May 1982 had not been warranted, which should lead to the logical conclusion that the charge should be retroactively reduced to 6.25 per cent from May 1, 1982. That same rate could be maintained for FY 1984 as well, a move that would involve a reduction of only SDR 40 million in the Fund's net surplus, which would still leave an amount of SDR 81 million over the target income in financial years 1982 and 1983. For FY 1984, the net surplus of SDR 93 million estimated by the staff might decline by about SDR 69 million to SDR 24 million, but that figure should still provide a sufficiently safe margin, especially given the experience of better than estimated outturns.

As noted by Mr. Polak, the increment to reserves that would result from the staff recommendations would be a multiple of what had been envisaged in 1981, Mr. Malhotra said. In taking a view about the appropriate level of reserves, the Executive Board should not base its decision on fortuitous developments such as larger income than expected. When an erroneous estimation was made, the only element affected by the estimation--i.e., the rate of charge--should be corrected. He had no objection to

Mr. Erb's suggestion for a separate discussion regarding the appropriate level of reserves. However, in any such discussion, the special character of the Fund and the amount of gold held by it, together with the valuation of that gold, would have to be taken into account.

Like Mr. Erb and Mr. Morrell, he was not convinced that the total accrual of liabilities for separation grants and annual leave benefits should be charged to the Fund's income in the current year, Mr. Malhotra commented. He had no strong views on the matter but found it odd that the staff had chosen to charge the total cumulative accrual to a particular year's income. It was not clear why the staff considered it inappropriate to spread the amounts over a number of years.

He was somewhat confused by the staff statement that "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..." Mr. Malhotra said. One could in fact argue that, when market interest rates were high, Fund charges were even more concessional. The staff had gone on to suggest that a reduction in the rate of charge from 6.60 per cent to 6.35 per cent "might give an incentive for members to use the Fund's resources purely on the basis of cost, which would be to the detriment of strengthening the Fund's liquidity position through voluntary early repurchases." In his view, such a reduction would not affect the judgment of the authorities in that regard. Charges for the use of resources under the Fund's oil facility had been much more concessional; nonetheless, many countries--including his own--had voluntarily effected repurchases when warranted by an improvement in their balance of payments. It was therefore not clear why a reduction in charges in the present case would create any different psychological attitude on the part of borrowers.

Regarding proposals to increase the rate of remuneration toward 100 per cent of the SDR interest rate, Mr. Malhotra noted that some sacrifice by surplus or creditor countries had always been accepted as an element that distinguished the Fund from a purely commercial institution. Besides, the rate of remuneration had not long ago been increased to 85 per cent of the interest rate on the SDR--which was equal to 100 per cent of the combined market rate--and the element of concessionality implicit in the remaining gap did not change with changing rates of interest in the market.

It was likely that, despite the recently agreed increase in quotas, the Fund would need to borrow in the market, and users of Fund resources would thus face a higher average cost of funds, whatever level of access was decided upon in the forthcoming review of access policy, Mr. Malhotra observed. It would therefore be unfair to raise the rate of remuneration, which in turn would necessitate an increase in charges. For several reasons, he was not enthusiastic about the suggestion for moving toward a combined rate of charge for borrowed and owned resources, mainly because countries making smaller use of Fund resources, such as credit tranches, would be disadvantaged.

Mr. Wicks noted the suggestion in the staff paper that the target for reserves growth should perhaps be higher than the present 3 per cent a year. While he could accept Mr. Erb's proposal for a full discussion of the appropriate nature and level of reserves, he was concerned that the staff had based its argument in favor of an increase on the need of the Fund to strengthen its financial standing and credibility in the markets. Surely the Fund's financial standing rested primarily on its backing from the totality of its member governments; for the Fund to aim at achieving a balance sheet similar to that of a commercial bank would only add to the misconceptions so prevalent in some quarters about the nature of the institution. The Fund would be failing in its duty to correct those misconceptions if it argued that its balance sheet was subject to the same considerations as that of an ordinary commercial bank.

He agreed with Mr. Erb and Mr. Grosche that the Executive Board should look closely during the summer at the matter of the rates of remuneration and charges, Mr. Wicks continued. His authorities had not recently pressed for an increase in the rate of remuneration because the effect would have been to raise Fund charges at a time when interest rates generally had been at historically high levels. At present, however, market interest rates were falling, and the case for moving toward a closer alignment of the rate of remuneration and the SDR interest rate had improved. Unless the rate of remuneration was increased, a country's reserve position in the Fund could become an inferior reserve asset, especially since rates on comparable assets had been adjusted upward in recent years. Finally, with the prospect of an early review of remuneration and charges, he could go along with the staff's recommendations in EBS/83/75.

Mr. Hirao stated that he too could support the proposed recommendations. Like others, he believed that it would be desirable in the long run to bring the rate of remuneration toward a level equal to the SDR interest rate. Creditor countries were required to offer freely usable currencies in exchange for an increase in their remunerated reserve positions or in their SDR holdings. For increased remunerated reserve positions, they were paid remuneration, while for increased SDR holdings they were paid SDR interest rates; it was difficult to see any convincing argument for differentiating between the two. Moreover, since progress was gradually being made toward enhancing the attractiveness of SDRs, a further effort should be made to improve the quality of another SDR-denominated asset, namely, the remunerated reserve position. He looked forward to a thorough discussion of the matter before too long.

Mr. Conrado observed that, as on previous recent occasions, the Fund was once again confronted by an actual net income position that was far more favorable than originally estimated. Net income for the financial year ended April 30, 1983 had been SDR 61 million, against a projected deficit of SDR 63 million. Indeed, the actual outcome would appear even more positive if account was taken of the rather large adjustment made for accrued annual leave and separation grants, which in future would represent relatively small amounts each year. In any event, net income for 1983 was approximately SDR 33 million in excess of the targeted increase in reserves for the year.

The disparity between the actual and estimated income for 1983 reflected the considerable margin of uncertainty involved in making projections, Mr. Conrado continued. The Fund's income and expense were determined by factors over which the Fund had little control, and even small variations in certain of those factors could have a considerable influence on the Fund's income position. Hence, he agreed with Mr. Polak that there might be a need to revise the procedures for estimating income and setting charges.

With regard to the disposition of surplus income in the current year, Mr. Conrado considered that a further increase in the rate of remuneration--already raised in 1981--was not at present warranted. There was a need to maintain some balance between the desires of creditors and debtors, and it would appear odd to raise the rate of remuneration at a time when interest rates were falling. The situation was, however, quite different with respect to the rate of charge. Charges had been increased in 1982 because of an expected negative net income, and, given the disparity between the actual and estimated income, it would seem justified that the rate of charge should be reduced retroactively by the amount of the excess over the required addition to reserves. Such an adjustment would also seem logical in view of the lower interest rates and increased financing needs of member countries at present. The rate of charge thus adjusted could remain at the reduced level, with a further review to be made no later than the time of the mid-year review of the Fund's income position. Despite his preference for a retroactive reduction in charges, he could go along with the staff's recommendations as presented in EBS/83/75 if that were the consensus of the Executive Board. Finally, he could accept some strengthening of reserves, given the uncertainties involved in forecasting and the possibility that an increase in reserves might give some stability to the rate of charge.

Mr. Kabbaj remarked that the better than expected income position in 1983 was welcome, except that it had been due in part to a smaller than projected average use of the Fund's ordinary resources. Because of the diminishing margin between the rates of remuneration and charge, the positive impact on net income of the smaller average use of resources by members was much less pronounced in 1983 than in earlier years; except for credit tranche and compensatory financing facility purchases, there had been actual declines in 1983 in purchases under the supplementary financing facility, enlarged access, and the use of unremunerated reserve tranches. For FY 1984, it was expected that the use of the compensatory financing facility would be substantially smaller than actual use in 1983. Although there was a general expectation for an improvement in commodity prices, the situation remained uncertain, and it was possible that the projection could underestimate the potential use of the compensatory financing facility in 1984.

The unexpected rise in net income had also been due to a general fall in interest rates, Mr. Kabbaj observed. The trend of falling rates could be short-lived, however, and should therefore not be cause for complacency. Any change in interest rates could greatly affect the projected net income complacency. Any change in interest rates could greatly affect the projected net income for 1984; still, the narrowing gap between the rates of remuneration and charges meant that the negative impact on the Fund's income of a possible increase in the average use by members of the Fund's resources would be minimized.

With regard to the disposition of net income in excess of the target amount of a 3 per cent addition to reserves, the staff had outlined a number of options, Mr. Kabbaj noted. A retroactive reduction in the rate of charge would have been preferable if it had not been for the uncertainties surrounding the future trend of interest rates and the relatively small amount by which the 1983 income would have served to reduce the rate of charge. Hence, he could accept the staff recommendation for no change in the rate of charge. By the same token, any increase in the rate of remuneration at present could prove premature and imprudent, even though falling interest rates did strengthen the case for increasing the rate of remuneration. In sum, his chair could support the staff recommendations in EBS/83/75.

Mr. Casey agreed with the staff that a retroactive adjustment of either the rate of charge or the rate of remuneration would be too small to be worthwhile; it would be better to use the 1983 net income to adjust rates in 1984. With regard to the staff recommendations, his Canadian authorities felt that, ideally, the net income in excess of 3 per cent of reserves should be used to increase the rate of remuneration for 1984. The interest rate on the SDR should remain at 100 per cent of the combined market rate, and the rate of remuneration should be raised to 90 per cent of the SDR interest rate, a move that could be facilitated by allocating the 1983 excess income as 1984 income. His authorities could accept a postponement of that action, if that were the consensus of the Board, but they believed that there should be some commitment to raising the rate of remuneration in stages to reflect the market rate more accurately. The rate of charge should remain at 6.6 per cent for FY 1984, and a review of the rate of charge should be made no later than the time of the mid-year review of the Fund's net income position. Finally, he could support an investigation by the staff of the various proposals put forward by Mr. Erb, Mr. Polak, and Mr. Morrell.

Mr. de Groote said that, like others, he could support the staff recommendations, particularly that for transferring FY 1983 net income to the special reserve. He was also in favor of a reconsideration of present procedures, with a view to adopting more frequent reviews--say, at quarterly intervals--in order to take account of the evolution of market interest rates.

It had been suggested that a review of the rates of remuneration and charges should be held during the summer, Mr. de Groote recalled. Such a review, if agreed, should cover the need to move the rate of remuneration toward the level of the SDR interest rate as well as the need to establish a rate of charge that, together with service charges, would roughly equal the rate of remuneration. That latter requirement was particularly important if the Fund in future were to consider borrowing in the markets. In that regard, he agreed with those who felt that, given the special nature of the Fund, the markets would probably not attach much importance to a further small addition to the reserves of the Fund if the institution were to be borrowing in much larger amounts. The markets would, however, attach considerable importance to a decision to cover future costs with income from lending. Central banks, for their part, would be more easily led to support borrowing by the Fund from the markets or other sources if the different forms of reserves that they held on the Fund were to yield a single income.

Mr. de Maulde took note of the staff's suggestion that "if the 1983 income is placed to reserve, the Fund's reserves will have expanded at an annual rate of 2.8 per cent over the last 10 years." As he understood it, the figure had been arrived at through a simple arithmetic average of the annual percentages of increase and decrease registered since the end of FY 1973. However, if one considered the level of the Fund's reserves at the end of FY 1973 and at the end of FY 1983 and relied on the usual compound interest approach, the average rate of increase would amount to 3.85 a cent per year and would reach 4.2 per cent for the years between FY 1974 and FY 1984. In fact, on average, the target of a 3 per cent increase per year in reserves had been continually and substantially exceeded since 1981. Similarly, the net income for FY 1983 amounted to some SDR 77 million, although compliance with orthodox accounting procedures had brought the available amount down to SDR 57 million.

It was obvious that the estimates for FY 1984 were subject to a number of uncertainties, Mr. de Maulde continued. The timing of subscription payments for the quota increase could affect the Fund's income position by as much as SDR 30 million, and changes in the level of interest rates in the market could bring about even more dramatic changes. Indeed, a change of 1 percentage point in the average SDR interest rate could change the FY 1984 estimates by some SDR 130 million in either direction. Given that the level of remunerated positions was unlikely to decline over the coming year, the uncertainties could be said to be somewhat "structural." Nonetheless, he was unhappy that the rate of charges had been raised at a time when interest rates had been declining, and he would continue to recommend resisting the temptation to stand too rigidly against a downward adjustment in the rate of charge for prudential reasons. Moreover, the Fund had benefited in FY 1983 from a reversal of the phenomenon by which an increase in the use of the institution's resources resulted in net losses. Under the conventional assumptions made about interest rate levels, an expansion in the use of the Fund's resources should result in a net income, thanks to the one-time service charge.

The considerations he had mentioned would naturally lead him to propose using the actual surplus in FY 1983 and the forecast surplus for FY 1984 to lower the rate of charge for 1984, Mr. de Maulde remarked. However, he could not ignore that issues surrounding the rates of remuneration and charges were closely linked to the decisions that would be arrived at following the discussion of the Fund's policy on enlarged access.

For that reason, he could go along with accepting the staff recommendations in a provisional decision, on the understanding that the Executive Board would return to rates of remuneration and charges as soon as possible after the next meeting of the Interim Committee. At that time, the current uncertainties regarding the policy on enlarged access would have been dealt with, and prospects for the future evolution of interest rates might be clearer. Finally, he wished to suggest one amendment to the staff's recommendations. Either the Executive Board should abstain from taking a decision on the allocation of net income for FY 1983, or it should decide that the allocation of the FY 1983 income to the special reserve should be limited to 3 per cent of that reserve and that the excess--equivalent to SDR 29 million--should be deemed income for FY 1984. Such a decision would, in effect, leave the Executive Board greater flexibility in deciding on other policy issues later.

Mr. Donoso stated that he could support the staff recommendations, despite his recognition that any decision to place net income for FY 1983 in the special reserve would be inconsistent with existing policies relating to reserves. If, in disposing of net income during the previous two years, the Fund had followed a policy of increasing reserves at an annual rate of 3 per cent, reserves in April 1982 would have been around SDR 810 million; in fact, reserves had been at SDR 935 million, 15 per cent more than the target. If the 1983 net income of SDR 61 million and the expected net income for 1984 were added, reserves in April 1984 could reach SDR 1,070 million, about 25 per cent higher than the target implicit in the policy guidelines relating to reserves that had been adopted in 1981. In his view, it would be better to use the excess income retroactively to reduce the rate of charge to 6.25 per cent; however, he would go along with the staff recommendations as written.

Mr. Sangare noted that the far better than expected net income in FY 1983--a surplus of SDR 61 million against a projected deficit of SDR 100 million--could be attributed mainly to a deceleration in interest rates, which had resulted in a substantial decline in the amount of remuneration paid by the Fund. It had also been due to a somewhat lower use of Fund resources than originally envisaged. The staff paper had specified the magnitude of the improvement associated with the deceleration in interest rates but had failed to make the same calculation with respect to the use of Fund resources; still, he was not too troubled by the omission, because the staff paper showed that the smaller use of Fund resources was a less important factor in the improvement than it had been in previous years.

He had no difficulty with the proposal to charge accumulated annual leave and earned separation grants against the Fund's income in FY 1983, Mr. Sangare continued. The approach was consistent with accounting practices in the United States, and, in any event, it was only logical to account properly for items that gave rise to a potential charge on the Fund's income.

He could accept the estimates for FY 1984, which provided for a net income of SDR 93 million on the assumption that quota increases became effective from December 1983, Mr. Sangare remarked. With regard to the disposition of the FY 1983 net income, his chair would prefer using the amount by which the net income was in excess of the target to reduce the rate of charge. Such an action would, without straining the Fund, have a beneficial effect on the adjustment process by encouraging members to approach the Fund for resources at an early stage of their balance of payments difficulties. At a time when debt servicing had become burdensome, an effort to make Fund assistance more concessional, even in a small way, would be helpful to poorer members and would help to reverse some of the erosion in concessionality in the rate of charge that had taken place over the years. The rate of remuneration, however, should not be raised, since any increase in that rate would run counter to the declining trend in international interest rates that had become observable in recent months.

Mr. Habib recalled that, on the basis of the estimated SDR 100 million deficit in the Fund's income position for FY 1983, and in order to eliminate that deficit and produce a net surplus equivalent to 3 per cent of the Fund's reserves, it had been decided in the previous year to increase the rate of charges for the use of the Fund's ordinary resources from 6.25 per cent to 6.6 per cent, effective from May 1, 1982. No revision had been made in the rate of remuneration, which had remained at 85 per cent of the SDR interest rate. In the event, there had been a surplus rather than a deficit, another surplus being estimated for FY 1984. His chair would prefer using the FY 1983 net income in excess of the 3 per cent target to reduce the rate of charges, especially since the overshooting of the income target in FY 1983 had been partly due to the increase in charges in 1982 that had been decided on the basis of a projected deficit in the net income position. It was clear, with the benefit of hindsight, that the increase in the rate of charges had been excessive, and that "mistake" should be mitigated through a reduction in the rate of charges.

Another argument in favor of reducing charges was related to the fall in market interest rates over the previous 12 months, Mr. Habib continued. The concessional element in the Fund's lending had been eroded by that decline, and one way of minimizing the erosion would be to lower charges. As mentioned by some of his colleagues, concessionality in Fund lending was a necessary element precisely because of the cooperative nature of the Fund and because it provided an incentive for member countries to approach the Fund at an early stage of their difficulties and to adopt Fund programs. Maintaining the element of concessionality was, in his view, vital if the Fund was to continue to have influence over the policies of its members and to avert crises associated with tardy adjustment efforts.

Mr. Zhang stated that he too could generally support the staff's recommendations in EBS/83/75. However, a reduction in the future rate of charge should be considered on the basis of the staff's estimation of the Fund's income position for FY 1984 and the trend in market interest rates.

Mr. Caranicas considered that the staff had presented a convincing case for most of its recommendations. The revised estimates for FY 1983 appeared reasonable, given that interest rates had fallen during the year. For FY 1984, he shared the concerns of the staff about the future behavior of interest rates and the timing of the payment of quota subscriptions. He was therefore in broad agreement with the proposal not to change the SDR interest rate, the rate of remuneration, or the rate of charge; he could agree to place net income for FY 1983 to the special reserve.

Like others, he believed that a detailed study should be undertaken on the nature, role, and adequacy of reserves, Mr. Caranicas continued. Particular attention in that regard should be given to the use of reserves; it was not enough to call for an increase in the level of reserves simply because there had been a decline in that level in relation to Fund quotas and drawings on the Fund's resources.

With regard to comments on the rates of remuneration and charges, strong arguments had been made on both sides, Mr. Caranicas observed. Some of his colleagues had rightly advocated a re-examination of the matter of remuneration in the near future. However, if the rate of remuneration were increased, charges would also increase, and other speakers had properly argued that the rate of charge should retroactively be reduced, since the overshooting of the target in FY 1983 had in part been due to an earlier increase in charges. It would be easier to take a position on those matters once the review of the Fund's policy on enlarged access had been completed. Finally, with respect to Mr. Tvedt's suggestion that it might have been better if the discussion on access to the Fund's resources had been held before the review of the Fund's income position, he wondered whether such a sequence would have affected the drafting of EBS/83/75.

Mr. Finaish stated that, like others, he could go along with the staff's recommendations.

Mr. Tshishimbi remarked that he too was generally in favor of the staff proposals. He shared the view that the financial situation of the Fund was being scrutinized by actual and potential creditors as well as by private investors and that the Fund's liquidity position should therefore be strengthened. However, recognizing that there were many uncertainties involved in estimating the Fund's income position a year in advance, he believed that flexibility was important, particularly with respect to charges. In the previous year's discussion, a number of speakers had indicated that an increase in charges to 6.6 per cent had been necessary because of the expected deficit; a surplus had in fact resulted, and a re-examination of the rate of charge therefore seemed in order. Although he could understand the arguments in favor of an increase in the rate of remuneration, he did not think present conditions, in particular falling interest rates, would warrant an increase in remuneration rates. In general, the review of the Fund's income position would be facilitated if a flexible mechanism could be adopted that would follow more closely the development of interest rates in the market.

The Treasurer recalled that some Directors had questioned whether certain accrued liabilities should be charged to the current year's income or whether they should be charged, in part, against prior years' reserves. In coming to a judgment on that matter, the staff had consulted closely with the accountants and auditors assisting the External Audit Committee. The staff had also recognized that the two items in question should not be lumped together because they were by nature separate. The accrued annual leave liability was the item on which new accounting standards had been issued, but no new accounting principles were applicable to the separation grant, which would have to be accounted for in some way even if there had been no change in accounting principles. The separation grant had not been accounted for earlier because it had not been considered material in the two preceding financial years. There was of course no rule for determining the point at which an amount was to be considered material, but the staff felt that, since the item had reached $11 million, it should be accounted for. In general, the practice of the Fund in accounting was to err on the safe side in deciding whether an amount was material or not.

The accounting standards set by the Financial Accounting Standards Board on accrued leave were applicable to the financial years after December 1980, the Treasurer noted. However, there was no particular compulsion for the Fund to apply the rule, because the Accounting Board had deferred a decision of whether or not it should apply to state and local government units. Again, it was Fund practice to adopt an appropriately conservative line in observing accounting principles even when not required to do so.

According to accounting theory, the Treasurer continued, it was not appropriate to reopen past financial statements and make retroactive adjustments to reserves unless two specific elements were present. The first was the need to correct a fundamental error in the financial statements of a prior year. The staff did not believe that an error had been committed by not charging annual leave and separation grants against reserves; however, even if there had been an error, the amounts involved would not have been sufficiently significant for the error to be regarded as a fundamental error. The second element necessary for a reopening of past financial statements was a change in accounting principles, and the staff did not believe that, effectively, there had been a change in such principles. The staff had attempted to follow the accrual accounting principle, but, as to the accrual for accumulated annual leave, it was not required to do so. In any event, the matter would be brought to the attention of the external auditors when they checked the statement of the Fund's accounts; if the auditors took issue with the approach followed by the staff, the Executive Board would certainly be informed.

In response to a question by Mr. Caranicas, the Treasurer remarked that it was uncertain whether the paper on the review of the Fund's income position would have been written differently if the Board discussion on access to the Fund's resources had already been held. One issue in the paper on the Fund's policy on enlarged access was whether charges should be unified to reflect the cost of borrowed and ordinary resources, and the staff had made no firm recommendation on that matter. However, if it had been clear that the Executive Board desired a unification of such charges, the staff paper reviewing the Fund's income position might well have been drafted differently.

A number of Directors had called for changes to establish better procedures for forecasting and for adjusting charges and the rate of remuneration, the Treasurer recalled. Some of the forecasting methods had already been significantly improved in recent years, particularly with respect to the determination of the extent of resources being drawn from the Fund under stand-by and extended arrangements. However, great uncertainty remained in other areas--such as the forecasting of drawings under the compensatory financing facility and the use of unremunerated reserve tranche positions--and it was difficult to see how the forecasting of those elements could be improved, even if the period for forecasting were shortened. Some Directors might recall a suggestion by the staff several years previously to lengthen rather than shorten the period over which net income would be averaged. Some had also suggested at the time that it might be desirable to link the rate of charge more closely to the basic element of cost, namely, the rate of remuneration, although the Executive Board had expressed little willingness at the time to move too far in that direction. He mentioned those suggestions, and the Board's reaction to them, mainly to show some of the complexities involved in carrying out the Board's request to make forecasting methods and methods of adjusting charges to meet basic costs more rational.

In response to a technical query by Mr. de Maulde, the Treasurer observed that the target rate of 3 per cent for the annual increase in reserves was a simple interest rate applied to reserves each year. However, since each year's reserves included an additional amount equal to 3 per cent of reserves in the previous year, annual compounding did take place. In reviewing the previous ten years, the staff had calculated the rate of increase year by year, which yielded the figure of 2.8 per cent; of course, that figure equaled the annual compounded rate of increase over the period and also the arithmetical average of annual rates of increase.

Regarding the appropriateness of the target itself, the Treasurer remarked that the underlying principle was that the Fund should aim for a net income each year. When charges and the Fund's net income position and reserve policy had been discussed on previous occasions, the Board had felt in general that it would be undesirable for the Fund to fall into deficit, even if only for a year and even if its reserves were already high; thus, Executive Directors had agreed on a target for an increase in reserves. It had soon become apparent that swings in the Fund's net income position from year to year could be of such a magnitude that it might be better to average one year with the next; thus, Executive Directors had accepted the idea that the full surplus in FY 1982 should be deemed income for FY 1983 for the purpose of determining the level of charges. It had been clear even at that time that the risk was not so much that the deficit would be as high as predicted, but rather that the outcome would be more favorable than expected. The decision to regard the FY 1982 income as income for 1983 had been taken, as he understood it, to avoid an increase in the rate of charge that would otherwise have been more substantial than the increase agreed.

Mr. Erb, recalling the suggestion by a number of Executive Directors that a concessional rate of charge was a feature of the cooperative character of the Fund, said that the United States felt strongly that the Fund's cooperative character depended on many factors, not simply on the degree of subsidy implicit in its charges. The very fact that the Fund charged a uniform rate to all members and did not attach risk factors to its charges to take account of differences in risk among countries made the Fund properly distinct from a commercial bank; even if the rate of remuneration were aligned with the interest rate on the SDR--which would necessitate some increase in charges--the Fund would still not be charging the full market rate that most countries paid when borrowing. Finally, if there were general support for Mr. de Maulde's proposal to treat the SDR 33 million from FY 1983 as income for FY 1984, he could go along with that proposal.

Mr. de Maulde observed that, if adopted, the recommendations would call for placing the net income for FY 1983 to the special reserve. He inquired whether that decision would make it impossible, following a later review of the issue of the rates of remuneration and charges, to deem the net income for FY 1983 income for FY 1984.

The Director of the Legal Department replied that it would be possible for the Executive Board to take a supplementary decision along the lines suggested by Mr. de Maulde, a possibility that was contemplated by Rule I-6(4).

Mr. Morrell remarked that an alternative procedure might be to adopt a different reserve growth target in the mid-year review, which would have the same effect as that desired by Mr. de Maulde.

The Director of the Legal Department agreed that it would be possible to follow the course of action suggested by Mr. Morrell. The question, however, was one of timing; if, before the mid-term review, the Executive Board decided to follow Mr. de Maulde's proposal, the course of action suggested by Mr. Morrell might not be necessary.

The Chairman, in summing up the discussion, said that it was clear that Executive Directors could accept the proposed recommendations set out on page 21 of EBS/83/75 on the understanding that a review of the rates of remuneration and charges would take place over the next few months, taking account of the suggestions put forward by Mr. Erb, Mr. Polak, Mr. Morrell, and others. A number of questions regarding the Fund's income position hinged, in his view, on related actions that might be taken by the Executive Board, including decisions on the frequency of interest payments on SDRs and remuneration, on enlarged access policies, and on the level of reserves that might be needed once the borrowing policy consequences of decisions on enlarged access became clear. The staff, for its part, would prepare for the early review by providing the Executive Board with a paper responding to questions raised in the present discussion and proposing ways of introducing more rationality into the mechanism of fixing rates of remuneration and charges with a view to better achieving the targets for the Fund's net income position in future.

The Executive Board then adopted the following decision: 1/

1. The net income for the financial year that ended April 30, 1983 shall be placed to the special reserve.

2. a. The Executive Board has reviewed, in accordance with Rules I-6(4)(a), I-10(b), and T-1(d), the rate of charge on the Fund's holdings of currency, the rate of remuneration, and the rate of interest on holdings of special drawing rights, and agrees to continue:

(i) the rate of charge levied by the Fund under Rule I-6(4)(a) at 6.6 per cent per annum,

(ii) the special drawing right interest rate at 100 per cent of the combined market interest rate; and

(iii) the rate of remuneration at 85 per cent of the special drawing right interest rate.

b. A further review of the rate of remuneration, and the rate of charge, shall be made not later than the time of the mid-year review of the Fund's income position.

Decision No. 7398-(83/70), adopted
May 16, 1983

1/ The decision was reaffirmed in a lapse of time decision (recorded in the minutes of EBM/83/82, 6/8/83) on the basis of a change in the Fund's net income (EBS/83/75, Sup. 2, 6/3/83).

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/83/69 (5/13/83) and EBM/83/70 (5/16/83).

4. SDR DEPARTMENT - PAYMENT OF NET CHARGES AND ASSESSMENT FOR FINANCIAL YEAR ENDED APRIL 30, 1983

The Executive Board notes the course of action set out in EBS/83/92 (5/11/83).

Decision No. 7399-(83/70) S, adopted
May 13, 1983

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the proposal set forth in EBAP/83/128 (5/11/83).

Adopted May 13, 1983

6. APPROVAL OF MINUTES

The minutes of Meetings 82/156 and 82/157 are approved. (EBD/83/128, 5/9/83)

Adopted May 13, 1983

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/83/129 (5/12/83) is approved.

APPROVED: October 12, 1983

LEO VAN HOUTVEN
Secretary