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To: Members of the Committee of the Whole on Review of Quotas

From: The Secretary

Subject: Reduction of Gold Payments Under Article III, Section 4(a)

The attached memorandum on legal aspects of the reduction of gold payments under Article III, Section 4(a) is one of the two papers on mitigation which, at Committee Meeting 69/5 (12/3/69), the Acting Chairman said would be circulated.

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INTERNATIONAL MONETARY FUND

Reduction of Gold Payments under Article III, Section 4(a)

Prepared by the Legal Department

(In consultation with the Research and Treasurer's Departments)

Approved by Joseph Gold

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Introduction

The payment of additional subscriptions when quotas are increased is governed by Article III, Section 4(a), which reads as follows:

> "Each member which consents to an increase in its quota shall, within thirty days after the date of its consent, pay to the Fund twenty-five percent of the increase in gold and the balance in its own currency. If, however, on the date when the member consents to an increase, its monetary reserves are less than its new quota, the Fund may reduce the proportion of the increase to be paid in gold."

This memorandum discusses certain legal aspects of this provision and the Fund's practice under it.

1. Past policy.

The policy hitherto followed by the Fund with respect to the payment of additional subscriptions when quotas were increased has been to require members to pay 25 per cent of the increase in their quotas in gold. This has been the invariable practice of the Fund in connection with individual increases and general reviews. The possibility of reducing the part payable in gold was considered in connection with the Third and Fourth Quinquennial Reviews of Quotas, but the decision in both cases was against this course. The reasons which motivated the decision in connection with the Third Quinquennial Review were explained as follows in the Report of the Executive Directors to the Board of Governors entitled "Enlargement of Fund Resources Through Increases in Quotas":

> "The present proposals for increases in quotas are based on the idea of a cooperative effort by the members of the Fund to provide larger resources against contingencies that may affect any member. In order to preserve the general character of that effort, it has been thought preferable not to exercise the discretion to reduce gold payments under Article III, Section 4. However, since the

prompt payment in gold of 25 per cent of the quota increase might cause hardship in some cases, the facilities described in the next two paragraphs will be available to members consenting to increases under the First or the Second Resolution." (p. 17)

The same explanation is contained in paragraph 11 of the Report of the Executive Directors to the Board of Governors entitled "Increases in Quotas of Fund Members: Fourth Quinquennial Review" which states in part:

"The increase in quotas under the Resolutions is based on the idea of a cooperative effort by the members of the Fund to provide larger resources against contingencies that may affect any member. In order to preserve the general character of that effort, it has been thought preferable not to exercise the discretion given to the Executive Directors under Article III, Section 4, of the Articles of Agreement to reduce gold payments in connection with these Resolutions."

If it were decided to reduce gold subscrptions under Article III, Section 4(a), a number of questions would arise. Most of these have been considered in the past on the occasion when the use of the provision was examined.

2. Condition for reduction.

The second sentence of Article III, Section 4(a) authorizes the Fund to reduce the proportion of a quota increase to be paid in gold if, on the date when the member consents to the increase, the member's monetary reserves are less than its new quota. Therefore, the situation of each member would have to be examined individually in order to see whether the gold payment could be reduced. As a result of the introduction of a gross concept of monetary reserves by the amendment of Article XIX(a), currency liabilities are no longer deducted from a member's official holdings. 1/ Again, the exclusions and deductions provided for in Schedule B, paragraphs 3 and 5 can be made solely for the repurchase purposes of Article V, Section 7(b) and (c) and therefore cannot be made in calculations for the purpose of Article III, Section 4(a). In addition, pursuant to Article XXV, Section 7(a), a member's total holdings of special drawing rights are included in its monetary reserves for the purpose of Article III, Section 4(a). The authority of the Fund to decide not to take any account of increases or decreases in monetary reserves which are due to allocations

1/ In the calculations for repurchase purposes, it follows from Schedule B, paragraph 6 that as of the end of financial year 1970, currency liabilities will be deducted because they were deducted as of the beginning of the year. This exception does not apply to calculations for the purpose of Article III, Section 4(a).

or cancellations of special drawing rights during the year applies exclusively for the repurchase purposes of Article V, Section 7(b) and (c).

It should be noted that the date as of which a member's monetary reserves must be calculated in order to determine whether its gold payment can be reduced is the date on which it consents to the increase in its quota. This date might be some months earlier than the date on which the member has to pay its subscription and the date on which the increase in its quota becomes effective. This could be the situation in which it consents soon after the Board of Governors adopts its resolution enabling the member to consent, but the resolution contains conditions, such as a minimum participation, which are not met for some time after the member has consented.

3. Amount of reduction.

Article III, Section 4(a) gives the Fund the discretion to decide whether there shall be a reduction in the proportion of the increase to be paid in gold and what the amount of any reduction shall be. This was explained as follows in SM/63/37 ("Quota Increases--Gold Subscriptions", April 8, 1963):

> "It may be presumed that had they [the drafters of the Articles] wished that the proportion be determined in accordance with some formula, e.g., on the basis of the level of the member's monetary reserves, rather than by the Fund in its discretion, they would have made this explicit, as they have done in other similar cases. For example, where charges are levied by the Fund on its holdings of a member's currency in excess of quota, it was expressly prescribed that if the member's monetary reserves are less than one-half of its quota, the member 'shall pay in gold only that portion of the charges due which such reserves bear to one-half of its quota, and shall pay the balance in its own currency' (Article V, Section 8(f)). A criterion for reduction in gold payments was also adopted under Article III, Section 3, which deals with payment of original gold subscriptions. That provision permits the payment of gold of less than 25 per cent of a member's quota, but it is specified that the amount payable in gold must be equal to 10 per cent of the member's net official holdings of gold and U.S. dollars if that amount is less than 25 per cent of quota."

In view of the scope of the Fund's discretion, a reduction may, but need not, be based on the ratio between the new quota and the member's monetary reserves, or on another formula. The Fund could also decide that no part of the increase in subscription need be paid in gold.

The establishment of different categories of reduction would not be inconsistent with the provision. The Fund could not establish distinctions that were not justifiable by reference to the purposes of the Fund and the provision under which it was acting, but within this principle

the Fund could establish categories of members to which different ratios of gold payment would apply. Distinctions might be based on the proportion of monetary reserves to new quota. For example, all members with monetary reserves less than one half of quota might be permitted to pay no gold or a small percentage of gold, while members with monetary reserves between one half and 100 per cent of quota would pay a higher percentage of gold. Moreover, the Fund could decide to apply the second sentence of Article III, Section 4(a) for general increases to the exclusion of special increases, or establish different proportions for the two types of increases.

4. Repurchase effect of reduction.

The express rule of Section 4(a) is that upon an increase in a member's quota 25 per cent of the increase is payable in gold and the balance in the member's currency. The second sentence mentions only a reduction in the "proportion of the increase to be paid in gold," which implies, however, that if there is a reduction in the gold payment there is a corresponding increase in the currency payment.

If the Fund's holdings of a member's currency are above 75 per cent of its increased quota after payment of the member's additional subscription, the member may incur repurchase obligations under Article V, Section 7(b) and (c), and these obligations may be large enough to reduce the Fund's holdings of the member's currency to 75 per cent of quota. Repurchase obligations might accrue in gold, convertible currencies, or special drawing rights, so that, sooner or later, the effect would be to substitute other reserve media in whole or in part for the gold that would have been payable if the gold subscription had not been reduced.

A repurchase obligation might accrue for a member at the end of the financial year in which it pays an additional currency subscription in excess of 75 per cent of the increase in quota and as a result of that payment. This is not likely because repurchase obligations do not arise unless a member's monetary reserves exceed 150 per cent of quota and the member would not have been permitted to make a reduced gold payment unless its monetary reserves were less than its new quota on the date when the member consented to its new quota. However, a member may incur a repurchase obligation as a result of an increase in the Fund's holdings of its currency not only in the year in which an increase occurs but in subsequent years also. In subsequent years, the obligation will be determined solely by increases in monetary reserves, provided again that repurchase obligations are not permitted to reduce monetary reserves below 150 per cent of quota.

5. Repurchase terms.

In exercising its discretion to reduce the gold subscription payment, the Fund could require, as a condition of the exercise of this discretion, that members repurchase the equivalent of the reduction in the gold payment

over a period determined by the Fund.[1] The Fund is not required to reduce gold payments, and if it decides to do so it may permit the reduction on terms reasonably related to the exercise of the discretion and not inconsistent with other provisions. Repurchase terms would meet this test because they would be related to the liquidity of the Fund's resources and this is a consideration that is directly related to the requirement of gold payments under Article III, Section 4. In addition, the terms would not be inconsistent with any provision of the Articles. In the usual way, repurchase terms could not be allowed to reduce the Fund's holdings of the member's currency below 75 per cent of quota. Accordingly, the Fund could permit a member to make a reduced gold payment provided that it undertook to repurchase the substituted currency in a number of equal yearly installments or within an outside limit of three, four, or five years.

6. Media of repurchase.

In the exercise of its discretion, the Fund could stipulate that repurchase shall be in any media in which repurchase may be made. Therefore, the Fund could require that the undertaking be discharged with gold or convertible currencies acceptable to the Fund, or both. In addition, under Article XXV, Section 7(c)(ii) the Fund could require that repurchase be made in special drawing rights. This last conclusion is not inconsistent with the rejection of the proposal that members be allowed to pay subscriptions under Article III, Section 4(a) with special drawing rights. It remains true that a member may make subscription payments only in gold and its own currency and cannot make them in the currencies of other members or special drawing rights. This is without prejudice, however, to repurchase. This is apparent from the fact that repurchases may accrue in special drawing rights even though no special terms are undertaken. If repurchase terms are bona fide they are not objectionable if they call for repurchase to be made in any media in which repurchase may be made, including special drawing rights. There would be no reason to doubt that any terms calling for repurchase in special drawing rights were bona fide if they called for repurchase in the same proportion that was involved in any general policy under Article XXV, Section 7(c)(ii).

There are some legal differences between payment of subscriptions with special drawing rights and repurchase with them which emphasize the fact that the operations are different. First, repurchase commitments are possible only in those cases in which members meet the monetary reserves criterion in Article III, Section 4(a) for the reduction of gold subscriptions. Secondly, even though the Fund were to prescribe the reserve media for repurchase, the repurchase commitment might still be discharged in

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1/ At Committee of the Whole Meeting 64/2 (11/23/64), the Chairman observed "The third point is that the Board is free to establish appropriate procedures or conditions in exercising its discretion in the application of Article III, Section 4(a). Therefore, it could decide on an appropriate way of making up the gold where members were not required to pay it at the outset. That gives us considerable freedom of action ...."

some circumstances in other media. For example, it might still happen that a member that had undertaken to repurchase, in whole or in part, with gold or special drawing rights would incur a repurchase obligation in convertible currencies under Article V, Section 7(b) which would reduce the Fund's holdings of 75 per cent of quota. The example makes a third point. The Fund's holdings of a member's currency cannot be reduced below 75 per cent of quota by alleged repurchase, and therefore repurchase terms would be discharged with currency even though other media of discharge had been prescribed. If the possibility of direct payments in special drawing rights had been adopted, it is not demonstrable that there would have been a comparable limitation.

7. Discharge of repurchase terms.

If repurchase terms are undertaken by a member and there are subsequent reductions in the Fund's holdings of the member's currency which do not reduce those holdings to 75 per cent of the member's quota, it is necessary to determine which repurchase undertakings or representations must be taken to be discharged by the reductions. The detailed rules of allocating these reductions have been set forth in SM/63/21 ("Allocation of Reductions in Fund Holdings of a Currency", February 20, 1963) and SM/69/136, Cor. 1 ("Gold Tranche Purchases Under the Amended Articles", August 29, 1969). The detailed rules rest on the following basic ideas:

(i) If a repurchase obligation under Article V, Section 7(b) can be identified as having arisen because of a particular purchase, the obligation will be deemed to discharge the undertaking or representation given in connection with that purchase.

(ii) If a member makes a repurchase outside Article V, Section 7(b), it may identify the purchase in respect of which the repurchase is made.

(iii) Subject to the foregoing, reductions in the Fund's holdings of a currency are deemed to discharge repurchase undertakings or representations in the order in which they mature.

These principles and the rules based on them will suffice to deal with the discharge of repurchase terms undertaken under Article III, Section 4(a) with the understanding that the maturity under those terms be treated as if it were a maturity associated with a purchase.

8. Maturities.

If repurchase terms were adopted under Article III, Section 4(a), some guidance might be found on the issue of maturity in the maturities associated with special purchases to relieve the impact of gold subscriptions in the past. The Report of the Executive Directors to the Board of Governors

entitled "Enlargement of Fund Resources Through Increases in Quotas" stated that where members would encounter undue payments difficulties through the reduction of their reserves by the payment of the 25 per cent gold subscription or of the outstanding balance, the Fund would sympathetically consider a request for an exchange transaction up to 25 per cent of the increase.

> " ... The Fund will expect that a member requesting such an exchange transaction beyond the gold tranche will represent that it will make a repurchase corresponding to any drawing in equal annual installments, to commence one year after the drawing and to be completed not later than three years after the drawing." (p. 18)

The Report of the Executive Directors to the Board of Governors entitled "Increases in Quotas of Fund Members: Fourth Quinquennial Review" stated in paragraph 16:

> "The Fund will expect that a member requesting such an exchange transaction under paragraph 15 above will represent that it will make a repurchase corresponding to the exchange transaction in accordance with the principles of E.B. Decision No. 102-(52/11) of February 13, 1952 and the following subparagraphs:
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> (i) The member will be expected to represent that it will make a repurchase corresponding to the exchange transaction in equal annual installments, to commence one year after the transaction and to be completed not later than five years after the transaction.
>
> (ii) If the member, when requesting the exchange transaction or at any time thereafter, represents that, because of other repurchase commitments or for such other reasons as it shall submit, the schedule referred to in (i) above would create undue payments difficulties, the Fund may accept a representation that the member will repurchase in accordance with the provisions of E.B. Decision No. 102-(52/11)."

9. <u>Reserved power</u>.

Article III, Section 4(c) requires a majority of 85 per cent of the total voting power "for any decisions dealing with the payment, or made with the sole purpose of mitigating the effects of the payment, of increases in quotas proposed as the result of a general review of quotas." Article XII, Section 2(b)(ii) reserves to the Board of Governors the power to decide on "the payment, or on the mitigation of the effects of payment, of increases in quotas proposed as the result of a general review of quotas." Consequently, the decision to apply the second sentence of Article III, Section 4(a) must be made by the Board of Governors and

adopted by at least 85 per cent of the total voting power. It might also be necessary to have a decision taken by the same majority of participants in accordance with Article XXVII (a)(iv). The question arises, however, whether the Board of Governors can delegate to the Executive Directors the power to decide on such aspects of the application of the second sentence as the content of repurchase terms. Article III, Section 4(c) stipulates an 85 per cent majority for "any decisions" dealing with the payment of quota increases. On this topic the Executive Directors' Report to the Governors regarding the Proposed Amendment of the Articles of Agreement stated as follows:

> "Under a new provision, Article III, Section 4(c), an 85 per cent majority will be required for decisions on other matters that are related to quota increases proposed as the result of a general quota review even though they do not involve conditions precedent to the effectiveness of the increases. These decisions include any decision pursuant to Article III, Section 4(a), under which a member may be permitted to pay less than 25 per cent of its additional subscription in gold. The new provision will also apply to any decision intended to mitigate the effects of the payment of additional subscriptions. At present, the Articles provide that all of these decisions are to be made by the Executive Directors by a majority of the votes cast. After the Proposed Amendment enters into force the power to make such decisions will be reserved to the Board of Governors."

The phrase "any decision pursuant to Article III, Section 4(a) under which a member may be permitted to pay less than 25 per cent of its additional subscription in gold" should be understood to encompass those terms on which a smaller payment would be permitted. These would include maturities and media if any were prescribed. Procedural rules dealing, for example, with the collection of monetary reserves data, or operational rules dealing, for example, with the allocation of reductions, would not be involved in the terms.