

# ■ Who is paying for the IMF?

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*The International Monetary Fund (IMF) is expected to show a rapidly growing deficit for a number of years. At present, charges on outstanding credit are its major source of income. The stable global economic environment, low interest rates and increased access to the international financial markets have reduced IMF lending and caused a rapid drop in income. There is a need for a long-term solution that stabilises the Fund's income and makes it less dependent on lending. This raises many important questions regarding the level of costs and their distribution among the IMF membership. At present, the financing of the IMF's operational costs is concentrated to a limited number of industrialised countries and emerging market economies. Most members do not contribute or do so only marginally. Poor countries do not contribute. The purpose of this paper is to describe the Fund's often ill-understood financing and to explain the current problematic situation.<sup>1</sup>*

The IMF (International Monetary Fund) is an international organisation with 184 members. It was founded in Bretton Woods in 1944 with the aim to promote the welfare of the member states through financial and monetary stability. Its main activities are economic surveillance, technical assistance and financial assistance. Like any other organisation, the Fund needs to cover its costs in the long run. The original idea was that members should pay in accordance with their economic size or strength. This was achieved through a system where each member is expected to hold a non-interest bearing deposit in the Fund. This set-up, which resembles that of a cooperative bank, gave the Fund a certain degree of independence but the world has changed significantly since then. Many members do not keep the stipulated deposits and the size of the non-interest deposits has not kept up with IMF's financial needs. Hence, the IMF has become increasingly dependent on charges on outstanding debt. The

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value of outstanding debt is cyclical but has decreased rapidly over the last two years and is now at its lowest for over 20 years. It is expected to continue to decrease over the next few years. Forecasts based on the present lending profile show that under these circumstances IMF will not be able to break even and needs to look over its revenues and costs. This is a complex problem with many potential trade-offs regarding distribution of costs etc. This so-called income problem and possible solutions cannot be isolated from the IMF's financial structure. Below we therefore describe the financial structure before going through the income problem.

## The Fund's financial structure at a glance

The General Department of the IMF is by far the largest department and in order to simplify matters we focus on it. The other departments are relatively small, make very limited or no contributions to covering costs and are in practice much of adds-on to the General Department. Throughout the paper we have translated all amounts usually expressed in Special Drawing Rights (SDR) into US dollars (USD), using the official exchange rate of August 30, 2006, i.e. one SDR is worth USD 1.486. First we describe the balance sheet of the General Department and then we link the balance sheet to the income statement. Thereafter we discuss the distribution of costs among Fund members, present the current financial situation and discuss possible ways to improve it.

### BASIC CONCEPTS

From an accounting perspective the Fund is made up of three separate accounts called departments. These departments should not be confused with the organisational departments. In this paper the term department will be used in its meaning of a set of accounts. The *General Department* is the account and subaccounts of the cooperative bank, i.e. the "original" Fund from 1945. The *SDR Department* manages the allocation, trade and use of something called Special Drawing Rights (SDR, see below). The *Administered Accounts Department* handles capital paid in for special purposes, mainly the loans to poor countries, which have a gift part of 60 percent. These accounts consist mainly of governmental budget money and are kept within the framework of two trusts: Poverty Reduction and Growth Facility and Exogenous Shocks Facility Trust (PRGF-EFS) and Poverty Reduction and Growth Facility – Heavily Indebted Poor Countries Trust (PRGF-HIPC). To obtain a consolidated view of IMF's balance sheet one would have to merge the balance sheets of the three departments but typically they are treated separately. IMF's financial year (FY) comprises the period May 1–April 30, i.e. FY 2007 is the period May 1, 2006–April 30, 2007.

Two basic concepts in Fund financing are quota and SDR. Each member is assigned a quota, which is an amount expressed in SDRs that determines the member's maximum financial obligation vis-à-vis the Fund and its access to Fund credit. The quota broadly reflects the economic size of the country, taking similar countries into consideration, and is determined partly by a quota formula, and partly through a selective assessment. The total of all quotas forms the financial base of the Fund. Just like an owner's share, the quota determines the member's influence in the organisation in terms of voting power. For more information on quotas, see IMF (2001) and Nedersjö (2001).

The SDR is an asset representing a claim on a weighted basket of the US dollar (USD), Euro, Pound Sterling and Japanese Yen. The SDR serves as the unit of account of the IMF, its value is an important factor for determining financial obligations vis-à-vis the Fund and it serves as the basis for the calculation of interest rates. The composition of the SDR basket is reviewed every five years to ensure that it reflects the relative importance of currencies in the world's trading and financial systems. The latest review was conducted in November 2005 and in terms of value the basket consists approximately of 42.5 percent USD, 35.4 percent Euro, 11.5 percent Pound Sterling and 10.6 percent Japanese Yen.<sup>2</sup> On August 30, 2006, its value was USD 1.486. The SDR was introduced in 1969 by IMF to supplement gold and the USD as international reserve assets. At that time there was a fear that there would be a shortage of such assets. It was envisaged that the Fund would be a major supplier of liquidity. This scenario was never realised but the SDR has survived as a reserve asset that is used for certain purposes. For more on the SDR, see IMF (2001) or Nedersjö (2003).

The highest decision-making body is the Board of Governors, which consists of one governor and one vice-governor for each member country. They normally meet once a year. To its aid it has two advisory committees: the International Monetary and Financial Committee (IMFC) and the Joint IMF – World Bank Development Committee. Below the Board of Governors we find the Executive Board, which consists of 24 members, each representing a constituency of countries or a single large member country. They meet several times a week. Below the Executive Board there are the Managing Director and Deputy Managing Directors.

## THE BALANCE SHEET

In the General Department of IMF, each member country is assigned an amount called *quota* (see box) which broadly reflects the economic size of the country. One fourth of this amount is paid to IMF in internationally acceptable currencies such as USD, Euro, etc. In the language of the Fund, this paid-in capital is called currencies from *quota subscriptions* and is usually paid by the central bank. From the perspective of the central bank the paid-in capital is a liquid claim on the Fund in reserve currencies. Therefore it is a part of the foreign reserve and you find it on the assets side of the balance sheet of the central bank. The remaining three-quarters of the quota is provided in the member's own currency. It is not paid into the Fund but held in a special account at the issuing central bank. In practice the Fund has a claim on the central bank. The paid-in capital is either used by the IMF for financial assistance or invested in low-risk, short term liquid positions. Hence the analogy with a credit cooperative. The stylised balance sheets of the General Department of IMF are displayed in Figure 1, where the numbers reflect actual values. Numbers in parentheses denote changes and are used to illustrate an example given below in the text. On the assets side we have IMF's claims on member central banks (usable currencies, other currencies and outstanding credit). The total of these claims is equal to total quota (USD 313 bn). Usable currencies are those currencies that can be used in the Fund's operations, i.e.

<sup>2</sup> These shares were computed using the exchange rates of August 30, 2006. To be more precise, the recipe of a SDR is expressed in the following number of units of each currency: Euro 0.41, Japanese Yen 18.4, Pound Sterling 0.0903, and USD 0.632.

whose issuing central banks have a sufficiently strong external position in the sense that use of their currencies does not risk creating a balance-of-payments problem for them. There are also gold and invested reserves. Liquid resources in terms of usable currencies, invested reserves and gold amounted to approximately USD 240 billion at the end of FY 2006. On the liabilities side we have the central banks' claims on IMF: paid-in capital, the non-paid in capital and various reserves. What is not directly seen in the balance sheet is that IMF has a hidden reserve in its gold holdings. Until April 1 1978, the paid-in quarter of a member's quota was normally paid in gold. The gold is valued at its historical value (USD 8.8 billion) which is far below its current market value of approximately USD 60 billion.<sup>3</sup> There is thus a large hidden reserve embedded in the gold holdings. These reserves can be viewed as the guarantee for members' paid-in capital in case of credit losses and, however unlikely, if the IMF were to be dissolved. The use of gold is strictly regulated in the Articles of Agreement of IMF.<sup>4</sup>

Figure 1. The balance sheets of the Riksbank and the General Department of the IMF USD billion.\*

	Assets	Liabilities
RIKSBANK	Gold 3.0	Notes & Coin 15.4
	Claim on IMF 0.7 (+1)	Debts 5.1
	Currency 23.2 (-1)	Reserves 7.9
	Foreign reserves 23.9	Results 0.4
	Other assets 1.9	
	<b>Total assets 28.8</b>	<b>Total liabilities 28.8</b>
IMF	Assets	Liabilities
	Credit outstanding 29 (+1)	Paid-in capital 29 (+1)
	Usable currencies 224 (-1)	Non-paid capital 284 (-1)
	Other currencies 60	313
	<b>Total currencies 313</b>	
	Gold 9	Other liabilities 16
	Other 7	
	<b>Total assets 329</b>	<b>Total liabilities 329</b>

\* The Swedish Krona and SDR have been converted into USD using exchange rates of August 30, 2006. Numbers for the Riksbank and IMF are taken from their Annual Reports for 2005 and 2006, respectively.

<sup>3</sup> IMF holds 3,217 metric tons of gold. Its value as of March 31, 2006 was approximately USD 60 billion. Source: IMF website.

<sup>4</sup> Selling gold requires an 85% majority of the total voting power in the Board of Governors. If the gold is sold outright on the market the historical value should be transferred to the members' accounts in the General Department (General Resource Account) in order to restore the value of the paid-in capital. The rest should be added to the reserves of the General Department (Special Disbursement Account or the Investment Account). The Articles of Agreement also restrict the activities that can be financed through these accounts. An outright sale of gold will therefore not release capital that can be used freely by the fund. Under some circumstances gold can also be sold to members at its historical value.

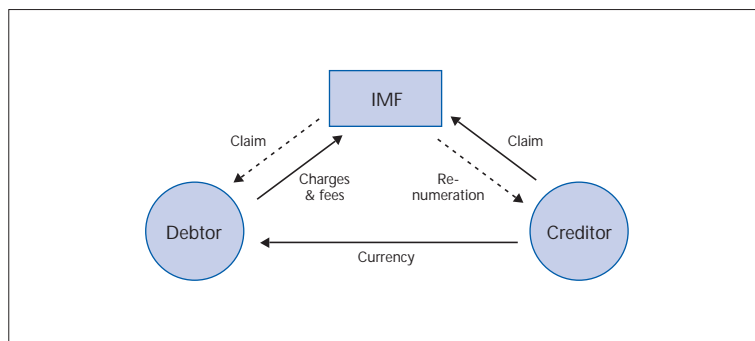
The main link between the balance sheet and the income statement is through IMF's role to provide loans to members with balance-of-payments problems.<sup>5</sup> This is, so to speak, the business idea of the cooperative bank: countries with strong balances of payments finance loans to members in need. This simple fact is hidden by a veil of so-called currency swaps between the IMF and the central banks of the debtor and the creditor countries (see Figure 2). Here, IMF and the debtor agree to swap some of the debtor's currency against some other currency, i.e. to let the debtor buy an internationally attractive currency, e.g. USD, which it pays for with its own currency, which is not attractive for international financial transactions and payments. IMF turns to one or several potential creditors. When Sweden acts as a creditor, the Fund withdraws Swedish currency from the account it holds with the Riksbank (usable but not paid-in currency). The Riksbank is then asked to exchange the withdrawn amount into the currency asked for by the debtor (USD in this example). This increases Sweden's paid-in capital and thus its claim on the IMF. The exchanged currency is then transferred to the debtor's central bank, which pays with its own currency to IMF's account in that central bank. The debtor's paid-in capital is reduced by the borrowed amount and if it becomes negative, IMF then has a net claim on the debtor's central bank. The loan is repaid when the currency swap is reversed, most often a few years later. In Figure 1 we show the impact of this financial assistance on the balance sheets of the Riksbank and the IMF. Notice that the value of the balance is unchanged for both the Riksbank and IMF but that the composition of the assets and liabilities has changed. The composition of the Riksbank's foreign exchange reserve has changed as it has traded currency against an increased claim on the IMF. On the assets side, the IMF has converted some of its claims on "usable currencies" into outstanding credit. On the liabilities side this is mirrored by an increased debt to central banks, i.e. paid-in capital has increased while reserves of non-paid in capital have decreased correspondingly. The balance-sheet changes at the debtor central bank mirror those in the books of the Riksbank. Book-keeping practices may of course differ between central banks. Using the analogy of a cooperative bank, the Fund owns its own balance sheet and is exposed to the financial risks associated with lending. The collateral it demands to reduce the financial risk is a so-called *programme* that essentially is an agreement on policy changes the debtor has to undertake, e.g. measures to reduce the government's deficit, deregulation of certain markets etc., to enable the country to repay its debt. A creditor country can-

<sup>5</sup> The lending discussed below is the ordinary financial assistance to non-poor countries handled through the General Department. Poor countries may access specific subsidised lending through the PRGF-EFS and PRGF-HIPC trusts (see Box on basic concepts).

not be asked to provide more currency than its quota and the debtor's access to currency is proportional to its quota (see below). Total quota is thus of vital importance for the Fund's capacity to carry out its tasks.

In summary, most of IMF's resources consists of paid-in capital and claims on member central banks. These resources are used to provide credit to members through a system of currency swaps. IMF also has own resources through its reserves and there is a hidden reserve in the Fund's holding of gold.

Figure 2. Financial assistance and related cash flows.



## THE INCOME STATEMENT

IMF's main source of income comes from the interest-rate spread between outstanding credit and paid-in capital. This income is used to finance the administration of the cooperative bank, the build-up of reserves and the "non-bank" core activities: surveillance and technical assistance.

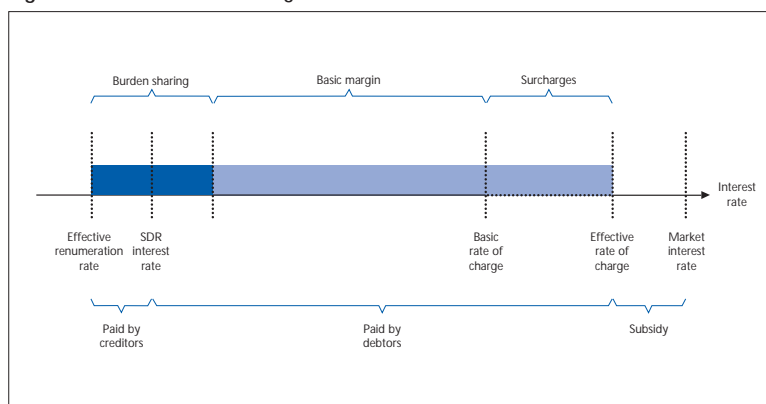
The interest paid by the debtor is called *charges* and the interest paid on paid-in capital is called *remuneration*.<sup>6</sup> Charges are determined by the type of financial assistance in question and the magnitude of the assistance. The latter is a relative measure where the size of the debt is related to the member's quota. All rich and middle-income debtors pay a *basic charge* and for debt levels above certain break points – often expressed as 200% or 300% of the country's quota – the debtor pays additional charges called surcharges (see Figure 3). Not all debtors pay surcharges and for them the effective rate of charge is the basic rate of charge.

To complicate matters further, this whole system is based on the *SDR interest rate*, which is the weighted average of the 3-month interest rates of the currencies in the SDR basket. The basic charge consists of the SDR rate plus a *basic margin* which currently is 108 points. Surcharges are pre-

<sup>6</sup> There are also fees which are the debtor's one-time cost of getting access to financial assistance.

determined numbers of interest-rate points and do not depend on the level of the SDR rate. The rate of remuneration is set to a certain per cent of the SDR rate (currently 100 per cent). There is also so-called *burden sharing*, which distributes the financial burden of late repayments and late charges over all members that pay charges or receive remuneration, i.e. it distributes the expected cost of liquidity risk over a subset of the members. From the viewpoint of the IMF there is almost no credit risk. A loan loss can occur only in the rare event of a debtor leaving the Fund. Unpaid charges and repayment are per definition late as long as the debtor is a member of the Fund.

Figure 3. The interest-rate margin.



The main source of income is charges. Additional income comes from returns from reserves and unremunerated assets (see below). On the cost side of the income statement the main items are remuneration and administrative expenses, where the latter are made up of costs for the three core activities: surveillance, financial assistance and technical assistance. In principle and given other sources of income, the basic margin is set to cover these costs and to generate a surplus. This surplus is used to build up reserves. Each financial year the Fund has a target for its surplus called the NIT (*Net Income Target*).<sup>7</sup> According to the rules of the IMF, surcharges can be used only to cover specific administrative costs and additional build-up of reserves, i.e. they cannot be used to cover ordinary administrative costs or to meet the NIT.<sup>8</sup> The purpose of these reserves is to protect the Fund against credit risk and income losses. Reserves also

<sup>7</sup> The NIT is equal to 5 per cent of the reserves of the General Resource Account minus approximately USD 140 million. This means that the IMF expects a long-term return of 5 per cent on its reserves, corrected for the profit from a gold sale in 1999.

<sup>8</sup> These administrative costs are related to the administration of the PRGF-EFS and PRGF-HIPC trusts that provide subsidised assistance to a limited number of low-income countries.

improve the Fund's liquidity, which enables the Fund to act quickly if necessary and the return from reserves is an income to the Fund. The Fund's target for the reserves is approximately USD 15 billion. At the end of FY 2006 the reserves amounted to nearly USD 10 billion.<sup>9</sup>

A source of income that has been successively less and less important to the IMF is the unremunerated paid-in capital. This requires some explanation. Recall that each member is expected to pay in 25 per cent of its quota and that the payment was usually made in gold. Gold has no returns and this paid-in capital was consequently unremunerated, which was fine as long as everyone paid in gold. When gold was abandoned for currency, the Fund could earn interest on paid-in capital from new members and it was only natural that the Fund started to pay remuneration on this capital. New members that paid in currency would thus get remuneration, while old members who had paid in gold would not. This was perceived as unfair. The dilemma was solved by deciding that both gold and a corresponding part of the new members' paid-in capital should be unremunerated. Every deposited asset in excess of this threshold is remunerated. These thresholds are, by construction, based on 1978 quotas but quota has been adjusted upwards a number of times since then. The unremunerated part has consequently decreased from 25 per cent of quota to 3.8 per cent on average over the whole membership. The return from these unremunerated assets is an income to the Fund. If the Fund has excess liquidity, this is often deposited with central banks of issue in order to reduce its remunerated positions. This is equivalent to a decrease in the paid-in capital.<sup>10</sup>

In short, debtors pay charges and surcharges and creditors receive remuneration. The interest-rate margin is the difference between paid charges and the effective rate of remuneration. It consists of the burden sharing, basic margin and eventual surcharges. The interest-rate margin is the main source of income and it finances administration and build-up of reserves.

<sup>9</sup> More specific, on April 30, 2006, the balance of the General Reserve was USD 5.3 billion, the balance of the Special Reserve was USD 3.6 billion and the balance of the SCA-1 was USD 1.3 billion. Source IMF Annual Report FY 2006.

<sup>10</sup> On the aggregate level the paid-in capital varies with the outstanding credit but the paid-in capital of an individual member also depends on other variables, i.e. whether the currency is considered usable or not (see section on the Fund's balance sheet above). The level of paid-in capital may therefore vary a lot over time for creditors and debtors. In the case of a creditor country such as Sweden the paid-in capital was 34.5 per cent of quota in March 2000. In September the same year it was 28.25 per cent. It then increased and in March 2003 it was 44.3 per cent of quota. It then decreased to 22.1 per cent in September 2005 and in August 2006 it was 12.4 per cent. Source: IMF website.



## THE DISTRIBUTION OF THE FINANCIAL BURDEN AMONG MEMBERS

The complicated financial set-up briefly sketched above makes it difficult to see how the burden of financing the Fund's costs is distributed among the members. At the same time, this is one of the most important aspects in that it contributes to the imposition of political constraints. The complexity of the issue is partly due to there being two alternative views, referred to here as the accounting view and the alternative-cost view.

Recall that the main income sources of the Fund are charges, returns on unremunerated resources and return on reserves. Charges and fees are paid by debtors to the General Department and returns from unremunerated resources are income forsaken by members with unremunerated positions, i.e. typically creditors. The share of IMF's administrative costs and increases in reserves that is covered by income from debtors through charges has increased from 27 per cent in FY 1982 to approximately 80 per cent in FY 2005. Creditors' share has decreased correspondingly. One reason for this shift in distribution is that, as mentioned above, the unremunerated part has not increased in nominal value with quota. The rate of remuneration has also increased from 90 per cent of the SDR-interest rate in 1979 to 100 per cent (1987). Any increase in expenses or increases in reserves has thus to be financed through other sources than unremunerated positions, i.e. it has to be funded through the basic margin paid by debtors. During the same period, administrative expenses have increased successively and, together with the policy decision to increase reserves, this has led to a large increase in the debtors' share.

However, this strict accounting view is questionable. The difference between the rate of remuneration and the corresponding market interest rate is a so-called alternative cost that is borne by the creditors, since it is an income they relinquish. Creditors' abstained income is then utilised by the Fund and debtors in the following way. Access to cheap capital enables the Fund to generate income through the interest margin and debtors are subsidised since they normally pay less for Fund credit than for corresponding market-based financing. This is illustrated in Figure 3. The subsidy to debtors corresponds to the distance between charges and the corresponding market interest rate for a loan, while the alternative cost for creditors is the distance between the effective rate of remuneration and the rate of return for alternative investments.<sup>11</sup> The picture is

<sup>11</sup> The average return on the creditor's remaining foreign reserve is a lower bound of alternative rate of return. Then the Riksbank's alternative cost was at least USD 20 million in the calendar year 2004 and USD 7 million in 2005. This corresponds to a difference of 154 points in 2004 and 85 points in 2005 as the paid-in capital varies (see footnote 10). The calculation does not take exchange-rate variations into account, which affects the amount of paid-in capital measured in SEK. Calculations are based solely on open sources such as Sveriges riksbank (2005 and 2006) and SDR-interest rates on IMF's homepage.

somewhat complicated by the fact that IMF's charges are based on the three-month SDR-interest rate, while the maturity of the loans is normally a few years. As the size of the risk premium usually increases with the maturity, debtors get a larger subsidy as they pay a short interest rate for a more long-term loan (this is not captured in Figure 3).

In the two views briefly presented above we talk about creditors and debtors as if the members of IMF could be easily divided into two separate subsets. In reality there is also the large group of members with little or no paid-in capital who are neither debtors nor creditors. The Fund has 184 members and in November 2005 about one half of them belonged to this third group with little or no paid-in capital. Since they don't pay charges or hold unremunerated or remunerated positions, they did not contribute, or contributed only marginally, to the financing of the Fund.<sup>12</sup> Less than one third of the members held 20 per cent or more of their quota with the Fund. Of these, not all are suitable as creditors because their external positions are not strong enough. It turns out that the G10 has approximately half of the total quota but accounts for approximately two thirds of the paid-in capital.<sup>13</sup> There is also a bias in the unremunerated positions, where rich countries usually have a higher unremunerated part than emerging market economies and low-income countries.<sup>14</sup> Hence, the financial burden attributed to creditors is concentrated to a small number of large creditors. Less than one fourth of the members were debtors but not all of them pay regular charges. Poor countries access special highly subsidised loans through the so-called PRGF-EFS and PRGF-HIPC trusts within the Administered Accounts Department. Usually they have also withdrawn their paid-in capital and consequently do not contribute. The debtors that contribute are thus a limited number of emerging market economies that are large debtors, foremost Turkey. To sum up, the burden of financing the Fund is concentrated to a limited number of rich countries and a small number of emerging market economies. The majority of the members contribute only marginally or not at all.

<sup>12</sup> At the end of FY 2006 there were 33 non-debtor countries with no paid-in capital. Of these, the following 22 countries have had no debts or any paid in capital during the four most recent financial years. Afghanistan, Angola, Antigua and Barbuda, Croatia, Egypt, El Salvador, Eritrea, Estonia, Guatemala, Islamic republic of Iran, Kiribati, Marshall Islands, Micronesia, Myanmar, Namibia, Palau, St. Lucia, Seychelles, South Africa, Syrian Arab Republic, Timor-Leste, and Turkmenistan. Source: IMF Annual Reports FY 2003 – 2006.

<sup>13</sup> More precisely, the G10 has 53.4 per cent of the total quota. In April 2003 the G10's share of paid-in capital was 71 per cent and in September 2005 it was 62 per cent. This share tends to be higher in times of high Fund lending than in times of low lending. In average the G10 share is approximately 2/3.

<sup>14</sup> On the equalities of unremunerated positions, see Polak (1999), who exemplifies this by contrasting the United Kingdom's unremunerated share of 6 per cent of its quota with Saudi Arabia's 0.5 per cent. In practice this means that one fourth of the United Kingdom's expected paid-in capital is unremunerated while the corresponding figure for Saudi-Arabia is only 2 per cent.

## The income problem

The General Department of the IMF resembles a cooperative bank that generates income from the interest rate spread between paid-in capital and outstanding credit. Over time the Fund has grown increasingly dependent on the part of this income that is generated from charges and thus also on the value of outstanding credit. During the last two years the Fund's outstanding credit has decreased from approximately USD 82 bn (December 2004) to USD 18.6 bn (October 5, 2006). This is more than the usual variation in lending and it has to do with various international and national factors such as economic growth, exchange rate volatility, debt levels, political stability etc. This suggests that the resulting deficit in IMF's finances is partly conjunctural, partly structural. The increased access for more countries to international financial markets, e.g. the eastern European countries, has increased their ability to handle variations in their balances of payments and thus decreased their need for financial assistance and so-called precautionary arrangements. Many countries have benefited from low international interest rates that have eased their burden of debt and helped to stabilise their balances of payments. Global economic and financial stability has so far eliminated the entry of new potential debtors and has allowed some of the old debtors to pay off their debts. The latter is exemplified by the early repayments by Brazil and Argentina totalling to USD 26 bn in December 2005 and January 2006. Indonesia also repaid their remaining debt of USD 3.2 bn early in October 2006.<sup>15</sup> After these repayments, 66 per cent of the remaining outstanding credit is owed by one debtor, Turkey. Through the strong link between income and lending, the current trend of economic stability and increased access for many countries to international capital markets has undermined the Fund's income position. In the medium-long run we expect IMF's income to fall from USD 1200 million in FY 2006 to USD 670 million in FY 2009. However, low interest rates and economic and financial stability may be temporary states of the world and it is too early to draw more long-run conclusions.

On the cost side, administrative expenses have increased in nominal terms from USD 600 million in the financial year (FY) 1998 to approximately USD 1020 million in FY 2006. Earlier forecasts for administrative expenses for the next few years indicate a slow growth in nominal terms. For the sake of simplicity, our simulations assume that administrative costs are frozen on the FY 2006 nominal level. The combination of decreasing

<sup>15</sup> On March 31, 2006 Uruguay announced its intention to make an early repayment of its 2006 obligations of USD 646 million (approx. SDR 435 million). Uruguay still owes USD 1.6 bn (SDR 1.1 bn) to be paid after 2006.

outstanding credit and non-decreasing administrative expenses will create a large and growing income gap over the next few years. IMF has taken two decisions to mitigate the impact of the expected fall in income. First, it has decided to temporarily abandon its policy target on accumulation of reserves (NIT) during FY 2007. This reduces the income gap by approximately USD 280 million. Secondly, it has created an investment account to increase returns from its reserves. The reserves amount to approximately USD 8.9 billion and the return has approximately been equal to the 3-month SDR-interest rate since much of the reserves has been held in central bank accounts in order to reduce remuneration. We estimate that a more active, but still cautious, investment policy in line with the one used by the Administered Accounts Department would increase the expected return by 40–60 points over time, i.e. an increase of approximately USD 50 million per year.<sup>16</sup> Table 1 illustrates the income gap under different policies (see below) under the assumptions of frozen administrative expenses and that NIT is set equal to zero for the whole period FY 2006–FY 2009.<sup>17</sup> The extended period during which the NIT is lifted reduces the income gap by approximately USD 310–330 million in FY2008 and FY 2009. The annual NIT is shown within brackets in Table 1 just to give an idea of its size. It is thus not included in the calculations. IMF has a net income of USD 180 million in FY 2006. This is USD 100 million less than the target but is not a deficit. Our calculations show that IMF will run a deficit already in the current financial year, i.e. FY 2007. This deficit may amount to USD 300 million in FY 2009. The growth of the deficit is due to decreasing income.

Below we briefly discuss a number of possible changes to the current policy for FY 2007–2009. Common for these policy changes is that they are easy to implement, i.e. there is no requirement for voting procedures with qualified majorities. We show that these easily implemented changes will not prevent the IMF from running a substantial deficit if the current development of lending prevails. Hence, there is a need for a more fundamental change that makes the Fund less dependent on lending. Such a change could take the Fund back to the original intention where all members contribute to the financing of the Fund in accordance with their eco-

<sup>16</sup> The investment policy for the PRGF-EFS and the PRGF-HIPC trusts stipulates that investments are made in fixed-term deposits, domestic government bonds of the United States, United Kingdom, Japan and the Euro zone. Bonds of some multilateral organisations are also invested in. Source: IMF Annual Report FY2005.

<sup>17</sup> The other underlying assumptions are (i) all debtors' repayments are made on time, (ii) no today unforeseen credit will be granted, (iii) the basic rate of charge remains unchanged at 108 points, (iv) the SDR-interest rate will be 4.0 per cent, and (v) the Fund stops waiving the reimbursement for the administrations of the PRGF-EFS and PRGF-HIPC trusts which is assumed to be approximately USD 90 million per year. The latter is financed through surcharges and a decision to stop waiving will decrease the build up of reserves from surcharges and increase "ordinary" income. This is merely a change in accounting that does not increase the revenues of the Fund or add any new resources.

TABLE 1. The expected income gap under different policies

	FY 2006	FY 2007	FY 2008	FY 2009
<b>Expenses and income under current policies</b>				
Income under current policies	1 200	780	690	670
Administrative expenses	1 020	1 020	1 020	1 020
Investment account	0	50	50	50
<b>Net income under current policies</b>	<b>180</b>	<b>-190</b>	<b>-280</b>	<b>-300</b>
Net income target (built up of reserves)	(280)	(300)	(310)	(330)
<b>Expenses and income under alternative policies</b>				
Use surcharges for administrative expenses	160	120	30	0
Stopped SCA-1 accumulation	0	90	60	40
<b>Remaining income gap</b>	<b>340</b>	<b>20</b>	<b>-190</b>	<b>-260</b>

Source: Own calculations based on data from open sources such as IMF Annual Report FY 2005 and FY 2006, and IMF's quarterly Financial Statements.

nomic size or strength. It would also mitigate the built-in contradiction in the finances of the Fund, i.e. that an organisation with the objective to prevent the need for financial assistance should be so financially dependent on lending. Finally, we discuss possible solutions to the income problem.

#### THE INCOME GAP UNDER ALTERNATIVE POLICIES

IMF has temporarily lifted the NIT but surcharges are still used to build-up reserves. A possible next step would be a total halt in the accumulation of reserves, i.e. to use surcharges to cover administrative costs. Under the assumption that repayments are made on schedule and that no new large debtor emerges, the contribution from surcharges would decrease over time, from USD 120 million in 2007 to zero in 2009. This would reduce, but not prevent, the expected deficit in each of the financial years 2007–2009.

It is also possible to increase the interest-rate margin. However, that might be counterproductive since higher charges may trigger more early repayments and lower remuneration may make members reluctant to pay in capital. Even if the interest-rate margin is held constant, the part of the burden-sharing that is not used to cover deferred charges (approx. USD 15 million per year) could still be used to cover administrative expenses. This part is basically an accumulation of reserves.<sup>18</sup> We assume that the level of burden-sharing and deferred charges will be constant over the coming period and that outstanding credit is paid on schedule. Then this

<sup>18</sup> Burden sharing comprises an adjustment for deferred charges and accumulation in the SCA-1 account. On August 30, 2006 this adjustment was 28 pts for creditors and 26 pts for debtors. That is, remunerated paid-in capital gave the SDR-rate minus 28 pts. Debtors paid the SDR-interest rate plus the basic charge plus 26 pts plus eventual surcharges.

will add some USD 90 million in 2007 and USD 40 million in 2009. The usage of both surcharges and the burden-sharing revenue would probably be sufficient to prevent a deficit in FY 2007 but not in FY 2008–2009.

We have deliberately chosen not to consider the introduction of charges for other services provided by the Fund, e.g. technical assistance and surveillance. The reason is that we believe such charges to be counterproductive in achieving the Fund's main objective. Surveillance and technical assistance have the character of a public good for all members. Therefore the burden of financing the production of the public good should also be distributed among the members. The introduction of charges could negatively impact the quality of the public good as it could risk individual members opting for less frequent surveillance. This public good argument is supported by the fact that there are strong synergies between the different core activities of the Fund. For this reason we also rule out large cuts in costs; a significant cut in cost and personnel is likely to have a large adverse effect on all three core activities.

The discussion above shows that there is a growing income gap under the current policies. The studied policy changes mainly halt the accumulation of reserves. Our calculations have shown that this will not be sufficient. If the level of outstanding credit keeps on declining, there is a need for more fundamental policy changes.

#### POSSIBLE SOLUTIONS

What should the frame of thought be for a fundamental change in the financing of the IMF? The output of the Fund has the character of public good and being a member of the Fund may also be perceived as some kind of insurance of financial assistance under certain circumstances. It is therefore reasonable that most countries contribute to the financing of the Fund. How much should they contribute? This question is related to two separate issues. The first is the degree of financial independence the members want the Fund to have, i.e. should the Fund be largely dependent on income from members or should it have a large income from own resources? The second issue relates to the perceived fairness of the distribution of the financial burden, e.g. should large and rich members pay relatively more than small and poor members? Below we discuss the alternatives of a member-based financing and an independent financing based on the Fund's own resources. The financing of the Fund, among other things, is regulated in the Articles of Agreement that stipulate what can be done and under what circumstances, e.g. that a gold sale requires the approval of at least 85 per cent of the total voting power of the Board of Governors. This is also the voting power that is required to change the

Articles of Agreement. To gather such a majority tends to be difficult and time consuming.

The first alternative, a financing that is based on income from members and is not dependent on lending, implies in practice either a lower rate of remuneration or some kind of annual fee. One difficulty with reduced remuneration is that, for the reduction to be sufficiently large, the Articles of Agreement have to be changed. At present the Articles do not allow a rate of remuneration below 80 per cent of the SDR rate and gathering the necessary qualified majority behind such a proposal is likely to be difficult. However, as other changes in the Fund are being discussed – for instance an increase in basic votes – that require amendments to the Articles of Agreement, a change in financing could be part of the package and be done at the same time. Given a change in the Articles of Agreement, we believe that lowered remuneration as well as a broader number of contributor countries would be a good long-run solution that would also have the benefit of opening up for a more transparent financing. In this context it is interesting to recall that a proposal called the uniform variable norm was discussed in the early 1990s. The basic idea was to require all members to hold unremunerated paid-in capital corresponding to a uniform share of their quota. This share could vary over time and would be set to cover the Fund's costs other than remuneration costs. This simple approach would then allow the Fund to set the remuneration rate and the basic charge equal to the SDR-interest rate, i.e. to skip the complicated basic margin (see figure 3). Despite intense discussions in 1994 and 1995, the proposal never received the requisite Board support. The main reasons for this were the issues of burden sharing and that countries that withdraw their paid-in capital would have to pay charges on the unremunerated part, i.e. in practice they would be required to hold the stipulated paid-in capital.<sup>19</sup> In theory it is also possible to implement some kind of annual fee but this solution also poses serious problems. First, the Articles of Agreement do not allow for such a fee and many central banks cannot, for legal reasons, pay such a fee. The Riksbank, for instance, would have to obtain parliamentary approval every year. With such a fee, the IMF would be more vulnerable to political pressure.<sup>20</sup>

Another way forward is to utilise IMF's hidden reserve in gold. The basic idea would be to sell gold and put the part of the profit that does not go back to the members' accounts in the investment account (see footnote 4). The returns from the investment account would then be used

<sup>19</sup> An annual contribution of USD 300 million would require an increase in the unremunerated positions of approximately USD 8-9 billion, i.e. 2.7 per cent of total quota or 11 per cent of required paid-in capital.

<sup>20</sup> An annual contribution of USD 300 million corresponds to an annual fee of 0.1 per cent of a member's quota or, alternatively, USD 1.6 millions per member.

to finance the Fund's core activities. This solution is consistent with the Articles of Agreement, which forbid the direct use of gold to finance IMF's operations (see footnote 4). Under the assumption that the investment account yields 40–60 points above the SDR-interest rate, IMF would have to sell approximately 15 per cent of its gold in order to generate the return of USD 300 million per year that is needed to eliminate the expected deficit. The difficulty of a gold sale lies in the fact that gold is one of the world's major reserve assets and is traditionally a part of every country's foreign reserve. For this reason, IMF and its members have in the past been reluctant to sell gold.<sup>21</sup> IMF's gold makes up a significant part of the world's total gold reserves. A large-scale sale by the Fund would have to be carefully designed to limit the market impact. Thus, an eventual sale of gold is no quick fix. It must be planned well in advance, is likely to be preceded by difficult and lengthy negotiations and the sale itself must be made over a long period of time. One short cut, albeit unlikely, would be for some central banks to agree to buy gold directly from IMF at market price.

Finally we want to mention an interesting suggestion by Polak (1999) that would both increase income and improve transparency.<sup>22</sup> He suggests a merger between the SDR Department and the General Department. The SDR Department administers a managed market for SDRs in which there is no interest-rate margin. In short, this means that unconditional lending through the SDR Department is cheaper than conditional lending from the General Department. A merger of the two departments would allow the Fund to introduce an interest-rate margin that would eliminate this anomaly and increase income. Under the assumption that this lending continues on the same level as in FY 2004–2006 (USD 10 billion) and that the interest-rate margin is equal to the basic margin plus burden sharing, the expected revenue is USD 160 million per year.

Above we have pointed to a gold sale as one solution to IMF's income problem. This solution would give the Fund greater financial independence. Another solution is a substantially decreased remuneration and a broadening of the number of contributors. This solution has the advan-

<sup>21</sup> In 1999, 15 European central banks entered an agreement that regulated their sales of gold. In short, they agreed to not sell more than approximately 400 tonnes per year for the next five years, i.e. 2000 tonnes over five years. In 2004 they renewed the agreement but changed the limit to 2500 tonnes over five years. The central banks that are parties to the second agreement are the European Central Bank and the central banks of Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and Switzerland.

<sup>22</sup> The interested reader is recommended to read Polak (1999) for a more detailed description of the consequences of a merger. The figures above are based on our own calculations and we are solely to blame for any errors.



tage of being in line with the original view of the Fund's financing – to let all members contribute to the Fund's production of public good.

## Summary and discussion

The aim with this paper has been to explain and discuss IMF's financial set-up. The Fund is set up like a cooperative bank and finances its core activities mainly through the interest-rate margin that exists between paid-in capital and lending. The current dependence on outstanding credit has successively been built up over time. This has created a structural weakness in the Fund's financing mechanism. The Fund's objective is to promote financial and monetary stability. If it is successful, there will be little demand for financial assistance. At the same time the Fund has become heavily dependent on lending. As a result, in times of low demand for financial assistance the Fund faces difficulties to finance the administration needed for its core activities: surveillance, financial assistance and technical assistance.

The present level of outstanding credit is at the lowest since the early 1980s and is expected to continue to decrease for at least the next few years. This absence of crises has created a growing income gap in IMF's finances. One long-run solution that we point to here is to utilise IMF's hidden reserves in gold by investing the profit from a gold sale. The returns from these investments could then be used to finance IMF's core activities. This would give the Fund a more self-sustained financial basis and thus a degree of financial independence. Another solution would be to lower the rate of remuneration, or to increase the unremunerated part of the paid-in capital, in combination with a broadening of the number of countries that contribute. This solution would be in keeping with the original line of thinking when the Fund was created. Our discussion has focused on increasing income rather than lowering administrative costs. The main reason is the public good nature of the core activities of the Fund and the presence of large synergies between them. This does not rule out that costs have to be kept on tight reins. This requires discipline from members, not only in adding new tasks but also in winding up old ones.

The current financing mechanism is non-transparent and the distribution of the financial burden is very different from the layman's belief. This non-transparency is bad as it also blurs the discussion on suggested changes in IMF. An eventual sale of gold would not in itself solve the problem with the non-transparent system of financing. Additional changes would be needed to make the distribution of the part of the income that comes from members more transparent. The uniform variable

norm has the advantage of making the system more transparent at the same time as most countries would contribute to the financing of the Fund in accordance with their economic strength.

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