

A photograph of two men in business suits sitting at a desk, reviewing documents. The man on the left is writing on a document. The background features a wall with several framed portraits of men in suits. The entire image has a teal color overlay.

Financial operations and policies

CHAPTER | 5

the IMF is a cooperative financial institution that lends to member countries experiencing balance of payments problems. The IMF extends financing to members through three channels:

Regular financing activities. The IMF provides loans to countries from a revolving pool of funds consisting of members' capital subscriptions (quotas) on the condition that the borrower undertake economic adjustment and reform policies to address its external financing difficulties. These loans are extended under a variety of policies and facilities designed to address specific balance of payments problems (Table 3.1). Interest is charged on the loans at market-related rates, and repayment periods vary depending on the lending facility.

Concessional financing activities. The IMF provides loans to low-income member countries at very low interest rates and with longer maturities than apply to regular Fund credit. The interest rate charged on loans extended under the Poverty Reduction and Growth Facility (PRGF) is 0.5 percent, and the repayment period for such loans is 5½–10 years. These loans support programs to strengthen balance of payments positions and foster durable growth, higher living standards, and a reduction in poverty. The IMF also makes grants available to eligible heavily indebted poor countries (HIPC) to help them achieve sustainable external debt positions. The principal of concessional loans is funded by bilateral lenders that make resources available to the IMF at market-based rates, with the IMF acting as a trustee. Resources to subsidize the rate charged to borrowers and grants for HIPC debt relief are financed through separate contributions by some member countries and the IMF's own resources.

Special drawing rights. The IMF can also create international reserve assets by allocating special drawing rights (SDRs) to members. These SDRs can be used to obtain foreign exchange from other members and to make payments to the IMF.

Among the key financial developments in FY2005 were the following:

- The IMF initiated a review of its finances and financial structure. This ongoing review is focusing on ways in which the existing financial structure can be strengthened. In particular, the review is considering measures to enhance, simplify, and increase the transparency of the

IMF's income mechanism and addressing ways to strengthen the IMF's financial position through the diversification of income sources. Measures to modernize the IMF's internal budgetary procedures are also ongoing (see Chapter 7).

- Outstanding IMF credit declined from last year's all-time high, as a favorable external financing environment for emerging market countries contributed to a sharp reduction in the demand for IMF credit.
- The IMF continued its efforts to help its poorest members achieve a higher pace of sustainable economic growth, reduce poverty, and reduce their debt burdens to sustainable levels. In this context, the IMF considered ways to strengthen its ability to provide financial resources to low-income countries over the medium term.

Regular financing activities

The IMF's regular lending activity is conducted through the General Resources Account (GRA), in which the members' quota subscriptions are held (Box 5.1). The bulk of IMF financing is provided under Stand-By Arrangements, which address members' short-term balance of payments difficulties, and under the Extended Fund Facility (EFF), which focuses on external payments difficulties arising from longer-term structural problems. Loans under Stand-By and Extended Arrangements can be supplemented with short-term resources from the Supplemental Reserve Facility (SRF) to assist members experiencing sudden and disruptive losses of capital market access. All loans incur interest charges and can be subject to surcharges, depending on the type and duration of the loan and the amount of IMF credit outstanding. Repayment periods also vary by type of loan (Table 3.1).

Lending

During FY2005, IMF credit outstanding declined from its all-time high reached in FY2004. At the end of FY2005, credit outstanding stood at SDR 49.9 billion, down from SDR 62.2 billion in April 2004.¹ Disbursements during the

¹As of April 30, 2005, SDR 1 = US\$1.51678.

Box 5.1 The IMF's financing mechanism

The IMF's regular lending is financed from the capital (quotas) subscribed by member countries. Each country is assigned a quota—taking into account the country's economic size and external trade—which determines its maximum financial commitment to the IMF. A portion of the quota is provided in the form of reserve assets (foreign currencies acceptable to the IMF or SDRs) and the remainder in the country's own currency. The IMF extends financing by providing reserve assets to borrowers from the reserve asset subscriptions of members or by calling on countries that are considered financially strong to exchange their own currency subscriptions for reserve assets (Box 5.3).

A loan is disbursed by the IMF when a borrower "purchases" the reserve assets from the IMF with its own currency. The loan is considered repaid when the borrower "repurchases" its currency from the IMF in exchange for reserve assets. The IMF levies a basic rate of interest (charge) on loans based on the SDR interest rate (Box 5.7) and imposes surcharges depending on the amount and maturity of the loan and the level of credit outstanding.

A country that provides reserve assets to the IMF as part of its quota subscription or

through the use of its currency receives a liquid claim on the IMF (reserve position) that can be encashed on demand to obtain reserve assets to meet a balance of payments financing need. These claims earn interest (remuneration) based on the SDR interest rate and are considered by members as part of their international reserve assets. As IMF loans are repaid (repurchased) by borrowers with reserve assets, these funds are transferred to the creditor countries in exchange for their currencies, and the creditors' claims on the IMF are extinguished.

The "purchase/repurchase" approach to IMF lending affects the composition of the IMF's resources but not their overall size. An increase in loans outstanding will reduce the IMF's holdings of reserve assets and the currencies of members that are financially strong and increase its holdings of the currencies of countries that are borrowing from the IMF. The amounts of the IMF's holdings of reserve assets and the currencies of financially strong countries determine the IMF's lending capacity (liquidity) (Box 5.4).

Detailed information on various aspects of the IMF's financial structure and regular updates of its financial activities are available on the IMF's website at www.imf.org/external/fin.htm.

reached SDR 13.9 billion—reflecting large repayments by Argentina, Brazil, Russia, and Turkey. Both Russia and Lithuania repaid all GRA principal obligations to the Fund; their advance repayments amounted to SDR 2.2 billion in January 2005 and SDR 16 million in February 2005, respectively. Uruguay also made several advance repayments totaling SDR 438.5 million. As a result, IMF credit outstanding at the end of FY2005 was SDR 12.3 billion lower than a year earlier.

During the year, 13 members—Argentina, Bosnia and Herzegovina, Brazil, Bulgaria, Ecuador, Jordan, Pakistan, Papua New Guinea, Romania, Serbia and Montenegro, Sri Lanka, Turkey, and Uruguay—made repayments on the expectation schedule in the amount of SDR 6.1 billion, of which SDR 1.3 billion constituted SRF repayments by Brazil. Six members requested and were granted extensions of repurchase expectations.² As of April 30, 2005, IMF outstanding credit amounting to SDR 24.8 billion was subject to time-based repurchase expectations under the policies adopted in November 2000 (Box 5.2).

New IMF commitments declined sharply from SDR 14.5 billion in FY2004 to SDR 1.3 billion in FY2005, in part reflecting favorable financing conditions for emerging market sovereign borrowers.

The IMF approved six new Stand-By Arrangements and two augmentations of an existing Stand-By Arrangement involving commitments totaling SDR 1.3 billion (Table 5.1). In addition, as detailed above, the Central African Republic,

Haiti, and Iraq made purchases under the policy on Emergency Post-Conflict Assistance (EPCA), and Grenada, Maldives, and Sri Lanka under the policy on Emergency

Table 5.1 IMF regular loans approved in FY2005

Member	Type of arrangement	Date of approval	Amount approved ¹ (In millions of SDRs)
Bolivia	Augmentation of Stand-By	June 10, 2004	42.9
	Augmentation of Stand-By	April 8, 2005	42.9
Bulgaria	25-month Stand-By	August 6, 2004	100.0
Croatia	20-month Stand-By	August 4, 2004	97.0
Dominican Republic	28-month Stand-By	January 31, 2005	437.8
Gabon	13-month Stand-By	May 28, 2004	69.4
Peru	26-month Stand-By	June 9, 2004	287.3
Romania	2-year Stand-By	July 7, 2004	250.0
			1,327.3

¹For augmentations, only the amount of the increase is shown.

financial year totaled SDR 1.6 billion; the largest disbursements were made to Turkey and Uruguay under their Stand-By Arrangements. Disbursements totaling SDR 312.9 million were made under Emergency Post-Conflict Assistance to the Central African Republic, Haiti, and Iraq. Disbursements totaling SDR 110.4 million were made under Emergency Natural Disaster Assistance to Grenada, Maldives, and Sri Lanka. During FY2005, total repayments

²Extensions of repurchase expectations were approved in FY2005 for Argentina, Dominica, the Dominican Republic, Ecuador, Sri Lanka, and Uruguay.

Box 5.2 Expectations versus obligations

The IMF's Articles of Agreement (Article V, Section 7(b)) specify that members are expected to make "repurchases" (repayments of loans) as their balance of payments and reserve positions improve. To encourage early repayment, the review of Fund facilities carried out in FY2001 introduced *time-based repurchase expectations* on "purchases" (loan disbursements) made after November 28, 2000, in the credit tranches, under the Extended Fund Facility, and under the Compensatory Financing Facility. Purchases under the Supplemental Reserve Facility have been subject to repurchase expectations since that facility's inception; in March 2003, the maturities of SRF expectations and obligations were extended by one year and by six months, respectively. The expectations schedule entails earlier repayments than the original obligations schedule, as shown in the table.¹

The time-based repurchase expectations can be extended upon request by members.

Credit facility	Obligations schedule (Years)	Expectations schedule (Years)
Stand-By Arrangements	3¼-5	2¼-4
Compensatory Financing Facility (CFF)	3¼-5	2¼-4
Extended Fund Facility (EFF)	4½-10	4½-7
Supplemental Reserve Facility (SRF)	2½-3	2-2½

¹A review of the policy on time-based repurchase expectations is being undertaken in the context of a broader review of the charges and maturities of IMF facilities.

Natural Disaster Assistance (ENDA). No Extended Arrangements were approved and no commitments were made under the IMF's Compensatory Financing Facility (CFF) during the year.

New IMF commitments made during FY2005 were small relative to large IMF commitments made during FY2004. The largest commitment made during FY2005, for the Dominican Republic (SDR 437.8 million), was far less than the large commitments made during FY2004 for the Stand-By Arrangement with Argentina (SDR 9.0 billion) and for the augmentation of Brazil's Stand-By Arrangement (SDR 4.6 billion).

Twelve Stand-By and Extended Arrangements were in effect as of the end of FY2005, of which seven are being treated as precautionary, with borrowers having indicated that they do not intend to draw on the funds committed to them by the IMF. Argentina has not drawn under its Stand-By Arrangement since March 2004. At the end of April 2005, undrawn balances under all arrangements still in effect amounted to SDR 7.9 billion.

Resources and liquidity

The IMF's lending is financed primarily from the fully paid-in capital (quotas) subscribed by member countries in the

Box 5.3 Financial Transactions Plan

The Financial Transactions Plan, adopted by the Executive Board for each upcoming quarter, specifies the amounts of SDRs and selected member currencies to be used in transfers and receipts expected to be conducted through the General Resources Account during that period. The IMF extends loans by calling on financially strong countries to provide reserve assets to weaker members in balance of payments need. The members that participate in financing IMF transactions in foreign exchange are selected by the Executive Board based on an assessment of each country's financial capacity. These assessments are ultimately a matter of judgment and take into account recent and prospective developments in the balance of payments and reserves, trends in exchange rates, and the size and duration of external debt obligations.

The amounts transferred and received by these members are managed to ensure that their creditor positions in the IMF are broadly equal in relation to quota, the key measure of members' rights and obligations in the IMF. The IMF publishes on its website the outcome of the Financial Transactions Plan for the quarter ending three months prior to publication. As of April 30, 2005, with the addition of the Russian Federation in March 2005, there were 46 participants in the Financial Transactions Plan.

Australia	France	Malaysia	Singapore
Austria	Germany	Mauritius	Slovenia
Belgium	Greece	Mexico	Spain
Botswana	Hungary	Netherlands	Sweden
Brunei Darussalam	India	New Zealand	Switzerland
Canada	Ireland	Norway	Thailand
Chile	Israel	Oman	Trinidad and Tobago
China	Italy	Poland	United Arab Emirates
Cyprus	Japan	Portugal	United Kingdom
Czech Republic	Korea	Qatar	United States
Denmark	Kuwait	Russian Federation	
Finland	Luxembourg	Saudi Arabia	

form of reserve assets and currencies.³ General reviews of IMF quotas, during which adjustments may be proposed in the overall size and distribution of quotas to reflect developments in the world economy, are conducted at five-year intervals. A member's quota can also be adjusted separately from a general review to take account of major developments. The IMF can borrow to supplement its quota resources and has in place two formal borrowing arrangements with member countries.

Only a portion of the paid-in capital is readily available to finance new lending because of previous commitments made by the IMF and the IMF policy of lending only in the currencies of members that are financially strong. The IMF's base of usable resources increased during FY2005 because Russia was considered sufficiently strong for its currency to be included in the IMF's Financial Transactions Plan (Box 5.3).

³Quotas also determine a country's voting power in the IMF, access to IMF financing, and share in SDR allocations.

Box 5.4 The IMF's lending capacity

The IMF's key measure of liquidity is the Forward Commitment Capacity (FCC), which is designed to be a clear measure of the IMF's capacity to make new loans. The one-year FCC indicates the amount of quota-based resources available for new lending over the next 12 months (Figure 5.2).

The one-year FCC is defined as the IMF's stock of usable resources less undrawn balances under current lending arrangements, plus projected repayments during the coming 12 months, less a prudential balance intended to safeguard the liquidity of creditors' claims and allow for any potential erosion of the IMF's resource base. The IMF's usable resources consist of its holdings of SDRs and the currencies of financially strong members included in the Financial Transactions Plan (Box 5.3). The prudential balance is calculated as 20 percent of the quotas of members included in the Financial Transactions Plan, plus any undrawn amounts under activated borrowing arrangements.

Information on the one-year FCC is published weekly (*Financial Activities: Week-at-a-Glance*) and monthly (*Financial Resources and Liquidity*) on the IMF's website at www.imf.org/external/fin.htm.

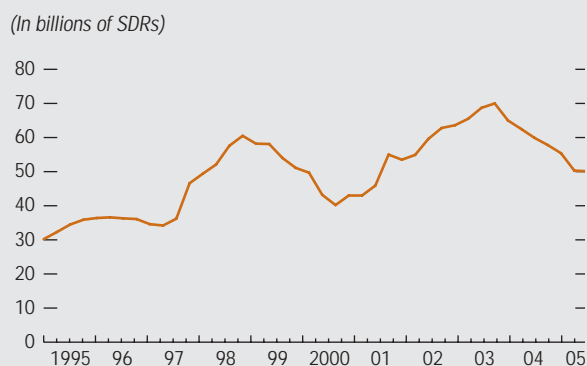
The Fund's liquidity, as measured by the Forward Commitment Capacity (FCC; see Box 5.4), rose to SDR 94.3 billion at the end of April 2005 from SDR 58.1 billion at the end of April 2004. This was due primarily to the expiration of Brazil's Stand-By Arrangement; the rise of usable resources as a result of net repurchases by Argentina, Brazil, Turkey, and Russia; and the inclusion of Russia in the Financial Transactions Plan (Figure 5.1).

Concessional financing activities

Poverty Reduction and Growth Facility

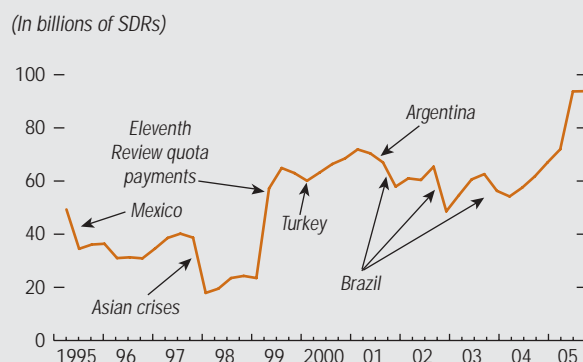
In 1999, the IMF modified its objectives for concessional lending to include an explicit focus on poverty reduction

Figure 5.1 Regular loans outstanding, 1995–April 2005



Source: IMF Finance Department.

Figure 5.2 IMF one-year forward commitment capacity, 1995–April 2005



Source: IMF Finance Department.

Note: The IMF started publishing data on its FCC in December 2002. For earlier periods the figure shows estimates of the FCC. The FCC increases when quota payments are made. It also increases when repurchases are made and decreases when the IMF makes new financial commitments. The reference to member countries and the Asian crises notes selected large financial commitments by the IMF to members and groups of members.

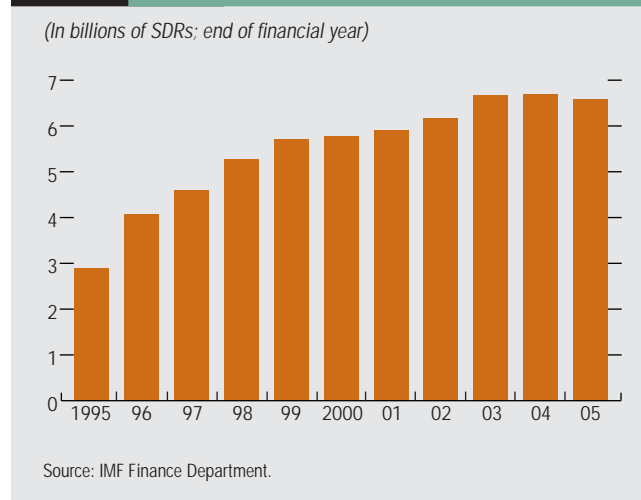
in the context of a growth-oriented economic strategy. The IMF, along with the World Bank, supports strategies elaborated by the borrowing country in a Poverty Reduction Strategy Paper (PRSP) prepared with the participation of civil society and other development partners. Reflecting the new objectives and procedures, the IMF established the Poverty Reduction and Growth Facility (PRGF) in place of the Enhanced Structural Adjustment Facility (ESAF) to provide financing under arrangements developed in the context of PRSPs. (See Chapter 4 for more information on the assistance the IMF provides to low-income countries.)

During FY2005, the Executive Board approved eight new PRGF arrangements (for Chad, the Republic of Congo, Georgia, the Kyrgyz Republic, Mali, Mozambique, Niger, and Zambia), with commitments totaling SDR 434.4 million (Table 5.2). In addition, the Board approved augmentations of the existing arrangements for Bangladesh and Kenya in the amounts of SDR 53.3 million and SDR 50 million, respectively. Bangladesh's augmentation was associated with the first approval under the newly created Trade Integration Mechanism, while Kenya's augmentation was in response to drought and the sharp rise in oil prices. The commitment of Azerbaijan's PRGF arrangement was reduced by SDR 12.9 million owing to the cancellation of one review. Mauritania cancelled its PRGF arrangement on November 7, 2004. Total PRGF disbursements amounted to SDR 0.8 billion during FY2005. As of April 30, 2005, 31 member countries' reform programs were supported by PRGF arrangements, with commitments totaling SDR 2.9 billion and undrawn balances of SDR 1.3 billion; total PRGF credit outstand-

Table 5.2 PRGF lending approved in FY2005

Member	Type of arrangement	Date of approval	Amount approved (In millions of SDRs)
Chad	3-year PRGF	February 16, 2005	25.2
Georgia	3-year PRGF	June 4, 2004	98.0
Kyrgyz Republic	3-year PRGF	March 15, 2005	8.9
Mali	3-year PRGF	June 23, 2004	9.3
Mozambique	3-year PRGF	July 6, 2004	11.4
Niger	3-year PRGF	January 31, 2005	6.6
Republic of Congo	3-year PRGF	December 6, 2004	55.0
Zambia	3-year PRGF	June 16, 2004	220.1
Subtotal			434.4¹
Bangladesh	Augmentation	July 28, 2004	53.3
Kenya	Augmentation	December 20, 2004	50.0
Azerbaijan	Reduction	December 22, 2004	(12.9)

Source: IMF Finance Department.

¹Figures may not add up to subtotal because of rounding.**Figure 5.3** PRGF credit outstanding, 1995–2005

ing as of the end of April 2005 stood at SDR 6.6 billion (Figure 5.3).

Financing for the PRGF is provided through trust funds administered by the IMF—the PRGF and PRGF-HIPC Trusts—that are separate from the IMF’s quota-based resources.⁴ The trusts have been financed from contributions from a broad spectrum of the IMF’s membership and the IMF itself. The PRGF Trust was established in 1987 and borrows resources at market or below-market interest rates from loan providers—central banks, governments, and government institutions—and lends them to PRGF-eligible member countries at an annual interest rate of 0.5 percent.

⁴For a fuller account of the sources of funds for IMF concessional lending operations, see International Monetary Fund, 2001, *Financial Organization and Operations of the IMF*, Pamphlet 45, 6th ed. (Washington), available online at www.imf.org/external/pubs/ft/pam/pam45/contents.htm.

The PRGF Trust receives grant contributions to subsidize the rate of interest on PRGF loans and maintains a Reserve Account as security for loans to the trust. The PRGF-HIPC Trust was established in 1997 to subsidize PRGF operations beginning in 2002 and to provide resources for HIPC Initiative assistance.

As of the end of FY2005, the total loan resources that had been made available for PRGF operations amounted to SDR 15.8 billion, of which SDR 13.0 billion had already been committed to borrowing mem-

bers and SDR 11.7 billion had been disbursed. It is estimated that the remaining uncommitted PRGF loan resources of SDR 2.7 billion will cover the projected demand for PRGF resources through 2006. There is a long-standing plan to move to a self-sustained PRGF once the interim PRGF runs its course. Following the March 2004 Executive Board discussion,⁵ the IMF staff updated its estimates of PRGF financing requirements over the medium term under current policies. These updated estimates indicated the need for a PRGF lending capacity of SDR 0.8–1.2 billion a year over 2006–10. Further projections will have to be made to take into account the possible impact of the G-8’s June 2005 proposal for additional debt relief to low-income countries.

Enhanced HIPC Initiative

Originally launched by the IMF and the World Bank in 1996, the HIPC Initiative was considerably strengthened in 1999 to provide deeper, faster, and broader debt relief for the world’s heavily indebted poor countries. By April 30, 2005, 27 countries had reached their decision points under the enhanced initiative and one (Côte d’Ivoire) under the original initiative. Of these countries, 18 reached their completion points under the enhanced initiative (see also Chapter 4).

The IMF provides HIPC Initiative assistance in the form of grants that are used to service part of member countries’ debt to the institution. As of April 30, 2005, the IMF had committed SDR 1.8 billion in grants to the following countries: Benin, Bolivia, Burkina Faso, Cameroon, Chad, Côte d’Ivoire, the Democratic Republic of the Congo,

⁵Box 7.6 of the IMF’s *Annual Report 2004* provides more information on this Board discussion of the financing of PRGF operations over the medium term.

Table 5.3 Status of commitments of IMF HIPC assistance*(In millions of SDRs; as of April 30, 2005)*

Member	Decision point	Completion point	Amount committed	Amount disbursed ¹
Under the original HIPC Initiative				
Bolivia	Sep. 1997	Sep. 1998	21.2	21.2
Burkina Faso	Sep. 1997	Jul. 2000	16.3	16.3
Côte d'Ivoire	Mar. 1998	—	16.7 ²	—
Guyana	Dec. 1997	May 1999	25.6	25.6
Mali	Sep. 1998	Sep. 2000	10.8	10.8
Mozambique	Apr. 1998	Jun. 1999	93.2	93.2
Uganda	Apr. 1997	Apr. 1998	51.5	51.5
Total original HIPC			235.3	218.6
Under the enhanced HIPC Initiative				
Benin	Jul. 2000	Mar. 2003	18.4	20.1
Bolivia	Feb. 2000	Jun. 2001	41.1	44.2
Burkina Faso	Jul. 2000	Apr. 2002	27.7	29.7
Cameroon	Oct. 2000	Floating	28.5	5.5
Chad	May 2001	Floating	14.3	8.6
Congo, Dem. Rep. of	Jul. 2003	Floating	228.3 ³	2.3
Ethiopia	Nov. 2001	Apr. 2004	45.1	46.3
Gambia, The	Dec. 2000	Floating	1.8	0.1
Ghana	Feb. 2002	Jul. 2004	90.1	94.3
Guinea	Dec. 2000	Floating	24.2	5.2
Guinea-Bissau	Dec. 2000	Floating	9.2	0.5
Guyana	Nov. 2000	Dec. 2003	31.1	34.0
Honduras	Jun. 2000	Apr. 2005	22.7	22.7
Madagascar	Dec. 2000	Oct. 2004	14.7	16.4
Malawi	Dec. 2000	Floating	23.1	6.9
Mali	Sep. 2000	Mar. 2003	34.7	38.5
Mauritania	Feb. 2000	Jun. 2002	34.8	38.4
Mozambique	Apr. 2000	Sep. 2001	13.7	14.8
Nicaragua	Dec. 2000	Jan. 2004	63.5	71.2
Niger	Dec. 2000	Apr. 2004	31.2	33.8
Rwanda	Dec. 2000	Apr. 2005	33.8 ⁴	33.8
São Tomé and Príncipe	Dec. 2000	Floating	—	—
Senegal	Jun. 2000	Apr. 2004	33.8	38.4
Sierra Leone	Mar. 2002	Floating	98.5	62.0
Tanzania	Apr. 2000	Nov. 2001	89.0	96.4
Uganda	Feb. 2000	May 2000	68.1	70.2
Zambia	Dec. 2000	Apr. 2005	468.8	468.8
Total enhanced HIPC			1,590.2	1,303.1
Grand total			1,825.5	1,521.7

Source: IMF Finance Department.

¹Includes interest on amounts committed under the enhanced HIPC Initiative.²Equivalent to the committed amount of \$22.5 million at the decision point exchange rate (March 17, 1998).³Amount committed is equivalent to the remaining balance of the total IMF HIPC assistance of SDR 337.9 million, after deducting SDR 109.6 million representing the concessional element associated with the disbursement of a PRGF loan following the Democratic Republic of the Congo's clearance of arrears to the IMF on June 12, 2002.⁴Excludes commitment of additional enhanced HIPC assistance of SDR 12.98 million subject to receipt of satisfactory financing assurances from other creditors.

During FY2005, the IMF Executive Board approved additional HIPC assistance amounting to SDR 51.8 million for four members (Burkina Faso, Ethiopia, Niger, and Rwanda).⁶

Under the enhanced HIPC Initiative, a portion of the assistance committed at the decision point can be disbursed before the country reaches its completion point. Such assistance from the IMF may amount to up to 20 percent annually, with a cumulative maximum of 60 percent of the total committed amount of HIPC assistance. In exceptional circumstances, the annual and maximum amounts of assistance can be raised to 25 percent and 75 percent, respectively. During FY2005, SDR 7.0 million of interim assistance was disbursed to three countries. As of April 30, 2005, SDR 624.2 million had been disbursed as interim assistance.

Resources still need to be identified to meet the IMF's share of HIPC Initiative assistance for three protracted arrears cases—Liberia, Somalia, and Sudan. In addition, the potential costs associated with further cases of "topping up" and the extension of the HIPC sunset clause have not yet been identified. Moreover, recent calls to consider further debt relief will have important financing implications for the IMF. In this regard, the IMF's Executive Board is considering the implications for the IMF's finances and operations of the G-8 proposal for additional debt relief (Box 5.5).

Ethiopia, The Gambia, Ghana, Guinea, Guinea-Bissau, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, São Tomé and Príncipe, Senegal, Sierra Leone, Tanzania, Uganda, and Zambia. Five members (Ghana, Honduras, Madagascar, Rwanda, and Zambia) reached their completion points under the enhanced HIPC Initiative during FY2005. As of April 30, 2005, total disbursements of HIPC Initiative assistance by the IMF amounted to SDR 1.5 billion (Table 5.3).

Financing of PRGF subsidies and the HIPC Initiative

The financing of the subsidy requirements of the PRGF and the IMF's participation in the enhanced HIPC Initiative is administered through the PRGF and the PRGF-HIPC Trusts. Under the current framework, the total cost

⁶This includes SDR 12.98 million in additional HIPC assistance approved for Rwanda subject to the receipt of satisfactory financing assurances from other creditors.

Box 5.5 Further debt relief beyond the HIPC Initiative and its financing

At the 2004 Annual Meetings of the IMF and the World Bank, the International Monetary and Financial Committee called on the international community, including the IMF, to consider further debt relief for low-income countries beyond that provided by the HIPC Initiative. In this regard, in March 2005, the IMF's Executive Board discussed two staff papers on the key issues relating to further debt relief and its financing.

The paper on further debt relief provided an opportunity to discuss how debt relief could play a role in helping low-income countries tackle their problems and make progress toward the Millennium Development Goals (MDGs). Further debt relief holds out the promise of easing concerns about debt sustainability while attracting additional financing to achieve the MDGs, and of providing predictable budget support with relatively low transactions costs for recipients. Drawbacks include the possibility that it could perpetuate moral hazard and raise issues of equity by allocating scarce resources on the basis of past borrowing and that it would not address the broader agenda of reforms needed to accelerate progress toward the MDGs. Directors emphasized that the benefits of further debt relief would depend importantly on the commitment of the donor community to increase the overall aid envelope to ensure additional net resource transfers to these countries

and that these benefits must be weighed against other potential uses of scarce resources.

The financing paper emphasized the close interlinkages between the financing of further debt relief and the financing of the IMF's ongoing lending operations with low-income countries. Directors agreed that it would be crucial to ensure that the IMF has adequate financing to meet the future demand for concessional lending.

In June 2005, the finance ministers of the Group of Eight (G-8) countries proposed that the IMF, the World Bank, and the African Development Bank (AfDB) cancel 100 percent of their claims on 18 countries that have reached the completion point under the enhanced HIPC Initiative and the claims on other HIPCs (currently 17 countries) as they reach the completion point.¹ The key elements of the G-8 proposal were as follows:

- Donors would provide additional contributions to the International Development Association (the concessional lending arm of the World Bank) and the AfDB, based on agreed burden sharing, to cover their full cost of debt relief.
- The costs of fully covering the Fund's debt relief would be met by the use of existing Fund resources, without undermining the IMF's financing capacity.

- In situations where other existing and projected debt relief obligations cannot be met by the use of existing IMF resources (for example, Somalia, Liberia, and Sudan), donors would commit to providing the additional resources necessary. The G-8 finance ministers committed to provide, on a fair burden-sharing basis, a minimum of \$350 million in resources over the next three years to cover costs to the IMF that are difficult to forecast and that are in excess of existing resources and to cover the costs of countries that may become eligible for HIPC assistance under the sunset clause (see Chapter 4). They also invited voluntary contributions to a new trust fund to support poor countries facing commodity price and other exogenous shocks.

The IMF's Executive Board met for an initial discussion of the G-8 proposal in late June 2005. Directors asked staff to prepare a careful assessment of the proposal and of its legal, financial, and policy implications for the IMF, as well as possible modifications.

¹The following 18 countries would be eligible immediately: Benin, Bolivia, Burkina Faso, Ethiopia, Ghana, Guyana, Honduras, Madagascar, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, Tanzania, Uganda, Zambia. As the remaining HIPCs reach their completion points, they would also become eligible.

required for these purposes is projected at SDR 6.3 billion on a cash basis through 2019: PRGF subsidies are projected at SDR 4.1 billion, and the IMF's cost of HIPC assistance is estimated at SDR 2.2 billion. (Further projections will need to be made to account for the possible impact of the G-8 proposal for additional debt relief.) These resource requirements are sensitive to interest rate assumptions. They are expected to be fully met by bilateral contributions from member countries and by the IMF itself.

Bilateral pledges for the PRGF and the PRGF-HIPC Trusts have come from a cross section of the IMF's membership (with 94 countries having pledged support), demonstrating broad support for the PRGF and the HIPC Initiative. Bilateral contributions are estimated at SDR 3.6 billion on a cash basis through 2019. As of the end of April 2005, all pledged bilateral contributions to the PRGF Trust, as well as 98 percent of total contributions to the PRGF-HIPC

Trust, had been made effective. Pledged contributions by 10 countries, amounting to about SDR 32 million, remain pending.

The IMF's own contributions amount to SDR 2.6 billion, of which SDR 2.2 billion is for the PRGF-HIPC Trust. The bulk of the contributions would come from the expected investment income on the net proceeds of SDR 2.2 billion generated from off-market gold transactions in 1999–2000 (see *Annual Report, 2000*, page 71). The investment income on the gold proceeds held in the Special Disbursement Account (SDA) may be used, up to a maximum limit of SDR 1.76 billion, to meet the IMF's share of the HIPC Initiative assistance.

The IMF's other contributions include a one-time transfer of SDR 0.4 billion from the SDA to the PRGF Trust in 1994 and forgone reimbursements to the GRA from the PRGF Reserve Account for the administrative expenses related to

PRGF operations during financial years 1998–2004, with the equivalent amount being transferred to the PRGF-HIPC Trust. In addition, part of the interest surcharges on financing provided in 1998 and 1999 under the SRF, related to activation of the New Arrangements to Borrow, were transferred to the PRGF-HIPC Trust. Investment income on the balances in the two trusts is also applied toward financing PRGF loan subsidies and HIPC Initiative assistance.

Investments to support concessional financing and HIPC Initiative assistance

The IMF invests assets supporting the PRGF subsidies and the HIPC Initiative in a diversified portfolio of fixed-income securities issued by governments and international financial institutions. As of April 30, 2005, the value of these assets totaled SDR 9.6 billion.

In March 2000, the IMF's Executive Board endorsed investment objectives and risk-tolerance parameters designed to supplement returns over time while maintaining prudent limits on risk.⁷ Under this investment strategy, about half the assets have been invested in bond portfolios, currently managed by the World Bank and two private external managers. The remaining assets have been invested in short-term deposits with the Bank for International Settlements to serve as a liquidity tranche and to conform with the administrative arrangements agreed with certain contributors.

Currency risk is minimized by limiting purchases to securities denominated in the four currencies of the SDR basket (euros, Japanese yen, pound sterling, and U.S. dollars), with regular rebalancing of the portfolio weight of each currency to remain in line with the weights of the SDR basket.

For the year ended April 30, 2005, the annual return on the portfolio was 2.1 percent, up from 1.7 percent a year earlier. In the five years that the investment strategy has been in place, the average annual portfolio return has been 3.5 percent.

Emergency assistance

The IMF provides emergency assistance to post-conflict countries, as well as to countries struck by natural disasters, in the form of loans subject to the IMF's basic rate of charge. In May 2001, a decision was taken to provide Emergency Post-Conflict Assistance (EPCA) for PRGF-eligible countries at a subsidized rate of 0.5 percent a year, and an administered account was established at that time for con-

⁷Prior to this shift in investment strategy, these assets had been invested in short-term SDR-denominated deposits with the Bank for International Settlements.

Table 5.4 Contributions to subsidize emergency assistance

(In millions of SDRs; as of April 30, 2005)

Contributor	Contribution pledged	Contribution received	Subsidy disbursed
Subaccount 1: EPCA subsidization only			
Belgium	0.6	0.6	0.3
Canada	1.7	1.7	—
Norway	3.0	3.0	—
Sweden	0.8	0.8	0.8
Switzerland	0.8	0.8	—
United Kingdom	2.9	2.9	1.1
Subtotal	9.7	9.7	2.2
Subaccount 2: ENDA subsidization only			
Austria	0.7	—	—
Canada	2.6	0.5	—
India	1.5	—	—
Japan	1.6	—	—
Luxembourg	1.1	—	—
Russia	1.0	—	—
Saudi Arabia	2.6	—	—
Switzerland	1.3	—	—
Subtotal	12.5	0.5	0.0
Subaccount 3: Subsidization of EPCA and ENDA			
France	1.3	—	—
Netherlands	2.8	1.5	—
Norway	1.1	1.1	—
Sweden	6.6	6.6	—
United Kingdom	1.2	1.2	0.1
Subtotal	12.9	10.3	0.1
Total	35.1	20.6	2.3

Source: IMF Finance Department.

tributions by bilateral donors. In January 2005, the IMF's Executive Board decided to extend the subsidization to Emergency Natural Disaster Assistance (ENDA) for PRGF-eligible countries—provided sufficient resources were available—and requested new bilateral contributions from member countries. The existing administered account was split into three subaccounts, allowing for bilateral contributions to be earmarked for either EPCA or ENDA, or to be used flexibly for either kind of emergency assistance.

As of the end of April 2005, 14 member countries have pledged bilateral contributions totaling SDR 35.1 million for the subsidization of emergency assistance (Table 5.4). Of this amount, SDR 23.9 million are new pledges received after the January 2005 decision. SDR 9.7 million of the overall total is available to subsidize EPCA only, SDR 12.5 million to subsidize ENDA only, and SDR 12.9 million to subsidize either.

During FY2005, six countries made purchases (borrowed) under emergency assistance. Three purchases were made under ENDA—SDR 2.9 million for Grenada in November 2004, SDR 4.1 million for Maldives in March 2005, and SDR 103.4 million for Sri Lanka in March 2005. Another three purchases were made under EPCA—SDR 5.6 million for the Central African Republic in July 2004, SDR 297.1

million for Iraq in October 2004, and SDR 10.2 million for Haiti in January 2005. Of these six countries, only Iraq is ineligible for subsidization of emergency assistance, since it is not a PRGF-eligible country.

Thus far, disbursements from the administered account have totaled SDR 2.2 million to subsidize the rate of charge on EPCA for nine countries (Albania, Burundi, the Central African Republic, the Republic of Congo, Guinea-Bissau, Haiti, Rwanda, Sierra Leone, and Tajikistan). Of these, only three countries—the Republic of Congo, the Central African Republic, and Haiti—still have purchases outstanding under EPCA. A total of SDR 0.1 million has been disbursed so far to subsidize interest on ENDA for two countries (Grenada and Malawi). They became eligible for subsidization following the Executive Board's decision in January 2005. As of April 30, 2005, four countries—Grenada, Malawi, Maldives, and Sri Lanka—have outstanding purchases under ENDA.

Income, charges, remuneration, and burden sharing

The IMF, like other financial institutions, earns income from interest charges and fees levied on its loans and uses the income to meet funding costs, pay for administrative expenses, and build up precautionary balances. The IMF's reliance on quota subscriptions and internally generated resources provides it with some flexibility in setting the basic rate of charge. However, the IMF also needs to ensure that it provides creditors with a competitive rate of interest on their IMF claims.

The basic rate of charge on regular lending is determined at the beginning of the financial year as a proportion of the SDR interest rate (see "SDR developments," below) to achieve an agreed net income target for the year. This rate is set to cover the cost of funds and administrative expenses as well as add to the IMF's reserves. The specific proportion is based on projections for income and expenses for the year and can be adjusted at midyear in light of actual net income and if income for the year as a whole is expected to deviate significantly from the projections. At the end of the financial year, any income in excess of the target is refunded to the members that paid charges during the year, and shortfalls are made up in the following year.

The IMF imposes level-based surcharges on credit extended after November 28, 2000, to discourage unduly large use of credit in the credit tranches and under Extended Arrangements. The IMF also imposes surcharges on shorter-term loans under the SRF. The surcharges vary according to the length of time credit is outstanding. Income derived from surcharges is placed in the IMF's reserves and is not taken into account in determining the net income target for the year.

The IMF also receives income from borrowers in the form of service charges, commitment fees, and special charges. A one-time service charge of 0.5 percent is levied on each loan disbursement from the GRA. A refundable commitment fee on Stand-By and Extended Arrangements, payable at the beginning of each 12-month period under the arrangement, is charged on the amounts that may be drawn during that period, including amounts available under the SRF. The fee is 0.25 percent on amounts committed up to 100 percent of quota and 0.10 percent for amounts exceeding 100 percent of quota. The commitment fee is refunded when credit is used in proportion to the drawings made. The IMF also levies special charges on overdue principal payments and on charges that are overdue by less than six months.

The IMF pays interest (remuneration) to creditors on their IMF claims (reserve positions) based on the SDR interest rate. The basic rate of remuneration is currently set at 100 percent of the SDR interest rate (the upper limit permitted under the Articles of Agreement), but it may be set as low as 80 percent of that rate (the lower limit).

Since 1986, the rates of charge and remuneration have been adjusted under a burden-sharing mechanism that distributes the cost of overdue financial obligations between creditor and debtor members. Loss of income from unpaid interest charges overdue for six months or more is recovered by increasing the rate of charge and reducing the rate of remuneration. The amounts thus collected are refunded when the overdue charges are settled. Additional adjustments to the basic rates of charge and remuneration are made to generate resources for a Special Contingent Account (SCA-1), which was established specifically to protect the IMF against the risk of loss resulting from arrears. In FY2005, the combined adjustment for unpaid interest charges and the allocation to the SCA-1 resulted in an increase to the basic rate of charge of 10 basis points and a reduction in the rate of remuneration of 11 basis points. The adjusted rates of charge and remuneration averaged 3.10 percent and 1.98 percent, respectively, for the financial year.

In April 2004, the basic rate of charge for FY2005 was initially set at 154.0 percent of the SDR interest rate, but it was reduced at midyear to 136.0 percent of the SDR interest rate to achieve the agreed net income target of SDR 191 million (excluding income from surcharges). Net income amounted to SDR 244 million, which exceeded the target by SDR 53 million, owing mainly to the rise in the SDR interest rate, which was partly offset by lower-than-expected use of IMF credit and higher GRA administrative expenses (net of reimbursement) in SDR terms. In accordance with decisions taken at the beginning of FY2005, this excess has been refunded to borrowing members by retroactively reducing the rate of charge coefficient applied in the first half of FY2005 from 154.0 to 144.0 percent of the SDR

interest rate. Income derived from SRF and level-based surcharges amounted to SDR 636 million in FY2005. Adjusted for expenses associated with administering the PRGF Trust (SDR 54 million)⁸ and the cost of pension and other post-retirement provisions (SDR 160 million), total net income for the year amounted to SDR 613 million. This amount was added to the IMF's reserves, of which SDR 582 million (equivalent to the surcharge income minus the cost of administering the PRGF Trust) went to the General Reserve and the remainder to the Special Reserve.

In April 2005, the Executive Board decided to calculate the rate of charge by using a fixed margin above the SDR rate instead of a proportion of the SDR rate. This change in calculating the basic rate of charge was aimed at increasing the transparency and stability of the rate of charge. For FY2006, the fixed margin was set at 108 basis points above the SDR interest rate. The Executive Board also decided to continue its ongoing review of the IMF's financing mechanism, which began in the second half of FY2005.

Credit risk management in the IMF and the level of precautionary balances

The IMF mitigates credit risk by rigorously implementing the policies governing the use of its resources and carefully managing its liquidity, while accumulating adequate precautionary balances.⁹

Credit risk management

The principal credit risks faced by the IMF stem from large arrangements with middle-income countries. As of the end of April 2005, three countries (Argentina, Brazil, and Turkey) accounted for some 73 percent of all General Reserve Account credit outstanding, and these three plus Indonesia and Uruguay accounted for 89 percent. The IMF's Articles of Agreement charge the IMF with assisting cooperating members—including those in very difficult circumstances. As a result, the size of the IMF's loan portfolio can change dramatically in a short time, as can assessments of its riskiness. Sound risk management requires the IMF to be prepared for the possibility of payments disruptions, which could arise from the increase in, and concentration of, its outstanding credit. However, in view of the cooperative nature of the IMF and the IMF's role in promoting global macroeconomic stability as a public good,

diversification of lending is not, and cannot be, one of its objectives.

Although the specific features of the IMF's institutional framework and financing role suggest that high credit concentration is inevitable in an uncertain world, such concentration does not embody the same degree of risk for the IMF as for other financial institutions. An important means of mitigating financial risk is the IMF's preferred creditor status—that is, members giving priority to repayment of their obligations to the IMF over those to other creditors—which is fundamental to the IMF's role in the international financial system and to the IMF's financing mechanism. The IMF's preferred creditor status has allowed it to take the risks necessary to provide financial assistance to members in exceptionally difficult balance of payments situations in support of their efforts to implement strong adjustment policies without resorting to measures destructive of national and international prosperity. The IMF's policies on access to, and the use of, its resources are, along with effective crisis prevention and conditionality in support of strong country-owned programs, the most important elements of the IMF's risk-management framework. An IMF member's commitment to adopt sound economic policies, the IMF's conditionality, and the safeguards in place (including an assessment of the member's ability to repay the IMF) reduce the risks to the IMF of lending and of credit concentration.

The profound changes in the IMF's lending policies in recent years in response to the changing global macroeconomic environment and the growing financial interdependence of members led to the adoption of the framework for exceptional access in 2003 that was reaffirmed by the Executive Board in April 2005 (see Chapter 3). Firm application of the criteria governing exceptional access to IMF resources and rigorous assessments of the risks to the IMF arising from high access and of the member's capacity to repay are crucial for effective risk management. In addition, it is the responsibility of IMF members benefiting from financial assistance to pay the IMF back as soon as their temporary balance of payments problems are resolved. Policies to promote this goal include surcharges, the shorter maturities on use of Fund resources under the SRF, the presumption that exceptional access will be provided on SRF terms, and the policy on repurchase expectations.

Precautionary balances

To safeguard its financial position, the IMF has a policy of accumulating precautionary financial balances in the GRA. These precautionary balances consist of reserves and a Special Contingent Account (SCA-1, see previous subsection). Reserves provide the IMF with protection against financial risks, including income losses and capital losses. The SCA-1

⁸As agreed in April 2004, the GRA is not reimbursed for the expenses of administering the PRGF Trust; instead, these resources remain in the PRGF Trust to meet concessional financing needs.

⁹For more details, see the IMF's website at www.imf.org/external/np/sec/pn/2004/pn0416.htm.

was established as an additional layer of protection against the adverse financial consequences of protracted arrears.

Existing precautionary balances have been financed through the retention of income and the burden-sharing mechanism (see previous subsection). The net income and the income from surcharges on the Special and General Reserves are added to reserves. Under the Articles of Agreement, the resources in the General Reserve may be distributed by the IMF to members on the basis of their quota shares. The IMF may use the Special Reserve for any purpose for which it may use the General Reserve except distribution. Total reserves increased to SDR 5.7 billion as of April 30, 2005, from SDR 5.1 billion a year earlier. The balance in the SCA-1 amounted to SDR 1.6 billion, compared with overdue principal of SDR 0.7 billion. SCA-1 resources are to be refunded after all arrears have been cleared but can be refunded earlier by a decision of the Executive Board.

The Executive Board has set an eventual target level of precautionary financial balances of SDR 10 billion. The adequacy of precautionary balances and the pace of accumulation, as well as the application of the burden-sharing mechanism, is kept under close review.

Quota developments

There were only a few noteworthy quota developments in FY2005, reflecting the fact that the Thirteenth General Review of Quotas (Box 5.6) is still at an early stage.¹⁰

As of April 30, 2005, 180 member countries accounting for more than 99 percent of quotas proposed in 1998 under the Eleventh General Review of Quotas had consented to, and paid for, their proposed quota increases. All member countries eligible to consent had done so by the end of the financial year, and three member countries were ineligible to consent to their proposed increases because they were in arrears to the IMF. On September 20, 2004, the Board of Governors adopted a resolution that established a new period for consent to the Eleventh Review quota increases that would cover 12 months from the date of the resolution. At the close of the financial year, total quotas amounted to SDR 213.5 billion.

SDR developments

The SDR is a reserve asset created by the IMF in 1969 to supplement other reserve assets. SDRs are allocated to members in proportion to their IMF quotas. A member may use SDRs to obtain foreign exchange reserves from other members and

Box 5.6 Twelfth and Thirteenth General Reviews of Quotas

The IMF normally conducts general reviews of members' quotas every five years to assess the adequacy of its resource base and to adjust the quotas of individual members to reflect changes in their relative positions in the world economy. The Executive Board completed the Twelfth General Review of Quotas on January 30, 2003, without proposing an increase (or adjustments), which leaves the maximum size of quotas unchanged at SDR 213.7 billion.

During the period of the Thirteenth General Review, which began with the completion of the Twelfth Review, the IMF's Executive Board will monitor closely and assess the adequacy of IMF resources, consider measures to achieve a distribution of quotas that reflects developments in the world economy, and explore measures to strengthen the governance of the IMF. In April 2005, the International Monetary and Financial Committee (IMFC) emphasized that the period of the Thirteenth General Review of Quotas provides an opportunity for the membership to make progress toward a consensus on issues of quotas, voice, and participation.

to make payments to the IMF. Such use does not constitute a loan; members are allocated SDRs unconditionally and may use them to meet balance of payments financing needs without undertaking economic policy measures or repayment obligations. A member that makes net use of its allocated SDRs pays the SDR interest rate, while a member that acquires SDRs in excess of its allocation receives interest at the SDR rate. A total of SDR 21.4 billion has been allocated to members—SDR 9.3 billion in 1970–72 and SDR 12.1 billion in 1978–81. The value of the SDR is based on the weighted average of the values of a basket of major international currencies, and the SDR interest rate is a weighted average of interest rates on short-term instruments in the markets for the currencies in the valuation basket (Box 5.7). The SDR interest rate provides the basis for calculating the interest charges on regular IMF financing and the interest rate paid to members that are creditors to the IMF. In addition, the SDR serves as the unit of account for the IMF and for a number of other international organizations.

There are two types of SDR allocations:

- *General allocations of SDRs.* Decisions on general allocations are made in the context of five-year basic periods and require a finding that an allocation would meet a long-term global need to supplement existing reserve assets. A decision to allocate SDRs requires an 85 percent majority of the total voting power.
- *Special one-time allocation.* In September 1997, the IMF Board of Governors proposed an amendment to the Articles of Agreement to allow a special one-time allocation of SDRs to correct for the fact that more than one-fifth of the IMF membership, having joined the IMF after the last general allocation, have never received an SDR allocation.

¹⁰For more details, see the IMF's website at www.imf.org/external/np/sec/pn/2003/pn03106.htm.

Box 5.7 SDR valuation and interest rate**Valuation**

The value of the SDR is based on the weighted average of the values of a basket of major international currencies. The method of valuation is reviewed at five-year intervals. Following completion of the latest review, in FY2001, the Executive Board decided on a number of changes to take account of the introduction of the euro as the common currency for a number of European countries and the growing role of international financial markets. Currencies included in the valuation basket are among the most widely used in international transactions and are widely traded in the principal foreign exchange markets. Currencies selected for inclusion in the SDR basket for 2001–05 are the U.S. dollar, the euro, the Japanese yen, and the pound sterling (see table). A review of the SDR valuation is scheduled to be completed in 2005 and the new basket to be in effect on January 1, 2006.

Interest rate

Since the method for determining the SDR interest rate was reviewed in FY2001, the weekly interest rate has been determined on the basis of a weighted average of interest rates (expressed as equivalent annual bond yields) on short-term instruments in the markets for the currencies included in the SDR valuation basket, namely the three-month Euribor (Euro Interbank Offered Rate), Japanese government 13-week financing bills, three-month U.K. treasury bills, and three-month U.S. treasury bills. During FY2005, the SDR interest rate evolved in line with developments in the major money markets, rising gradually from 1.62 percent at the beginning of May 2004 to peak at 2.49 percent in the last week of April 2005. Over the course of FY2005, the SDR interest rate averaged 2.1 percent (see figure).

SDR valuation, as of April 30, 2005

Currency	Amount of currency	Exchange rate ¹	U.S. dollar equivalent ²
Euro	0.4260	1.29560	0.551926
Japanese yen	21.0000	105.15000	0.199715
Pound sterling	0.0984	1.91200	0.188141
U.S. dollar	0.5770	1.00000	0.577000
			1.516782

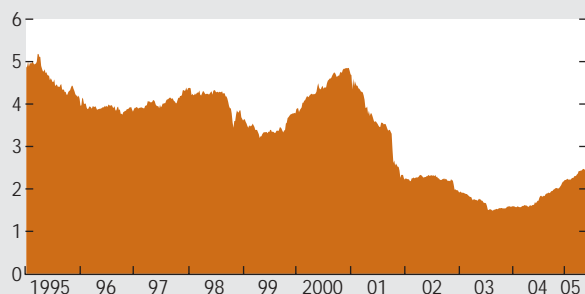
Memorandum:

SDR 1 = US\$1.51678

US\$1 = SDR 0.659291

¹Exchange rates in terms of US dollars per currency unit, except for the Japanese yen, which is in currency units per US dollar.

²Rounded to six digits.

SDR interest rate, 1995–April 2005*(In percent)*

The special allocation of SDRs would enable all members of the IMF to participate in the SDR system on an equitable basis and would double cumulative SDR allocations to SDR 42.9 billion. The proposal will become effective when three-fifths of the IMF membership (111 members) having 85 percent of the total voting power have accepted the proposal. As of April 30, 2005, 131 members having 77.33 percent of the total voting power had agreed and only acceptance by the United States was required to implement the proposal.

SDR operations and transactions

All SDR transactions are conducted through the SDR Department (which is a financial entity, not an organizational unit). SDRs are held largely by member countries and by official entities prescribed by the IMF. The balance of allocated SDRs is held in the IMF's GRA. Prescribed holders do not receive SDR allocations but can acquire and use SDRs in operations and transactions with IMF members and with other prescribed holders under the same terms and conditions as IMF members. Transactions in SDRs are facilitated by 14 voluntary arrangements under which the parties stand ready to buy or sell SDRs for currencies that are readily usable in international transactions, provided that their own SDR holdings remain within certain limits.¹¹ These arrangements have helped ensure the liquidity of the SDR system.¹²

Total transfers of SDRs decreased in FY2005 to SDR 10.6 billion, from SDR 13.8 billion in FY2004. The largest transfers of SDRs (49.1 billion) took place in FY1999, when the volume of SDR transactions increased significantly because of members' payments for quota increases.

By end-April 2005, the IMF's own holdings of SDRs, which had risen sharply as a result of payments for quota subscriptions in 1999 and subsequently fallen to a low of SDR 0.5 billion in FY2004, had risen to SDR 0.6 billion. SDRs held by prescribed holders amounted to SDR 0.3 billion. SDR holdings by participants remained unchanged from FY2004 at SDR 20.6 billion. SDR holdings of the industrial and net creditor countries relative to their net cumulative allocations decreased from a year earlier. SDR holdings of nonindustrial members amounted to 96 percent

¹¹These include 12 IMF members and 1 prescribed holder that have established two-way arrangements with the IMF and 1 member that has established a one-way (selling only) arrangement with the IMF.

¹²Under the designation mechanism, participants whose balance of payments and reserve positions are deemed sufficiently strong may be obliged, when designated by the IMF, to provide freely usable currencies in exchange for SDRs up to specified amounts. The designation mechanism has not been used since 1987, following the setup of voluntary arrangements starting in 1986.

Box 5.8 Safeguards assessment policy

The safeguards policy, which was initiated in FY2000 following several instances of misreporting to the IMF and allegations of misuse of IMF resources, aims at supplementing conditionality, technical assistance, and other means that have traditionally ensured the proper use of IMF loans.

Objective of safeguards assessments

- To provide *reasonable* assurance to the IMF that a central bank's control, accounting, reporting, and auditing systems and legal framework in place to manage resources, including IMF disbursements, are adequate to ensure the integrity of financial operations and reporting to the IMF.

Applicability of safeguards assessments

- Central banks with new arrangements for use of IMF resources approved after June 30, 2000; existing arrangements that are augmented; member countries following a Rights Accumulation Program (RAP) under which resources are being committed; member countries receiving EPCA (determined on a case-by-case basis);

- Voluntary for members with staff-monitored programs; and
- Not applicable to first-credit-tranche purchases and stand-alone Compensatory Financing Facility arrangements.

Scope of policy

Assessments examine five important safeguards areas in central banks. These areas, referred to by the acronym ELRIC, are

- External Audit Mechanism;
- Legal Structure and Independence;
- Financial Reporting Framework;
- Internal Audit Mechanism; and
- Internal Controls System.

Methodology

- Safeguards assessments follow an established set of procedures to ensure consistency in application. All central banks subject to an assessment provide a standard set of documents to IMF staff, who review the information and communicate as needed with central bank officials and the external auditors. The review may be supplemented by an on-site visit to the

central bank to obtain or clarify information necessary to draw conclusions and make recommendations.

- The outcome of a safeguards assessment is a confidential report that identifies vulnerabilities, assigns risk ratings, and makes recommendations to mitigate the identified risks. Country authorities have the opportunity to comment on all safeguards assessment reports. The conclusions and agreed-upon remedial measures are reported in summary form to the IMF Executive Board at the time of arrangement approval or, at the latest, by the first review under the arrangement, but the safeguards report itself is not made available to the Board or the general public.
- The implementation of safeguards recommendations is monitored periodically by IMF staff.

Publication references

- The staff's papers and other background information concerning the safeguards policy are available on the IMF website at www.imf.org/external/fin.htm.

of their net cumulative allocations, compared with 76 percent a year earlier.

Safeguards assessments

Since FY2000, the IMF has conducted safeguards assessments of member countries' central banks in connection with IMF lending operations. These safeguards assessments—which are aimed at providing reasonable assurance to the IMF that a central bank's framework of reporting, audit, and controls is adequate for management of its resources, including IMF disbursements (Box 5.8)—continued to identify vulnerabilities in central banks' safeguards frameworks, including in external audits and financial reporting. In FY2005, 17 safeguards assessments of member countries' central banks were completed, bringing the total number of finished assessments as of April 30, 2005, to 112.¹³

¹³This total includes 27 abbreviated assessments that were conducted for arrangements in effect prior to June 30, 2000, and that examined only one key element of the safeguards framework, namely, that central banks publish annual financial statements that are independently audited by external auditors in accordance with internationally accepted standards.

The findings of safeguards assessments to date have indicated that significant but avoidable risks to IMF resources may have existed in certain cases, although over time identified vulnerabilities have declined in importance and frequency. Experience has shown that the central banks are progressively implementing the measures recommended to mitigate identified vulnerabilities. In FY2005, central banks continued to implement assessment recommendations at a high rate (over 92 percent for the most important measures). The main areas of improvement in central bank operations and controls resulting from the implementation of safeguards measures have included (1) establishing independent external audit policies in accordance with international standards; (2) reconciling the economic data reported to the IMF for program-monitoring purposes with the underlying accounting records of the central bank; (3) improving the transparency and consistency of financial reporting, including publication of the audited financial statements; (4) improving controls over reserves management; and (5) implementing independent, high-quality internal audit functions. Central banks have generally embraced the findings of safeguards assessments, and this policy has enhanced the IMF's reputation and credibility as a prudent lender while helping to improve the operations and accounting procedures of central banks.

In April 2005 the Executive Board completed a second review of the experience of the safeguards assessments policy and confirmed continued broad support for the policy.¹⁴ In concluding its review, the Board (1) recognized that the existing framework for assessing operations of central banks was broadly appropriate; (2) agreed that safeguards assessments had a positive impact on central banks' operations, including their governance and controls frameworks; (3) endorsed, as appropriate, a case-by-case approach for the application of safeguards assessments to the use of IMF resources provided through EPCA and the modalities for the conduct of three types of assessments in the future; and (4) consented to modify the frequency of the safeguards update papers from semiannual to annual. The next review of the safeguards policy will take place in three years.

As part of the second review, the Executive Board considered the findings in a report issued by an independent panel. This panel, consisting of four deputy central bank governors from different regions, prepared a report on the policy, after surveying 27 central banks. The panel's report concluded that the safeguards policy has been successful but suggested a few improvements to the process.

As in previous years, in FY2005 IMF staff continued to explain the safeguards methodology and the relevance of the framework to central banks by conducting seminars on safeguards assessments. Such seminars were held at the Singapore Training Institute in May 2004 and at the IMF Institute (Washington, D.C.) in December 2004. As of April 30, 2005, more than 170 officials from 92 countries had attended these seminars.

Arrears to the IMF

The strengthened cooperative strategy on overdue financial obligations to the IMF consists of three essential elements: prevention, intensified collaboration, and remedial measures.¹⁵

Total overdue financial obligations to the IMF were SDR 2.0 billion at the end of April 2005, a slight decline from SDR 2.1 billion at the beginning of the financial year (Table 5.5). The main reason for the decline was Iraq's settlement of its protracted arrears to the IMF of SDR 55.3 million on September 22, 2004. Sudan's arrears to the IMF also declined as a result of its regular monthly payments in excess of obligations falling due. At the end of April 2005,

Table 5.5 Arrears to the IMF of countries with obligations overdue by six months or more and by type

(In millions of SDRs; as of April 30, 2005)

	By type				
	Total	General Department (incl. SAF) ¹	SDR Department	Trust Fund	PRGF
Liberia	510.7	455.2	25.1	30.4	—
Somalia	223.1	204.4	10.8	8.0	—
Sudan	1,058.1	978.8	0.1	79.2	—
Zimbabwe	203.7	122.8	—	—	80.9
Total	1,995.6	1,761.2	36.0	117.6	80.9

¹Structural Adjustment Facility.

most arrears to the IMF were protracted (outstanding for more than six months), 44.9 percent of which represented overdue principal, with the remainder consisting of overdue charges and interest. More than four-fifths of arrears were to the GRA and the remainder to the SDR Department and the PRGF Trust.

The two countries with the largest protracted arrears to the IMF—Sudan and Liberia—account for 78.6 percent of the overdue financial obligations to the IMF; Somalia and Zimbabwe account for the remainder. Under the IMF's strengthened cooperative strategy on arrears, remedial measures have been applied against the countries with protracted arrears.¹⁶ No changes were made in the IMF's strengthened cooperative strategy on arrears during FY2005.

The IMF's Executive Board reviewed the overall arrears strategy in August 2004 and extended the rights approach for one more year.¹⁷ The Board also conducted several reviews of individual member countries' overdue financial obligations to the IMF during FY2005:

- The Board twice reviewed Liberia's overdue financial obligations to the IMF—on October 20, 2004, and April 20, 2005. During the October review, the Board urged the authorities to implement a time-bound action plan to address slippages in fiscal and monetary management. During the April review, the Board noted that Liberia's record on cooperation with the IMF in terms of policies and payments had been mixed since the last review, but agreed that this uneven policy performance reflected, to a large extent, the difficult post-conflict recovery and political circumstances. The Board decided

¹⁶For Somalia, the application of remedial measures has been delayed because of the absence of a functioning central government.

¹⁷Established in 1990, the rights approach permits a member to establish a track record on policies and payments to the IMF under a rights accumulation program and to earn "rights" to obtain IMF resources under successor arrangements following the completion of the program and settlement of the arrears to the IMF.

¹⁴The report, together with a report by an independent panel and previous update reports, is available on the IMF website at www.imf.org/external/fin.htm.

¹⁵See *Annual Report*, 2001, pages 72 and 73, for background on the IMF's strengthened cooperative strategy for dealing with arrears.

that no further remedial measures would be taken at that time. However, the Board urged the authorities to adopt and implement at an early date a comprehensive economic program that could be monitored by IMF staff and to increase their monthly payments to the IMF in light of fiscal and balance of payments developments.

- On December 15, 2004, the Board reviewed Sudan's overdue financial obligations to the IMF. The Board welcomed the favorable economic policy performance by the Sudanese authorities under the 2004 staff-monitored program, as well as the authorities' commitment to increase payments to the IMF to \$30 million for 2004. They urged Sudan to further increase its payments to the IMF in light of balance of payments developments, taking into account the fiscal and foreign exchange requirements of the peace process.
- The Board twice discussed the complaint by the Managing Director regarding Zimbabwe's compulsory withdrawal from the IMF.¹⁸ On July 7, 2004, the Board urged the authorities to adopt and implement a comprehensive adjustment program—including measures on the exchange rate, monetary and fiscal tightening, and structural reforms—as a matter of urgency. The Board noted the resumption of Zimbabwe's quarterly payments of \$1.5 million to the IMF. To provide the authorities with a further opportunity to improve cooperation with the IMF, the Board decided to again consider the complaint before January 6, 2005, which was subsequently extended to February 17, 2005. At its meeting on February 16, 2005, the Board noted Zimbabwe's payments of \$13.5 million to the IMF since the last review, which, however, fell short of stabilizing Zimbabwe's arrears to the IMF. The Board urged Zimbabwe to make every effort to increase payments and to resolve its overdue financial obligations to the IMF. The Board noted Zimbabwe's initial steps to arrest the economic decline but considered them to be insufficient. The Board again urged the authorities to adopt and implement a comprehensive adjustment program as a matter of urgency. The Board decided to further consider the Managing Director's complaint within six months or at the time it considered the 2005 Article IV consultation with Zimbabwe, whichever is earlier.

¹⁸The procedure on Zimbabwe's compulsory withdrawal from the IMF (under Article XXVI, Section 2(c) of the Articles of Agreement) was initiated on February 6, 2004.

As of the end of April 2005, Liberia, Somalia, Sudan, and Zimbabwe were ineligible under Article XXVI, Section 2(a) to use the general resources of the IMF. In addition, Zimbabwe had earlier been removed from the list of PRGF-eligible countries. Declarations of noncooperation—a further step under the strengthened cooperative arrears strategy—were in effect for Liberia and Zimbabwe, and their voting and related rights in the IMF were suspended. In addition, a complaint with respect to the compulsory withdrawal of Zimbabwe from the IMF remained outstanding.

External audit mechanism

The IMF's external audit arrangements consist of an External Audit Committee and an external audit firm. The External Audit Committee has general oversight of the external audit function and internal control processes. It consists of three members selected by the Executive Board and appointed by the Managing Director. The members serve for three years, on a staggered basis, and are independent. Committee members are nationals of different member countries of the IMF at the time of their appointment and must possess the qualifications required to carry out the oversight of the annual audit. The External Audit Committee generally meets twice a year in Washington and is available for consultation throughout the year.

The 2005 External Audit Committee members are Mr. Philippe Adhémar (Chair), *Conseiller Maître à la Cour des Comptes*, France; Mr. Pentti Hakkarainen, Board Member, Bank of Finland; and Dr. Len Konar, independent consultant, South Africa.

The responsibility for performing the external audit and issuing the opinion rests with the external audit firm. The external audit firm is selected by the Executive Board in consultation with the External Audit Committee and is appointed by the Managing Director. At the conclusion of the annual audit, the External Audit Committee transmits the report issued by the external audit firm, through the Managing Director and the Executive Board, to the Board of Governors. In the process, the External Audit Committee briefs the Executive Board on the results of the audit. The external audit firm is normally appointed for five years. Deloitte & Touche LLP is the IMF's present external auditor.

The IMF's financial statements for FY2005 form Appendix VII of this *Annual Report*.