FOR AGENDA

EBS/95/132

CONFIDENTIAL

August 8, 1995

To: Members of the Executive Board

From: The Secretary

Subject: Possible Modalities for Use of Gold in Connection with a Continuation of ESAF Operations

Attached for consideration by the Executive Directors is a paper on possible modalities for use of gold in connection with a continuation of ESAF operations, which is tentatively scheduled for discussion on Wednesday, September 6, 1995. A summary and conclusions appear on pages 16-18.

Mr. Dhruba Gupta (ext. 38321), Mr. Munzberg (ext. 36675), or Mr. Wittich (ext. 38307) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

Possible Modalities for Use of Gold
in Connection with a Continuation of ESAF Operations

Prepared by the Treasurer's and the Legal Departments

(In consultation with the Policy Development and Review Department)

Approved by Günter Wittich and Reinhard Münzberg

August 7, 1995

I. Introduction

1. Questions about the possible use of the Fund's gold holdings have arisen on a number of occasions in recent discussions in the Executive Board, and particularly in the context of the consideration of continued Fund support to low-income countries. 1/ In early June, the Executive Board reviewed the role and use of gold in the Fund, 2/ including the possibility of modest sales of gold to support the continuation of ESAF-type operations until the facility could become self-sustaining. In that discussion, Directors generally agreed on the overriding need to maintain and, where possible, strengthen the Fund's overall financial position; any use of the Fund's gold therefore would need to be approached with caution and should be supported by a wide majority of members. A number of Directors saw no compelling need for the Fund to consider selling gold at this time, in particular as even small sales of Fund gold could be seen as prelude to continued recourse to a "costless" way of financing worthwhile purposes. Most other Directors, however, considered a sale of a modest portion of the Fund's relatively large gold holdings justified, both because of the cost of holding gold and in view of the need for resources to continue ESAF operations in the interim until the ESAF becomes self-sustaining. 3/

2. In these circumstances, the Managing Director suggested that the staff prepare, in the context of the Executive Board's further examination of a

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1/ See *Possible Modalities for Continued Fund Involvement in Low-Income Countries, including the Most Heavily Indebted Countries, through ESAF* (EBS/95/60, 3/31/95) and Executive Board Meeting No. 95/39 (4/12/95).

2/ See *Gold in the Fund* (EBS/95/69, 4/21/95) and Executive Board Meeting No. 95/54 (6/2/95).

3/ See *Concluding Remarks by the Chairman at Executive Board Meeting No. 95/54*, June 2, 1995 (Buff 95/53, 6/12/95).

continuation of ESAF operations, a short paper outlining, on a strictly illustrative basis, the possible modalities of use of a modest part of the Fund's gold to support an "interim" ESAF until that facility became self-sustaining. Such a modest use of the Fund's gold should be compatible with the need to safeguard and strengthen the Fund's capital base, and consideration would need to be given to how to ensure that it would not become a prelude to continued use of the Fund's gold.

3. The present paper has been prepared in this context. It is organized as follows: Section II discusses the amount of gold that would need to be sold in order to help finance interest subsidies under an "interim" ESAF. Section III considers the use of a gold pledge in connection with a continuation of ESAF operations. Section IV summarizes possible modalities of gold sales, should a sales program be agreed. A summary and conclusions are provided in Section V.

II. Illustrative Gold Sales Required to Fund the Subsidy Needs of the "Interim" ESAF

4. Estimates of the potential demand for ESAF resources during the interim period of six years (1999-2004) before the ESAF becomes self-sustaining are contained in a separate staff paper. 1/ The demand for ESAF loan resources during the interim period from all ESAF-eligible countries 2/ is projected to average SDR 1.15 billion per year or a total SDR 6.9 billion. Assuming that resources would be available to finance ESAF-type loans--say by way of loans from member countries to the ESAF Trust or through the use of GRA resources under extended arrangements--the subsidy requirements would be projected at about SDR 2.9 billion. If the three countries in protracted arrears that are eligible for the rights approach--Liberia, Somalia, and Sudan--after becoming current in payments to the Fund were permitted access to ESAF resources up to the (exceptional) limit of 255 percent of quota (taking into account their quota increase under the Ninth Review of Quotas), an additional SDR 1 billion in ESAF-type loan resources and SDR 0.4 billion for subsidies would be needed. If ESAF-type resources were made available up to the full amount of current overdue obligations (i.e., the current maximum of rights that might be accumulated by these members under Rights Accumulation Programs), SDR 1.8 billion in additional loan resources and SDR 0.8 billion in additional subsidies would be required. 3/

5. As discussed in the paper on continued ESAF financing, it would be important to mobilize as much support as possible from bilateral donors in the form of direct contributions (possibly including the proceeds of refunds

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1/ See *Continued Financing and Adaptation of the ESAF*, (EBS/95/130, 8/4/95).

2/ Excluding the countries in protracted arrears (Liberia, Somalia, and Sudan), and assuming that China and India would not use resources under an "interim" ESAF.

3/ See *Continued Financing and Adaptation of the ESAF*, page 17.

from the Second Special Contingent Account), with the remaining resources for subsidies being provided by the Fund, based on the sale of a modest amount of gold. This section presents simulations, for illustrative purposes, of the amount of gold necessary to finance up to one-half of the subsidies required for the interim period.

6. If the Fund were to sell gold, the "capital" value of the gold sold (SDR 35 per fine ounce) must be placed in the General Resources Account, and the proceeds in excess of the capital value--the "profits"--would be placed in the Special Disbursement Account (SDA), which provides the financial framework for the disposition of the profits realized upon the sale of gold acquired before April 1978. 1/ Balances in the SDA may be transferred to the General Resources Account (GRA) for immediate use in operations and transactions authorized under the Articles, or for operations and transactions not specifically authorized by the Articles but consistent with the purposes of the Fund, including balance of payments assistance on special terms to developing member countries in difficult circumstances. 2/ Pending use, the Fund with a majority of votes cast may decide to invest these assets in marketable obligations of members or of international financial organizations to produce income for further use.

7. As has been generally agreed during the discussion of the role of gold in the Fund, the value of the gold in the form of the profits from the sales would be kept intact as part of the Fund's assets, and only the income from the investment of the profits would be used to finance the subsidy requirements of an "interim" ESAF, in order to ensure that a gold sales program remained compatible with the need to safeguard and strengthen the Fund's capital base. 3/

8. Estimates of the amounts of gold that would need to be sold so that the investment income from the profits of gold sales would be sufficient to fund one-half of the total subsidy requirements for loans extended during the interim period are shown in the Table 1. The simulations are based on an illustrative program of sales of 500,000 ounces a month starting in mid-1996, and on continuation of the current market price of gold of about

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1/ The Fund could also decide, with a majority of 85 percent of the total voting power, to transfer part or all of the profits from gold sales, up to an amount equal to the Fund's reserves, to the Investment Account. Income from the Investment Account may be used to meet the expenses of conducting the business of the Fund, but could not be used to subsidize loans of the ESAF Trust.

2/ See *Gold in the Fund* (EBS/95/69, 4/21/95), pp.7-10, and *Commentary on the Proposed Second Amendment of the Articles of Agreement* (Washington, D.C., 1976), pp. 43-52. Transfers to the GRA require a decision taken with a 70 percent majority of the total voting power, while decisions on use not specifically authorized under the Articles require a majority of 85 percent of the total voting power.

3/ See *Concluding Remarks by the Chairman--Gold in the Fund* at Executive Board Meeting 95/54, June 2, 1995 (Buff 95/53, 6/12/95).

Table 1. Volume of Gold Sales Required to Fund One-Half of the Subsidy Requirements of an "Interim" ESAF 1/

	All ESAF Countries (Except Liberia, Somalia, and Sudan)	Liberia, Somalia, and Sudan (Access limited to 255 percent of quota)	Liberia, Somalia, and Sudan (Access equal to total arrears)	Total Gold Sales (in millions of ounces)
		(In billions of SDRs)		
1. Total Loan Commitments Interim ESAF	6.9	1.0	1.8	
2. Total Subsidies	2.9	0.4	0.8	
To finance one-half of Subsidy Requirements	1.5	0.2	0.4	
		(In millions of ounces)		
3. Gold Sales Required 2/				
To finance one-half of Subsidy Requirements	*6.1*	*1.5*	*2.7*	*7.5-8.8*

Note: Figures may not add due to rounding.

1/ Based on gold sales of 0.5 million ounces per month starting in mid-1996, and the current gold price of about US$385 per fine ounce (SDR 250 per ounce at an exchange of SDR 1 = US$1.55). Investment income is assumed to be 6.0 percent per annum.

2/ Gold sales required for investment income on profits to finance one-half of the subsidy requirement of an "interim" ESAF.

US$385 an ounce, the current exchange rate of about US$1.55 per SDR, and a rate of return on investments used in ESAF simulations of 6 percent per annum. If one-half of the subsidy requirement for all ESAF eligible countries were to be funded from the income on the invested profits of gold sales, sales of 6.1 million ounces of gold would be required. 1/

III. Use of a Gold Pledge ESAF in Connection with a Continuation of ESAF Operations

9. The ESAF Trust instrument provided for the establishment of a Reserve Account in order to ensure that resources are available to meet the Trust's obligations as they fall due even if members making use of Trust resources fail to meet their obligations in a timely manner. The resources of the Reserve Account are derived from repayments of and interest on Trust Fund and SAF loans and the SDA-financed part of ESAF loans. Balances in the Account that exceed the liabilities of the Trust to lenders may be retransferred by the Fund to the SDA for further use as appropriate. To the extent that loan repayments will be made when due, balances accumulating in the Reserve Account could be considered ample in relation to the likely need to meet the Trust's obligations, and it has been suggested that consideration could be given to "early" use of resources in the Reserve Account.

10. A transfer of resources from the Reserve Account before the date on which resources in that account exceed the liabilities of the Trust requires the consent of all creditors to the Loan Account of the ESAF Trust, who in turn may ask for some form of additional assurance that loan repayments will be met when due. Such assurances could take the form of a pledge by the Fund that it would make available additional amounts of gold for sale to ensure the availability of resources for repayment to lenders to the ESAF Trust, should this become necessary. As is the case with the gold pledge adopted by the Fund in support of the use of ESAF resources for the encashment of rights, 2/ the pledge would take the form of a decision by the Fund to sell a given amount of gold under specified circumstances in order to provide assurances to ESAF Trust creditors in line with the additional risk

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1/ Excluding members in protracted arrears eligible for the rights approach (Liberia, Somalia, and Sudan); if these members settled their arrears and were permitted to use ESAF resources to fund the encashment of rights after successfully completing rights accumulation programs, additional gold sales of between 1.5 million and 2.7 million ounces would be required to fund one half of the subsidy requirements during the interim period. Total gold sales to fund one half of the subsidy requirement during the interim ESAF would then range between 7.5 and 8.8 million ounces.

2/ It will be recalled that the Executive Board in 1990 agreed to pledge use of up to 3 million ounces of the Fund's gold, if needed, as additional security for the use of ESAF resources in connection with the encashment of rights under the Rights Approach. See *Modalities of a Gold Pledge for Use of ESAF Trust Resources under the Rights Approach* (EBS/93/10, 1/25/93), and Executive Board Decision No.10286-(93/23) ESAF.

that might be thought to arise because of such "early" use of Reserve Account resources. In the event that the resources that remain in the Reserve Account are insufficient to cover the liabilities of the Trust, the gold pledge would require the sale of gold, up to the maximum amount of fine ounces specified in the pledge, to replenish the Reserve Account. The first part of this section contains illustrative calculations of the size of a possible gold pledge necessary to provide the same security as balances in the Reserve Account that may be used to subsidize "interim" ESAF loans or to permit a self-sustaining ESAF to commence in 1999; the second part provides a summary of the modalities of a gold pledge.

a. Size of a Possible Gold Pledge

11. The resources made available by the Reserve Account could be used either (i) to finance the subsidy requirements of an "interim" ESAF (with the loan component being financed with resources derived from loans to the Trust, or from the GRA resources), or (ii) to provide resources to the ESAF Trust to allow self-sustained ESAF operations to begin before the time when balances in the Reserve Account exceed the liabilities of the Trust.

(i) Use of Reserve Account resources to finance "Interim" ESAF subsidies

12. As mentioned above, commitments during the interim period until ESAF becomes self-sustaining are projected to amount to SDR 6.9 billion and the subsidy requirement is estimated to be SDR 2.9 billion. 1/ If one half of the subsidy requirement would be met by bilateral contributions, the remaining half (SDR 1.45 billion) would need to be financed by other means, such as resources made available by the Reserve Account. Any use of Reserve Account resources before the time when the balances in the Account equal remaining liabilities of the ESAF Trust (projected to take place by the end of 2004) would reduce the reserves available below the amount of outstanding liabilities of the Trust. To ensure that security for the lenders is not reduced, the size of the gold pledge would have to correspond to the maximum reduction in reserves (in absolute terms) over the period. The amount of gold that would have to be pledged accordingly would have to approximate the aggregate value of the Reserve Account resources used for subsidies (and the investment income forgone on those resources). 2/ Projected balances in the Reserve Account are given in Table 2, which shows balances in the absence of early use in Column 2, and those reflecting early use to finance subsidies on loans from an "interim" ESAF in Column 3. Column 4 shows the difference between the balances without and with early use, reflecting the potential reduction in security to creditors. The maximum reduction of balances in the Reserve Account is estimated to amount to SDR 350 million

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1/ See Paragraph 4 above. Based on loans to all ESAF-eligible countries except the three rights-approach-eligible members in protracted arrears.

2/ In view of fluctuations of the market price of gold, there can be no determination with certainty of an amount of gold which would exactly correspond in value to the reduction of balances in the Reserve Account.

Table 2. Reduction in Projected Balances in the ESAF Reserve Account
Following "Early" Use of Reserve Account Resources 1/

(In millions of SDRs)

			"Interim" ESAF (1999 to 2004) 2/		Self Sustained ESAF Starting in 1999 3/	
Year Ending	ESAF Trust Loans Outstanding (1)	Projected Reserve Account with no Early use (2)	Projected Reserve Account with Early Use (3)	Reduction in Coverage Resulting from Early Use (4)	Projected Reserve Account with Early Use (5)	Reduction in Coverage Resulting from Early Use (6)
1988	102.7	--	--	--	--	--
1989	360.1	--	--	--	--	--
1990	674.2	--	--	--	--	--
1991	1,261.5	--	--	--	--	--
1992	1,763.1	--	--	--	--	--
1993	1,990.4	--	--	--	--	--
1994	2,786.3	1,075.9	1,075.9	--	1,075.9	--
1995	4,098.9	1,360.7	1,360.7	--	1,360.7	--
1996	5,366.8	1,768.4	1,768.4	--	1,768.4	--
1997	6,721.3	2,211.4	2,211.4	--	2,211.4	--
1998	7,261.7	2,623.6	2,623.0	-0.6	2,614.2	-9.4
1999	7,809.3	3,066.2	3,057.8	-8.5	2,811.3	-254.9
2000	7,954.3	3,371.8	3,341.3	-30.4	2,863.5	-508.2
2001	7,317.8	3,679.7	3,605.3	-74.5	2,634.4	-1,045.3
2002	6,397.5	3,949.3	3,800.3	-149.0	2,303.1	-1,646.3
2003	5,258.5	4,237.0	3,977.9	-259.1	1,893.0	-2,343.9
July 2004 4/	4,428.6	4,428.6	4,077.2	-351.4	1,594.3	-2,834.3
2004 5/	3,991.5	3,991.5	3,991.5	--	1,436.9	-2,554.5
2005	2,706.0	2,706.0	2,706.0	--	974.1	-1,731.8
2006	1,663.6	1,663.6	1,663.6	--	598.9	-1,064.7
2007	892.4	892.4	892.4	--	321.3	-571.1
2008	409.5	409.5	409.5	--	147.4	-262.1
2009	132.8	132.8	132.8	--	47.8	-85.0
2010	19.6	19.6	19.6	--	7.1	-12.6
2011	1.1	1.1	1.1	--	0.4	-0.7
2012	--	--	--	--	--	--

1/ For detailed notes on projections of the Trust Reserve Account and Obligations of the ESAF Trust, see *Continued Financing and Adaptation of the ESAF*, (EBS/95/130, 8/4/95) Annex II, Table 1.

2/ Assumes one-half of interim ESAF subsidies financed from resources in the Reserve Account. Initiation of self sustained ESAF would begin in 2005.

3/ Assumes all loan resources for initiation of a self-sustained ESAF beginning in 1999 funded from resources in the Reserve Account.

4/ Linear interpolation of the point at which columns 4 and 5 are at a maximum.

5/ It is assumed that a Board decision will be taken to permit the amounts in the Reserve Account in excess of outstanding ESAF Trust liabilities to be transferred to the Special Disbursement Account starting after mid-2004 to finance a self-sustained ESAF at a level of SDR 600 million a year.

which, at the current price of gold and US$/SDR exchange rate, would be equivalent to about 1.7 million ounces. Taking into account potential use by rights-eligible members in protracted arrears, the maximum reduction could reach SDR 680 million, equivalent at current prices to about 3.2 million ounces. The amount of gold that might ultimately have to be sold, if any, would of course depend on the timeliness of the repayment of ESAF loans as well as the prevailing market price of gold; to the extent that past users of ESAF resources meet their repayment obligations to the Trust as they fall due, it could be expected that the need for actual sales of gold would be considerably lower than the amount of the pledge.

13. The "early" use of reserves to finance subsidies on loans extended during the "interim" ESAF is comparatively low, and the size of the required gold pledge accordingly modest. However, the subsidy needs of the resources committed during the interim period would continue until loans committed in the interim period have been repaid, which will stretch until the year 2018. Part of the subsidy payments would continue to have to be met from the resources of the Reserve Account, and accordingly would reduce the amount of transfers to the SDA which otherwise would accrue to the self-sustaining ESAF. 1/ Reflecting the reduction of the resources that would become available to the SDA, the level of commitments that could be made by the self-sustained ESAF starting in 2005 would be reduced to SDR 600 million per year, substantially less than the SDR 800 million projected without such a use of the Reserve Account.

(ii) Use of Reserve Account Resources to Commence Self-Sustaining ESAF Operations in 1999

14. Several Executive Directors suggested during the earlier discussion of the continuation of ESAF that the staff explore with present ESAF Trust the possibility of an early transfer of resources to the SDA, reducing coverage in the Trust's Loan Account, in order to allow an earlier initiation of a self-sustaining ESAF. 2/ An early start of a self-sustaining ESAF would obviate the need for bilateral contributions to finance subsidies 3/ but would also reduce the scope of the self-sustaining facility. The possible initiation of operations would depend on the amount of transfers to the SDA; the larger the transfers, the earlier would it be possible to commence substantial operations of a self-sustained ESAF but also the lower the coverage ratio and the higher the potential need for a gold pledge. For example, if the agreed ratio of reserves to outstanding liabilities were set

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1/ One half of the required subsidies would amount to SDR 1.1 billion; including loans to rights-approach-eligible members, they could total SDR 1.2 billion.

2/ See *Continuation and Adaptation of ESAF* (EBS/95/130, 8/4/95), pp. 18-21.

3/ To this extent the illustrative requirements for Fund support of an early self-sustaining ESAF are not strictly comparable to those reported in previous sections which assumed bilateral contributions to meet one-half of subsidy requirements.

at no more than 36 percent, the earlier transfers of Reserve Account resources to the SDA would permit operations under the self-sustained ESAF to begin in 1999, with a level of potential commitments of SDR 600 million per year. 1/ The maximum reduction in reserves occurs at the end of 2004, when there would have been 100 percent coverage of the liabilities of the Trust if there had been no early transfer of resources, would amount to SDR 2.8 billion. To provide ESAF Trust creditors with an equivalent assurance of repayment, an estimated gold pledge of 13.3 million ounces would be necessary. However, since the reduction in coverage in the years prior to and after 2004 would be less than the maximum reduction, a gold pledge of 13.3 million ounces would overcompensate the reduction in coverage during most of the self-sustained ESAF, parallel to the potential overcompensation discussed earlier.

15. As discussed more fully in the paper on *Continued Financing of ESAF*, use of ESAF Trust reserves to finance subsidies or to permit an early initiation of operations of a self-sustaining ESAF has the disadvantage of reducing substantially the resources that otherwise would become available to and potential loan commitments of the self-sustaining facility, and thus requiring other resources for the facility to meet anticipated needs. This would not appear a satisfactory basis for self-sustained ESAF operations, and on balance it would appear preferable to delay the transfer of ESAF Trust reserves for permanent financing until they are sufficient to meet the anticipated needs of a self-sustaining facility. 2/

1/ See *Continued Financing and Adaptation of the ESAF* (EBS/95/130, 8/4/95), page 20. It will be noted that a self-sustained ESAF implies no contribution from bilateral sources, which is partly responsible for the lower level of potential commitments.

2/ See *Continued Financing and Adaptation of the ESAF* (EBS/95/130, 8/4/95), page 21.

b. Modalities of a Gold Pledge

16. This Section explains the legal basis for a "gold pledge" for the purpose of protection of ESAF Trust resources and describes in general terms the characteristics of such a pledge. 1/

(i) A "gold pledge" in the context of the Fund

17. The Fund cannot mobilize the value of its gold other than through a sale of gold. Gold is held in the General Resources Account and cannot be used directly (i.e., without a sale) for purposes of guaranteeing claims of the ESAF Trust. However, the Fund may establish a "gold pledge" for the benefit of the ESAF Trust which, in the context of the Fund, would require a decision (i) to sell gold (held in the General Resources Account) under specified circumstances, and (ii) to use the proceeds of the sale in excess of SDR 35 per ounce as security. 2/ To that end, such proceeds would be transferred to the ESAF Trust Reserve Account. The Fund has already adopted a "gold pledge" to protect the ESAF Trust against the effects of shortfalls on the Reserve Account due to arrears under obligations arising from the encashment of "rights" from the ESAF Trust. 3/

(ii) The sale of gold

18. In accordance with Article V, Section 12(c), the Fund has the authority to sell gold at a market related price. A decision to sell gold under this provision requires an eighty-five percent majority of the total voting power

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1/ As has been confirmed at EBM/90/96, such a gold pledge would not affect the Executive Board's decision of December 18, 1987 that the "Fund is committed, if it appeared that any delay in payment by the Trust to lenders would be protracted, to consider fully and in good faith all such initiatives as might be necessary to assure full and expeditious payment to lenders" (Decision No. 8759-(87/176) ESAF). It was confirmed in the summing up of the Board discussion of December 15, 1987 that the decision had to be understood to include the possible use of gold. The Managing Director stated as follows: "Although noting the views of some Directors, I have repeated that the phrase 'all such initiatives as might be necessary' had to be understood to include the possible use of gold." The Fund's commitment is to consider all necessary initiatives, and the reference to "good faith" defines the spirit in which the Executive Board's deliberations would take place. Action on these initiatives would require decisions to be taken at the time when it appears that any delay in payment by the Trust to lenders would be protracted.

2/ The "gold pledge" decision could be amended only with the consent of all lenders to the ESAF Trust's Loan Account because it contains an undertaking for the protection of such lenders.

3/ Decision No. 10286-(93/23) ESAF, adopted February 22, 1993. See also *Modalities of a Gold Pledge for Use of ESAF Trust Resources under the Rights Approach* (EBS/93/10, 1/25/93) and *Modalities of a Gold Pledge for Use of ESAF Trust Resources under the Rights Approach* (EBS/90/108, 6/12/90).

(Article V, Section 12(b)). 1/ A decision to sell gold may authorize either an immediate sale or a sale in the future when certain objectively specified conditions are met. In the latter case, the Fund would decide at the outset to sell gold under specified conditions. Moreover, since any sale would take place only in the future, it would be provided, that for a specified period and under certain conditions, the Fund would retain full ownership of a specified amount of ounces of gold. 2/

(iii) Use of proceeds from the gold sale

19. As noted above, when gold is sold by the Fund under Article V, Section 12(c), an amount equivalent to one special drawing right per 0.888671 gram of fine gold is to be placed in the General Resources Account, and the excess is to be held in the Special Disbursement Account (Article V, Section 12(f)). 3/

20. Article V, Section 12(f) enumerates the various purposes for which resources held in the Special Disbursement Account may be used. It is possible to use these resources, inter alia, for the protection of loans made by the ESAF Trust. Article V, Section 12(f)(ii), second sentence, prescribes that "... balance of payments assistance may be made available on special terms to developing members in difficult circumstances, and for this purpose the Fund shall take into account the level of per capita income." 4/ The Fund has transferred resources derived from previous gold sales which were placed first in the Special Disbursement Account to the Reserve Account of the ESAF Trust ("Reserve Account.")

1/ It is understood that certain members would need to obtain an authorization for them to vote for such a decision. The consent of lenders to the reduction of the Reserve Account and the effectiveness of a gold pledge would need to be harmonized.

2/ Less any amounts that may have been sold under the respective gold pledge. See also below.

3/ Under Article V, Section 12(f) and (g) the excess may also be transferred to the Investment Account. This provision is not relevant to the present discussion and is not considered further.

4/ When establishing the Reserve Account in 1987, the Fund has relied on the same provision when transferring amounts from the SDA to the Reserve Account. Resources in the Reserve Account are used to compensate for the failure of borrowers from the ESAF Trust to make payments to the Trust when due, by making payments to lenders to the ESAF Trust's Loan Account corresponding to the undischarged obligations of borrowers and unsubsidized interest thereon. In this way, protection is provided to lenders to the ESAF Trust's Loan Account. The modalities of the use of resources transferred from the Special Disbursement Account to the Reserve Account have been explained in the context of the establishment of the ESAF Trust. See, in particular, *Enhancement of the Structural Adjustment Facility--Operational Arrangements* (EBS/87/245, 11/25/87).

21. The profits from gold sales under the "gold pledge" mechanism would also be transferred to the Reserve Account and would be available for use under the established rules of that Account. The decision on the transfer of profits from the SDA to the Reserve Account would be taken at the same time as the decision to sell pursuant to Article V, Section 12(c) under the "gold pledge mechanism" and would require a majority of eighty-five percent of the total voting power (Article V, Section 12(f) (last paragraph)). 1/

(iv) Conditions for the sale

22. Amounts placed to the Reserve Account in accordance with the "gold pledge" decision would replenish the Reserve Account so as to compensate for the reduction of its resources 2/ for subsidization of the "Interim ESAF" or to permit new commitments under a "self-sustained ESAF".

23. As envisaged under the previous gold pledge, the adequacy of the ESAF Trust Reserve Account would be reviewed periodically, say every six months. The previous gold pledge decision envisages that a determination would be made in the review whether the amounts held in the Reserve Account were sufficient to meet all obligations of the Trust in the coming six-month period which could give rise to a payment from the Reserve Account, and whether any other means of financing are available that would effectively restore the resources of the Trust available for payments to lenders and thus forestall or reduce the need for these last resort sales of gold. The determination would be based on objective data that would be known at that time, and would be made by the Executive Board by a majority of the votes cast. The new gold pledge could provide for a similar determination mechanism. 3/

24. To the extent that the resources held in the Reserve Account and any other available resources were insufficient to meet all obligations (the "potential shortfall"), gold would be sold to generate resources for placement to the Reserve Account up to the equivalent of the potential shortfall and within the overall limit of gold available for the sale. The cumulative amounts of such sales would be subject to the overall limit of 3 million ounces of gold for purposes of the previous "gold pledge" and of [x] million ounces for the new "gold pledge." Moreover, the proceeds to be generated by gold sales could not exceed an amount equivalent to the previous reduction of the Reserve Account because of a shortfall attributable to the financing of rights or the contemplated reduction of the Reserve Account plus foregone investment earnings on these amounts. Moreover, if the conditions for sales

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1/ The ESAF Trust Instrument, which specifies the resources of the Reserve Account, would need to be amended in order to provide for inclusion of resources transferred to it under the new "gold pledge" mechanism.

2/ Plus foregone investment earnings such on such amounts retransferred from the Reserve Account.

3/ As under the existing pledge, if a potential shortfall is "small", and expected earnings could compensate the shortfall, creditors of the Loan Account of the ESAF Trust would be consulted.

under the previous gold pledge decisions are met, the Fund would first sell gold under that decision, to be supplemented as needed under the new pledge.

25. The need to retain the amount of gold available for sale would be reviewed on the occasion of the periodic reviews, and the Executive Board could decide to reduce the amount by a majority of votes cast. However, since the "gold pledge" contains an undertaking that provides protection to lenders to the Loan Account of the ESAF Trust, any such reduction could be made only with their consent.

26. Provision would be made for a termination of the decision if lenders to the ESAF Trust Loan Account are in any event fully protected by the amounts held in the Reserve Account against any risk from outstanding ESAF Trust loans.

(v) Retransfer to the Special Disbursement Account

27. Since resources derived from a "gold pledge" would replenish the Reserve Account, they would be retransferred to the Special Disbursement Account following the same rules as established for other resources of the Reserve Account.

IV. Modalities of Possible Further Gold Sales

28. The general considerations that would be relevant for possible further sales of gold by the Fund are similar to those that were considered prior to the program of gold sales for the Trust Fund in 1976-80. 1/ First among them is the prescription in the Articles of Agreement that requires the Fund in all its dealings in gold to avoid the management of the price, or the establishment of a fixed price, in the gold market. 2/ Second, the Fund would wish to maximize the benefits from the sale of gold, while avoiding, to the extent possible, any pressure on gold prices or contributions to disorderly market conditions. Third, as a public entity accountable to its membership, the Fund probably would wish to conduct these sales in as transparent a manner as is compatible with other considerations. Fourth, the modalities appropriate for sales of gold by the Fund might also be influenced by the amount of gold to be sold.

29. The most obvious alternatives for selling gold held by the Fund discussed in preparation for the gold sales program to finance the Trust Fund during 1976-80 were (i) sales to the private market through individual gold dealers or through a consortium of such dealers, and (ii) sales through auctions conducted by the Fund and open to any bidder meeting the specified terms and conditions ("public" auctions). Sales through private gold

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1/ *Financing the Trust Fund* (EBS/75/368, 10/15/75), and discussions at Executive Board Meetings Nos. 75/173 and 75/174 (11/7/75).
2/ Article V, Section 12. See also *Commentary on the Proposed Amendment of the Articles of Agreement*, pp.2 43-52.

dealers represented the normal procedure in the private gold market, including the official sales of major gold producers (such as South Africa or the USSR). In contrast, governmental authorities when raising resources (e.g., through the sale of public debt) or when disposing of surplus property often prefer some form of public auctions, and that sales method had also been used by the United States authorities for the disposal of part of the official gold stocks of the United States in the late 1970s. 1/

30. Sales through private channels--whether an individual dealer, a consortium of dealers, or the BIS--would require a number of decisions by the Fund, some of which may pose delicate issues of selection and control. These include questions regarding the selection of the dealer or dealers to be included in a consortium; the negotiation of a reasonable transactions fee to be charged by such dealers; the body responsible for decisions on the timing and amounts of sales, and the influence the current (and perhaps expected future) market price for gold should have on these decisions. Some of these questions may also raise issues regarding consistency with the prescription in the Articles against Fund management of the price or the establishment of a fixed price, in the gold markets. Moreover, impending sales of gold by the Fund are likely to become known in the markets--in contrast perhaps to sales by other monetary authorities which as a rule are publicized only after completion--and uncertainties as to the timing and extent of such sales are likely to affect markets adversely.

31. At the time of the 1975 agreement on sales of gold by the Fund, the balance of these considerations suggested a preference for "public" auctions, and this was the method chosen for the Fund's gold sales program for the benefit of the Trust Fund during 1976-80. 2/ 3/ Some of the issues mentioned in the preceding paragraph would have been all the more difficult to resolve satisfactorily because private dealings in the international gold

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1/ The United States sold 1.25 million fine ounces of gold in two auctions in 1975, and 15.8 million fine ounces in 19 auctions in 1978-79. See *Monthly Report on Gold Prices in World Markets* (DM/80/6, 1/22/80), Appendix Table 4.

2/ Earlier gold sales by the Fund had been sales to member countries in order to replenish the Fund's currency holdings in connection with activations of the General Arrangements to Borrow (GAB), which did not raise issues as regards sales procedures. See *Gold in the Fund* (EBS/95/69, 4/21/95), Annex I.

3/ For a summary of the 1976-1980 gold sales by the Fund, see *Gold in the Fund*, Annex III.

markets generally are not transparent to the public but are characterized by a great deal of confidentiality. 1/

32. Sale through public auctions, in contrast, permitted the Fund to meet a number of *desiderata* at the same time. First, it allowed the Fund to act as a price taker, thus meeting the strictures against management of prices (and, *a fortiori*, those against the establishment of a fixed price) in the gold markets. Moreover, the announcement of a fixed schedule of auctions of specified amounts of gold for some time ahead removed a great deal of uncertainty in the markets about the intentions of the provider of what represented a substantial addition to the normal supplies to the markets. By allowing market participants to know the conditions likely to pertain at least in the immediately foreseeable future, announcement of the amount to be sold through auctions for two years ahead reduced uncertainties that otherwise would most likely have exerted (additional) downward pressures on market prices--affecting, among others, the resources that could be expected to flow to the Trust Fund. Auctions with generally unrestricted access also avoided all the difficulties inherent in the choice of private dealers or of consortia to act as agents for the Fund in gold sales which would have required not only an evaluation of the standing and creditworthiness of dealers but which would undoubtedly also have raised issues of national or geographical distribution or participation.

33. The considerations broadly summarized in the preceding paragraphs would appear to be as relevant today as they were in 1975 for the sale of any significant quantity of the Fund's present holdings of gold. The staff would propose that if agreement would be reached for sales of more than very small amounts of the Fund's gold, consideration again be given for such sales to be made through "public" auctions of predetermined quantities of gold at specified intervals, along the lines of the gold sales program of 1976-1980.

34. The proposal of gold sales by means of preannounced regular auctions is not intended to prejudge the procedures or decisions that would be appropriate if developments require an activation of the Fund's existing gold pledge, or of any pledge to sell an additional amount of Fund gold to provide repayment assurances in connection with a continuation of ESAF operations. The quantity of gold that may need to be offered for sale at the occasion of such an activation may be too small to contemplate a program of regular periodic auctions, and rather different considerations would appear likely to apply if such an activation ever became necessary. There does not appear any need to consider such an eventuality at the present

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1/ In this regard, the position of the Fund is not comparable to that of the central banks of member countries which have a much greater degree of freedom in the pursuit of desirable portfolio adjustments that may call for the sale of part of their gold holdings. Such sales usually are announced *post factum*, as was the case with the sales of gold by the National Bank of Belgium, the Netherlands Bank, and Canada in recent years. See *Gold in the Fund* (EBS/95/69, 4/21/95), Annex V.

time; if it were to appear likely to occur in the foreseeable future, the staff would intend to make appropriate proposals.

V. Summary and Conclusions

35. Projections of the potential demand for ESAF resources during the interim period until the ESAF Trust becomes self-sustaining indicate a subsidy requirement of about SDR 2.9 billion without taking into account potential loans to three members currently in protracted arrears, and of SDR 3.3 billion to SDR 3.7 billion--depending on the level of access--if the potential needs of these members after the settlement of arrears are taken into account. For the illustrative simulations presented in the paper it is assumed that part of these subsidy requirements would be provided from bilateral sources, and the remainder from resources of the Fund. Two alternative methods of providing resources from the Fund to meet subsidy requirements are examined: (i) sales of a modest amount from the Fund's holdings of gold, and use of the investment income on the profits from these sales; and (ii) use of part of the balances accumulating in the ESAF Trust's Reserve Account, either to finance subsidies or to permit early initiation of a self-sustaining ESAF.

A. Use of Profits on Sales of Gold

36. The amount of gold that would need to be sold to meet the subsidy requirements of an "interim" ESAF depends on the projected demand for ESAF-type loans and the share of the subsidies contributed by the Fund. Sales of 6.1 million fine ounces of gold would be necessary to generate sufficient investment income to finance one-half of the subsidies on projected loans to ESAF-eligible members excluding loans to the members in protracted arrears; if potential loans to these latter members are taken into account, necessary gold sales would amount up to 8.8 million ounces.

B. Gold Pledge to Secure Early Use of Reserve Account Resources

37. Alternatively, it has been suggested that part of the resources in the Reserve Account of the ESAF Trust could provide a basis for subsidies on loans of the "interim" ESAF, which would require the consent of members that have extended loans to the ESAF Trust's Loan Account. In order to provide additional protection, if needed, a pledge by the Fund--in addition to the existing pledge supporting the use of ESAF resources for financing the encashment of rights--could be considered if this should become necessary to ensure timely repayment of loans to the ESAF Trust. The Fund would decide to sell, in specified circumstances, up to a specified amount of gold to replenish the ESAF Trust Reserve Account.

38. The amount to be pledged would be determined in the light of the purpose to provide additional protection that may be needed because of "early" use of balances in the Reserve Account. However, full use under such a pledge would be unlikely to become necessary except under very adverse circumstances of widespread failure of members in meeting their

repayment obligations to the ESAF Trust. The amount of gold that would need to be pledged would depend on the particular method of reserve use chosen--i.e. to finance subsidies in support of an "interim" ESAF, or to permit an early initiation of a self-sustaining ESAF.

(i) <u>Use of Reserves to finance subsidies</u>

39. One method of supporting the "interim" ESAF would be the use of Reserve Account resources for the payment of subsidies on ESAF-type loans that would be financed from other resources, such as the GRA. The maximum reduction of Reserves for this purpose would occur in the year 2004; with one half of subsidy requirements being provided by the Fund, the reduction is estimated to amount to approximately SDR 350 million, equivalent to about 1.7 million fine ounces at the current market price of gold of about US$385 a fine ounce (or about SDR 250 a fine ounce at the current rate of about US$1.55 per SDR) excluding the three members in protracted arrears, and up to 3.2 million fine ounces if projected potential loans to these members are included. The part of the subsidy payments financed from ESAF Trust reserves would continue to have to be met from the resources of the Reserve Account until repayment of loans is completed around 2018, and accordingly would reduce the amount of transfers to the SDA which otherwise would accrue to the self-sustaining ESAF. Reflecting the reduction of the resources that would become available to the SDA, the level of commitments that could be made by the self-sustained ESAF starting in 2005 would be reduced to SDR 600 million per year, substantially less than the SDR 800 million projected without such a use of the Reserve Account.

(ii) <u>Use of Reserves for Early Initiation of Self-Sustaining ESAF</u>

40. Alternatively, a reduction in the desired coverage of outstanding Trust liabilities by the Reserve Account of the Trust--if that were acceptable to the lenders to the ESAF Trust--could be considered to make possible an earlier commencement of the operation of a self-sustaining ESAF, albeit at a somewhat reduced rate of annual loan commitments. For example, if reserves of marginally more that one third of outstanding Trust liabilities (more exactly, 36 percent) would be acceptable to the Trust's creditors, and resources that exceed this coverage ratio would be made available, then self-sustaining ESAF operations could begin in 1999 (at a level of potential commitments of SDR 0.6 billion a year). The maximum "shortfall" in the Reserve Account would reach an amount of SDR 2.8 billion SDRs and, in order to offer the same repayment assurances implied by full coverage by Reserves of Trust obligations, an additional gold pledge of 13.3 million fine ounces would be required.

41. Use of ESAF Trust reserves to finance subsidies or to permit an early initiation of operations of a self-sustaining ESAF has the disadvantage of reducing substantially the resources that otherwise would become available to and potential loan commitments of the self-sustaining facility, and thus requiring other resources for the facility to meet anticipated needs. As this would not appear a satisfactory basis for self-sustained ESAF operations, it would appear preferable to delay the transfer of ESAF Trust

reserves for permanent financing until they are sufficient to meet the anticipated needs of a self-sustaining facility.

C. Modalities of Gold Sales

42. A number of considerations are relevant when considering the most appropriate manner of sales of gold by the Fund. These include the proscription in the Articles of Agreement that the Fund in all its dealings in gold avoid the management of the price, or the establishment of a fixed price, in the gold market; the avoidance of downward pressures on the market price of gold or of creating disorderly market conditions; the desirability of maximizing profits on the sale of gold; and the obligation of a public entity accountable to its membership to conduct its operations in as transparent a manner as is compatible with other considerations.

43. The balance of these considerations led to a preference for "public" auctions over sales through private channels when the Fund had decided, in the mid-1970s, to dispose of a substantial part of its gold holdings (25 million fine ounces) to the private markets for the benefit of the Trust Fund. In the staff's view, the same considerations continue to be relevant for the sale of any significant quantity of the Fund's remaining holdings of gold. Accordingly, the staff would propose that if agreement were reached for sales of more than very small amounts of the Fund's gold, consideration again be given for such sales to be made through "public" auctions of predetermined quantities of gold at specified intervals, along the lines of the gold sales program of 1976-80.

44. The proposal of gold sales by means of preannounced regular auctions would not be intended to prejudge the procedures or decisions that would be appropriate if developments require an activation of the Fund's existing gold pledges, or of any pledge to sell an additional amount of Fund gold. The quantity of gold that may need to be offered for sale at the occasion of such an activation may too small to contemplate a program of regular periodic auctions, and rather different considerations would appear likely to apply if such an activation ever became necessary. There does not appear any need to consider such an eventuality at the present time; if it were to appear likely to occur in the foreseeable future, the staff would intend to make appropriate proposals.