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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/198

3:00 p.m., December 15, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	W. K. Parmena, Temporary
	Jiang H.
	M. K. Bush
	H. G. Schneider
A. Donoso	
	T. Alhaimus
	M. Sugita
	B. Goos
	Khong K. N., Temporary
A. Kafka	
	M. Foot
	O. Isleifsson, Temporary
	G. D. Hodgson, Temporary
	N. Toé, Temporary
Y. A. Nimatallah	I. Al-Assaf
G. Ortiz	
H. Ploix	S. de Forges
	J. de Beaufort Wijnholds
	I. Sliper, Temporary
G. Salehkhou	
	A. Vasudevan, Temporary
S. Zecchini	

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

Also Present

Administration Department: N. S. Jackson. Legal Department: R. H. Munzberg. Treasurer's Department: T. Leddy, Deputy Treasurer; J. E. Blalock, R. B. Hicks, B. E. Keuppens, G. Wittich. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, K. Murakami. Assistants to Executive Directors: J. R. N. Almeida, H. S. Binay, M. Hepp, T. Morita, L. M. Piantini, A. V. Romuâldez, C. A. Salinas, B. Tamami.

1. INCOME POSITION FOR FINANCIAL YEAR 1987 - MIDYEAR REVIEW

The Executive Directors continued from the previous meeting (EBM/86/197, 12/15/86) their consideration of a staff paper on the review of the Fund's income position for the first six months of financial year 1987, including a proposal to delay a decision on the disposition of income in excess of the target amount until the end of the financial year (EBS/86/258, 11/21/86).

Mrs. Ploix made the following statement:

> Let me stress at the outset that, had a consensus on burden sharing not been reached in July 1986, the Board would have faced today a net income forecast for the year as a whole of approximately SDR 53 million, which would have been SDR 3 million short of the target for a 5 percent increase in reserves. And most likely, the present meeting would have been a difficult one. In stressing that point, I do not intend to suggest that the burden sharing approach should lessen our concerns about arrears; but I want to indicate that burden sharing tends to strengthen the Fund's financial position, as evidenced by the fact that we are today dealing with an excess of income rather than with deficits.
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> The excess income amounts to SDR 26 million for the first semester and is projected to be SDR 44 million for the year as a whole. The staff provides us with various possible courses of action for dealing with the excess. I understand the rationale behind each of these approaches, but I would like to suggest another possibility, which was alluded to during our meeting on July 25 and which deals with the part of the excess income attributable to the repayment of arrears. The present excess of income arises from two different sources: the change in market interest rates and other minor items (and this result must be treated as genuine excess income); and the settlement of charges that had been deferred before May 1, 1986. In our opinion, the amount of excess from this latter source of some SDR 20 million deserves special treatment. Since the corresponding arrears were offset by increases in the rate of charge alone, it would appear logical that debtors directly benefit from the repayment of these arrears. Since this relates to past events, the basic rate of charge could be lowered retroactively without influencing the present or the future.
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> As for the disposition of the other part of the excess income due to the change in market interest rates, I have no strong feelings. Overall, I agree with the staff that there may be advantages in delaying a decision on the disposition of the excess, but my proposal can just as easily be put into practice at the end of the year.

Mr. Khong made the following statement:

It is a pleasant surprise to note that the Fund's net income for the first half of FY 1987 has exceeded--by some SDR 26 million--the target of SDR 45 million set at the beginning of the year. This excess over the income objective, as well as the projected excess of SDR 44 million for the whole of FY 1987, should help to alleviate the adverse impact of the large deferral of income from charges expected in FY 1987.

Before addressing the main issues in the midyear review of the Fund's income position, I would like to make a few general comments on the excess of surplus earned during the first half year. The main factor contributing to the excess was the settlement during the first half year of SDR 20.3 million of charges that had been deferred earlier. This makes me wonder whether the Board discussion and decision on action to neutralize the adverse impact of the newly deferred charges of SDR 73.2 million should not have taken the settlement into account. In this matter, the adjustment of the rate of charge and the rate of remuneration could have been made on the net deferred charges, rather than on a gross basis. The Board would also not have to take two separate decisions relating to the net income target in isolation from one another.

The present exercise is taking place less than three weeks after the decision to adjust the rate of charge and the rate of remuneration. I cannot help but feel that the Board had not had before it all the facts on the likely evolution of the Fund's financial position--especially as regards achievement of the net income objective--when it had taken the decision on November 26 to adjust the rate of charge and remuneration in response to the gross deferred charges. The November 26 date at the top of EBS/86/258 leads me to believe that the Board could have been informed about the likely excess surplus in the first half year. I, for one, might have arrived at a different conclusion on the appropriate adjustment if I had known about the likely excess surplus.

In this connection, I would like to submit for the Board's consideration the idea that the two exercises--one on the action concerning deferred charges and the other on the midyear review of the Fund's income position--might be usefully looked at together. I have in mind that, should the Board decide today to reduce the rate of charge and increase the remuneration coefficient to achieve the net income targeted at the beginning of the year, it would lead to a downward adjustment of those rates of charge and remuneration that had been adjusted upward only three weeks earlier. Outsiders might well consider such action frivolous. Fortunately, it is clear that Directors who have addressed the issue are not inclined to take such action.

On the occasion of the 1985 midyear review, the Board discussed various possibilities to overcome the deficit. This chair supported a proposal that combined an increase in the rate of charge and a reduction in the rate of remuneration to generate the acquired additional income to meet the net income target. Consistent with that stand, it is my preference that the surplus now (and any deficit in later years) should be shared equally by debtors and creditors. In this regard, I support option (c) described on page 10 of the staff paper, which proposes that the excess surplus be disposed of through a combination of a reduction in the rate of charge and an increase in the remuneration coefficient. I can also go along with the proposal to reduce the rate of charge without any increase in the remuneration coefficient--option (a)--given that debtors are more likely to be the ultimate bearers of the burden in the case of a deficit, for instance, when the "safeguard" formula is activated. I do not think there are strong reasons for resorting to options (b), (d), and (e).

For purely prudential reasons, my inclination is toward a delay in any action until the end of FY 1987 when actual financial performance can be determined. In this manner, a relatively stable rate of charge and rate of remuneration can also be maintained. In addition, any decision now to reduce the rate of charge and to raise the rate of remuneration would look odd, given the Board's earlier decision based on the deferred charges of SDR 73.1 million. I would earnestly wish, however, that the Board would discuss this issue at the end of FY 1987 with full knowledge of the facts about the developments in deferred charges. In other words, any action on deferred charges projected on page 19 of the staff paper should be considered with this issue.

Mr. Donoso made the following statement:

During the first half of FY 1987, developments regarding the Fund's income position have been more favorable than projected, with actual net income exceeding the targeted amount by SDR 26 million. To a large extent, this outcome reflects the recent implementation of a number of measures aimed at protecting the Fund's financial position in light of the increasing outstanding amounts of overdue obligations that the Fund has been facing in the past several months. In particular, the calculations reflect the fact that income projections no longer include a projection of the settlement of deferred charges and that no decision has been taken on the treatment of net income deriving from the settlement of charges deferred before May 1, 1986, so that any payment received in this connection will constitute, in the absence of other deviations, a net income in excess of the target amounts.

In the case of the present exercise, the above-mentioned settled deferred charges amounted to SDR 20 million, leaving a still unsettled amount of some SDR 107 million, which eventually will accrue to the general income of the Fund in future exercises. It is important for us to underscore the fact that, before May 1, 1986, the deferred charges were financed entirely through adjustments in the rate of charge paid by member countries using Fund resources; hence, the settlement of those deferred charges should in turn be used entirely to reduce the prevailing rate of charge, either for the period immediately ahead in the case of midyear reviews, or retroactively, if the decision is adopted at the end of any financial year.

A totally different approach will apply to the case of charges deferred during the first half of FY 1987 as well as in future exercises, since their financing is now based on sharing the burden of their occurrence, through simultaneous adjustments in the rate of charge and the rate of remuneration. This is clearly a case in which the settlement of the deferred charges should benefit, as agreed to in the relevant principles and decisions, those members that paid an adjusted rate of charge or received reduced remuneration when the charges were deferred.

On the results of the present exercise and the revised projections for the whole of FY 1987, it is encouraging to note that the latest estimated figures suggest a possible net income of SDR 128 million, which represents an excess of about SDR 44 million over the projections made at the beginning of the year. The two main elements behind this improved position are related to the decline observed in the SDR interest rate and, thereby, in the value of the rate of remuneration, as well as to the above-mentioned settlement of income deferred in prior years.

Noting that the final outcome of the calculations could change, depending upon the behavior of a number of variables, and given that it is desirable to keep the rate of charge as stable as possible, we are prepared to endorse the view that no action should be taken on the occasion of this midyear review. To that extent, we can go along with the staff suggestion that there may be advantages in delaying a decision on the disposition of income in excess of the targeted amount until after the end of the financial year, when the actual figures will be known. However, and given the nature of sources of the improvement in the Fund's income position, we would like to indicate our preference to use any income in excess of the targeted amount to reduce retroactively the prevailing of charge or to consider reducing the rate of charge while at the same time deeming as income for the next financial year part of the excess income.

Mr. Hodgson made the following statement:

After considering the various options set out by the staff in EBS/86/258, it is our view that a decision on the disposition of income in excess of the income target for FY 1987 should be delayed until the end of the financial year, when all the facts are available. Besides, the compromise approach to the burden sharing principle and its relationship to the Fund's income position has been operating only for six months, and one of its elements--the increase in the remuneration coefficient to 100 percent--would not take effect until February 1, 1987.

A further issue that needs to be addressed concerns our method of setting the reserve target. While the target has been set to permit a 7.5 percent increase in the level of reserves for FY 1987 and FY 1988, we have not yet examined the adequacy of reserves; nor have we linked changes in the level of reserves to the changing risk of those reserves actually being used. It is our belief that this question still needs to be reviewed in depth, since only then can we assess whether excess income, such as from the settlement of charges deferred prior to May 1, 1986, should be retained by the Fund or distributed to the membership. I hope that the staff will examine this issue in the near future.

Mr. Zecchini considered that the excess income of SDR 26 million realized in the first half of FY 1987 was a welcome development not only for itself but also because of the factors behind it. The primary factor was the settlement of overdue charges, which represented at least a break in the worrisome trend of rising overdue payments to the Fund. Of course, it could not be denied that the situation of arrears remained serious, and one could not discount the possibility of a rise in arrears in the second half of FY 1987.

The second major factor behind the realization of excess income was the decline in the SDR interest rate, Mr. Zecchini continued. Since there was not sufficient information to indicate that such a decline would persist in the coming months, one could consider the factor as temporary in nature.

Taking note of the realized excess income could be viewed as sufficient to fulfill the purposes of the midyear review of the Fund's income position, Mr. Zecchini remarked. According to the Rules--I-6(4) and I-10--the aim of the review was to ensure that appropriate increases in the rate of charge and the net income target for the year would be achieved. Some might contend that other courses of action were not prevented by those Rules and that a reduction of the rate of charge or an increase in the rate of remuneration might be advisable; and the validity of some of the arguments in favor of such an approach could not be denied.

Nevertheless, as he saw it, there were other more important reasons which argued in favor of taking no action at the present time, Mr. Zecchini said. First, there remained uncertainty about the amount of excess income that would be realized for the year as a whole, since the phenomenon of overdue charges still represented a major threat to the income accounts of the Fund. Second, the problem of arrears was far from being resolved. Apart from the historic rise in the stock of overdue payments, the simple fact of the lengthening of the average period of outstanding arrears indicated that the problem was becoming structural, if not systemic, and that it called, inter alia, for an accelerated strengthening of the reserve base of the Fund aimed at fostering the liquidity of the institution's resources and its financial viability. Third, it had in the past been considered a valuable objective to reduce the variability of the rate of charge within the financial year. Finally, nothing prevented the Board from retroactively adjusting the rate of charge, as well as the rate of remuneration, at the end of the financial year when the precise amount of excess income would be known. In light of all those considerations, it would be appropriate to delay any decision on the disposition of the excess income until the end of the current financial year.

Mr. Jiang made the following statement:

> It is comforting to know that the Fund's income position has improved, with data from the first six months of the financial year showing SDR 26 million in excess of the targeted net income. Moreover, the revised estimates for FY 1987 as a whole indicate that the Fund's income position will improve further, with a net income of SDR 128 million, or SDR 44 million above the amount forecast at the beginning of the year. This significant improvement is attributable partly to the settlement of income deferred in prior years and partly to the SDR interest rate and the rate of remuneration being below projected values. It is evident that the projected net income is sensitive to these two factors, as well as to the other factors mentioned by the staff. Further settlement of charges deferred before the current financial year will increase the realized income, and every change in the SDR interest rate by 10 basis points over the second half of the financial year will result in a decrease or increase of the net income by some SDR 8 million. Since these two factors are more or less outside the control of the Fund, we can see much uncertainty attached to the projections.
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> Given uncertainty about the final results and the expressed desirability of a substantial degree of stability in Fund charges, it seems better for the Board to delay a decision on the disposition of income in excess of the targeted amount until after the end of the financial year. Any decision to be taken at that time on a reduction of the rate of charge or an increase of the rate of remuneration will be effective retroactively from the beginning of the financial year.

Mr. Ortiz made the following statement:

We welcome today's discussion on the review of the Fund's income position, the first to be held after the agreement on burden sharing reached in July. As Madame Ploix has noted, we are already benefiting from this agreement, since, in its absence, we could be dealing today with a difficult situation of income shortages; instead, we are in the more comfortable position of having to decide on the allocation of a significant surplus that has been generated during the first half of FY 1987 and the prospect of an increase in this surplus by the end of the year.

On the possible courses of action outlined in the staff paper, we would favor a straight and retroactive reduction of the rate of charge for the year as a whole. Most of the surplus is derived from the discharge of overdue charges that had been deferred prior to the implementation of the burden sharing scheme. It seems clear that the proceeds of these settlements should benefit those countries which were affected by the problem of overdue obligations through the payment of a higher rate of charge in the first place.

In balancing the various considerations, and given that even greater surplus is expected for the year as a whole, we could go along with the more conservative action of basing the reduction of the rate of charge on the results already obtained rather than on the projected excess. We take this position for the following reasons: first, the rate of charge on the use of ordinary resources would be brought more in line with the current trend of market interest rates. Second, given that the proposed adjustment would be only on the order of 14 basis points for the whole year, it would not conflict with the desired objective of maintaining a certain degree of stability in the rate of charge. In fact, a retroactive reduction taken at the end of the fiscal year would probably result in a larger movement in the rate of charge. Third, given that we would only be considering the distribution of the realized surplus at the present stage, and in light of an even larger projected surplus for the second half of the fiscal year, we would, in fact, be leaving a substantial margin to accommodate unforeseen events; in addition, as noted by the staff, the degree of uncertainty at the present time appears to be somewhat reduced in relation to earlier reviews. Fourth, we should also consider that the net income target has been raised both for FY 1987 and FY 1988 and that an additional SDR 26 million corresponding to the excess registered over the targeted amount in FY 1986 was added to reserves. Finally, on the idea--raised by Mr. Schneider and Mr. Zecchini--that midyear reviews were originally implemented with a view to protecting the income position of the Fund, I would note that it is perhaps time to extend the scope of these reviews in a symmetrical fashion to pass on the benefits of possible reductions in the rate of charge to countries utilizing Fund resources at an early, although not premature, stage.

However, in view of the position taken by other Directors, and considering that our views today should be shaped by the same spirit and principles that shaped discussions on burden sharing, we could go along with a decision to maintain the rates of charge and remuneration at present levels until the end of the fiscal year when the figures of income in excess of the targeted amount will be known. We do so, however, on the understanding that at least the portion of this excess attributable to the discharge of overdue obligations incurred prior to the adoption of our agreement on burden sharing should be utilized to reduce retroactively the rate of charge.

Mr. Toé made the following statement:

I am pleased to note that the improvement registered in the Fund's income position in FY 1986 has been repeated during the first half of FY 1987 and is expected to continue in the second half. Indeed, actual figures for the first half of FY 1987 indicate that an excess in net income of SDR 26 million, representing nearly 58 percent of the net income target for this period, has been generated. This is a welcome development. The main factors instrumental in bringing about this outcome are the discharge by members of their overdue financial obligations, for which income was deferred, and the effects of the fall in the SDR interest rate on remuneration paid by the Fund to member countries. On the first factor, the staff has noted in footnote 1 on page 4 of EBS/86/258 that no decision has been taken on the treatment of net income deriving from the settlement of charges deferred before May 1, 1986. The staff goes on to say that such income will accrue to the Fund's general income. Was the failure to take a decision an omission, or was it simply that no decision was necessary? I would appreciate staff comment on this matter. In any event, this chair is of the view that the SDR 20.3 million, and any other income deferred before May 1, 1986, deserves--as Mrs. Ploix has stated--special treatment.

By assuming a continued favorable evolution of the abovementioned factors, the staff expects that the income target for the whole fiscal year would be exceeded by 52 percent. Although the staff points out that the two main factors that have contributed to the improvement of the income position are beyond the Fund's control, I find the projections for the remainder of the fiscal year to be on the conservative side. However, this increases the likelihood that the income target may be significantly exceeded.

For the disposition of the actual and prospective income in excess of the targeted amount for FY 1987, the staff suggests five options. Of these, this chair favors the first, namely, a reduction of the rate of charge for the second half of the current fiscal year based on the outcome of the first half. This will ensure that the SDR 20.3 million referred to earlier goes to debtor members. Moreover, as indicated by the staff, such a course of action would bring the rate of charge in line with the recent trend in market interest rates. Anything that could alleviate the debt service burden on our debtor members is welcome. However, if the majority of the Board were to favor delaying a decision on the disposition of the income in excess of the targeted amount until the end of the fiscal year, so as to base such a decision on the actual outcome, then the reduction of the rate of charge should be made effective May 1, 1986. I support Mr. Ortiz's comments on the need to ensure symmetry in the midyear review of the Fund's income position.

Mr. Nimatallah considered that action on the disposition of income in excess of the targeted amounts should be postponed until the end of the financial year.

Mr. Vasudevan made the following statement:

The Board decisions on burden sharing in July 1986 have made the midyear review of the Fund's income position a comparatively easy task. For the first half of FY 1987, we made the necessary adjustments during the previous month in the rate of charge and the rate of remuneration, in accordance with the decision on burden sharing. We recently agreed to reduce the periods of adjustment to synchronize them with the periods of payments of charges to the Fund and of remuneration by the Fund. The midyear review before us today shows that our net income has exceeded the initial target of SDR 45 million by SDR 26 million. The revised projections for the year as a whole indicate an excess of SDR 44 million over targeted net income.

It is important to note that the excess in net income that has occurred in the first half of FY 1987 was mainly attributable to the settlement of income that was deferred in the period before May 1, 1986. Members in debtor positions had to pay a rate of charge higher than what would have been the case during FY 1986 because of the existence of deferred charges and because there was no burden sharing at the time. I draw the attention of my colleagues to Table 2 of Appendix III on page 19 of the staff paper, which shows that such deferred charges up to April 30, 1986 amounted to as much as SDR 127 million. Clearly, members in debtor positions had, prior to end-1986, paid a higher rate of charge than needed because of the large amount of deferred charges.

The issue before us today is a simple one. We should return to debtor members the amount of overdue charges deferred before, but settled since, May 1, 1986 in accordance with the burden *that they bore--because of the overdue amounts--in the period* before May 1, 1986. This is not merely a moral principle but a principle that we had followed in FY 1986 while reducing the rate of charge from 7.8 percent--determined in December 1985--to 7 percent in February 1986 at the time of the special review. The same principle was upheld in our decision on burden sharing in July 1986, under the provisions of Section V, 4(a) and (b). It is necessary, therefore, to return first the amount of SDR 20 million that represents the settlement of overdue charges of the previous period to those who paid additional charges and thus bore the burden of overdue charges in the previous period. If we do not do this now, we would not only be deviating from the principles which we have laid down, but we would also be getting into awkward situations that we will find difficult to defend. Let me illustrate. Suppose, at the time of the next review, there were settlements of portions of deferred charges pertaining to (a) the period before May 1, 1986 and (b) the first half of FY 1987. According to the burden sharing decision, the latter will be returned to those who paid additional charges or have received less remuneration as a result of the adjustment that has been made to the rates of charge and remuneration, as per the burden sharing decisions, whereas the former burden, which was borne by debtors in FY 1986 by way of payment of higher rates of charge than necessary would not be returned, even though both cases relate to the settlement of overdue charges of the prior periods. To avoid such problems, I suggest that we first return the settled amount of SDR 20 million to the debtors who bore this burden in proportion to the charges paid by them. We could make a decision to this effect today. Once we do this, we will be left with only SDR 6 million in excess of income over the targeted amount. This could be used to reduce the rate of charge, although I recognize that it may not amount to any significant change in the rate of charge.

Mr. Sugita remarked that his authorities felt that any action on the disposition of the income in excess of the target should be delayed until the end of the financial year. It was clear that the Fund's net income could not be projected with any precision at the present stage; moreover, there existed uncertainties regarding the SDR interest rate, the amount of purchases, and the discharge of income deferred before May 1, 1986. In that regard, he found the staff's sensitivity analysis to be useful. The problem of the overdue financial obligations to the Fund was expected to remain serious. In the circumstances, the Fund should act prudently in monitoring developments in the arrears problem in order to decide whether the situation at the end of the financial year justified any larger addition to the Fund's reserves.

Mr. Foot, welcoming the surplus in income registered thus far, indicated that his preference was to postpone any disposition of the excess in income until the end of the financial year when all relevant facts on which such a decision should be based would be known.

Mr. Isleifsson stated that his authorities continued to attach importance to maintaining the rate of charge and the rate of remuneration as stable as possible. It appeared that it would be difficult to assess with any precision the income position for the year as a whole; as a consequence, his authorities would prefer to postpone a disposition of excess net income, until the end of the year when all the relevant facts were known.

Mr. Alhaimus remarked that he would join the consensus which seemed to be emerging to delay action on the disposition of any excess in net income until the end of the financial year. However, he saw some validity in the arguments made by Mr. Ortiz and others in favor of more symmetrical treatment in passing on the benefits of excess income over the target at an early stage. Also, he could attach importance to the argument in the paper on the need to bring the rate of charge and remuneration payments more in line with the recent trend in market interest rates and returns on other reserve assets.

Mr. Salehkhou made the following statement:

> The origin of the projected excess of SDR 44 million in Fund income stems from lower SDR interest rates, a lower rate of remuneration, and the settlement of some charges deferred before May 1, 1986. The likelihood of external net income for 1987 turning out much different from the projected income was diminishing, as there was less uncertainty in the present international economic environment. Besides, further decline in the SDR interest rate--which was not unlikely--should only enhance the Fund's net income position, as should any further settlement of charges deferred before May 1, 1986. The reduction in the SDR interest rate militates in favor of disposing of the excess income over target by reducing the rate of charge on use of ordinary resources.
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> It has been the consistent position of this chair to call for alleviating the debt burden on debtor members. And that position can be voiced even more firmly at present when the international economic environment is causing an increasing number of countries to seek Fund support in the face of serious payments positions. Furthermore, Fund members would certainly welcome any reduction in charges now that the Fund's income position is strengthened and a surplus is expected over the projected target. This would be especially helpful in view of the present reluctant attitude of the commercial banks toward borrowing members.

Another factor which militates in favor of this approach is the buildup of the reserve position as the net income target has been raised for FY 1987 and FY 1988 from 5 percent to 7.5 percent of reserves and the net income of SDR 26 million in excess of the targeted amount in FY 1986 has been added to reserves as outlined by the staff. This unusual strengthening of the Fund's financial position cannot be regarded as a welcome development, since it comes at a time when debtor members are experiencing severe problems due to the adverse international economic environment. The sharp drop in oil prices has only aggravated the situation by adding some of the traditionally surplus oil exporting countries to the list of members in need of external financing.

The adjustment of the rate of charge to strengthen the prospects for Fund income calls for a symmetrical rollback when excess income is secured over the projected target. This element of symmetry should be maintained if the Fund is to deal with borrowing members on a fair basis.

It is ironic that as the number of members with overdue obligations to the Fund increases, the rate of charge also increases, penalizing even those who remain current with the Fund. Furthermore, while the SDR interest rate continues to decline, there is less than a proportionate decline in the rate of charge. Increasing the cost of the Fund's resources clearly discourages members from seeking Fund support in the early stages of their difficulties. Some element of concessionality should exist in the cost of Fund resources if the institution is to maintain its cooperative character. In comparing the rate of charge to the combined domestic five-year interest rate, the staff on page 23 of EBS/86/258 could in all fairness have given us a comparison to the London interbank rate, which has been fluctuating around 6 percent, and often under the 6 percent level.

Since our examination of the midyear review of the Fund's income position a year ago, a number of member countries have settled all or part of their overdue obligations to the Fund. The improved picture of the Fund's income today warrants a rollback of the rate of charge to the level at least equivalent to what it would have been if the impact on the Fund's income position of those overdue financial obligations had not been taken into account in setting the rate of charge.

As to the timing of the decision on the allocation of the excess of income over target, there is little advantage in delaying it until the end of the year. Since a revised method of determining the rate of charge and the rate of remuneration was adopted by the Board for FY 1987 and FY 1988, the element of uncertainty has been removed in determining the target amount of that income.

Finally, I would like to reiterate my support for option (a) in the staff paper, under which the basic overall and the adjusted rate of charge would be reduced by 23 basis points for the year. This would be consistent with the decline in market interest rates since the beginning of the year and would be in line with the cooperative nature of the Fund.

Mr. Goos stated that he would prefer delaying a decision on the disposition of net income in excess of the target until the beginning of the next fiscal year, for the reasons which had been mentioned by other Directors.

Mr. Parmena made the following statement:

This chair takes the position that the Executive Board should postpone its decision on the disposition of the excess income until the end of the financial year. This would allow the Board to make a decision based on the actual outcome for income at that time. We have decided to take this position not because we prefer to see a stable rate of charge; on the contrary, we feel the rate of charge should be adjusted, as it is now at an artificially high level. We take this position because we recognize that it will not be possible to muster the required majority for some other action, given the pattern of opinions that have been displayed in the Board on this issue in the past.

Notwithstanding the position adopted here, we feel it is important to raise one or two points on the estimates. The staff has consistently provided estimates that have erred on the side of caution. While this is commendable pragmatism, it should be noted that this invariably tends to exaggerate the rate of charge. In the present case, the rate of charge may be exaggerated to the extent that it does not reflect current trends in market rates of interest. In this connection, I am not certain how far the staff would be willing to speculate and give some indications on the overall movements in interest rates in the coming year. I would appreciate any comments the staff might have on the matter.

The point to be made, however, is that the staff should endeavor to make estimates as close to reality as possible in order to avoid any upward bias in the rate of charge, which is already burdensome on members. Even with the agreed mechanism of burden sharing, the rate of charge continues to bear the larger proportion of the cost of overdue obligations. The large excess of income over target implies that the rate of charge has, in effect, generated more income than would otherwise be justified by the incidence of overdue obligations. Hence, depending on the manner of the disposition of excess income, the burden could in effect be much heavier on borrowing members.

Finally, I would welcome staff comment on the possibility raised by one Director for considering adjustments in the rate of charge and the rate of remuneration in combination with the midyear review of the Fund's income position. Such a consolidation could perhaps improve the framework for mid-term adjustments in various elements relating to the Fund's income.

Ms. Bush made the following statement:

The burden sharing arrangement as implemented so far is working as anticipated in that the adjustments to the rate of charge and rate of remuneration to cover deferred charges and the reserve target increase have resulted in the necessary income target for the first half of the year. As other Directors have pointed out, the SDR 26 million excess income above target generated during the first half of the year mainly reflects the settlement of charges that had been deferred prior to May 1. We welcome this payment of past due charges by various members in arrears.

With regard to the disposition of excess net income, I concur with the suggestion in the staff paper that it would be prudent to await the outcome of the full year's operations before deciding on a course of action. The primary aim of the midyear review is to determine whether any action might be necessary to ensure the net income target for the year. Only when we have the final picture would it be prudent to decide what, if any, action should be taken regarding any possible excess income. Moreover, charges (for the second half of the year) due from members who now have overdue payments of greater than six months' duration are larger than those deferred in the first half of the year and therefore could result in an even higher surcharge on the rate of charge and lower rate of remuneration than during the first half of the year. This additional consideration adds emphasis to the need to take the conservative approach and wait until the end of the year to see if there remains a surplus in the Fund's income position.

Another important factor is that, in the past, when there has been likelihood of income in excess of target, the rate of charge was not reduced at midyear. In our view, we should maintain this approach.

With regard to the disposition of net income at the end of the year, our inclination at this time is to add a somewhat larger amount to reserves, which we believe are low in relation to several key variables and which we believe could use further augmentation in view of the arrears problems and the absence of provisioning. In sum, we, like others, believe the end of the financial year is the appropriate time to make a determination about the use of excess income, taking into account at that time all relevant factors.

Mr. Kafka stated that his position on the issue at hand was the same as that taken by Mr. Ortiz.

Mr. Wijnholds commented that, like others, he could support postponing action on the disposition of excess net income until the end of the fiscal year, when presumably all relevant facts would be known.

The staff representative from the Treasurer's Department, responding to questions on the treatment of deferred charges that were settled, recalled that at the burden sharing discussions in July 1986, Directors had agreed to a method of dealing with income that reflected the settlement of charges deferred after the effective date of the burden sharing decision. The proceeds of the discharged deferred charges would be paid to those members who had paid the adjusted rate of charge and who had received less remuneration. However, no agreement had been reached at that time on how to treat charges deferred before May 1, 1986 but settled afterward. Various proposals about how to treat such amounts had been discussed, but no decision had been adopted and the question therefore remained open.

The adjustments in the rate of charge and the rate of remuneration made at the end of the first adjustment period had been effected automatically on the basis of the burden sharing decision, the staff representative continued. The only question the Board had considered at the time was whether or not the adjustment period should be shortened from a semiannual period to a quarterly period; but that question was separate from the issue of the treatment of deferred income or the extent of the adjustment which was specified by the decision on burden sharing.

In response to questions on the projections for Fund income, the staff representative noted that in the previous financial year, three factors had had a major influence: the projected amount of deferred income, the SDR interest rate projections, and the expected use of Fund resources. As Mr. Parmena had pointed out, the uncertainty regarding the amount of deferred income had been removed in the sense that the rate of charge no longer took into account projections of deferred income; instead an amount equal to deferred charges was recouped after the fact, at the end of the adjustment period. As for the rate of interest, in order to avoid the necessity of making projections for half a year in advance, the staff customarily used the SDR interest rate at the time of the calculations. In fact, if the Fund income projections were to be made at the present meeting, the projected excess in income would be some SDR 10 million lower than that referred to in the staff paper, because the SDR interest rate had risen since the paper had been issued. Finally, the expected use of Fund resources was based on the area departments' estimates of purchases that would be made during the remainder of the financial year. Experience suggested that those estimates were not always accurate, since arrangements could be postponed and actual drawings might not be made. Still, there was little the staff could do but to provide projections based on the best information it had at the time.

Mr. Nimatallah considered that the lowered estimate for excess income for the remainder of the year--based on the current SDR interest rate--was information that the Board should have had available to it at the beginning of the discussion.

The Chairman, drawing the sense of the meeting, observed that Directors were willing to delay action on the disposition of income in excess of target until the end of the financial year, when actual net income could be calculated. Eight Directors had expressed a preference for reducing the rate of charge, arguing that SDR 20 million out of the excess had been derived from the settlement of charges deferred before May 1, 1986. Those who preferred such an approach either wanted an immediate reduction in charges or could accept waiting until the end of the year and reducing the rate of charge retroactively.

Mr. Vasudevan wondered whether he had been included among the eight Directors preferring a reduction in the rate of charge. His stated preference had been for a return of the amounts to those who had paid the additional charges.

The staff representative from the Legal Department recalled that on the occasion of the burden sharing discussions, the General Counsel of the Fund had made it clear that it was not possible to refund amounts specifically to those members that had paid charges which included a projection of deferred income with respect to a previous financial year. The burden sharing decision which provides for a distribution of amounts equal to the original adjustment payments was only adopted effective May 1, 1986. The staff representative from the Legal Department went on to say that the books for FY 1986 had been closed and could not be reopened. The amount of income in excess of the target that was attributable to a settlement of charges deferred before May 1, 1986 could, of course, be offset with a retroactive reduction in the rate of charge for the current financial year, but that reduction would have to be made on a uniform basis with respect to all debtors subject to charges during the period covered by the reduction. With the adoption of the burden sharing decision, the situation was rather different with respect to the treatment of the proceeds of the settlement of charges deferred after May 1, 1986. Those amounts could in fact be distributed, under the burden sharing decision, to the members who had paid an increase in charges when the income had been deferred. The point was that before the burden sharing decision, the Fund had not operated under a system that created an obligation for the institution to pay to specific members in a later financial year amounts equivalent to the adjustment of charges and of remuneration in a prior year.

Mr. Vasudevan replied that it would look peculiar if, say, the following week several members settled their overdue obligations to the Fund and the institution was forced to distinguish between those amounts that had been counted as deferred income since May 1, 1986 and those amounts that had been deferred prior to May 1, 1986. It seemed to him that the mere fact that a system for treatment of such repayments had not existed prior to the burden sharing decision should not mean that such a system could not be applied.

The staff representative from the Legal Department said that he had not suggested that the amounts deferred before May 1, 1986, but paid in a later financial year, could not be used by the institution to benefit debtors. It was simply that those amounts could not be returned only to those particular members who had borne the burden of paying higher charges on account of the deferred income in the first place. The rate of charge for the current financial year could certainly be retroactively reduced, but that would be a benefit to all debtors subject to charges during the period covered by the reduction.

Mr. Parmena said that he was still unclear why, as suggested by Mr. Khong earlier, a midyear review of the Fund's income position could not be taken up at the same time as the automatic adjustment at the end of the adjustment period. The sort of information provided during the midyear review might well lead the Board to suggest a rather different adjustment than was called for under the automatic formula.

The staff representative from the Treasurer's Department said that the decision on burden sharing deliberately had set up a system under which the rate of charge and the rate of remuneration were adjusted automatically shortly after the end of an adjustment period in such a way as to yield an amount equal to the income deferred during the adjustment period. The information on which the midyear review of the Fund's income position was based would not yet be available at that time, as the accounts could be closed only two to three weeks after the end of the month. Provisional information could, of course, be submitted to the Board, if desired. However, unless the Board wished to change the present method of sharing the cost of deferred charges, the adjustment would continue to be made automatically; another decision of the Executive Board would not be required.

Mr. Khong observed that it was his understanding that the final objective was to protect the income position of the Fund without imposing too great a burden on the debtors and without asking the creditors to sacrifice too much of their remuneration. Had the Board known three weeks earlier about the surplus over the projected income for the first half of the financial year, it might well have questioned whether the automatic adjustment that had occurred at the time was consistent with the Fund's objectives.

The staff representative from the Legal Department observed that the two exercises--the automatic adjustment and the midyear review--and the driving forces behind them were quite different. The automatic adjustment was based on a retrospective look at actual amounts of deferred income, while any action that might be taken at the time of the midyear review would be based on a prospective look at the net income target and at estimates of whether or not it would be achieved or by what amount it would be lacking or exceeded. Theoretically, therefore, the two exercises were quite different.

The staff representative from the Treasurer's Department added that any attempt to combine the two exercises would also entail certain costs to the Fund. Remuneration and charges were paid and collected, respectively, at the end of each quarter. Any delay in the collection of charges would represent a substantial cost to the Fund, and creditors would incur a cost if the payment of remuneration were delayed.

The Executive Board then concluded its discussion of the midyear review of the Fund's income position, accepting that no action would be taken on the disposition of income in excess of the target until the end of the financial year.

APPROVED: July 31, 1987

LEO VAN HOUTVEN
Secretary