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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/176

3:00 p.m., December 6, 1985

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	Mawakani Samba
C. H. Dallara	M. K. Bush
J. de Groote	H. G. Schneider
B. de Maulde	S. de Forges
	T. Alhaimus
	M. Sugita
G. Grosche	B. Goos
	Jaafar A.
A. Kafka	
	M. Foot
	H. Fugmann
M. Massé	L. Leonard
E. I. M. Mtei	
F. L. Nebbia	C. A. Salinas, Temporary
Y. A. Nimatallah	
P. Pérez	
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
S. Zecchini	N. Coumbis
	Jiang H.
	Yang, W., Temporary

L. Van Houtven, Secretary
S. J. Fennell, Assistant
K. S. Friedman, Assistant

Also Present

Administration Department: H. Wiesner. Asian Department: S. Kohsaka. European Department: L. A. Whittome, Counsellor and Director. External Relations Department: J. E. McEuen. Legal Department: G. P. Nicoletopoulos, Director; J. G. Evans, Jr., Deputy General Counsel; Ph. Lachman, A. O. Liuksila, S. A. Silard. Middle Eastern Department: D. Hammann. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, M. P. Blackwell, J. E. Blalock, D. H. Brown, J. C. Corr, D. Gupta, R. B. Hicks, B. E. Keuppens, J. T. McDonald, P. M. Tillotson, G. Wittich. Internal Auditor: R. Noë; C. P. McCoy. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, L. P. Ebrill, M. B. Chatah, S. Ganjarerndee, J. Hospedales, G. Nguyen, P. Péterfalvy, G. W. K. Pickering, M. Z. M. Qureshi, A. Steinberg, E. M. Taha, A. Vasudevan. Assistants to Executive Directors: H. Alaoui-Abdallaoui, A. Bertuch-Samuels, J. de la Herrán, G. Ercel, R. Fox, S. Geadah, V. Govindarajan, N. Haque, G. D. Hodgson, L. Hubloue, O. Isleifsson, A. R. Ismael, Z. b. Ismail, S. King, H. Kobayashi, S. Kolb, K. Murakami, A. Mustafa, W. K. Parmena, M. Rasyid, M. Sarenac, B. Tamami, L. Tornetta, A. J. Tregilgas, H. van der Burg.

1. OVERDUE FINANCIAL OBLIGATIONS - SPECIAL CHARGES

The Executive Directors continued from the previous meeting (EBM/85/175, 12/6/85) their consideration of a staff paper on special charges to recover costs and losses arising from members' overdue financial obligations to the Fund (EBS/85/242, 10/29/85).

Mr. Foot noted that although most Directors--representing more than the qualified majority of 70 percent of the voting power needed to introduce special charges--had expressed support for a system of special charges at the previous meeting, Directors had been divided in their views on the structure of special charges. He had originally expressed his support for Option B but was prepared to go along with Option A provided that the special charges applied to overdue obligations to the Trust Fund were capped at a lower rate, perhaps at 2.83 percent. Although the special charges applied to Trust Fund resources would not fully cover the direct cost of arrears to the Fund, the shortfall would be small and was therefore acceptable to his chair.

Mr. Fugmann expressed his agreement with Mr. Foot.

Mr. Sengupta observed that the necessary qualified majority of the voting power had been reached. However, as those Directors that had opposed such a system had not yet given their views on the two options for the structure of special charges and as the staff had not fully assessed the implications of a system of special charges, the Executive Board should be given a further opportunity to discuss the matter on the basis of a new staff paper before taking a final decision.

Mr. Kafka supported Mr. Sengupta's suggestion.

Mr. Dallara indicated his agreement with the proposal put forward by Mr. Foot but suggested that the cap on the special charges applied to Trust Fund resources should be capped at about 3.5 percent.

Mr. Polak indicated his agreement with Mr. Dallara's proposal.

Mr. Grosche commented that he favored Option A with the provision that the special charges applied to overdue obligations to the Trust Fund be capped at a lower rate, perhaps at a rate that was one half of the SDR rate of interest.

Mr. Alhaimus stated that the Executive Board should reconsider the question of special charges at a later date, giving Directors time to consider in detail the various proposals and their implications.

Mr. Leonard stated that he continued to favor Option A and could agree to establishing an upper limit for special charges on overdue obligations to the Trust Fund.

Mr. Mtei, Mr. Salehkhou, Mr. Jaafar, and Mr. Yang stated that they supported Mr. Sengupta's suggestion.

Mr. de Maulde remarked that he could agree to Mr. Sengupta's suggestion that Directors be given more time to study the various options provided that the decision to introduce special charges would be retroactive to the present meeting.

The Treasurer observed that the Executive Directors in favor of the imposition of a system of special charges also agreed that such a system should not be put into effect for at least one month following the Executive Board's decision on its establishment. Therefore, even if the decision to establish a system of special charges were made retroactive to the present meeting, the system would begin to be implemented only after a delay of one month. The staff had been requested by the Executive Board to present various schemes for structuring special charges that would recover the costs to the Fund of overdue obligations. The staff had not intended to present Directors with proposals. The staff could prepare in a short time a brief paper with a version of Option A modified to include a cap on special charges applied to overdue obligations to the Trust Fund. However, it would take longer for the staff to prepare a paper on the difficult question of the probable effectiveness of a system of special charges in reducing the incidence of overdue obligations.

The Deputy Treasurer stated that it was difficult to determine exactly the cost to the Fund of overdue obligations to the Trust Fund. The full amount of resources in the Special Disbursement Account would not be invested in perpetuity; loans would bear interest, but at rates well below investment yields. It would be impossible to project the exact balances in that account and the amount those resources would earn. However, in light of the uncertainty about yields and therefore about true costs, it would be consistent with the principle of cost recovery to establish a limitation that would be substantially below the SDR interest rate. Perhaps the most appropriate limitation on the rate of special charge applied to overdue obligations to the Trust Fund would be the midpoint between the yield on loans from the Special Disbursement Account and the SDR interest rate--approximately 3.5-4 percent at present rates. The limitation would change over time as the SDR interest rate changed.

Mr. Dallara stated that in the interest of reaching a compromise, he could agree to postpone taking a decision on special charges until the staff had prepared a paper presenting a structure of special charges along the lines of Option A, but adapted to include a cap on the rate of charge applied to overdue obligations to the Trust Fund. However, the question should be considered by the Board at the earliest possible date.

The Chairman remarked that if the staff were able to present a paper for consideration by the Executive Board before the end of 1985, and assuming the Executive Board decided to introduce a system of special charges, the system could begin to be implemented following a delay of one month on about February 1.

The Treasurer observed that on the basis of the timeframe proposed by the Chairman, the introduction of the system would coincide with one of the financial quarters in which charges were calculated and collected.

Mr. Pérez indicated his agreement with the Chairman's proposal.

Mr. Sengupta remarked that it was not advisable to adopt a totally new system without examining all the implications very carefully, particularly the effectiveness of the system.

The Chairman commented that it was very difficult to evaluate the effectiveness of a system of special charges. Furthermore, the qualified majority necessary to introduce such a system had already been reached. It would therefore be unnecessary for the staff to prepare an extensive paper describing the advantages and drawbacks of a system of special charges, a question it had addressed in previous papers. The staff would prepare a paper presenting a structure of special charges along the lines of Option A, but adapted to include a limitation on the rate of charge applied to overdue obligations to the Trust Fund, together with a proposed decision to establish the system of special charges, for consideration by the Executive Board by end-December so that the system could be implemented by end-January, thereby giving members one month's notice of the new procedures.

The Executive Directors accepted the Chairman's suggestion.

2. INCOME POSITION FOR FINANCIAL YEAR 1986 - MIDYEAR REVIEW

The Executive Directors considered a staff paper on the midyear review of the Fund's income position for the financial year ending April 30, 1986 (EBS/85/258, 11/20/85).

Mr. Kafka said that relying on the safeguard provision under Rule I-6(4)(b) to cover the projected deficit would involve a sharp increase in charges. In covering the deficit it would be inappropriate for the Executive Board to hold only the Fund's punctual debtors responsible for some members' arrears, the accumulation of which had undermined the Fund's income position. Creditors and, if possible, members with arrears, as well as users of Fund resources that remained current in their obligations to the Fund, should contribute to covering the deficit. Accordingly, he did not favor either of the two suggestions on page 13 to alleviate the effects of an increase in charges, neither of which would place any of the burden for covering the deficit on creditor countries. Under another staff proposal, which would raise the rate of charge to the level of the SDR rate of interest, creditors would make a direct contribution through a reduction in the rate of remuneration and an indirect contribution through the use of the Fund's reserves. As suggested on page 17, that combination of actions could be combined with some use of the Fund's reserves, so that either the increase in the rate of charge or the reduction in the remuneration coefficient could be smaller than would be the case if the reserves were not so employed. It would not be advisable to wind down reserves indefinitely, and the three-part scheme that he favored should be used only in the current financial year.

A reduction in the remuneration coefficient might admittedly have a somewhat discouraging effect on members' willingness to accept creditor positions in the Fund, but that effect was likely to be negligible, Mr. Kafka continued. Moreover, given the cooperative nature of the Fund, members' willingness to accept quota increases should not be significantly affected by the remuneration coefficient. Nevertheless, creditors' concerns should be taken into account by ensuring that any reduction in the remuneration coefficient would be moderate and by using any excess income resulting from the discharge of overdue obligations to increase the rate of remuneration retroactively after an appropriate reconstitution of reserves had been made.

Mr. Sengupta recalled that for several reasons he had in the past opposed the proposal that overdue charges should be excluded from the Fund's accrued income. First, only a few members had overdue financial obligations to the Fund, and the arrears problem was therefore likely to be temporary. Second, the arrears had become a problem in 1984 because of the special difficulties that had persisted in a few members despite the economic recovery in industrial countries. Third, unpaid overdue charges were ex post data, while all other items of the Fund's income statement were on an accrual basis; hence, the decision to treat overdue charges as nonaccrued income had given rise to accounting inconsistencies within the Fund. Fourth, it would be inappropriate to take projected arrears into account in setting the projected net income target for a financial year because projections of arrears were typically inaccurate and because the Fund's experience in dealing with arrears was relatively limited.

The revised income projections seemed to be worrying at first glance, but that was mainly because of the decision to exclude from accrued income charges that had been overdue for six months or more, Mr. Sengupta said. In the absence of that accounting policy change, the Fund would have a projected net income surplus of SDR 107 million for the current financial year; at the end of the financial year, after making the required addition to reserves of SDR 52 million, the Fund would still have had extra income of SDR 55 million, which could have been used to reduce retroactively the rate of charge to 6.45 percent in the second half of FY 1986.

During the meeting at which the Executive Board had decided that unpaid charges that were overdue for six months or more would no longer be included in accrued income (EBM/85/41, 3/13/85) he had warned that the decision could result in an increase in charges for a handful of users of the Fund's resources, Mr. Sengupta recalled. He had also raised the question of how the burden resulting from that change in the Fund's accounting policy could be shared among the membership. He had taken the position that the burden should be shared equitably by all members in relation to their voting power. At the same meeting, Mr. Nimatallah had noted that a number of Executive Directors had expressed concern about the high rate of charge that would be necessitated by a move to non-accrual accounting and by a reserve target increase, and he had urged that the burden of overdue obligations and rising administrative costs of the Fund be borne by both borrowing and nonborrowing members. At that meeting Mr. Nimatallah had urged Executive Directors to consider imposing more meaningful sanctions against countries with overdue obligations; he had noted that a declaration of ineligibility did not, in effect, change a member's status, as even before the declaration a member that was in arrears to the Fund could not use Fund resources or seek an arrangement with the Fund. Mr. Nimatallah had understandably asked why borrowing members that did not have overdue obligations should suffer because some members did not repay the Fund on time.

At EBM/85/41 it had been noted that a decision to exclude overdue charges from accrued income required the support of a simple majority while a decision to increase the rate of charge required the support of a 70 percent majority, Mr. Sengupta remarked. The decision on the non-accrual of overdue charges at EBM/85/41 could lead to a decision at the present meeting to increase the rate of charge. Hence, a decision taken by a simple majority--namely, the decision on the nonaccrual of overdue charges--could result in an increase in the rate of charge, something that normally could happen only under a decision approved by a 70 percent majority.

In his summing up of the discussion at EBM/85/41, the Managing Director had made the following statement:

> The sense of the meeting was to accept the practice of non-accrual accounting for overdue charges. Ten Directors, representing 61 percent of the voting power, favored nonaccrual accounting for charges from members that are late for six months or more in meeting financial obligations to the Fund. Five other Directors indicated that they could go along in principle with, or were not opposed to, option (b) in my opening statement (Buff 85/47) proposing nonaccrual accounting combined with a smaller increase in reserves than would be necessary without a move to nonaccrual accounting, but noted that their final position would be conditional upon examination of burden-sharing in the Fund.

An overall re-examination of the rate of charge, remuneration, the reserve target, and present accounting practices should be undertaken; none of those variables was sacrosanct, and they were all interrelated.

In proposing optional ways of dealing with the projected deficit, the staff had noted that the following three relevant general principles had been accepted by the Executive Directors, Mr. Sengupta remarked: there was a need for a moderate growth of net Fund income and reserves; there should be a stable and predictable relationship between the rate of remuneration and the SDR interest rate; and there should be an element of conditionality in the rate of charge on the use of the Fund's ordinary resources. All those principles were equally important, but the precise numbers related to any of the principles could be changed over time, as circumstances warranted. For instance, the Executive Board should not be overly attached to a particular net income target, rate of remuneration, or rate of charge; the Board might have to review and change each one periodically in order to continue to adhere to the general principles.

The staff had noted that if the safeguard provision under Rule I-6(4)(b) were to be applied, the rate of charge would have to be raised to 7.87 percent for the second half of FY 1986, Mr. Sengupta continued. The staff had acknowledged that that rate of charge would be higher than the present SDR interest rate of 7.6 percent and would therefore not be consistent with the general principle of maintaining an element of concessionality in the rate of charge. That important principle had been reconfirmed during the Executive Board's lengthy discussions on the rate of remuneration in December 1983-January 1984. That principle would be maintained only if the rate of charge were lower than the SDR interest rate.

According to his calculations, a rate of charge of 7.87 percent for the second half of FY 1986 would place an enormous payments burden on the borrowing members, Mr. Sengupta said. The issue of the rate of charge should not be seen merely in terms of that rate's contribution to meeting a net income target. Members used both the ordinary and borrowed resources of the Fund for balance of payments reasons and paid different costs for the use of those two types of resources. In most cases, members in need of balance of payment support used both types of resources. Given the interest cost of borrowed resources, the effective cost of Fund credit for most borrowers was substantial, between 8.5-9.0 percent a year. If the rate of charge on the use of the Fund's ordinary resources were further raised, the effective cost of Fund credit would also increase further, thereby straining the payments position of borrowing members. In assessing a possible change in the rate of charge, Executive Directors should take into account the stress that the change was likely to produce on the balance of payments position of borrowing members. It would be ironic if the Executive Board, in acting to strengthen the Fund's income position, also intensified the balance of payments problems facing many members.

On several previous occasions he had opposed the idea of placing the burden of dealing with late charges only on members that used the Fund's resources, Mr. Sengupta recalled. There was no reason why that problem should be handled only by increasing the rate of charge. The burden caused by overdue charges should be shared by the entire membership.

The net income target for FY 1986 could be achieved without changing the rate of charge, provided that the remuneration coefficient were reduced effective November 1, 1985 from the 93 percent to 89.3 percent for the remainder of the financial year, assuming that the SDR interest rate would remain at 7.6 percent over the rest of the financial year, Mr. Sengupta continued. He was not convinced by the staff's argument that a reduction in the remuneration coefficient would discourage creditor countries from enlarging their reserve tranche positions and from agreeing to further increases in quotas. The Fund was based on international cooperation, the benefits of which were felt by the Fund's creditor members as well as its debtor members. In any event, every central bank had portfolios with assets that varied in quality and rate of return. The average financial return of most assets was low, and investments in the Fund's assets had many positive qualities that other assets did not have.

In arguing against a change in the rate of remuneration at the present stage, the staff had concluded that, under Rule I-10, the remuneration coefficient could not fall below 91.66 percent of the SDR interest rate on May 1, 1985, Mr. Sengupta went on. However, Article V, Section 9 (a) provided that "the rate of remuneration, which shall be determined by the Fund by a 70 percent majority of the total voting power, shall be the same for all members and shall be not more than, nor less than four fifths of, the rate of interest under Article XX, Section 3 (i.e., the SDR interest rate)." Rule I-10 was subordinate to Article V, Section 9 (a) and could be changed if necessary. In any event, the rate of inflation in industrial countries had been less than 4 percent thus far in FY 1986, and a rate of remuneration of 6.78 percent--which was 89.3 percent of the SDR interest rate of 7.6 percent--would be positive in real terms. It would be consistent with the spirit of the Articles to reduce the rate of remuneration to protect and safeguard the financial soundness of the Fund; that approach would not sacrifice the important interests of members with creditor positions in the Fund.

Rule I-10(d) provided that if the rate of charge exceeded the SDR interest rate, the Executive Board would review the remuneration coefficient, and would consider whether the coefficient should be set at a level that would permit the rate of charge to be reduced and still enable the Fund to meet its target net income, Mr. Sengupta noted. If, in order to avoid changing the rate of remuneration, the Executive Board raised the rate of charge to equal the SDR interest rate, the Fund's net income in FY 1986 would vary depending upon the movement of the SDR interest rate. If the remuneration coefficient remained at the present level of 93 percent of the SDR interest rate, the net income target for FY 1986 could be achieved only if the rate of charge and the SDR interest rate were to average about 9 percent over the second half of FY 1986, something that was highly improbable. In all likelihood, the SDR interest rate would fall below the present level, or at best remain at the present level, through the rest of FY 1986. In the circumstances, the key to reaching the net income target seemed to be a reduction in the remuneration coefficient. One option if the rate of charge were raised to the present

SDR interest rate of 7.6 percent, would be to reduce the remuneration coefficient from the present 93 percent to 91.66 percent as of May 1, 1985; the staff seemed to feel that that option was easier to handle than a review of Rule I-10. Under that option, net income would be in surplus by only SDR 33 million, or 3 percent of reserves, compared with the target of SDR 52 million, or 5 percent of reserves.

The points that he had made underscored the relatively limited room in which the Executive Board had to maneuver, Mr. Sengupta remarked. The Executive Board had recently decided to keep the net income target at SDR 52 million. There seemed to be no reason to change that target; therefore, to avoid giving up all of the concessional element of the rate of charge, there seemed to be no alternative to reconsidering the remuneration coefficient. That alternative was consistent with the principle of equitable burden sharing. Since the present difficulty in meeting the Fund's income target was due almost entirely to the arrears of three or four members, the entire membership should make adjustments to deal with that difficulty. At the present meeting, as at earlier ones, in deciding what steps to take, the Executive Board had to deal with several variables--the net income target, the level of reserves, the rate of charge, and the rate of remuneration--and had to keep in mind three principles--namely, the need for a reasonable level of reserves, the need for a stable relationship between the rate of remuneration and the SDR interest rate, and the need for concessionality in the rate of charge, which implied that the rate of charge should be less than the SDR interest rate. To adhere to those principles, the Executive Board should choose an option based on a combination of changes in all the relevant variables.

Accordingly, he strongly favored the option in paragraph (iv) on page 17, Mr. Sengupta continued. In proposing that option the staff had suggested raising the rate of charge to the level of the SDR interest rate and reducing the remuneration coefficient from 93 percent to 89.3 percent. Those steps would protect the income target. He would wish to see the Executive Board agree on a rate of charge that was less than the SDR interest rate in order to adhere to the principle of maintaining a concessional element in the rate of charge; the income target could be reduced somewhat. The proposal that he favored would be acceptable only if it were understood that income in excess of the projection resulting from the subsequent discharge of overdue obligations would be returned to creditors and borrowers to offset the sacrifices that they would have made in the interim period. He did not agree with the staff that creditors should be reimbursed first and borrowers second; such discriminatory treatment would be entirely unacceptable.

Mr. de Maulde said that he did not agree with Mr. Sengupta that a rate of charge near or equal to the SDR interest rate would lack any concessionality. Fund credit was long term in nature and naturally carried a higher interest rate than the rates on the shorter-term credit on which the SDR interest rate was based. In addition, the interest rates used to compute the SDR interest rate were based on loans given to the relevant creditors' best borrowers and were therefore relevantly low.

Mr. Sengupta remarked that it seemed sensible to use the SDR interest rate as the reference discount rate in assessing the degree of concessionality of the rate of charge because all calculations concerning Fund operations were based on the SDR. The Articles mentioned that the SDR interest rate should be used as a reference. Other reference interest rates--such as the World Bank rate--would yield a different result.

Mr. Foot commented that the Fund's income position was worrying; the strain on that position in the first half of the current financial year was reflected in the present deficit of SDR 20 million, and a further loss of SDR 30 million was expected over the rest of the year. That trend could cause considerable damage to the Fund's credit standing.

The staff had clearly shown that the growing amount of arrears had been the main factor in the deterioration of the Fund's income position, Mr. Foot continued. He strongly doubted whether the Fund's income position would appear any stronger to an informed outsider if the Fund did not treat overdue charges as deferred income. That treatment was a reflection of reality. The Fund was a mutual institution, and arrears to it not only damaged the members concerned by reducing their access to the Fund's resources and other potential sources of credit but also increased the burden on the members that remained current in their obligations to the Fund. The Executive Board had discussed the appropriate response to arrears on previous occasions, and a decision to introduce special charges would make a further small contribution to solving the problem of arrears. However, all members had an obligation to do whatever they could to encourage individual countries to remain current in the Fund; such encouragement could be given during discussions by the Executive Board and through members' bilateral contacts with countries with arrears.

In assessing the issues at hand he attached the greatest importance to safeguarding the Fund's overall financial standing, Mr. Foot continued. Accordingly, his authorities were reluctant to abandon the 5 percent reserve target, which had been set only a few months previously. Abandoning that target at the first sign of trouble would send the wrong signal and would be a retrogressive step. Moreover, he did not favor changing the remuneration coefficient. At the present stage, there seemed to be no alternative to permitting some increase in the rate of charge. That move would be regrettable, and he hoped that measures would soon be implemented to reverse the rising trend in arrears, thereby permitting charges to be reduced.

His authorities understood that the position they favored would place the burden for strengthening the Fund's financial position on the users of Fund resources which had remained current in their obligations to the Fund, Mr. Foot went on. However, any attempt to permit the Fund's reserves to shoulder some of the burden would run the risk of rapidly and seriously undermining the Fund's credibility.

It had been suggested that the Fund's creditor members should shoulder all or part of the burden of the Fund's income shortfall, Mr. Foot continued. However, there was no single, straightforward way of calculating the way that the burden would be shared. At the time of the distribution of the staff paper on burden sharing in May 1985, the effective overall rate of remuneration had been equivalent to 72 percent of the average SDR interest rate and to 60 percent of the five-year set of rates which were used as a proxy for market rates for the period of the availability of Fund credit. Accordingly, lenders to the Fund had already been accepting below-market interest rates from the Fund. In addition, a rate of charge even as high as 7.8 percent would still be well below the rate of interest that most users of Fund resources would have to pay in the market and would be well below the rate on loans to the Fund. Moreover, the successful solution to the arrears problem would require the active involvement of a number of creditor countries that were already receiving a low rate of return on their Fund-related assets.

In looking ahead, Executive Directors would naturally hope that the arrears problem would ease, but they should not make plans on the basis of that hope, Mr. Foot considered. That conclusion raised the question whether the Fund should not adopt a more pessimistic figure for deferred income in the second half of FY 1986 than the staff had provided. He preferred not to do so for the time being. After all, the elimination of the arrears of one or two certain countries could greatly improve the outlook for the Fund's income position. However, the experience of the previous 18 months--particularly the previous six months--suggested that the arrears situation was volatile, and to keep adequate track of it, developments concerning arrears should be reviewed again in about three months. The arrears situation at that time might well be much better or much worse than it was at present. If the situation seemed worse, his authorities would have an open mind on how the Fund should respond: they would be prepared to consider all options, including the possibility of burden-sharing. They were aware of the difficulties that an increase in charges would cause for some members.

Mr. de Maulde said that his position on the issues at hand was based on three ideas. First, the Executive Directors were responsible for ensuring that the Fund maintained a sound financial position. The decision adopted in June 1985 setting the present net income target had been clearly designed to keep the Fund's financial position sound and should be fully implemented. Second, the arrears to the Fund constituted a serious problem for the whole membership: they threatened the liquidity of the claims of creditors and were unfair to the great majority of the users of the Fund's resources which remained current in the Fund often at considerable cost to themselves. All members should contribute to the effort to handle the arrears problem. Third, the present problem with respect to the Fund's income position should be seen as exceptional and temporary, and the measures to deal with its consequences should be exceptional, temporary, and easily reversible.

Those three basic ideas had several operational implications for the Fund, Mr. de Maulde continued. First, the Fund was likely to have a revenue shortfall, owing mainly to the arrears of some SDR 80 million for all of FY 1986, and the Executive Board should take the steps needed to increase the Fund's resources by that amount before the end of FY 1986. Second, since the arrears were a problem for the entire membership, the Executive Board should both increase charges by an amount sufficient to raise SDR 40 million and decrease the remuneration coefficient by an amount sufficient to save the Fund SDR 40 million. Those steps should take the form of an exceptional and temporary surcharge on the rate of charge and an exceptional and temporary reduction in the rate of remuneration. Since the current amount of Fund lending was SDR 20.4 billion and the amount of ordinary resources on which interest was paid was SDR 22 billion, the amount of the temporary surcharge should be 0.4 percent and the amount of the temporary reduction in the rate of remuneration should be 0.37 percent. The rates could be reviewed at regular and frequent intervals, and refunds could be made in the event of a reversal in the present trend in the Fund's financial position.

Mr. Pérez remarked that the issues at hand were difficult ones. The Executive Board faced the likely need to increase the rate of charge because of the Fund's unsatisfactory income position. There had been substantial deviations from the earlier assumptions concerning the amount of deferred income, the use of Fund resources, the level of interest rates, and the U.S. dollar/SDR exchange rate. As a result, a deficit of SDR 32 million was projected for FY 1986. The difficulty in predicting developments concerning the Fund's income position had been increased by the decision to treat overdue charges as nonaccrued income. That decision had created some uncertainty that obliged the Executive Board to take certain decisions at the present stage, although those decisions should be seen as temporary.

The staff had noted that with the sharp rise in overdue payments, changes in the level of the Fund's accrued income resulting from the amounts placed to deferred income had exerted the most significant influence on the projections of the Fund's income position in any given financial year, Mr. Pérez commented. The evolution of the Fund's income position should be monitored closely; the position should be reviewed periodically. Since the Fund's income position could improve or deteriorate quickly, the formulas for responding to changes should be used flexibly.

Given the recent trends in capital markets, the SDR interest rate was likely to decline in the coming months, Mr. Pérez remarked. Each decline of ten basis points in the SDR interest rate reduced the Fund's income deficit by SDR 3 million. In addition, recent developments suggested that the use of Fund resources was likely to decline in coming months, a conclusion that was a cause for great concern. As on previous occasions, the question naturally arose why, despite the problems still facing most developing countries, the actual use of the Fund's resources continued to be lower than expected.

The staff had noted that there were two extreme possible outcomes for the Fund's income position in FY 1986, Mr. Pérez said. First, if all the arrears were eliminated, the Fund's net income for the year would be SDR 170 million. Second, if none of the arrears were eliminated, the Fund could run a deficit of SDR 148 million. The actual outcome was likely to fall somewhere between those extremes.

The best solution to the problem of the Fund's unsatisfactory income position was to increase the rate of charge, decrease the remuneration coefficient, and reduce the Fund's administrative expenditures, Mr. Pérez considered. Given the current trends in market interest rates, an increase in the rate of charge to make it equivalent to the SDR interest rate of 7.6 percent--let alone a rise in the rate of charge to 7.87 percent--would be unnecessary. The rate of charge should be increased by a moderate amount, bringing the rate toward the middle of the range of 7-7.87 percent, and there should be a corresponding decrease in the remuneration coefficient in keeping with the provisions of Rule I-10. It should be agreed that an improvement in the Fund's income position above the SDR 52 million target level should be used to finance refunds to members that would either pay more charges or receive less remuneration under the option that he preferred. The Fund itself should make a contribution to the effort to reduce its income deficit: during the coming midyear budget review the Executive Board should take steps to cut administrative expenditures. In that connection, an initial proposal by management would be helpful.

Mr. Jaafar commented that there had been a dramatic deterioration in the Fund's net income position since the previous review, when a decision had been taken to raise the net income target from 3 percent to 5 percent of reserves. At that time it had been understood that the rate of charge would remain unchanged at 7 percent for FY 1986. The latest revised estimates suggeted that, without any change in the remuneration coefficient, the rate of charge would have to be increased to 7.87 percent in order to generate enough income to meet the net income target of SDR 52 million. In order to meet that target, the Fund needed to generate an additional SDR 84 million in income. That could be accomplished in the following three ways: increasing the rate of charge; reducing the remuneration coefficient; or a combination of those actions.

Over the previous several years, there had been a rapid increase in the rate of charge, which had been adjusted regularly to cover the increased cost of administration and the increased expenses owing to the rise in the remuneration coefficient and to meet the target of a more rapid rate of accumulation of reserves, Mr. Jaafar noted. It was unfair to borrowing members to raise charges further in order to meet the net income target for FY 1986. A preferred alternative would be to reduce the rate of remuneration and to raise the rate of charge somewhat. Mr. Sengupta made a number of useful points with respect to burden sharing, and the proposed solution in paragraph (iv) on page 17 seemed fair and equitable. Accordingly, the present income target would be retained, the rate of charge would be raised to the level of the SDR interest rate, and the remuneration coefficient would be reduced to 89.3 percent, all effective November 1, 1985.

If in May 1984 the level of arrears had been at the present level and the decision to treat arrears as nonaccrued income had already been in place, the Executive Board probably would not have decided to increase the remuneration coefficient, Mr. Jaafar remarked. If the remuneration coefficient in effect before May 1984 had been maintained after that date, the Fund's expenses in FY 1986 would probably be SDR 130 million less than was now estimated and the Fund would have no difficulty in meeting the net income target for that year even without increasing the rate of charge.

Many members continued to face serious economic problems, and it was important for the Fund to maintain a fair element of concessionality in its rate of charge, Mr. Jaafar concluded. That element would be eroded excessively if the entire burden of meeting the reserve accumulation target in FY 1986 were imposed on the borrowing members.

Mr. Salehkhou said that actual developments in the first half of FY 1986 and the projections for the remainder of the year showed that there had been some deterioration in the Fund's income position. The preliminary projections had indicated that there would be a net income of SDR 55 million for the whole year, but the revised estimates, based on actual data and new assumptions, suggested that there would be a deficit of SDR 32 million and a total shortfall of SDR 87 million. The deviations from the original projections had been due mainly to the continued accumulation of overdue financial obligations to the Fund and to the lower than expected use of the Fund's resources. The negative impact of those factors on the Fund's income had been more than offset by the net benefits of the lower than expected SDR interest rate and the weakening of the U.S. dollar in terms of the SDR.

In addition to those factors, the estimated shortfall was a reflection mainly of the Executive Board's policies with respect to the Fund's income and the conflicting objectives of some of those policies, Mr. Salehkhou went on. At a time when debtor members were facing unprecedented difficulties--including an extremely unfavorable international economic environment--many members had incurred arrears to the Fund, the Executive Board had adopted policies aimed at strengthening the Fund's general reserves, enhancing the return of Fund-related assets, and offsetting the impact of arrears to the Fund on the Fund's income exclusively through higher charges on the use of the Fund's ordinary resources.

The continued high rate of charge despite the significant decline in the SDR and international interest rates had steadily eroded the concessionality of Fund resources, and, according to the staff's estimates, the concessionality would be eliminated by the end of FY 1986, Mr. Salehkhou remarked. Over the previous four financial years, the average SDR interest rate had dropped from 13.05 percent to 8.81 percent in early 1985 and to 7.6 percent at present, while the rate of charge had increased from 6.25 percent to 7 percent over the same period and might have to be raised to 7.87 percent for the second half of the current financial year. Those trends hurt the users of Fund resources, reduced their ability to meet their financial obligations to the Fund, and undermined the Fund's ability to meet some of its major objectives. The lower use of Fund resources in the recent past was due not only to the higher conditionality and lower access limits but also to the higher cost of using the Fund's resources. A continuation of the trends in conditionality, access, and the rate of charge would leave members with no incentive to seek the Fund's assistance at an early stage in the development of their balance of payments problems.

Relatively low charges were an essential part of arrangements with members, Mr. Salehkhou continued. Eliminating the concessional element of the use of Fund resources would raise doubts about the Fund's ability to play an effective adjustment and catalytic role in helping members to solve their payments problems. In that connection, it was useful to note that, although interest on borrowed resources did not affect the Fund's income position, the rate paid by the members for Fund borrowed resources over the first six months of FY 1986 had exceeded the lending rate of the World Bank, which borrowed from capital markets, and the combined rate on the Fund's borrowed and ordinary resources was approaching market interest rates. Those trends clearly indicated that the Fund should review its borrowing policy and the medium-term prospects for the relation between the Fund's lending rates and those of the markets as well as other multilateral institutions.

Recent developments in, and prospects for, the Fund's income warranted a reconsideration of the issue of burden sharing in order to find a more sustainable and equitable means of handling imbalances in the Fund's income, Mr. Salehkhou said. The Executive Board's discussion of the burden-sharing issue in June 1985 had not provided satisfactory answers to the questions raised by many Executive Directors concerning the continued rise in the Fund's reserves, administrative costs, and the rate of remuneration at a time when the use of Fund resources was on the decline.

The importance of the rate of remuneration and the level of reserves for the Fund's liquidity and the institution's ability to borrow and to encourage members to accept increased quotas should be kept in perspective; it should not be exaggerated, Mr. Salehkhou considered. In the past, when the rate of remuneration had been low or no remuneration had been offered, creditors and members had still been willing to hold Fund-related assets. Their willingness to hold such assets was based on more essential factors than the financial yield, including the cooperative nature of the Fund, members' influence over the Fund's policies, and the common objective of maintaining a stable international monetary system.

He welcomed the staff's analysis in its report of the conflicting nature of some of the Executive Board's objectives with respect to the Fund's income, Mr. Salehkhou said. However, he could not go along with the staff's recommendations, which relied excessively on an increase in the rate of charge and would eliminate the concessionality of Fund resources. While the need to maintain a sound and strong financial position for the Fund obviously should be given a high priority, it was equally important to strengthen the Fund's ability to be highly effective in assisting members and in playing an international role as a cooperative institution.

There was a reasonable expectation that members with arrears--including the two members with the largest arrears--would make some payments soon, Mr. Salehkhou remarked. Such payments would considerably alter the Fund's income position in FY 1986. It was therefore essential to decide at the present stage that any income in excess of the net income target should be used to reduce the rate of charge retroactively to the level that would have obtained at the beginning of FY 1986 in the absence of the arrears to the Fund.

He was opposed to any increase in the rate of charge, which was already high, Mr. Salehkhou concluded. The expected shortfall in the Fund's income in FY 1986 could be covered partly by revising the net income target for the year. In the past, although that target had been equivalent to 3 percent of reserves, actual additions to reserves had been substantially higher, reaching an average of 9 percent in 1981-84. Moreover, there had been no interruption over the previous two years in the scheduled increase in the rate of remuneration; therefore, a meaningful contribution to handling the present income shortfall should be made by lowering the remuneration coefficient. Finally, he agreed with Mr. Sengupta's comments on the measurement of the concessional element of the rate of charge. In that connection, account should be taken of the liquid character of Fund-related assets. Given that character, Executive Directors should compare the rate of charge with short-term interest rates, such as the SDR interest rate, in assessing the concessionality of the rate of charge.

Mr. de Maulde remarked that he doubted whether the interest paid on borrowing by the World Bank was an appropriate rate on which to base an assessment of the concessionality of the Fund's rate of charge. The rate paid by the World Bank was based significantly on markets in Switzerland, Germany, Japan, and Holland where interest rates were relatively low. The staff could usefully prepare a paper on the question of the concessionality of the rate of charge.

Mr. Grosche said that the rapid worsening of the Fund's income position in recent months raised difficult issues. Postponing appropriate action until the end of FY 1986 would only make the necessary decisions even more difficult to take.

Using the safeguard provision of Rule I-6(4)(b) would regrettably result in an increase in the rate of charge, Mr. Grosche noted. However, reducing the remuneration coefficient would not be an appropriate solution to the problem of the income shortage. The Fund's liquidity depended upon the willingness of creditors to provide the Fund with sufficient resources. It would be awkward to avoid resorting to the provisions of Rule I-10; there had been considerable difficulty in reaching an agreement on the decision to raise very gradually the remuneration coefficient. Deviating from that agreement would not contribute to a reasonable increase in quotas under the next general review. It was important to remember that creditor members had continued to lend to the Fund at below-market rates, and that a number of creditors were being asked to provide additional financial assistance to members with arrears to the Fund. Those requests had already created considerable problems for creditors, and the reduction in the remuneration coefficient would add to those problems.

He had carefully considered the options in addition to increasing the rate of charge above the SDR interest rate, Mr. Grosche went on. Retaining the present rate of charge and rate of remuneration would mean that the Fund itself--through its reserves--would have to carry some of the burden of meeting the income target for FY 1986, as only SDR 22 million--about 2 percent of reserves--could probably be added to reserves by the end of the financial year. He continued to favor reaching the present 5 percent income target. That target could conceivably be reduced temporarily, during the remainder of FY 1986, on the clear understanding that any excess net income at the end of that year would be used first to meet the 5 percent target. However, that approach could create difficulties. There was no certainty that overdue obligations to the Fund would be reduced in the remaining months of FY 1986. The decision to build up reserves and increase the net income target had been taken fairly recently, and a temporary suspension of that decision at the first sign of difficulty in applying that decision might well seem unwarranted, particularly when the Fund's income problem was due to the arrears of some members. A temporary suspension of the decision on the 5 percent target would be better justified if the Fund could be certain that substantial payments of arrears would be made fairly soon. In that connection, the latest news from Sudan was disappointing.

In considering whether or not to maintain the present income target, the Executive Board should err on the side of caution, Mr. Grosche said. Accordingly, he preferred to apply the relevant rules as they stood, thereby increasing the rate of charge to 7.87 percent, which was still substantially concessional in comparison with rates that Fund borrowers would have to pay in the market. It was his clear understanding that any excess income in FY 1986 would be used to reduce the rate of charge retroactively to 7 percent, the rate on November 1, 1985.

Mr. Polak noted that the use of the safeguard provision would result in an automatic increase in the rate of charge to 7.87 percent. However, it was important to remember that the safeguard provision was designed to ensure that an income shortage would be fully covered. Accordingly, under the safeguard provision, the income shortfall for an entire financial year was corrected in just six months. As a result, the rate of charge resulting from the application of the safeguard provision was likely to be higher than necessary in the financial year following the application of that provision. Those facts should act as an incentive to the Executive Directors to reach a decision to handle the present income shortage through a combination of actions, rather than through an increase in the rate of charge alone.

There were a variety of such possible solutions, and he was willing to accept the one in paragraph (iv) on page 17 for several reasons, Mr. Polak continued. First, the rate of charge must be concessionary, and the Executive Board had determined during its discussion on the rate of remuneration two years previously that the guideline for assessing the concessional element of the rate of charge was the SDR interest rate; accordingly, the rate of charge should not exceed the SDR interest rate. There was no reason to deviate from that guideline at the present stage. The staff had usefully proposed having a variable rate of charge that over time would remain equal to the SDR interest rate; that solution would eliminate the uncertainty that had resulted from having a fixed rate of charge and a variable SDR interest rate and rate of remuneration. Second, the agreement on the present 5 percent income target had been reached only recently, and the Executive Directors should adhere to that decision. There was still considerable uncertainty about the arrears situation, and it was illusory to believe that the Executive Board could fine-tune the Fund's income position in FY 1986 by temporarily changing the income target. It would be appropriate to deviate temporarily from the decision to raise gradually the rate of remuneration. The possible need to approve such a deviation had been foreseen at the time of the adoption of the present decision on the rate of remuneration two years previously: at that time the Executive Board had adopted rules providing for a review of the remuneration coefficient in certain circumstances. As a part of the compromise proposed in paragraph (iv) on page 17, it should be agreed that any excess net income at the end of FY 1986 should be distributed to the Fund's creditors and debtors.

Mr. Grosche said that he did not favor introducing a variable rate of charge. The Fund tended to borrow in the short run and lend over the long run. Moreover, the Fund's administrative expenditures were not variable, in the sense that they were unlikely to decline.

Mr. Polak commented that he agreed that there was a rising trend in the Fund's administrative expenditures. However, the basic mismatch was between the rate of remuneration--which varied in line with movements in market rates--and the rate of charge, which was fixed.

Mr. Leonard remarked that failure to reach a decision supported by a 70 percent majority would result in an automatic increase in the rate of charge from 7 percent to 7.87 percent. It would be inappropriate to have the rate of charge increase automatically, on the basis of a kind of lapse of time procedure, rather than as a result of a deliberate decision by the Executive Board. It was the Executive Board's duty to take formal decisions on such pressing matters.

The staff had outlined a number of possible ways of strengthening the Fund's income position, Mr. Leonard noted. It would be unfair and unwise to recover the income shortfall solely by increasing the rate of charge; under that solution, the rising cost of arrears would be borne by members that had remained current in the Fund. The Fund was a club of countries that were shareholders in the organization. Just as all shareholders in a corporation or in a financial institution must bear part of the cost of unexpected income losses, so should all the Fund's shareholders accept the burden of unanticipated shortfalls in the Fund's income. The entire Executive Board had participated in the decision that had led to the purchases by members that had subsequently fallen into the arrears, and the entire membership should therefore bear the consequences for the Fund of the arrears.

In dealing with the Fund's income shortfall, Executive Directors should limit the increase in the rate of charge to the extent possible and accept some adjustment in the remuneration coefficient and, if necessary, in the reserve target, Mr. Leonard considered. He could accept an increase in the rate of charge to make that rate equal to the SDR interest rate of about 7.6 percent and a temporary reduction in the remuneration coefficient to 91.66 percent, which was the base remuneration coefficient that had been established for the current financial year. While that solution would result in a fairly steep increase in the rate of charge, he would be reluctant to reduce further the remuneration coefficient at present in view of the importance that he attached to the established mechanism for gradually increasing the remuneration coefficient to 100 percent of the SDR interest rate. The combination of measures that he favored might not enable the Fund to reach the present 5 percent income target, and he was prepared to go along with a temporary reduction in that target.

His proposal was based on the staff's projection of deferred income of SDR 139 million for the entire FY 1986, including SDR 81 million in the second half of the year, Mr. Leonard continued. That estimate could prove to be pessimistic if even a few members with large arrears were able to become current in the Fund and if the measures that the Executive Board had adopted to discourage additional arrears proved to be effective. If the Fund's income in FY 1986 were higher than projected, there should be, first, a return of the rate of remuneration to its present rate; second, a restoration to the present income target for FY 1986; and, third, a reduction in the rate of charge. If the arrears problem at the end of FY 1986 were worse than was now projected, thereby resulting in an even larger income shortage that was now expected, the Executive Board would immediately have to implement stronger measures. To avoid such an outcome, it might be prudent for the Executive Board to re-examine the Fund's income position in three months.

Some Executive Directors apparently were prepared to permit the rate of charge to bear the entire burden of covering the income shortage expected in FY 1986, but that solution could prove costly both to the Fund and other parties, Mr. Leonard said. Secretary Baker's debt initiative had received broad support from Executive Directors but might be subject to unfortunate and adverse interpretations if one of the key participants in the strategy--namely, the Fund, were to shift its income burden increasingly onto the very debtor countries that Secretary Baker's initiative was intended to help. An increase in the rate of charge alone to handle the income shortage shortfall might also be interpreted as a sign of creditor countries' unwillingness to make the financial contribution needed to help manage the debt problem. Reliance solely upon increases in the rate of charge to deal with income shortages might result in a reduction in the Fund's credibility and influence, as it could discourage members that needed to make balance of payments adjustments from coming to the Fund when their payments problems were still manageable.

Mr. Sugita remarked that he continued to attach considerable importance to tackling effectively the problem of overdue financial obligations. The staff paper clearly showed that the Fund's income shortfall was due mainly to the expected large overdue charges, which were being treated as deferred income. As long as the problem of arrears remained unsolved, the Fund would continue to face the difficult and unpleasant task of offsetting the arrears at a cost to some members. Serious consideration should be given to introducing a system of special charges.

In response to the sharp increase in arrears and the SDR 30 million income deficit in FY 1985, the Executive Board had recently decided that the net income target should be increased from 3 percent to 5 percent of reserves, Mr. Sugita recalled. The arrears situation had deteriorated in the first half of FY 1986, and his authorities continued to attach importance to achieving the present income target that year. The staff had projected that in the second half of FY 1986 there would be a net increase in overdue charges--and, hence, deferred income--of SDR 62 million. That projection was subject to a considerable margin of error, as the staff had admitted, and might well prove to be very optimistic, like the projection of deferred income at the beginning of the current financial year. It would be imprudent to decide at the present stage to reduce the net income target for financial year 1986.

The remuneration coefficient was a significant factor in ensuring the continued financial cooperation and support of creditor members, Mr. Sugita said. A reduction in the remuneration coefficient in response to the increase in overdue charges would damage the Fund's credibility and adversely affect the prospects for an increase in the Fund's resources in the future, thereby undermining the Fund's ability to provide timely and effective assistance to members facing balance of payments problems.

The rate of charge on the use of the Fund's ordinary resources should have a certain element of concessionality, Mr. Sugita considered. The rate of charge should encourage members to approach the Fund early in the development of balance of payments problems. However, even if the rate of charge were to exceed the SDR interest rate, the concessional element would not necessarily be eliminated. A rate of charge of 7.87 percent would still be low compared with market interest rates, such as the five-year SDR interest rate, which had averaged about 9 percent over the previous six months. If a reduction in the rate of remuneration at the present stage made it difficult for the Fund to increase its own resources in the future, the Fund would have to rely increasingly upon borrowed resources, and the cost of using Fund resources would rise to the equivalent of long-term market interest rates.

In the circumstances, his authorities regrettably accepted an increase in the rate of charge to 7.87 percent as of November 1, 1985, so that the present net income target could be met without reducing the remuneration coefficient, Mr. Sugita said. If that solution were accepted, it should be understood that any excess income in FY 1986 resulting from the payment of overdue charges would automatically be used to reduce the rate of charge retroactively to no less than 7 percent.

Mr. Dallara remarked that the Fund's actual and prospective income position in FY 1986 had been adversely affected by the growing arrears problem. A substantial operating loss was likely to occur in the absence of immediate action to strengthen the Fund's income position. The Fund could not afford to sustain such a loss following the loss already recorded in FY 1985. Indeed, there had been a broad consensus in the Executive Board at the end of the previous financial year that the Fund's income position must be strengthened. The decision to treat overdue charges as deferred income was a necessary accounting and prudential step. The accumulation of arrears--not the decision to treat overdue charges as deferred income--was the main factor that jeopardized the achievement of the 5 percent income target for FY 1986, would unfortunately require an increase in the rate of charge, and underscored the need to shore up the Fund's financial position.

He had originally proposed increasing the reserve target for FY 1986 to 7-8 percent, Mr. Dallara went on. The target that had been finally agreed--namely, 5 percent, seemed even less adequate now than at the time of its adoption. The staff's latest projection of deferred income for all of FY 1986 was SDR 139 million. Such projections were difficult to make, and he was worried that the staff's latest figure might well prove to be overoptimistic. The amount of income from charges that might have to be deferred in FY 1986 could be significantly higher than had been projected unless members took immediate steps to become current in their obligations to the Fund. There was no encouraging evidence in recent weeks that debtors and creditors were willing to take the steps needed to solve the arrears problem. Accordingly, the Fund might be unable to reach the 5 percent target for FY 1986 even if the rate of charge were increased to 7.8 percent. Nevertheless, at the present stage the Executive Board should rely on the staff's estimates of deferred income, though the staff should consider whether its projection methods could better reflect the recent rising trend in overdue charges. The staff had admitted that the indicator on which its deferred income projections were based might not be the most propitious one.

The proposed mid-course correction--an increase in the rate of charge to 7.87 percent--was explicitly provided for under Rule I-6(4)(b) and should be approved, Mr. Dallara commented. Rule I-6(4)(b) deliberately provided for an increase in the rate of charge that would clearly offset the projected income loss for the entire financial year. The midyear review offered an opportunity to take steps to eliminate a projected income deficit for the financial year. In mid-FY 1985, the Executive Board had not forseen the income deficit that actually occurred; accordingly, the Executive Board had failed to take steps that would have avoided the deficit.

The Executive Board could hold another review of the Fund's income position in three months, Mr. Dallara said. In addition, excess net income in FY 1986 resulting from the payment of overdue charges and perhaps other developments should be used to reduce retroactively the rate of charge paid by members that had remained current in their obligations to the Fund. Any extra income available after that distribution should be added to the Fund's reserves.

He too was reluctant to see the rate of charge increased to 7.87 percent, Mr. Dallara commented. A number of Executive Directors had understandably commented on the issues of burden sharing and the concessionality of the Fund's charges. Even at 7.87 percent, the rate of charge would have a substantial element of concessionality. That element would not be lost merely because the rate of charge were to exceed the SDR interest rate. The average five-year SDR interest rate was 8.75 percent; many members would have to pay a much higher rate for market financing. The overall decline in interest rates in recent years had helped the Fund's financial position and had enabled the Fund to keep its charges lower than would have been possible in the absence of the declining trend. In any event, the cost of maintaining the concessionality of the Fund's rate of charge--even if it were increased to 7.87 percent--would be borne by the Fund's creditors as well as the users of the Fund's resources, as the remuneration coefficient would remain significantly below the SDR interest rate in the rest of FY 1986. Moreover, it was important to bear in mind the effective rate of remuneration; after all, his Government, like many others, had to borrow in financial markets in order to finance lending to the Fund, and the rate on that borrowing was much higher than the rates that the Fund paid on creditor positions in the Fund.

It was of course true that creditors to the Fund were not interested solely in the rate of return on their Fund-related assets, Mr. Dallara continued. However, it was incorrect to believe that creditors were uninterested in the remuneration that they received on their creditor positions in the Fund. Under the legislation on the quota increase for the United States under the previous general review, the Secretary of the Treasury was required to instruct the Executive Director for the United States to work to bring the rate of remuneration in line with market interest rates. The United States remained prepared to share in the financing of the Fund's operations. The creditor position of the United States in the Fund had grown significantly in recent years and currently represented 46 percent of the total remunerated positions of the G-10 countries and Saudi Arabia, which accounted for 34 percent of total quotas. In addition, his authorities were willing to support U.S. bilateral assistance to members that were having difficulty in meeting their financial obligations to the Fund; with one or two important exceptions, there had been little indication that other donors were willing to do so as well. The United States had offered to seek an additional $450 million in direct bilateral assistance from the U.S. Congress to be channeled into the World Bank for use in parallel with Trust Fund reflows. That offer had yet to be taken up by any other member, including countries that stood to benefit from the assistance.

Executive Directors were understandably reluctant to see the rate of charge rise to 7.87 percent, Mr. Dallara said. However, he was worried about the lack of urgency evident in recent discussions on individual members' arrears. Those arrears were clearly the main cause of the Fund's present income shortage, but only a small number of creditor members seemed to be very concerned about those arrears. Evidence of greater concern might increase the Fund's effectiveness in reducing and eliminating the arrears. There was regrettably no alternative to increasing the rate of charge if the income target for FY 1986 were to be met. Executive Directors should urge their authorities to mobilize the bilateral assistance needed to support comprehensive economic policy packages in members with large arrears.

Mr. Zecchini noted that, while the staff had originally projected net income of SDR 30 million in the first half of FY 1986, the Fund had actually registered a loss of SDR 20 million. Moreover, in the absence of further measures, the Fund was expected to record a loss of SDR 32 million for FY 1986 as a whole. That disappointing situation was due mainly to the rapid and unexpected rise in overdue payments and to the decision to treat overdue charges as nonaccrued income. The outcome for FY 1986 could be completely inconsistent with the original objectives for the year. Following the rapid increase in arrears the Executive Board had decided that the Fund's financial position should be strengthened. To that end, the Fund's reserve position was to be strengthened through an increase in the net income target. However, the corrective measures had not been sufficient, as the Fund had registered an income loss and a decline in reserves in FY 1985 and had suffered an additional loss in income in the first half of FY 1986. Corrective actions were clearly required.

The overdue obligations had significantly increased the uncertainty about the Fund's projected income, Mr. Zecchini observed. While there was some difficulty in projecting the amount of nonaccrued income, the arrears were at present a multiple of the income target. The method used by the staff to project deferred income seemed to be sound, as it reflected the actual increase in overdue payments. Further experience would indicate whether refinements in the projection techniques were required. Deferred income in FY 1986 was at present projected at SDR 139 million, but under the most unfavorable scenario it could be as much as SDR 255 million. Accordingly, in considering the staff's recommendations, Executive Directors should err on the side of caution.

The Executive Directors faced the difficult choice of either increasing the rate of charge alone, or combining such an increase with some measures affecting the remuneration coefficient, Mr. Zecchini remarked. The burden of the income shortage should be shared to a certain extent among debtor and creditor members. In choosing among the various options that seemed consistent with the Fund's rules, especially Rules I-6(4) and I-10, Executive Directors should bear in mind the difficulty that they had had in reaching the compromise under which the remuneration coefficient increased gradually and automatically. It was also important to remember that in most, if not all, countries with arrears, the domestic policies in place had not been sufficient either to prevent arrears or to deal with accumulated arrears. Moreover, as pointed out by the staff on a previous occasion, many countries with arrears were not giving the highest priority to repaying the Fund.

Nevertheless, merely increasing the rate of charge would place the burden of the Fund's income shortage entirely on debtor countries that, despite the problems facing their economies, had managed to remain current in the Fund, Mr. Zecchini continued. Therefore, he favored a solution that would raise the rate of charge to 7.87 percent and delay the increases in the remuneration coefficient scheduled for February 1 and May 1, 1986. That solution would increase the chances that the Fund would be able to exceed the income target for FY 1986; any excess income could be used to reduce the rate of charge retroactively.

Alternatively, the Fund's financial position could be strengthened by reducing the target for the desired increase in reserves together with the establishment of a loan-loss provision, Mr. Zecchini went on. The net income target would be met by increasing the rate of charge and delaying the scheduled increases in the remuneration coefficient. The establishment of a loan-loss provision would be financed by contributions from all members on the basis of a common denominator, such as quotas. Moreover, additional, voluntary contributions could be made. Lowering the reserve target and establishing a loan-loss provision would spread the burden of arrears on the budget more evenly across the membership and would avoid placing an undue burden on the debtors that had remained current in their obligations to the Fund. Finally, it would be useful to establish a special fund, financed by voluntary contributions of members, to support members that wished to eliminate their arrears to the Fund and were willing to implement an effective adjustment program recommended by the Fund.

Mr. Polak remarked that the SDR interest rate was not the sole or main criterion for judging whether or not the rate of charge was concessional. Rather, the Executive Board had used the SDR rate as a guideline in determining how concessional the rate of charge should be. Accordingly, the rate of charge would be sufficiently concessional as long as it did not exceed the SDR rate.

The Treasurer commented that in accessing the concessionality of the rate of charge, Executive Directors were required under Rule I-10(d) to take into account not only the SDR interest rate, but also the objective of reaching the Fund's income target for a financial year. In effect, the net income target variable was independent of the movement in the SDR interest rate. Rule I-10 stipulated that if the rate of charge should exceed the SDR interest rate, the Executive Board must review the remuneration coefficient and, in particular, should consider whether the remuneration coefficient should be set, within the range permitted by the Articles, at such a level as would permit the rate of charge to be the same as the SDR interest rate and still enable the Fund to meet the target amount of net income for the current financial year.

Mr. Mawakani said that the projected shortfall in income for FY 1986 was a cause for concern but was not a permanent problem requiring the Executive Board to take specific actions at the present stage, such as an increase in the rate of charge. The main factor behind the projected income shortfall was the amount of deferred income resulting from overdue obligations to the Fund. On several previous occasions he had expressed his concern about the arrears and their financial implications for the Fund, and he remained committed to maintaining the Fund's financial soundness.

However, only a few countries--which faced serious financial and economic problems--had accumulated arrears to the Fund, Mr. Mawakani continued. The authorities in those countries had indicated their willingness to become current in their obligations to the Fund, and the Fund's income deficit was therefore temporary in nature.

The Executive Board had already discussed the problem of arrears to the Fund and had taken steps to improve the Fund's financial position, Mr. Mawakani commented. The Fund was encouraging increased participation by private creditors in meeting the financing needs of members, and it would therefore be inappropriate at the present stage for the Fund to take steps that would send conflicting signals to the financial markets. The overdue obligations to the Fund should be treated as a temporary problem, and the Fund should not take such steps as an increase in the rate of charge which would introduce an element of uncertainty in the Fund's dealings with members. At the same time, the Executive Board should not take any step that would increase the payments burden of members that already faced serious balance of payments problems. In any event, as interest rates were falling in many countries, it would be inappropriate to increase the Fund's rate of charge.

The Fund's income shortfall should be eliminated through a reduction in the income target for financial year 1986 and through the use of the

Fund's ample reserves, Mr. Mawakani considered. The reserves should be replenished later, as the deferred income was actually collected in the SDR Department.

Mr. Fugmann commented that the Fund's income shortage had far-reaching consequences for the Fund and the entire membership. The shortfall was attributable mainly to the unexpectedly large amount of deferred income arising from overdue obligations to the Fund. Reasonable assumptions about the amount of arrears in the coming period were a prerequisite for assessing the prospects for the Fund's income position. He agreed with the staff that the so-called net deferral coefficient was the most reasonable--if not an ideal--indicator of the future trend in deferred income. The relevant calculations should be made at regular intervals, perhaps every six months. In addition, the latest three months in the period on which the coefficient was based should be given a heavier weight than the first three months.

The income shortage could be dealt with by increasing the rate of charge, lowering the remuneration coefficient, or reducing the Fund's reserve target, Mr. Fugmann remarked. He agreed with the staff that it would be best to avoid reducing the Fund's reserve target, which had only been recently increased from 3 percent to 5 percent in order to compensate for the negative effects of the overdue obligations to the Fund. In choosing between the two remaining alternatives his authorities had been guided by two basic considerations. The first was the need to avoid obscuring the real problem of the Fund's income position and to solve it immediately. The second was the need for a reasonable sharing by members of the burden of the income shortfall. Burden sharing was a complex issue, and it alone could not provide a basis on which to take steps to deal with the problem of the income shortfall.

In deciding on the rate of charge and the rate of remuneration for the coming period, Executive Directors must try to strike a balance between the need to maintain a healthy supply of credit for the Fund and the need to avoid a marked reduction in the demand for the Fund's financial support and policy advice, Mr. Fugmann continued. The choice between increasing the rate of charge or reducing the remuneration coefficient was difficult, as either step would adversely affect the membership as a whole. The least undesirable alternative was to combine an increase in the rate of charge to the SDR interest rate with a temporary reduction in the remuneration coefficient to 89.3 percent, both with effect from November 1, 1985, for the rest of FY 1986. It would be understood that any excess income at the end of the year would be distributed in the form of a retroactive increase in the rate of remuneration.

If that solution did not command the support of a majority, he could go along with a broadly-supported proposal for a more limited, temporary reduction in the remuneration coefficient, for example, to 91.66 percent, the basic level for FY 1986, Mr. Fugmann said. The rate of remuneration should not be regarded as a residual. The rate of charge would then have to be set at a level that would ensure the achievement of the 5 percent reserve target. That solution would unfortunately bring the rate of charge above the SDR interest rate. Accordingly, additional income in FY 1986 arising from a reduction in deferred income should be used to reduce the rate of charge retroactively. A rate of charge in excess of the SDR interest rate would underscore the fact that the Fund's present financial situation was unsustainable and would emphasize the need for a comprehensive solution to the Fund's income problem. Drastic changes in the rate of charge should be avoided; frequent, moderate changes were preferable.

Mr. Romuáldez commented that although the issues at hand were complicated, some of the options proposed by the staff could be readily eliminated. For example, any proposal to defer action at the present stage should be rejected. The Executive Board must act forthwith to protect the Fund's financial position.

It would be inappropriate for the Fund to bear some of the risk of overdue obligations by earning less income--or incurring a deficit--that would lead to a reduction in the Fund's reserves, Mr. Romuáldez continued. That outcome would be inconsistent with recent Executive Board decisions aimed at strengthening the Fund's financial position. The course that was finally chosen must immediately restore the Fund's net income to a level that was consistent with the achievement of the current net income target. There was no scope for compromising on adhering to the principle of achieving a moderate positive net income each financial year. The uncertainty about the trend in arrears in the coming period was another reason to avoid any steps that would make the Fund's reserves temporarily bear the burden of the arrears and the Fund's income shortfall.

As the staff had noted, the projected amount of deferred income in the second half of FY 1986 was subject to a substantial margin of error because recent experience regarding the discharge of overdue obligations might not be an accurate indication of future developments, Mr. Romuáldez noted. In fact, there was every reason to believe that the projected amount of deferred income in FY 1986 could be on the low side. Deferred income had already amounted to SDR 77 million in the first half of the current financial year, and the figure for the quarter alone including October was SDR 58 million. Even more important, deferred charges for FY 1986 of all members with overdue payments to the Fund on October 31, 1985 could total SDR 255 million. The risk of a substantial increase in deferred income beyond the staff's estimates was clearly considerable. Accordingly, any delay by the Executive Board in taking steps to deal with the Fund's income shortage would be entirely unwarranted.

The main issue with respect to the various possible options was whether the brunt of the adjustment in response to the income shortage should fall on the rate of charge or on the rate of remuneration, Mr. Romuáldez remarked. In that connection, the Executive Board had to bear in mind conflicting principles. On the one hand, the Executive Board would wish to maintain a relatively stable, predictable, and close relation between the SDR interest rate and the rate of remuneration; on the other hand, the Executive Board would wish to maintain a relatively stable and concessional rate of charge. On balance, the staff's proposal in paragraph (iv) on page 17, or some variant on it, represented an appropriate compromise between those conflicting principles. He could support any consensus that developed along those lines.

Such a compromise was warranted not because of the existence of any shared responsibility for the cause of the income shortage, but because of the relative capacities of different groups of members to absorb the burden and because of the mutual interest of all members in shoring the Fund's financial position, Mr. Romuâldez went on. It would be particularly inappropriate if the burden were to fall completely on the rate of charge and therefore on members that were fully current in their obligations to the Fund, particularly in view of the large increase in the rate of charge under the compromise he favored. Some of the burden must be shared by creditor members in the form of a reduction--which he hoped would be temporary--in the rate of remuneration. In his note, Mr. Dallara had presented a worst-case scenario that underscored the potential adverse financial implications for the Fund of the growing arrears. Mr. Dallara had stressed that members with arrears must take immediate steps to become current in their obligations and that those steps must receive appropriate support from bilateral donors; accordingly, strengthening the Fund's income position was the responsibility of both members with arrears and the membership in general.

Mr. Schneider said that the recent unexpected increase in the amount of deferred income was serious--because it increased the uncertainty about the net income projection for financial year 1986--and delicate, because of the conflicting interests involved, which would make an agreement difficult to reach. Moreover, the safeguard provision for use in the event the Executive Board could not reach an agreement would force the debtor countries to bear the full burden of generating the additional income required, an outcome that would be particularly inopportune given the present declining trend in market interest rates.

In seeking a solution to the income problem, Executive Directors must preserve the Fund's central role in dealing with the debt problem, Mr. Schneider continued. If the Fund were to continue to play its role, Fund credit must continue to have a sufficiently large concessional component. Maintaining the Fund's central role in dealing with the debt problem was in the common interest of debtors and creditors, and a common effort to safeguard to Fund's income position was therefore called for.

The present amount of deferred income already represented a large fraction of the Fund's reserves, but the present level of reserves still gave the Fund some flexibility in its financial management, Mr. Schneider considered. For example, there was no need to contemplate large changes in the Fund's interest rates; such adjustments would be inconsistent with the present trends in market rates and would threaten the Fund's financial stability. In any event, given the uncertain prospects for the Fund's income, such changes might well turn out to be unnecessary in a few months' time.

The burden of the Fund's income shortage should be shared to some extent among the membership, Mr. Schneider considered. Accordingly, the Executive Board should agree on a combination of actions, such as an increase in the rate of charge, a moderate reduction in the remuneration coefficient, and a temporary, modest reduction in the present income target. Under that solution, the Executive Board would refrain from formally changing the present income target, a move that could easily be misinterpreted, as it would appear odd for the Fund to reduce the target at a time when it was threatened with an income deficit. The solution that he favored was described on page 15 and was not far from Mr. de Maulde's position. That solution should not be extended into FY 1987; the actions that he favored would be provisional and exceptional. Members with arrears should find in that solution neither justification nor excuse for failing to eliminate the arrears. A clear position must be taken before April 1986 with respect to the treatment of members with arrears; in that connection, extreme solutions could not be excluded. The credibility and solvency of the Fund were at stake, and their importance transcended that of the question of the role of the Fund in dealing with the debt problem. In addition, the Executive Board's present stance must take into account the need to have the best possible conditions for successful negotiations on the Ninth General Review of Quotas.

Mr. Mtei noted that the projected financing gap for FY 1986 consisted of the projected deficit of SDR 32 million and the net income target of SDR 52 million. The rate of charge needed to generate the income required to meet the income target for the whole financial year was 7.87 percent. The staff had indicated that there were several optional ways of meeting the income target. In considering those options, Executive Directors should bear in mind the important role that the Fund must play in the international monetary system and the Fund's long-term usefulness in helping members to handle cyclical economic and financial problems. Executive Directors should also bear in mind the new suggestions concerning the reform of the international monetary system and the associated objective of increasing the net flow of financial resources to the heavily-indebted low-income countries to help them to restore economic growth and to be able to repay the Fund. Of course, in examining possible means of financing the Fund's income deficit, Executive Directors should take into account the narrower interest of creditor and debtor members in the sharing of the burden of that deficit.

The Fund's rather large income deficit was due partly to the deviations from projections of the average SDR interest rate during the first half of a financial year; the actual rate had been lower than the rate used in projecting the Fund's income at the beginning of FY 1986, Mr. Mtei observed. The shortfall of SDR 26 million in the first half of FY 1986 was attributable mainly to the unexpectedly limited use of the

Fund's resources, an outcome that was a reflection of the Fund's increased conditionality and of the reduction in the Fund's exposure to the highly indebted countries and to the prolonged users of Fund resources. The continuation of the Fund's present attitude toward conditionality, debtor members, and prolonged users, could be expected to reduce further the use of Fund resources and thereby the Fund's income. The income deficit in the rest of FY 1986 was due to other policy changes by the Executive Board, such as the increase in the income target and the change in accounting policy with respect to overdue obligations. During the discussion that had led to the increase in the net income target from 3 percent to 5 percent of reserves, his chair had expressed the fear that the more ambitious target might result in an increased burden--through a higher rate of charge--on debtor countries in what was still a difficult period for those members. The high net income target for FY 1986 of SDR 52 million was a major factor in the present need to increase the rate of charge.

The income deficit in FY 1986 was due mainly to the deferred income arising from overdue obligations, which could vary considerably over time, Mr. Mtei commented. During the first six months of the current financial year, deferred income had amounted to SDR 77 million, a figure that was SDR 48 million larger than had been projected; the deviation from the projection was almost as large as the projected total net income for FY 1986. For the entire FY 1986, the staff expected that deferred income would reach SDR 139 million. However, the staff had admitted that it was difficult to estimate the amount of deferred income and arrears. Apparently the projection formula, which was based on the last 12-month period, did not provide accurate results during a cyclical downswing, such as the present one, or during a cyclical upswing, when the projected amount of deferred income was likely to prove to be on the low side. The ongoing negotiations would probably lead to a reduction in the arrears of members in his constituency, thereby drastically changing the outlook for deferred income. The staff's projection methodology, which by the staff's own admission yielded results that were subject to a considerable margin of error, must be treated with great caution by Executive Directors when they consider policy actions that would have serious repercussions on debtor members that already had little room in which to maneuver.

Given the uncertainties about the outlook for a major portion of the Fund's income, he agreed with the staff that the current rate of charge could be maintained in the coming three months, Mr. Mtei said. That decision would help the Executive Board to avoid taking hasty steps based on insufficient analysis which would increase the burden on the poorest members and which would be difficult to reverse. It was important to bear in mind that the Fund's income position was not in a crisis stage and that the income deficit was the reflection of a change in the Fund's accounting policy. He agreed with Mr. Sengupta that the present procedures for handling an income shortage should not be thought of as being sacrosanct and that the Executive Board should review the various policies and procedures as soon as possible. Meanwhile, the Executive Board should agree at the present meeting to review the Fund's income position again in three months. If at that time the Fund still seemed likely to incur an income deficit, the Executive Board could take some of the suggested steps, including using the Fund's reserves until the present cyclical downswing in the Fund's income was over, at which time the Fund could rebuild its reserve position, restoring or exceeding the initial level.

Mr. Nebbia recalled that at the time of the previous review of the Fund's income position, net income for FY 1986 had been estimated at SDR 55 million, about 5.3 percent of reserves. Responding to that projection the Executive Board had agreed to increase the net income goal from 3 percent to 5 percent of reserves, thereby setting a target in absolute terms for FY 1986 of SDR 52 million. Under that agreement, the rate of charge had been kept unchanged at 7 percent, and the SDR interest rate had remained at 100 percent of the combined market rate. In addition, it had been informally agreed that excess income would be added to reserves in order to achieve a rate of reserve growth of 7 or 8 percent.

The decision to increase the net income target had been adopted at an appropriate time, Mr. Nebbia went on. There had been a general consensus that the Fund's income position needed to be strengthened because of the negative developments with respect to overdue payments to the Fund and because the projections at that time suggested that the increased income target could be reached without any adverse consequences for the Fund's creditor and debtor countries.

The present picture of the Fund's overall income position was much different from the picture at the time of the previous review in June 1985 (EBM/85/89 and EBM/85/90, 6/5/85), Mr. Nebbia went on. Instead of achieving the projected SDR 30 million in net income the first half of FY 1986, the Fund had recorded a deficit of about SDR 20 million. Moreover, while a net income for the whole of FY 1986 of SDR 55 million had been expected, the revised projections suggested that there would be a deficit of about SDR 32 million. Moreover, the achievement of the new income target was no longer compatible with the current rates of charge and remuneration.

The staff had stressed that the difference between the projected and actual income in the first half of FY 1986 was due mainly to the larger than expected deferred income owing to the increased number and amount of overdue obligations to the Fund, Mr. Nebbia commented. However, the deterioration in the income position had also been due to other factors, such as the unexpectedly limited use of the Fund's ordinary resources, which had contributed some SDR 26 million to the income shortfall. The limited use of borrowed resources together with lower interest rates had caused a substantial decline in income from charges.

Projections of the Fund's income and expenses were understandably difficult to make, Mr. Nebbia continued. The uncertainties surrounding such forecasts should be borne in mind by the Executive Board when it considered possible options like those in the staff paper, which would have a substantial adverse effect on a number of members. The main objective at present should be to decide how best to achieve a reasonable net income target--not necessarily the current target--without imposing an undue burden on the users of the Fund's resources and without discouraging creditor members from continuing to make their resources available to the Fund. In considering the various options the Executive Board should take into account the need to adhere to certain general principles, especially the need for a stable rate of charge that should have an element of concessionality. In addition, achieving a moderate net income during each financial year to permit some increase in the Fund's reserves was not an end in itself but rather a means of strengthening the Fund's financial position and the Fund's capacity to handle the temporary effects of such problems as overdue payments to the Fund. In addition, the return on Fund-related assets should bear a reasonably close relationship to short-term market rates in order to encourage creditor members to maintain their reserve tranche positions.

The best solution to the problem of the Fund's income shortage would be a combination of steps along the line of the staff's proposal in paragraph (iv) on page 17, Mr. Nebbia considered. Accordingly, there would be both a reduction in the remuneration coefficient and an increase in the rate of charge bringing that rate to no more than the SDR interest rate. If a majority of Executive Directors felt that it was inappropriate to use the Fund's reserves to cope with the emerging deficit, it would in his view be equally unreasonable at the present stage to agree to accelerate the rate at which the reserves were to be accumulated. The target rate for reserve accumulation in FY 1986 should be restored to 3 percent, and the rate of charge and the remuneration coefficient should be adjusted accordingly. That approach would still enable the Fund to strengthen its financial position by increasing reserves, but it would keep reserve accumulation from becoming an objective unto itself. If the Fund's reserves were not going to be used to handle such difficult situations as the present one, there was no need to accelerate the pace of reserve accumulation, especially at a time when a sensible effort by all members was needed to handle the Fund's income shortage. Under the approach that he favored, excess net income at the end of FY 1986 could be used to restore the 5 percent reserve target. If there were still additional extra income after reserves had been replenished, the rate of charge and the rate of remuneration should be adjusted retroactively. In other words, the Fund should follow the advice that it had often been given to members facing balance of payments problems: it should reduce expenditures--remuneration--to the extent possible, and increase income, through the rate of charge, to the extent feasible, while building up reserves.

Mr. Jiang noted that in the first half of FY 1986 the Fund had recorded a deficit of SDR 20 million. To reach the net income target for the year of SDR 52 million, the rate of charge would have to be increased to 7.87 percent in the absence of a decision to take other steps by December 15, 1985. The Executive Board clearly had a difficult choice to make. Interest rates in general had been declining, and the Fund had been called upon to play a central role in solving the world debt problem

The proposal to increase the rate of charge to 7.87 percent would therefore clearly be inconsistent with interest rate trends and the role that the Fund should be playing in the present circumstances.

There was no compelling reason to increase the rate of charge to a level as high as 7.87 percent, Mr. Jiang continued. Moreover, it would be unfair to place the burden of the Fund's income shortage entirely on members that used the Fund's resources. After all, the income shortage was due not only to arrears to the Fund but also to the fluctuation in the U.S. dollar, the decline in interest rates, and the unexpectedly limited use of the Fund's resources.

The best compromise solution was the one proposed in paragraph (iv) on page 17, Mr. Jiang considered. Accordingly, the rate of charge should be raised to equal the SDR interest rate, and the remuneration coefficient should be reduced to 89.3 percent. Under that solution all members would share in the effort to handle the Fund's income shortage. Other options that Executive Directors had mentioned at the present meeting were worth considering, such as a reduction in the income target from 5 percent to 3 percent, and the establishment of a special fund--financed by contributions by donor countries--to help members reduce their arrears to the Fund. The Fund's income position should be reviewed again in three months.

Mr. Alhaimus stated that an increase in the rate of charge to 7.87 percent would be excessive and that means should be found to alleviate it perhaps to a level slightly below the SDR interest rate. He doubted whether a retroactive distribution of net income was an appropriate way to achieve that objective. The burden of the Fund's income shortage should be borne by the remuneration coefficient and the income target as well as by the rate of charge.

A reduction in the remuneration coefficient, especially if it fell to as low as 89.3 percent, would certainly raise legitimate concern among members providing usable resources to the Fund, some of which were experiencing increasing financial difficulties, Mr. Alhaimus continued. The only other alternative that could help to alleviate the adverse effect of the arrears to the Fund was a reduction in the reserve accumulation target, perhaps to about the previous level of 3 percent. There was understandably some difficulty in changing the reserve target so soon after its adoption. However, the reduction should be seen as an interim measure; future income from the discharge of overdue payments to the Fund should be returned to reserves and to members affected by the actions that the Executive Board would take at the present meeting to deal with the income shortage.

Mr. Nimatallah recalled that his chair had consistently warned that the overdue financial obligations to the Fund would eventually result in an increase in charges, stricter conditionality, and possibly some difficulty in raising additional resources for the Fund. He strongly hoped that the arrears problem would be solved by the time of the next general quota review.

His authorities had an open mind on the sharing of the burden of the Fund's income shortage in FY 1986, Mr. Nimatallah continued. However, he doubted whether his authorities would favor a reduction in the net income target for the year. After all, the target had been adopted just recently, and changing it so soon after its approval would appear odd. In addition, the staff had implied in its paper that there would be instability in the rate of charge if it were connected with the SDR interest rate. In his view, there should be no connection between the rates. The SDR interest rate was subject to considerable fluctuation and the rate of charge should not be tied to it, especially in view of the difficulty in setting and changing the net income target for the financial year.

He still had an open mind on the best solution to the problem of the Fund's income shortage, Mr. Nimatallah said. Saudi Arabia had made substantial efforts to support developing countries; for example, Saudi Arabia had contributed to the subsidy account for the supplementary financing facility. His authorities were willing to help finance a new subsidy account to assist members that could not pay higher rates of charge if necessary.

The Treasurer commented that he agreed with Mr. Polak that the assumptions underlying the staff's estimates in its paper were based on variables that could conceivably change rapidly and unpredictably. However, it was important to remember that the procedures that the staff used in projecting the Fund's income had been reviewed and endorsed by the Executive Board on several previous occasions. Some of the staff's projections were made on the basis of the staff's experience in assessing the likely use of the Fund's resources in a coming period. Projected administrative expenses were based on estimates in the budget. The staff admittedly had relatively little experience in projecting income to be deferred due to prolonged arrears, and the staff would of course wish to review its projecting technique as it accumulated experience. The staff did not attempt to forecast market interest rates; such forecasts were inherently difficult to make. The staff's projections included a sensitivity analysis of interest rates and other major variables, so that Executive Directors could determine the effect of divergencies from the projections.

There was no established guideline for measuring the concessionality of the Fund's rate of charge, the Treasurer remarked. In earlier papers the staff had examined the question of the interest rates that might be used in making such a comparison. It seemed best to use the SDR interest rate rather than the rate for assets denominated in a particular currency, such as the dollar or the yen, or a pool of currencies such as the one used by the World Bank. The composition of the SDR interest rate basket was different from that of the comparable World Bank basket. There was some question as to which maturity should be used in assessing the concessionality of the Fund's rate of charge. Some Executive Directors seem to favor the short-term SDR interest rate and others the five-year interest rate. Moreover, the varying creditworthiness of different borrowers needed to be taken into account. The SDR interest rate was based on the borrowing cost to governments or prime creditors in the five domestic markets; those borrowing costs were of course the lowest available to the various creditors in those markets. The Euro-market rates for the currencies in the SDR basket would be higher than the individual interest rates on which the SDR interest rate was based. There was clearly a variety of standards that could be chosen to measure the concessionality of the Fund's rate of charge. He doubted whether the staff would have much to say on that question in addition to its discussion in the recent paper on a possible special charge.

The question had been raised whether it would be desirable to link the rate of charge to the rate of remuneration or the SDR interest rate, on the assumption that the rate of charge would become variable if it were linked to the SDR interest rate, the Treasurer recalled. Some Executive Directors apparently felt that such a link would not be desirable. Mr. Polak had stressed that the rate of remuneration was also floating, and that it was a major part of the Fund's total costs, while Mr. Grosche had noted that some of the Fund's expenses did not vary--at least in a downward direction--and seemed to be on a steady rising trend in nominal terms. The issue of the link that had been proposed was complex, as the Fund's net income was based on factors in addition to the rate of remuneration and administrative expenses. For example, the Fund's remuneration expenses were determined not only by the rate of remuneration--which, in turn, was based on market interest rates--but also by the absolute balances on which remuneration was paid. Accordingly, total remuneration expenses could rise or fall for reasons that were unrelated to movements in market interest rates. It was useful to remember that a change of 0.1 percentage point in the rate of remuneration would change the Fund's current net income by about SDR 10 million. At the same time, a 1 percentage increase in the SDR interest rate was accompanied by an increase in the rate of remuneration of about 0.9 percent: movements in the rate of remuneration were not perfectly parallel to movements in the SDR interest rate. Moreover, the Executive Board had agreed to increase the remuneration coefficient in three steps of 3.33 percentage points each, and the remuneration coefficient was to rise further or fall within a floor and ceiling depending upon movements in market interest rates. Accordingly, a link between one of the main factors in the Fund's costs--the rate of remuneration--and one of the main factors in its income--the rate of charge--would not necessarily enable the Fund to reach its net income target for a financial year. The Executive Board had examined that issue on previous occasions and consistently reached the same conclusion, noting that it would be undesirable to have a floating rate of charge and that it would be inappropriate to take decisions that would result in considerable swings in the net income target.

The income shortfall for FY 1986 was estimated at SDR 84 million, including a deficit of SDR 32 million and the net income target of SDR 52 million, the Treasurer noted. The income shortfall was identical to the increase in the amount of deferred income owing to the arrears to the Fund. Hence, the income shortfall could conceivably be attributed to the increase in arrears. In fact, however, it was difficult in an accounting sense to attribute a deficit in the Fund's income to a particular expenditure or income items.

The staff representative from the Treasurer's Department added that if the staff's forecast of overdue charges--and therefore nonaccrued income--in June 1985 had remained unchanged, the rate of charge would need to be increased only slightly, to 7.03 percent, in order to meet the present net income target for FY 1986.

Under Mr. Nebbia's proposal, the rate of charge and the remuneration coefficient should be adjusted in equal proportion by the amount necessary to reach a net income target of 3 percent, the staff representative noted. At present, a deficit of SDR 32 million was expected; in addition, the income surplus required to increase reserves by 3 percent was SDR 31 million, compared with the projected shortfall for a target of SDR 84 million on the basis of a 5 percent net income target. Mr. Nebbia's proposal would require the rate of charge to be increased 31 basic points to 7.31 percent while the remuneration coefficient would have to be lowered by roughly 3.8 percentage points to about 88.7 percent.

The Director of the Legal Department recalled that Mr. Sengupta had noted that the decision to treat overdue charges as nonaccrued income had been taken by a majority of the votes cast even though it had direct implications for the rate of charge, which could only be changed by a 70 percent majority. The Fund took many decisions which affected the Fund's income and expenses and which did not require a special majority. The Executive Directors were aware that such decisions could have an indirect and consequential effect on the rate of charge. The Executive Board could, however, take a separate decision on another occasion on the specific question of whether to increase or decrease the rate of charge. If it were desired to adopt a rate of charge different from the rate that would apply as a result of the application of Rule I-6(4)(b), that could be done only by a decision of the Executive Board, which would require a 70 percent majority of the total voting power.

The Chairman noted that nearly all Executive Directors had underlined the seriousness of the Fund's financial situation. The increase in arrears to the Fund was clearly exerting pressure on the Fund's financial position. Everyone agreed on the need to maintain the Fund's financial strength and credibility. Decisive action was needed to deal with individual cases of arrears. The Fund's long-standing principle that adjustment measures must be combined with adequate financial support was more valid at present than ever before. A number of Executive Directors had stressed that the efforts to handle some of the individual arrears cases would require strong bilateral financial support by donor countries of the adjustment efforts of the members concerned.

Various Executive Directors seemed to favor three possible solutions to the immediate problem of the Fund's income shortage, the Chairman continued. The individual positions of Executive Directors were strongly influenced by the priority that each speaker attached to the main relevant principles--namely, the need to keep some concessionality in the rate of charge, the need to strengthen the Fund's financial position, and the need to adhere to the agreement to increase gradually the rate of remuneration in relation to the SDR interest rate. Four Executive Directors, with over one third of the total voting power, said that they did not believe that it was advisable to change either the present reserve target or the remuneration coefficient. Accordingly, they reluctantly agreed to accept an increase in the rate of charge to 7.87 percent, the level needed to meet the present net income target for FY 1986. Some of those Executive Directors also wished to review the Fund's income position in three months; at that time, if the income position had worsened, they would be willing to review all the relevant variables, including the remuneration coefficient.

Four other Executive Directors, with some 10 percent of the voting power, had said that they did not wish to accept at the present stage any increase in the rate of charge, the Chairman noted. They believed that the preferable course of action would be to keep the rate of charge unchanged over the coming three months, thereby having the Fund's reserves bear the burden of the consequences of the income shortfall. They noted that most of the arrears involved a small number of members that might well be able to make payments to the Fund in the near future. In their view the rate of charge should not be increased until the evolution of the arrears situation became clearer.

Thirteen Executive Directors, with almost one half of the voting power, said that they favored a combination of actions to limit the impact of the emerging income deficit on the rate of charge, so that that rate would not exceed the SDR interest rate, the Chairman remarked. They also favored a reduction in the remuneration coefficient, and some of them felt that, if necessary, a moderate reduction in the net income target would be appropriate. Mr. Zecchini had said that, while he could accept an increase in the rate of charge to 7.87 percent effective November 1, 1985, he would delay the next scheduled increases in the remuneration coefficient. Hence, Mr. Zecchini's position was close to that of Executive Directors who favored a sharing of the burden of the income shortfall, as Mr. Zecchini would ask creditors to bear a part of the burden.

There was not a 70 percent majority in favor of adopting a decision at the present meeting, the Chairman said. He hoped that the Executive Directors would agree to discuss the matter further in the near future with a view to reaching a decision.

After a further brief discussion, the Executive Directors agreed to reconsider the matter on December 13, 1985.

APPROVED: July 14, 1986

LEO VAN HOUTVEN
Secretary