INTERNATIONAL MONETARY FUND

The Fund's Medium-Term Income—Outlook and Options

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In Consultation with Other Departments

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I. Introduction

1. **Key Issues**. The Fund needs to generate income to cover its operational expenses and build reserves to protect against key financial risks. Under current arrangements, the Fund is heavily dependent on credit outstanding for its income. The margin on the basic rate of charge is set each year on a cost-plus basis. This system was adopted in 1981 and has been successful in covering the Fund's operating costs and, together with the introduction of surcharges in 1997, building reserves to around SDR 6 billion at present.

2. Credit outstanding, however, has now fallen to its lowest level in 25 years. GRA credit outstanding is currently just over SDR 20 billion, less than a third of its peak of over SDR 70 billion reached just three years ago. This signals success in terms of the Fund's core mandate of promoting global financial stability and helping its members resolve their balance of payments difficulties in a timely and non-disruptive manner. However, it also entails a commensurate drop in the Fund's income base.

3. As anticipated in the ongoing review of Fund finances, the current system for setting the rate of charge is not sustainable in a low-credit environment. In previous discussions, it was agreed that the review should aim to secure a financial structure that is robust under a plausible range of future scenarios. These issues were also considered by the Committee on the Budget in November 2005 based on a staff paper that presented a range of scenarios for Fund credit outstanding, including the implications of a low interest rate and low credit environment. The low credit scenario has since become a more central one, following early repayments by two of the Fund's largest borrowers.[1]

4. The current environment suggests that the Fund needs a long-term source of financing not dependent on lending. While it is too early to determine whether the recent decline in credit outstanding is a structural break or a temporary dip, a change in focus in the Fund's work from crisis resolution to crisis prevention would require a similar shift in revenue generation through a diversification of income sources.

5. A variety of options has been discussed for broadening the Fund's income base. These include establishing an Investment Account, reducing remuneration, introducing user fees, increasing third-party financing, and selling part of the Fund's gold and investing the

[1] Although transactions on the account of the Fund take the form of an exchange of assets, for the purposes of this paper, such transactions will be referred to as "borrowing", "lending", or "Fund credit", depending on the context. A member purchasing reserve assets undertakes to repurchase from the Fund the Fund's holdings of its own currency acquired in the transaction. For ease of understanding, these transactions will be referred to as "payments" and "repayments".

proceeds. Several of these options are closely connected with the work conducted by the various medium-term strategy groups.

6. **Proposed Approach**. This paper updates earlier projections of the Fund's income position in FY07 and in the medium term, and revisits the available options. Specifically, the paper considers the following issues:

- *Current Policies*. The outlook for the Fund's income needs and sources under existing rules and decisions and preliminary budget estimates suggest that substantial financing gaps could emerge over the medium term under current projections.

- *Policy Adjustment*. To close these gaps, policy adjustments will be needed. In light of the required voting majorities, broad support from the membership will be necessary to adjust existing policies.[2] Given the likely time lags in generating additional income sources, it will also be important to start working on these measures now in order to be well positioned to close projected income gaps over the medium term.[3]

- *Precautionary Balances*. The Fund's precautionary balances are held primarily to mitigate credit and income risk. The current credit and income outlook suggests that a pause in the Board's agreed strategy for accumulating reserves is needed while additional income options are being developed.

7. This paper puts forward a number of measures which, if implemented, would eliminate the income gap in FY07. However, these measure still leave a large financing gap moving forward. Therefore, further work is needed to examine mechanisms for financing the Fund's operations in the medium-term in a manner that ensures that the Fund has a sound financial basis to operate without relying on sharp growth in lending. These medium-term issues and the need for follow-up work will be highlighted in the next Strategic Review paper.

II. Income Outlook Under Current Policies

8. **Overview**. Under current policies and rules, the Fund sets the margin for the rate of charge ("the margin") at the level needed to cover expenses and meet the net income target (Box 1).[4] The margin was set at 108 basis points for FY06, a level projected at the start of the

[2] Decisions affecting the rate of charge and the rate of remuneration require a 70 percent majority of the total voting power; sales of gold require an 85 percent majority of the total voting power.

[3] Issues relating to the expenditure side are taken up separately as part of the work of the medium-term strategy groups.

[4] The shift from a coefficient to a fixed margin was agreed in April 2005.

year to be sufficient to achieve a net income target of SDR 188 million, after paying administrative expenses of SDR 646 million (Table 1). These projections were updated at the mid-year review and again following the early repayments by Argentina and Brazil.[5]

Box 1. The Rule on the Rate of Charge and Surcharge Income

The Rate of Charge

The Fund adopted Rule I-6(4) to provide objective guidance for determining the rate of charge on the use of Fund resources and an appropriate margin to protect the Fund's income position against the adverse effect of unforeseen circumstances during the financial year. The provisions of Rule I-6(4) address the following issues:

The **basic rate of charge** is determined at the beginning of each financial year on the basis of (i) estimated income and expenses for the coming year and (ii) the net income target. The rate of charge is set as a margin over the SDR interest rate.

The rule specifies a **net income target** equal to 5 percent of the Fund's reserves at the beginning of the financial year, unless the Executive Board decides otherwise.

The Fund **reviews its income position semi-annually**. The purpose of the midyear review is to determine if any corrective measures, such as an adjustment to the rate of charge, need to be taken in order to achieve the net income target. At year end, the Fund decides on the disposition of net income for the current financial year and the net income target and the rate of charge for the next financial year. If the actual net income for the financial year as a whole is below the net income target, the Board's practice has been to add the shortfall to the following year's net income target.

Surcharge Income

Surcharges of 100 and 200 basis points apply on credit outstanding in the credit tranches and the Extended Fund Facility (EFF) above 200 and 300 percent of quota, respectively. The Supplemental Reserve Facility carries an initial surcharge of 300 basis points, rising by 50 basis points one year after the first purchase and each subsequent six months to a maximum of 500 basis points. Surcharge income is excluded from the calculation of net income for the purpose of determining whether or not the net income target has been achieved.

[5] The updated projections showed a possible net income shortfall of about SDR 80 million in FY06—still implying a significant build-up in reserves.

Table 1. Potential Income Shortfalls over the Medium Term Under Current Policies
(In millions of SDRs, except where indicated)

			Medium-term projections		
		FY06	FY07	FY08	FY09
A.	**Administrative expenses** 1/	**646**	**679**	**708**	**735**
B.	**Income sources under current policies**	**754**	**520**	**498**	**471**
B.1.	Margin for the rate of charge 2/	410	208	159	110
B.2.	Implicit return on reserves and the SCA-1 3/	210	254	279	298
B.3.	Payment of PRGF expenses 4/	58	58	60	63
B.4.	Payment for SRP funding 5/	76	--	--	--
C.	**Net income (B-A)**	**108**	**-159**	**-210**	**-264**
D.	**Net income target (current rules) 6/**	**188**	**283**	**220**	**232**
E.	**Income shortfall (C-D)**	**-80**	**-442**	**-430**	**-496**
	Memorandum Items:				
	Fund credit outstanding (average)	35,800	17,800	13,700	10,200
	External financing by donors 7/	27	28	29	30
	Surcharge income (after payment of PRGF expenses)	238	66	20	1
	SDR interest rate path (in percent) 8/	2.7	3.3	3.7	3.9
	Required margin under current rule (in basis points)	108	356	422	594
	Burden sharing adjustments (average, in basis points):	19	34	45	61
	Deferred charges	4	8	11	15
	SCA-1	15	26	34	46

1/ Based on assumed FY07 administrative net budget of US$915 million plus capital budget expenditure that is not capitalized and depreciation; assumes 4 percent nominal increases in FY08 and FY09; converted into SDR at an SDR/US dollar exchange rate of 1.45.

2/ At current margin for the rate of charge of 108 basis points; total includes income from service charge of 50 basis points on purchases and commitment fees.

3/ Based on projected end-FY06 balances.

4/ Currently paid out of surcharge income; assumes continued use of surcharge income in FY07–09.

5/ Since FY00, the SRP funding has been paid from an earmarked reserve that resulted from an accounting gain recognized in FY99; the earmarked reserve is now exhausted.

6/ FY07 target includes SDR 80 million shortfall from FY06; assumes no shortfalls carried forward to FY08–09.

7/ Third-party financing of Fund technical assistance.

8/ Based on a gradual increase in global interest rates, as assumed in the most recent published WEO and as used for the MDRI projections. Other things equal, a one percentage point increase in the SDR interest rate increases implicit earnings by around SDR 75 million.

9. The Fund's cost of financing is broadly given by the SDR interest rate. The SDR rate is the weighted average of risk-free three-month instruments in the four component currencies of the SDR basket. Members providing their currencies for use by the Fund in credit operations with borrowing members receive a liquid claim on the Fund, known as the reserve tranche position. Remuneration is paid at the SDR interest rate on reserve tranche positions.[6]

10. For analytical purposes, the net contribution from lending activities to the Fund's income can be viewed as the amount generated by the margin, i.e., after paying for the cost of financing. This income is supplemented by an annual commitment fee, which is refunded as purchases are made, and a 50 basis point service charge on purchases.[7] In FY06, total income generated in this way is projected at SDR 410 million (Table 1).

11. The Fund's other major income source is the implicit return on its precautionary balances (the Special Contingent Account (SCA-1) and the Special and General Reserves ("reserves")). In the absence of an Investment Account, these balances are held with creditor members, thereby reducing reserve tranche positions and saving the Fund remuneration costs. In FY06, the implicit return from this source is estimated at around SDR 210 million.

12. Certain of the Fund's costs have been paid from other sources.[8] PRGF administrative expenses are reimbursable to the GRA from the PRGF Trust, but in order to maximize the resources available for subsidized financing, these expenses have in recent years not been paid from the Trust. Rather, surcharge income was used to offset the impact on the margin.

13. **The Income Outlook**. Given the above structure, developments in the Fund's credit outstanding play a key role in determining its medium-term income position. Staff has updated its projections on the assumption that current borrowing member countries continue to repay the Fund as scheduled (on an expectations basis[9]), and that remaining scheduled disbursements also take place under existing arrangements. Staff considers this to be a reasonable central scenario in current circumstances. On the one hand, it makes no allowance

[6] A portion of the reserve tranche positions (currently around SDR 6.6 billion) is not remunerated. The genesis of the unremunerated positions is the past payment of quota subscriptions in gold, which does not generate any income for the Fund. The rate of remuneration is also adjusted downward as a consequence of burden sharing.

[7] The commitment fee is 25 basis points on amounts up to 100 percent of quota, and 10 basis points on amounts in excess of 100 percent of quota.

[8] During FY00–FY06 the Fund's contributions to the staff retirement plans have been paid from an earmarked balance in the Special Reserve. This balance is now exhausted.

[9] Repurchases are calculated on an obligations basis for those countries that have already received approval for a shift from an expectations to an obligations schedule.

for possible new financial arrangements that are not presently foreseen, and thus could be regarded as conservative. On the other hand, it also makes no allowance for possible further early repayments or a decision by members with existing arrangements not to draw their remaining available disbursements. Under this central scenario, Fund credit could decline to SDR 15 billion by end-FY07, and less than SDR 8 billion by end-FY09.

14. At the current margin of 108 basis points, total income from regular sources in FY07 would decline from SDR 755 million to SDR 520 million under the central scenario (Table 1). The main reason is that income from the margin would drop sharply, reflecting the decline in the credit base. With the Fund's administrative expenses projected at about SDR 680 million on preliminary budget estimates, the Fund would face a loss under current policies. Moreover, under existing practices for determining the net income target, the total shortfall vis-à-vis this target would be in the order of SDR 440 million. Covering this shortfall under the existing rule for setting the rate of charge would require a margin of about 360 basis points, more than three times the current level.

15. Over the medium term, the income shortfall would continue to widen if the Fund's budget continues to expand at an assumed nominal rate of 4 percent, while income from lending continues to decline. For example, by FY09, the Fund's regular income from the margin could be as low as SDR 110 million, or only about 15 percent of the administrative budget (compared with about 65 percent at present). Assuming that global interest rates continue to rise, the decline in income from lending would be partly offset by a higher implicit contribution from reserves. However, the overall shortfall vis-à-vis the net income target could be as high as SDR 500 million by FY09 (and income could fall short of expenses by about SDR 265 million). Raising the margin to cover the shortfall would be counter-productive in current circumstances as it could induce market borrowing to repay the Fund.[10]

16. These estimates assume that Fund reserves remain unchanged at the end-FY06 level, while implicit earnings on reserves increase as global interest rates rise. This may be optimistic for several reasons: interest rates may not increase as projected, arrears clearance (e.g., for Liberia or Sudan) could involve use of the SCA-1 resources and therefore reduce the Fund's interest-free resources, and reserves may need to be drawn on temporarily to cover administrative deficits.

17. The outlook also needs to take into account the burden-sharing mechanism, which finances the consequences of arrears and unpaid charges by refundable increases and decreases in the rates of charge and remuneration, respectively. Other things equal, a decline in the credit base causes an increase in burden-sharing adjustments. As indicated in Table 1, under the baseline credit scenario, the adjustments to the rate of charge would rise from

[10] See discussion in paragraph 29 et seq.

around 20 basis points currently to over 60 basis points in FY09 under current policies.[11] Under such a scenario, the burden-sharing adjustments alone would require an effective increase of around half the current total margin.

III. Assessing Medium-Term Sustainability

18. As discussed above, under current policies, the Fund depends on two main income sources: the margin on its GRA lending operations, and the implicit earnings on its interest free reserves. Thus, without additional income measures, the medium-term sustainability of the Fund's budget can be broadly considered in terms of alternative combinations of these two variables. Several such combinations are illustrated in Table 2.

Table 2. Income Generated Under Different Scenarios of Credit Outstanding and Precautionary Balances 1/
(In millions of SDRs)

Precautionary Balances	Fund Credit Outstanding			
	10,000	20,000	30,000	40,000
2,500	195	305	410	520
5,000	285	390	500	605
7,500	370	480	585	695
10,000	460	565	675	780

1/ Assumes a margin for the rate of charge of 108 basis points and an SDR rate of 3.5 percent; excludes service charges and surcharge income.

19. The first point to note is that the build up in reserves in recent years has significantly increased the resilience of the Fund's income position. While this increase was motivated primarily by concerns to protect the Fund against the credit risks associated with the earlier sharp expansion in its loan portfolio, the implicit contribution of precautionary balances to the Fund's income is currently projected at about SDR 250 million in FY07 and to increase further in subsequent years as noted above. If precautionary balances were still in the SDR 2-3 billion range, for example, the Fund's present income position would be significantly more serious. Conversely, if precautionary balances were already at the agreed target level of SDR 10 billion, the Fund would be able to cover operating expenses around

[11] Adjustments to rates of remuneration would be broadly similar, subject to the size of unremunerated positions and the current decision limiting adjustments to a floor on the rate of remuneration of 85 percent of the SDR rate. The Fund's Articles of Agreement set the floor for remuneration at 80 percent of the SDR rate.

their current size at credit levels of SDR 30 billion, and the income shortfall at significantly lower credit levels would be much smaller than currently projected.

20. The second point is that with precautionary balances around their current level of SDR 7.5 billion, a Fund budget in the order of SDR 700–750 million (Table 1) is not sustainable unless credit expands substantially from current levels. A credit base of about SDR 40 billion would be required to sustain a budget of this order. Conversely, if credit continues to decline to around SDR 10 billion, as projected in the central scenario discussed above, the sustainable budget would be only about SDR 370 million, well below projected levels, and not much more than half its current size.

21. These estimates assume that surcharge income continues to be used to accumulate reserves as at present. At low credit levels, surcharge income would likely also decline to very low levels, as shown in the baseline projections above, and thus would not significantly alter the picture presented here.

22. The Fund's GRA credit has been highly volatile in recent years, against the background of successive crises in several middle income economies. Until recently, that volatility has generally occurred around an upward trend. However, the sharp decline in credit over the past year has taken it well below the range that would normally be associated with such a path (Box 2). It is too early to know if this represents a continuation of the pattern of high volatility around a sizable and possibly increasing credit base, or a shift to a world in which the Fund's lending role may be more limited for an extended period. The Fund must be prepared for both scenarios, and prudence would require a strategy to cover the Fund's income needs in a low credit environment along the lines of the baseline scenario discussed above. This points to a need to broaden the Fund's income base, which would also be consistent with the thrust of the discussions to date under the review of Fund finances.

23. In the event that SDR 10 billion in credit outstanding becomes the central scenario over the longer term, a different financing structure would need to be adopted to ensure a sustainable income position. As previously noted in the review of Fund finances, options in this regard include (i) an annual levy or assessment in proportion to quotas, (ii) expanding the unremunerated reserve tranche positions (e.g., through the uniform adjustable norm): (iii) reducing the floor under the Articles for the rate of remuneration, and (iv) amending the Fund's investment authority. All of these steps would require changes in the Articles.

Box 2: Trends in Fund Credit Outstanding

During the past twenty-five years, Fund credit outstanding has followed a rising upward trend (see figure). Changes in GRA credit around this changing trend were driven by major systemic international developments (such as the debt crises in the early 1980s and the Asian crisis in the late 1990s), individual member country needs (such as in 1994–95 and in 2000–02), at times both systemic developments and members' needs (as during the economic and financial crises in the late 1990s), and members' exceptional access to Fund credit (beginning in the mid-to-late 1990s). The figure also shows the variability of Fund lending increased in the 1990s.

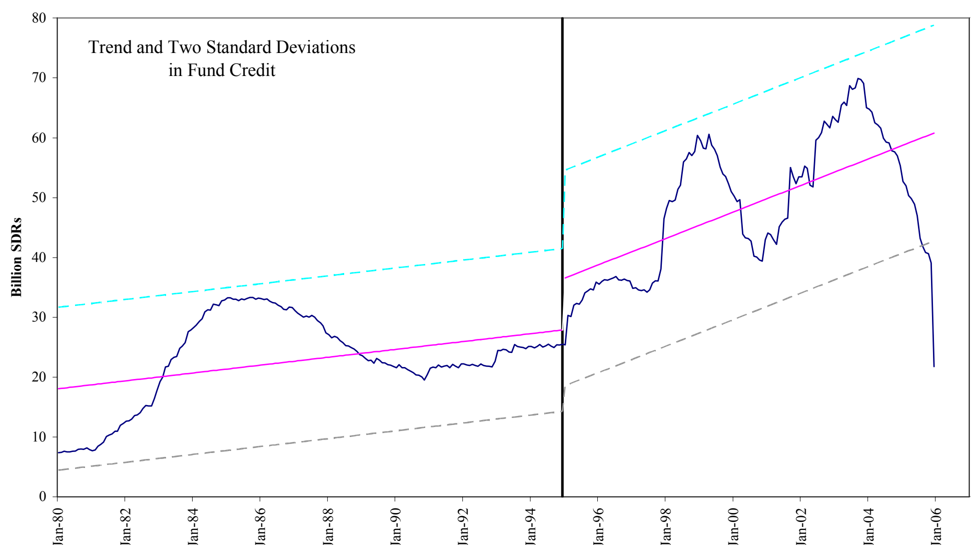
Previous statistical analysis suggests at least one structural break in the trend associated with the large access lending from the mid-1990s.[1] Most recently, credit outstanding has fallen sharply, to well below (two standard deviations) from the previous trend.

It is too early to assess whether the recent sharp decline in credit outstanding reflects a temporary cyclical development or the beginning of a new and lower trend. On the one hand, it is possible that better macroeconomic policies, more flexible exchange rates, and the accumulation of reserves by many members will lead to a structural decline in the demand for Fund financial resources. In that context, the large-scale lending since the mid-1990s could prove more of an aberration than a lasting trend. On the other hand, the recent decline in demand for Fund credit may instead reflect the outcome of a long period of accommodative global monetary policy and growing international imbalances. If this is the case, new latent risks and vulnerabilities may yet emerge from the tightening cycle that is underway.

More time, and further analytical work, will be needed to assess which of these scenarios is more likely, but a few observations can be made from past experience. First, even if an upward trend remains broadly valid, actual credit can remain below the trend line for an extended period, as occurred in the past. Second, exceptional access could lead to a rapid rise in Fund credit outstanding if a major crisis affects only a few large economies. And third, given the extent of the recent decline, such an event would likely be needed for Fund credit to move back to anything close to the previous longer-term trend line over a medium-term horizon.

[1]The figure shows a structural break in 1994–95, which is a statistical hypothesis that could not be rejected. Similarly, structural breaks earlier (1990) and later (1997, with the formal introduction of the exceptional access framework), respectively, also could not be rejected.

Fund Outstanding Credit, January 1980-December 2005 2/
(In Billions of SDRs)



Source: Finance Department
2/ End-December 2005 data are adjusted to reflect the early repayment by Argentina of its entire outstanding Fund credit on January 3, 2006.

IV. BROADENING THE INCOME BASE

24. A range of options has been considered to date for broadening the Fund's income base. This section revisits and where possible seeks to quantify these options.

25. **Investment Account**. The Articles provide for the establishment of an Investment Account to generate income to help meet the Fund's operating costs. The total amount that may be transferred to the Investment Account is equivalent to the Fund's reserves, which are currently close to SDR 6 billion (i.e., excluding balances in the SCA-1 of SDR 1.7 billion). These reserves represent the Fund's own resources, which have been accumulated over time. To date, these reserves have not been separately invested but rather are part of the currency balances kept with creditor members, thus reducing the Fund's costs of finance by reducing remunerated positions. As a result, the implicit return on these balances at present is the three-month SDR interest rate.

26. Investment of currencies in the GRA up to the amount of the reserves would be akin to the more normal operations of a financial institution, within the limits on the range of investments imposed by the Articles. In particular, staff has proposed a strategy of investing these balances in a portfolio of government securities, similar to the approach used for PRGF and HIPC resources. Past experience suggests that the resulting extension of investment maturities beyond the three-month SDR rate would generate additional income over time. While a certain degree of volatility in income is inevitable, a reasonable estimate of potential additional income from this source is about 50 basis points per annum, which would generate additional average annual income of about SDR 30 million.

27. The Board discussed the establishment of an Investment Account in September 2005. Most Directors expressed support, though some concerns were raised about return prospects in the current market environment. If the Board were to decide to proceed with a decision on the establishment and activation of an Investment Account, the staff stands ready to circulate a paper that lays out the basis for its establishment and funding.

28. **Gold Sales**. Some Executive Directors have called for the Fund to sell part of its gold holdings and invest the proceeds to generate additional investment income. This option is specifically foreseen under the Articles and could provide resources for placement to the Special Disbursement Account or the Investment Account to generate income to finance Fund activities. Indeed, the Special Reserve was created in 1957—with the proceeds from a gold investment program—to cover income shortfalls in the early years of the operation of the Fund. One possible approach would be to sell sufficient gold within an agreed timeframe to hold investments (both in the Special Disbursement Account and Investment Account) equivalent to the SDR 10 billion target for precautionary balances, which as noted would significantly strengthen the Fund's ability to maintain its operations under a range of credit scenarios. At current market prices, this could require a gold sales program of about 11–12 million ounces, or roughly 11 percent of the Fund's total holdings. Any such program would need to be carefully designed to limit any market impact. While such an approach appears

feasible operationally, it would require a decision adopted by an 85 percent majority of the total voting power.[12]

29. **Increase the Margin**. As noted, the current margin over the SDR rate charged on GRA lending is 108 basis points. This margin has been increasing steadily in recent years, and the current level represents a new high (Figure 1). Indeed, since 2002 when Fund credit peaked at SDR 70 billion, the margin has more than doubled. At the current SDR interest rate, it implies a borrowing rate of about 4 ½ percent, excluding surcharges on exceptional access, which is still well below the rates at which most member countries can borrow from private markets, suggesting that Fund credit remains relatively cheap for most borrowers.[13]

30. However, there are several qualifications to this conclusion in considering the extent to which the margin could be further increased as part of a response to the current income shock:

- First, there are limits in a cooperative institution to how far the cost of borrowing can or should be raised. An increase to anything like the levels implied by the current rules (see paragraph 14 above) would be totally out of line with past experience (the margin fluctuated in a relatively narrow band below 50 basis points in the 1990s and only recently rose above 100 basis points), and does not seem either feasible or desirable. This could make Fund credit, even at the basic rate of charge, relatively expensive for many borrowers.

- Second, given the rise in the margin in recent years, borrowing members have already borne part of the burden of the recent decline in the Fund's income.

- Third, for large access cases subject to surcharges (currently Turkey and Uruguay), the total cost of borrowing from the Fund is significantly higher than the basic rate of charge as they pay surcharges of 100–200 basis points on credit in the credit tranches over 200 percent of quota.[14] Thus, the marginal borrowing cost of Fund credit for these countries is around 310 basis points over the SDR interest rate, before burden-sharing adjustments. Particularly in a global environment of historically low private market borrowing spreads, further increases in the margin could be counter-

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[12] Issues relating to the possible modalities for gold sales were most recently discussed in *Financing Further Debt Relief for Low-Income Countries—Preliminary Considerations*.

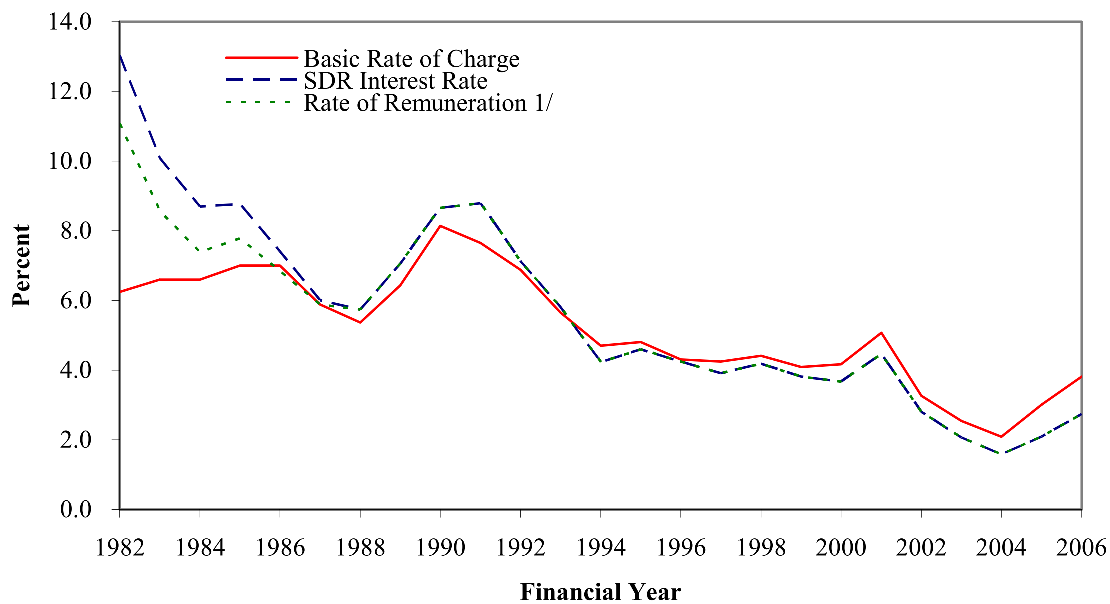
[13] As discussed in *Review of Charges and Maturities—Policies Supporting the Revolving Nature of Fund Resources*, the Fund's policies on charges aim, inter alia, at ensuring that members have access to financing that is appropriate to their balance of payments need, and preserving the revolving character of Fund resources.

[14] At present, there is no SRF credit outstanding.

productive from a stability perspective if they were to encourage these remaining large access cases to repay the Fund—in a cost-saving effort—before their economies are securely on a sustainable economic and financial footing (Annex II).

- Fourth, uncertainties associated with future fluctuations in the margin also risk making Fund credit less attractive to its borrowing members, which could adversely affect the Fund's ability to fulfill its role.

Figure 1. Average SDR Interest Rate, Basic Rate of Charge, and Rate of Remuneration
FY 82–06
(in percent)



Source: IMF Finance Department.
1/ Since FY 88, the rate of remuneration has been 100 percent of the SDR interest rate.

31. Estimates of the additional income that would be generated by further increases in the margin are presented in Table 3. As can be seen, at current credit levels, an increase in the margin by 10–20 percent could generate additional income of about SDR 20–40 million.

Table 3. Income Generated from Changes in the Margin
Under Different Scenarios for Credit Outstanding
(In millions of SDRs)

	Fund Credit Outstanding			
	10,000	20,000	30,000	40,000
Additional income generated from an increase in the margin of about:				
10 percent (i.e., to 119 basis points)	11	22	33	44
20 percent (i.e., to 130 basis points)	22	44	66	88

32. **Reduce Remuneration**. The Fund's Articles permit remuneration to be paid at between 80 and 100 percent of the SDR interest rate. Since FY88, remuneration has been paid at 100 percent of the SDR interest rate (before adjustment for burden-sharing). A reduction in this coefficient to below 100 percent would have the effect of increasing the effective contribution of creditor members to meeting the cost of the Fund's operations.

33. Such a measure would reduce the Fund's burden sharing capacity, and could also adversely affect the Fund's financing mechanism, if it were to be viewed by central banks and their auditors as adversely affecting the attractiveness of maintaining reserve tranche positions. These concerns point to limits in the extent to which remuneration could be reduced, though there may still be scope to use the flexibility provided under the Articles, at least temporarily, in response to the current income shock. In this regard, it may be noted that the effective rate of remuneration is already less than 100 percent (because of unremunerated positions, the relative importance of which has declined gradually over time), and that the rate of remuneration was set at less than 100 percent of the SDR rate prior to FY88.

34. The potential savings from such a measure depend on the level of Fund credit. As the credit base declines, so does the level of remunerated reserve tranche positions. Table 4 illustrates the savings that could be generated from alternative reductions in the rate of remuneration below 100 percent of the SDR rate.

Table 4. Savings Generated by Changes in the Rate of Remuneration
Under Different Scenarios for Credit Outstanding
(In millions of SDRs)

	Fund Credit Outstanding			
	10,000	20,000	30,000	40,000
Savings generated from a reduction in the rate of remuneration to: 1/				
95 percent of the SDR rate	6	23	41	58
90 percent of the SDR rate	12	47	82	117
85 percent of the SDR rate 2/	12	70	123	175
80 percent of the SDR rate 2/ 3/	12	82	152	222

1/ Assumes an SDR interest rate of 3.5 percent and a constant difference between the amount of Fund credit outstanding and remunerated reserve tranche positions of SDR 6.6 billion.
2/ Because of the need to maintain a cushion for burden-sharing of estimated deferred charges (SDR 12 million), under a scenario of SDR 10 billion in credit outstanding, there are no additional savings generated from reducing the rate of remuneration below 90 percent of the SDR rate.
3/ After allowing for an assumed SDR 12 million in burden-sharing for deferred charges.

35. **Medium-Term Strategy Review**. The Fund's role continues to evolve, which may suggest a need to explore and develop a stream of additional income sources as an integral part of the Fund's overall strategic orientation in the medium term. This could build on the proposals of the strategic review groups and include examination of the scope for additional income from the following sources:

- *External Financing*. The Fund already receives over SDR 25 million annually in external financing from donors. A management-chaired task force is examining the broad policy and strategic framework for external financing, and there may be scope for increasing recourse to such financing.[15] One possibility could be the establishment of a trust fund to hold donor support for technical assistance activities, along the lines discussed above. Members may also be willing to contribute subsidy resources through deposits in a new administered account at below market interest rates, similar to the approach used for mobilizing PRGF subsidy resources.

- *User Fees*. The Fund provides a number of services and products to the membership at no cost, and charging fees for some of these services, where permissible under the Articles of Agreement, could be considered. Building on the strategic review group on capacity building, options could be developed for user fees to allow full or partial

[15] Additional financing by such sources is potentially volatile and often subject to specific donor requirements.

cost recovery for some of these activities. Given that a significant part of these activities are delivered to low-income countries, mechanisms would also need to be developed to defray the costs for such members, such as by seeking subsidies from other members who view financing the Fund's provision of such services as an effective use of available grant resources.

- *Commitment Fees*. The Fund has substantial quota-based financial resources available to assist member countries. At the current fee structure, precautionary arrangements of SDR 10 billion could generate up to SDR 25 million per annum in fees. Possible adaptations of the Fund's financial instruments to assist the changing needs of members were reviewed by the strategic review group on the Fund's role in emerging markets. Charges for such instruments could contribute to broadening the Fund's income base.

V. Modifying the Accumulation of Reserves

36. Precautionary balances (i.e., reserves and the SCA-1) are held to mitigate the Fund's financial risks (Box 3). The current strategy for reserve accumulation involves the annual placement to reserves of two income sources: (i) net surcharge income placed to the General Reserve, and (ii) net income (i.e., the net income target, if achieved) placed to the Special Reserve. Balances are also accumulated in the SCA-1 through the burden-sharing mechanism; notably, under current decisions, an annual amount of SDR 94 million representing the estimated annual cost of the 1999–2000 off-market gold transactions.

37. In 2002, the Board adopted a target for precautionary balances of SDR 10 billion, which was reaffirmed in 2004. Precautionary balances have since increased from SDR 4.5 billion at the time the target was adopted to around SDR 7.5 billion currently (Annex III).

Box 3. The Fund's Precautionary Balances

Precautionary balances comprise reserves and the Special Contingent Account (SCA-1).

The Fund's reserves comprise the Special Reserve and the General Reserve and have three main functions: (i) to protect the Fund's financial position against credit risk and risk of operational losses; (ii) to demonstrate, through the achievement and retention of net income, the soundness and prudence of the institution's financial management; and (iii) to augment the Fund's liquidity.

Special Reserve

The Special Reserve was established in 1957 with the proceeds from a gold investment program to provide safeguards against deficits in the Fund's operations. Deficits were subsequently charged against the Special Reserve. Additions to the Special Reserve have been financed out of net income (other than income derived from surcharges). The Fund may use the Special Reserve for any purpose for which it may use the General Reserve, except distribution.

General Reserve

In 1958 it was decided to refer to the reserves contemplated in Article XII, Section 6 (a) where net income could be placed as "General Reserve" to distinguish it from the "Special Reserve" established for the income generated from the gold investments program. The General Reserve is available to meet losses of a capital character or administrative deficits. Additions to the General Reserve have been made since FY 1998 from income derived from surcharges under the Supplemental Reserve Facility, in the credit tranches, and under the Extended Fund Facility.

SCA-1

This account was set up in 1987 to protect the Fund against the risk of loss arising from the ultimate failure of members to settle their overdue principal obligations in the GRA.

- *Allocations to the Account*: The SCA-1 was initially funded with a modest amount of income in excess of the target the Fund realized in FY87. Subsequently, and until FY01, the Fund allocated to the SCA-1 annually an amount equal to 5 percent of its reserves. Since then, the addition to the SCA-1 has been set at SDR 94 million, the amount representing the reduction in the net income target from the gold mitigation.
- *Uses of SCA-1 resources:* Should the Fund realize a loss resulting from the ultimate failure of a member to repay its overdue principal in the GRA, the loss would first be charged against the SCA-1. All contributors would bear the burden of the loss in proportion to their cumulative contributions to the SCA-1.
- *Dissolution and Refunds:* The SCA-1 would be dissolved and the resources would be distributed to all members in proportion to their cumulative contributions when there are no overdue GRA charges or principal balances. The Fund could also decide to make an early distribution.

38. **Slowing Reserve Accumulation**. Some of the available options to broaden the Fund's income base may take time to develop and will only provide additional income over the medium term. Thus, a pause in the agreed strategy for accumulating precautionary balances may be appropriate in the short term while such measures are being evaluated and put in place. This would also provide further time to assess the prospective future path of Fund credit. A variety of steps could be considered along these lines, which would slow or even halt the pace of reserve accumulation in the short term.

39. For the net income target, two changes in its computation could be considered within the current rules (Table 5):

- *Rebasing*. Executive Directors have noted during the review of Fund finances that the net income target has become distorted by decisions taken to achieve different objectives. In particular, the accumulation of surcharge income in the Fund's General Reserve has increased the base upon which the net income target is calculated. Rebasing the target to exclude the General Reserve would reduce the net income target by about SDR 160 million.

- *Eliminate Carryovers*. The current estimate of the FY06 income shortfall is SDR 80 million, largely attributable to the advance repurchases by Brazil and Argentina. Current practice is to increase the next year's net income target with shortfalls from the current financial year.[16] The FY07 net income target could be reduced by further SDR 80 million if it were decided to change current practice and exclude the carry over of the income shortfall from FY06.

Table 5. Slowing the Pace of Reserve Accumulation
(In millions of SDRs)

		Medium-term projections		
		FY07	FY08	FY09
A.	Projected income shortfall (from Table 1)	-442	-430	-496
B.	Changing the net income target	237	161	162
	Rebasing (exclude the impact of accumulated surcharge income)	157	161	162
	Eliminating the carryover of the FY06 shortfall	80	--	--
C.	Suspend the remaining net income target 1/	45	58	69
D.	Use net surcharge income to pay for administrative expenses	66	20	1
	Surcharge income	124	80	64
	Less: PRGF administrative expenses	-58	-60	-63
E.	Remaining income gap (A+B+C+D)	-94	-191	-264

1/ Assumes a net income target of SDR 1 million for consistency with the current rule.

[16] Rule I-6(4) does not require the carryover of an income shortfall—the Executive Board has discretionary power to determine the subsequent net income target "in light of the results in the previous financial year."

40. Both the above options would still leave a positive target for net income and therefore reserve accumulation in FY07. A further option for slowing reserve accumulation would be to effectively suspend the net income target. This could be achieved under existing rules by setting the target at some token nominal amount.[17]

41. Reserve accumulation could also be slowed through a change in the treatment of surcharge income. In accordance with existing Board decisions, surcharge income is currently placed directly to reserves, except for that portion used to pay for PRGF administrative expenses. As part of an agreed package, the Board could decide temporarily to use surcharge income as a source of finance for administrative expenses more generally. The amount of financing available from this source would depend on future decisions governing the reimbursement of the PRGF administrative expenses to the GRA from the PRGF Trust.[18] If such reimbursements were reintroduced, the contribution of surcharge income to covering the Fund's administrative budget would be commensurately higher, but this would come at the expense of a reduction in the available resources for subsidized financing to low income countries.

42. **Suspending SCA-1 Accumulations**. A further option is to suspend the current practice of burden-shared contributions to SCA-1 for gold mitigation. As noted, this practice implies an annual accumulation of SDR 94 million, shared equally between creditor and debtor members. Several considerations suggest this approach could be slowed or abandoned, and possibly replaced by an alternative more suitable mechanism:

- As highlighted above, the declining credit base accentuates the necessary burden-sharing adjustments, which could be as high as 60 basis points over the medium term.

- In the case of borrowing members, the SDR 47 million collected through the rate of charge is borne by only a few countries. In contrast, the SDR 47 million collected through the rate of remuneration is shared by the much larger number of countries in the Financial Transactions Plan.

- The capacity of the burden-sharing mechanism in the case of remuneration (because of the floor on remuneration of 80 percent of the SDR rate) would likely prove insufficient to generate SDR 47 million by FY09 under the baseline credit scenario.

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[17] Rule I-6(4) requires the net income target to set as a "percent of reserves" which would preclude a net income target of zero.

[18] If the Reserve Account of the PRGF Trust (which was established with resources transferred from the SDA) is used for PRGF lending, there is a legal requirement under the Articles for the GRA to be reimbursed for the expenses that would arise from the administrative cost of such loans.

- More fundamentally, the current approach is not appropriate as it involves using a refundable mechanism (related to arrears clearance) to cover a permanent increase in the Fund's costs. Also, the recent use of the proceeds of the 1999–2000 off-market gold transactions (held in the SDA) in the context of the MDRI adds to the case for finding a more permanent arrangement that is both simpler and more transparent.

43. One possible approach would be to simply suspend gold mitigation. This would increase the effective rate of remuneration (after burden sharing) for creditors and reduce the effective rate of charge for borrowers, at the expense of the corresponding accumulation of precautionary balances. This could be combined with offsetting adjustments in the rate of remuneration, within the scope provided by the Articles, and the rate of charge along the lines discussed earlier as part of the response to the current income shortfall.

44. **Drawing Down Reserves**. The Fund has met temporary losses in the past by drawing down capital and reserves while it adjusted to new environments and could do so again (Annex IV).[19] This is clearly not a desirable scenario, and it will therefore be important to bolster the income position in a timely manner.

45. **Possible Approach.** In sum, an approach along the lines discussed above has the potential to cover the income shortfall currently projected for FY07 and potentially over the medium term. This could involve some combination of (i) activation of the Investment Account; (ii) suspension of gold mitigation, a slowing or pause in reserve accumulation through the setting of a notional net income target, and possibly temporary use of surcharge income to cover operating expenses; (iii) at least offsetting reductions in the rate of remuneration and increases in the rate of charge; and (iv) steps to explore the possible introduction of alternative income-broadening mechanisms. The last option would become particularly important if credit continues to decline, as the other measures would not be sufficient to cover the Fund's operating needs in the outer years under this scenario.

VI. Next Steps

46. Some policy changes appear inevitable given current prospects for the Fund's income position.[20] Generating income for FY07 is an immediate priority and a decision on the rate of charge will be needed by end-April. In this regard, options for Board consideration could involve a combination of the following elements:

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[19] Past periods of losses at the Fund have been followed by major policy changes: the early losses in the Fund's history led to the gold investment program of the 1950s; the losses in the 1970s led to the overhaul of the Fund's financing mechanism under the Second Amendment of the Articles, while the loss in the early 1980s led to the introduction of burden-sharing.

[20] See Annex V for a summary of the options for changes in existing policies discussed in this paper.

- The establishment and funding of the Investment Account,
- A reformulation of the computation of the net income target,
- Adjustments to the rate of remuneration and the margin, and
- A temporary slowdown or suspension in the pace of accumulation of reserves and the SCA-1.

47. One possible package could involve maintaining the effective rate of charge and rate of remuneration (i.e., including burden-sharing adjustments) at their current level, while establishing and funding the Investment Account (Table 6). The effective margin in FY06 has been in the order of 125 basis points after burden-sharing for the SCA-1 and deferred charges (see Table 1 above). If the Board were to decide not to renew the decision to accumulate further balances in the SCA-1, the reduced burden-sharing adjustments could facilitate a nominal increase in the margin, without increasing the effective rate of charge beyond the current level. For example, an increase in the margin to 125 basis points, which would generate around SDR 30 million in FY07, could be accommodated by suspending SCA-1 accumulations.[21] Similarly, the current SCA-1 burden sharing adjustments to the rate of remuneration could be used to help close the projected income gap by an equivalent amount of SDR 30 million. This package, in conjunction with the Investment Account, could bring the FY07 income outlook on current projections into broad balance.

[21] SCA-1 burden-sharing adjustments are determined quarterly based on average balances of credit outstanding and remunerated reserve tranche positions. As reflected in Table 1, average adjustments to the rate of charge for FY06 as a whole are projected at around 15 basis points.

Table 6. Closing the Income Gap
(In millions of SDRs)

		Medium-term projections FY07	FY08	FY09
A.	Projected income gap (from Table 5)	-94	-191	-264
B.	Policy options	90	81	60
	Establish the Investment Account 1/	30	30	30
	Increase the margin 2/	30	23	17
	Reduce remuneration 2/	30	23	8
C.	Remaining income gap (A+B)	-4	-110	-204
	Memorandum Items:			
	Remaining income gap as a percent of administrative expenses	--	16	28
	Remaining income gap as a percent of reserves	--	1.9	3.5

1/ Assumes average annual incremental return of 50 basis points.
2/ Increase in the margin and reduction in the rate of remuneration offset by the suspension of further accumulations in the SCA-1; adjustments in FY08 and FY09 are limited by the floor on the rate of remuneration of 80 percent of the SDR rate, after allowing for existing burden-sharing for deferred charges.

48. However, this package would not on current projections be sufficient over the medium term. As part of this approach, therefore, it would be important to set in motion further work on other aspects of the Fund's finances. In particular:

- Putting in place new revenue mechanisms as described earlier in paragraph 35.
- Further examination of options to use the Fund's own resources, including its gold holdings, to generate income.
- Continued analysis of the adequacy of precautionary balances and the future demand for Fund credit.
- Development of a medium-term strategy and budget that is explicitly linked with the medium-term income framework.
- Reconsideration of the rules for setting the margin for the rate of charge; in particular, it may be desirable to shift the current rules-based system for setting the net income

target to a medium-term time-frame, with a defined objective for longer-term reserve accumulation.[22]

VII. Issues for Discussion

49. This paper has outlined the Fund's medium-term income outlook under current policies, which suggests that the current cost-plus system for setting the rate of charge is not sustainable in a low-credit environment. This scenario had been anticipated, albeit not this soon, under the ongoing review of Fund finances, which was already considering options to place the Fund's income position on a more durable footing. A sustainable income position for the Fund, irrespective of the level of Fund credit outstanding, will require additional revenue sources, including those that are more reflective of the evolution in the Fund's activities. Against this background:

- Do Directors agree that the Fund needs a stable and durable source of financing? Do Directors agree that this will require developing proposals for financing the Fund in an environment of continued low demand for Fund credit?

- Do Directors agree on the need to avoid a sharp increase in the rate of charge for FY07? Do Directors agree on the need to modify the rules for setting the rate of charge in FY07?

- Do Directors agree on implementing the set of measures needed to close the financing gap in FY07? Specifically: What are Directors' views on the package of options that could close the income gap in FY07? Are Directors ready to make a decision on the establishment of the Investment Account? Would Directors support a reduction in remuneration in FY07, in conjunction with the suspension of accumulations in the SCA-1? Do Directors consider that there is scope for increasing the margin in FY07 on the same basis?

- What are Directors' views on (i) the feasibility of generating income through user fees for services provided by the Fund, (ii) the scope for increased external financing by donors, and (iii) charges on new financing instruments (e.g., commitment fees)? Do Directors see other opportunities for generating additional revenue from Fund activities?

[22] The amended system would need to retain discretionary elements to allow the Board to make needed adjustments (e.g., to the margin) as a result of unexpected outcomes and to conduct periodic income reviews in conjunction with budgetary decisions.

Annex I. Linking the Analytical Presentation with the Fund's Income Statement

Table 1 of this paper (see page 6) presents a different formulation of the Fund's income and expense flows from the traditional format that has been presented in previous income reviews, which is based on the Fund's financial statements.[23] Overall, of course, the projected net regular income position is the same in both tables: SDR 108 million.

The purpose behind developing a new format was to present a simpler analytical framework that succinctly captures the main variables that drive the Fund's income position. To this end, the new presentation focuses on the net contribution made by the Fund's main income-earning assets, namely Fund credit and the so-called interest-free resources. At the present time, the latter are essentially equivalent to the Fund's precautionary balances (i.e., the total of the General and Special Reserves and the SCA-1).

For analytical purposes, gross flows of income and expense that are closely related have been netted. The starting point for moving from the traditional format to the new format, therefore, is to net financing costs (i.e., remuneration) against the income generated from Fund credit and the GRA's SDR holdings.[24] Thereafter, the main adjustments involve a re-arrangement of the various line items on the Fund's traditional income statement. Specifically (see attached Table):

- **Adjustment (i)**. This nets the financing cost of the estimated average balance of credit outstanding of SDR 35.8 billion at the average SDR interest rate of 2.74 percent against the associated remuneration expense (i.e., SDR 981 million). Similarly, the interest earned on SDR holdings is netted against the associated remuneration expense.

- **Adjustment (ii)**. This reclassifies the service and stand-by charges to reflect this income together with the *net* contribution from charges on Fund credit.

- **Adjustment (iii)**. This reclassifies the SRP funding costs as administrative expenses to reflect the *gross* impact of the administrative and capital budgets. In the traditional presentation, the funding costs had been *excluded* from the definition of administrative expenses for purposes of setting the rate of charge because these costs were paid for out of an earmarked reserve.[25]

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[23] The most recent presentation of the traditional format can be found in Table 1 of *The Fund's Income position for FY 2006—Update to the Midyear Review*.

[24] Under the Fund's financing mechanism, the marginal cost of financing is the rate of remuneration, currently payable at the SDR interest rate.

[25] Annex VII of *Review of the Fund's Income Position for FY 2005 and FY 2006* reconciles the administrative and capital budgets with administrative expenses, reflecting the exclusion of the SRP funding cost of SDR 76 million. While this cost has been excluded from the

(continued)

- **Adjustment (iv)**. This removes the burden-sharing adjustments to reflect the net position.

After making the above adjustments, the negative balance for remuneration reflects the implicit contribution of the Fund's interest-free resources to savings in remuneration expense. In FY06, these balances are estimated at an average of SDR 7.6 billion, resulting in remuneration savings of SDR 210 million at the average SDR rate of 2.74 percent.

Table 1. Reconciliation of Traditional and Analytical Presentations of Projected Income and Expense
Financial Year 2006

(In millions of SDRs)

	FY 2006	Adjustments				
		(i)	(ii)	(iii)	(iv)	
	Updated Revised Projections 1/	Net Financing Costs	Reclassify Service Charges	Reclassify SRP Funding	Burden-Sharing	Analytical Presentation 2/
Regular Income						
1. Operational Income						
a. Periodic charges, including burden sharing	1,363	(981)	21		7	410
b. Interest on SDR holdings	25	(25)				0
c. Service and stand-by charges:	21		(21)			(0)
Total operational income	1,409					
2. Operational Expense						
Remuneration, including burden sharing	789	(1,006)			7	(210)
3. Net operational income	620					
4. Administrative expense	570			76		646
Less: estimated cost of administering the PRGF Trust	(58)					(58)
	512					
5. Regular net income	108					
Payment of SRP funding out of special reserve				(76)		(76)
						108

1/ As reported in Table 1 of The Fund's Income Position for FY 2006--Update to the Midyear Review.
2/ As reported in Table 1 of the main body of this paper.

administrative expenses used for the computation of the rate of charge, it is nevertheless reflected as part of the IAS 19 expenses in the Fund's financial statements.

Annex II. Cost of Credit: Markets and the Fund 1994–2005

Many factors affect a member's borrowing and repayment decisions.[26] This appendix examines Fund charges and market rates facing Fund members. It provides an assessment of early repayment incentives for the overall Fund portfolio.

It is important to note that the comparison of Fund charges and market rates is not straightforward. This is not only due to differences in the currency denomination, the interest rate type (fixed and flexible rates) and maturities between Fund and market instruments, but also due to the Fund's charge structure (e.g., the recent implementation of the non-linear high access surcharges), the burden sharing mechanism, and the Fund's preferred creditor status.

Although as noted, caution is required in making comparisons, Figure 1 shows that the costs of borrowing from the market[27] and the Fund for an average emerging market economy have come closer in the last decade as a result of lower emerging market rates and the introduction of level based surcharges[28] by the Fund in 2000. The differential between market rates and the maximum credit tranches rate has narrowed. The average U.S. dollar-denominated market rate that members face on average has fallen below the maximum SRF Fund rate.

It is also noteworthy that the share of euro-denominated debt in the total external public debt for some Fund members is significant. The euro-denominated market rate has fallen below the maximum cost of credit from the Fund under both the SRF and the credit tranches, although these market rates do not capture the potential increase that could result if substantial amounts of new debt were to be issued in the market. Data limitations rule out calculation of an average euro-denominated index composite for large users of Fund credit (bottom panel of Figure 1).

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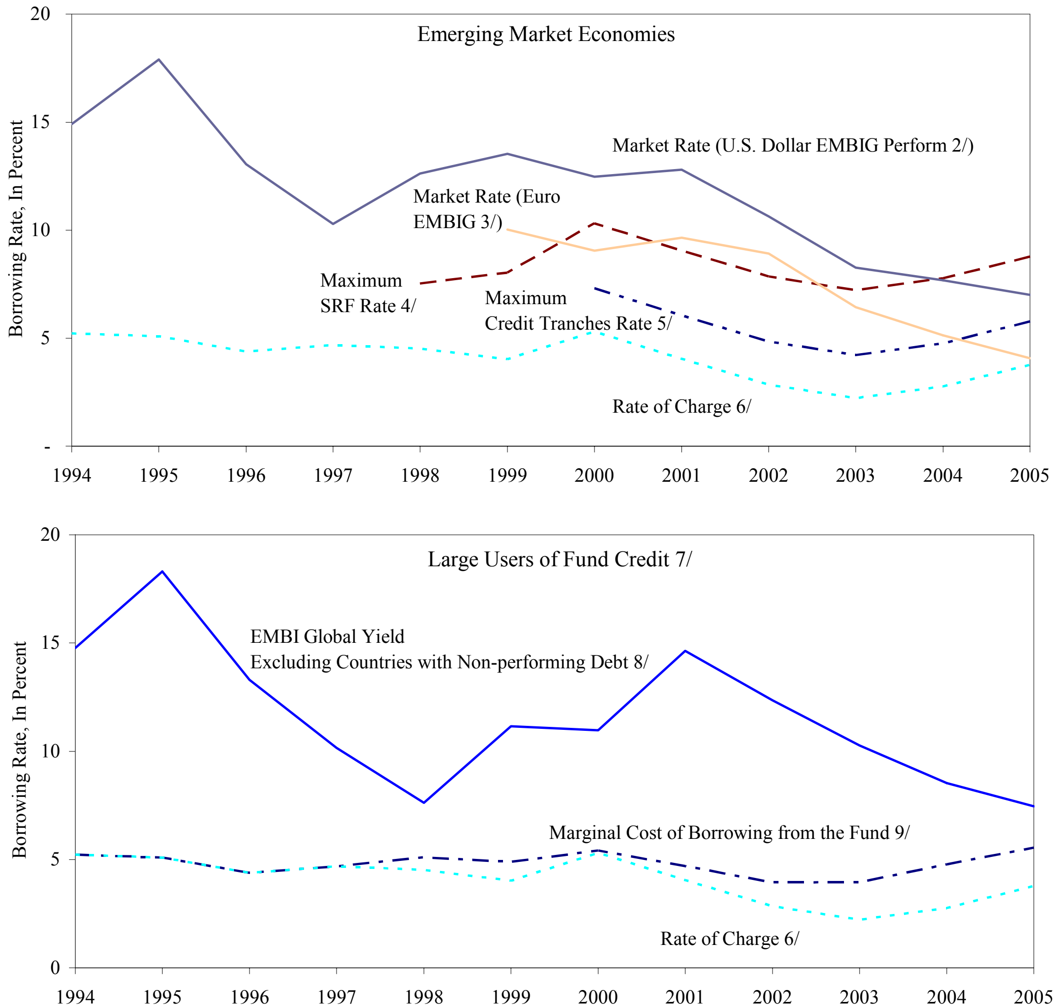
[26] See *Review of Charges and Maturities—Policies Supporting the Revolving Nature of Fund Resources*.

[27] The U.S. denominated EMBIG perform index and the euro-denominated Euro EMBIG index are used as the market rates. See Figure 1 for a detailed description of these indexes.

[28] After November 28, 2000 holdings of a member's currency arising from purchases made in the credit tranches and under the Extended Fund Facility that exceed 200 percent of the member's quota are subject to surcharges of 100 basis points over the basic rate of charge and holdings above 300 percent of quota are subject to a surcharge of 200 basis points above the basic rate of charge.

Figure 1. Cost of Credit: Markets and the Fund, 1994-2005 1/



Source: J.P. Morgan, Finance Department, and IMF International Financial Statistics

1/ The cost of borrowing from the markets on U.S. dollar terms is approximated by the EMBIG Perform yield to maturity and the cost of borrowing on euro terms is approximated by the Euro EMBIG yield to maturity. The cost of Fund credit is based on the rate of charge (adjusted for burden-sharing) and Fund surcharges.
2/ Stripped EMBIG Perform is a subindex of the EMBI Global (EMBIG) that takes only the performing debt instruments into account and is stripped of collateralized debt. Annual average for the yields are shown.
3/ J.P. Morgan's Euro EMBIG yield to maturity.
4/ The maximum rate of charge for a member with credit under the SRF.
5/ The maximum rate of charge for a member with credit under the credit tranches and/or the EFF.
6/ Annual average of the basic rate of charge adjusted for burden-sharing.
7/ Top 20 users of Fund credit, based on average annual credit outstanding in the GRA.
8/ For the top 20 users of Fund credit with available EMBIG yields weighted by average credit outstanding. Excludes countries with some form of domestic or external non-performing public debt (Russia between 1999-2000, and Argentina from 2002 onwards).
9/ The marginal cost of Fund credit is a weighted average of marginal costs across the top 20 users of Fund credit with available EMBIG yields and facilities, using average monthly credit outstanding as weights. A member's marginal cost is defined as the highest surcharge rate applicable under the relevant facility plus the adjusted rate of charge. Credit outstanding in the credit tranches to which the surcharge policy does not apply is treated like a separate facility.

Annex III

The Fund's Precautionary Balances in the GRA, 1990–2005

	End of					
	Financial Year				December	December
	1990	2000	2004	2005	2002	2005
	(In billions of SDR)					
Precautionary balances	1.6	4.0	6.4	7.2	5.2	7.6
Reserves	1.4	2.8	4.9	5.6	3.8	6.0
General	0.4	0.9	2.7	3.3	1.7	3.5
Special 1/	1.0	1.9	2.2	2.4	2.2 4/	2.5
SCA-1	0.2	1.1	1.5	1.6	1.4	1.7
SCA-2	--	--	--	--	--	--
Free reserves 2/	-1.0	3.1	5.6	6.5	4.5	7.0
Memorandum items:						
Credit capacity 3/	60.2	150.8	164.1	170.1	162.6	170.5
Credit outstanding	22.1	43.9	62.2	49.9	63.6	21.8 5/
Credit in good standing	19.5	43.0	61.4	49.1	62.9	21.2 5/
Arrears	3.4	1.9	1.8	1.8	1.7	1.7
Principal	2.6	0.9	0.8	0.7	0.7	0.6
Charges	0.8	1.0	1.0	1.0	1.0	1.0
	(In percent)					
Ratios of:						
Precautionary balances to credit capacity	2.7	2.6	3.9	4.3	3.2	4.5
Precautionary balances to credit outstanding	7.2	9.0	10.2	14.5	8.1	35.0
Free reserves to credit capacity	-1.6	2.0	3.4	3.8	2.8	4.1
Free reserves to credit in good standing	-5.0	7.1	9.1	13.2	7.2	33.1

Source: IMF Finance Department.

1/ After adjusting for IAS 19 related accounting gains. Adopted 2000.

2/ Precautionary balances in excess of arrears on principal and SCA-2.

3/ Quotas of members in the FTP and resources available under NAB/GAB, excluding the prudential level of uncommitted usable resources. Credit capacity is approximated by quotas of FTP participants.

4/ Net income accumulation to special reserve until Dec 2002 does not take into account the refund of the excess income for FY03 of SDR 56 million.

5/ End-December 2005 data reflects the early repayment by Argentina of its entire outstanding Fund credit on January 3, 2006.

Annex IV

General Resources Account
Historical Information

FY	Use of Fund Credit 1/ (In millions of SDRs)	Average SDR Interest Rate 2/ (In percent)	Average Rate of Charge 3/ (In percent)	Average Rate of Remuneration 4/ (In percent)	Annual Net Income (In millions of SDRs)	Annual Administrative Expenses 5/ (In millions of SDRs)
1946	-	-	-	-	-	-
1947	69	-	-	-	(2)	2
1948	161	-	-	-	2	3
1949	204	-	-	-	(2)	4
1950	176	-	-	-	(2)	4
1951	176	-	-	-	(2)	4
1952	176	-	-	-	(2)	5
1953	182	-	-	-	(1)	5
1954	97	-	-	-	-	5
1955	65	-	-	-	(3)	5
1956	422	-	-	-	(4)	5
1957	955	-	-	-	8	5
1958	1,076	-	-	-	12	6
1959	409	-	-	-	20	7
1960	420	-	-	-	14	7
1961	1,437	-	-	-	7	7
1962	1,004	-	-	-	25	8
1963	1,088	-	-	-	21	9
1964	1,436	-	-	-	23	11
1965	3,024	-	-	-	26	13
1966	3,021	-	-	-	45	15
1967	2,482	-	-	-	50	18
1968	3,688	-	-	-	56	21
1969	4,011	-	-	-	71	24
1970	3,232	1.50	-	1.50	58	29
1971	4,117	1.50	-	1.50	46	33
1972	2,948	1.50	-	1.50	(13)	37
1973	3,593	1.50	-	1.50	(22)	39
1974	3,469	1.50	-	1.50	(37)	43
1975	6,633	4.42	-	3.09	(10)	46
1976	12,071	3.90	-	3.60	(3)	54
1977	16,068	3.83	-	3.83	(18)	63
1978	13,934	3.56	-	3.56	27	68
1979	10,270	4.59	-	4.39	46	71
1980	8,884	7.87	-	7.08	3	83
1981	9,862	9.45	-	8.50	80	101
1982	14,801	13.03	6.25	11.08	92	144
1983	23,590	10.09	6.60	8.58	65	191
1984	31,742	8.69	6.60	7.39	73	193
1985	34,973	8.77	7.00	7.78	(30)	224
1986	34,640	7.40	7.00	6.84	78	223
1987	31,646	6.01	5.89	5.89	86	191
1988	27,829	5.74	5.37	5.74	49	175

General Resources Account
Historical Information
(concluded)

FY	Use of Fund Credit 1/ (In millions of SDRs)	Average SDR Interest Rate 2/ (In percent)	Average Rate of Charge 3/ (In percent)	Average Rate of Remuneration 4/ (In percent)	Annual Net Income (In millions of SDRs)	Annual Administrative Expenses 5/ (In millions of SDRs)
1989	23,700	7.05	6.43	7.05	54	173
1990	22,098	8.66	8.14	8.66	86	189
1991	22,906	8.79	7.65	8.79	70	189
1992	23,432	7.12	6.88	7.12	90	232
1993	24,635	5.81	5.65	5.81	71	263
1994	25,533	4.23	4.70	4.23	74	318
1995	32,140	4.60	4.81	4.60	85	288
1996	36,268	4.25	4.31	4.25	89	301
1997	34,539	3.91	4.25	3.91	94	317
1998	49,701	4.18	4.41	4.18	164	368
1999	60,595	3.82	4.09	3.82	436	392
2000	43,913	3.67	4.17	3.67	536	448
2001	42,219	4.46	5.07	4.46	175	385
2002	52,081	2.80	3.26	2.80	360	531
2003	65,978	2.06	2.54	2.06	646	607
2004	62,153	1.58	2.09	1.58	824	549
2005	49,854	2.09	3.01	2.09	613	673
2006 6/	20,312	2.74	3.82	2.74	210	706

Source: IMF Finance Department.

1/ Use of Fund credit prior to 1971 is scheduled on a calendar year basis.

2/The SDR interest rate, which was originally set at 1.5 percent, was increased in July 1974 to 5 percent for the 6 month period ended December 1974. After this period and until 1976, the SDR interest rate was determined in relation to a combined market rate (i.e. the "basket") and set in accordance with a formula. In July 1976, the SDR interest rate was set at 60 percent of the combined market rate, and in January 1979, it was increased to 80 percent of the market rate. Since May 1981, the SDR interest rate has been set at 100 percent of the combined market rate.

3/ Prior to 1982, the rate of charge calculation was based on the amount and the maturity of credit outstanding. Calculations exclude surcharges.

4/ The original Articles of Agreement did not provide for the payment of remuneration prior to 1970. Instead, the Fund was authorized to make discretionary distributions of net income.

5/ Includes the impact of IAS 19 accounting since FY 01, which increased volatility in administrative expenses.

6/ FY 2006 balances are based on actual results to November 2005 and projections for the remainder of the year, except for credit outstanding which has been updated to reflect the advance repurchases by Brazil and Argentina.

Annex V. Options for Adjusting to a Low Credit Environment

Option	Comments
Slow reserve growth; drawdown reserves	Temporary palliative. Erodes income generating capacity. Reserves would need to be rebuilt in event of renewed demand for Fund credit. Prolonged recourse to reserves would raise reputation risks.
Suspend mitigation of off-market gold transaction	Method of permanently mitigating impact of the 1999–2000 gold transaction on the GRA would need to be identified.
Reduce rate of remuneration	Scope for reduction limited as rate of remuneration must be at least 80 percent of SDR interest rate. Yield function of credit outstanding.
Reduce administrative expenditures	Would need to be considered in context of Fund's medium-term strategy; outside scope of present review.
Invest profits of gold sales	Would increase the income generating capacity of the Fund's balance sheet. Would convert an illiquid asset into a liquid one whose preservation would need to be safeguarded. Sales would need to be approved by 85 percent of the total voting power, and be phased to limit market impact.
Investment Account	Potential to boost and diversify income over time, with risk of volatility from year to year. Investment income potential currently a function of reserve level and investment performance. Gold sales would boost income potential.
Increase rate of charge margin	Scope for margin increases limited by the Fund's role as a cooperative financial institution and the cost of alternative sources of funding. Yield function of credit outstanding.
Fees for services	Scope for charging membership for services provided by the Fund is limited by the public good aspect of Fund services and, in the case of some members, by the capacity to pay.
Third-party financing	Increasing donor financing of technical assistance provided by the Fund could take the form of grants or the endowment of a trust/administered account. Donor response has not been tested. Potential loss of independence in determining areas of technical assistance. Individual funding may conflict with public good aspect.
Commitment fees	Charging fees on new precautionary arrangements has the potential to boost income. Such arrangements would first need to be designed and popularized.