**INTERNATIONAL MONETARY FUND**

# The Fund's Income Position for FY 2006—Update to the Midyear Review

Prepared by the Finance Department

In consultation with the Legal Department and the Office of Budget and Planning

Approved by Michael G. Kuhn

January 5, 2006

1. **This paper provides updated information on the Fund's income position.** The regular midyear review of the Fund's income for FY 2006 was completed by the Executive Board on December 9, 2005.[1] That review projected a small shortfall of SDR 18 million from the regular net income target of SDR 188 million. The projection was based on the usual set of assumptions, including that repurchases would be made as scheduled.

2. **In mid-December, Brazil and Argentina announced their intention to make advance repurchases of all outstanding obligations to the Fund.** The advance repurchases by Brazil of SDR 10.8 billion were completed on December 27, 2005. The advance repurchases by Argentina of SDR 6.7 billion were completed on January 4, 2006. These repurchases are a welcome sign of these countries' success in strengthening their external positions.[2] They also underline the revolving nature of the Fund's resources, which is a central element of the Fund's financial structure.

3. **The advance repurchases add to the Fund's already comfortable liquidity position.** The main measure of the Fund's liquidity, the one-year forward commitment capacity, already at a record high, has risen further to about SDR 112 billion. Fund credit outstanding in the GRA has declined from SDR 39.1 billion at end-November 2005 to SDR 21.7 billion in early January 2006. Apart from a short period in 1990, this is the lowest level of Fund credit outstanding since the early 1980s.

4. **The advance repurchases also add to the expected income shortfall in FY 2006.** Updated projections, presented in Attachment I, indicate a projected shortfall in regular net income of SDR 80 million, an increase of SDR 62 million from the earlier midyear projection. This increased shortfall is attributable to lower earnings from the margin for the rate of charge because of the reduction in GRA credit outstanding. The early repurchases by Brazil account

[1] See *The Fund's Income Position for FY 2006—Midyear Review*.

[2] See Press Release Nos. 05/275 (12/13/05) and 05/278 (12/15/05).

for SDR 40 million of the increased shortfall, while the early repurchases by Argentina account for the remainder.

5. **No immediate action is required by the Executive Board**. The projected income shortfall remains below the threshold that would have triggered the safeguards clause at the midyear review. A shortfall exceeding the threshold (SDR 112 million, equal to two percent of reserves at the beginning of the year) would have called for consideration by the Executive Board of how to deal with the situation had this occurred at midyear.[3]

6. **Reserve accumulation for FY 2006 is still projected at SDR 210 million.** This represents a decline of SDR 92 million relative to the projections at the time of the midyear review. Taking into account the accumulation of SDR 94 million in the SCA-1, which is financed through burden sharing, precautionary balances would increase by slightly over SDR 300 million, or 5.3 percent of the Fund's reserves at the beginning of FY 2006.

7. **The recent large early repurchases highlight the pressures on the Fund's medium-term income outlook.** Under current arrangements, the Fund's income position depends heavily on the future path of Fund credit. In November 2005, the Committee on the Budget was presented with alternative scenarios for FY 2007 and over the medium-term of the margin for the rate of charge depending on the outlook for Fund credit and the SDR interest rate. These scenarios assumed the continued application of existing rules and decisions governing the rate of charge, and were therefore intended to be purely illustrative. It was noted that a fall in Fund credit to below SDR 25 billion over the next three years was a plausible scenario, and the latest developments suggest that the low credit scenario may have become a reality sooner than was previously anticipated.

8. **These developments suggest that a comprehensive examination of the options for handling the Fund's income position in FY 2007 and beyond is needed**. On current projections, the Fund would record a loss in FY 2007 at the current margin of 108 basis points. Thus, the size of the margin along with the other available options will need to be examined. The staff plans to circulate a paper to the Board in late January that will consider these issues. That paper will revisit the various options that have been discussed to date, including: (i) activation of the Investment Account with the objective of generating net investment income which could help cover the Fund's operating expenses; (ii) widening the scope for user and commitment fees and third-party financing; (iii) reducing the rate of remuneration within the limits set by the Articles of Agreement; and (iv) adapting the current system for setting the net income target to an environment of substantial fluctuations in credit

[3] The Executive Board reviews the Fund's income position at midyear and, if necessary, considers how to address any shortfall in income at midyear. Under Rule I-6(4)(b), referred to as the "safeguard clause", should actual regular net income at midyear indicate an annualized shortfall equal to or greater than two percent of the Fund's reserves at the beginning of the financial year (equal to SDR 112 million for FY 2006), the Executive Board will consider how to deal with the situation. If by December 15 no agreement has been reached as a result of this consideration, the margin over the SDR interest rate, used to calculate the rate of charge at the beginning of the year is increased as of November 1 to the level necessary to reach the target amount of net income for the year.

levels over the medium term. The paper will also discuss various combinations of measures that could be considered, with the aim of facilitating a consensus on the appropriate approach for FY 2007 before the end of the current financial year.

## Table 1. Updated Projected Income and Expense
## Financial Year 2006

(In millions of SDRs)

| | FY 2006 | | | |
|---|---|---|---|---|
| | Actual Result November | Revised Projections at midyear 1/ | Updated Revised Projections 2/ | Initial Projections 3/ |
| **Regular Income** | | | | |
| 1. Operational Income | | | | |
| a. Periodic charges, including burden sharing | 953 | 1,596 | 1,363 | 1,558 |
| b. Interest on SDR holdings | 13 | 20 | 25 | 22 |
| c. Service and stand-by charges: | 10 | 20 | 21 | 23 |
| Total operational income | 976 | 1,636 | 1,409 | 1,603 |
| 2. Operational Expense | | | | |
| Remuneration, including burden sharing | 571 | 954 | 789 | 920 |
| 3. Net operational income | 405 | 682 | 620 | 683 |
| 4. Administrative expense | 331 | 570 | 570 | 551 |
| Less: estimated cost of administering the PRGF Trust | (34) | (58) | (58) | (56) |
| | 297 | 512 | 512 | 495 |
| 5. Regular net income | 108 | 170 | 108 | 188 |
| **Other Income** | | | | |
| 6. Surcharges | 222 | 326 | 296 | 402 |
| Less: estimated cost of administering the PRGF Trust | (34) | (58) | (58) | (56) |
| | 189 | 268 | 238 | 346 |
| 7. Other - IAS 19 4/ | 79 | 136 | 136 | -- |
| 8. Total other income | 109 | 132 | 102 | -- |
| 9. Total net income | 218 | 302 | 210 | -- |

1/ Projections based on assumptions set out in *The Fund's Income Position for FY 2006—Midyear Review*.

2/ Updated projections based on assumptions set out in *The Fund's Income Position for FY 2006—Midyear Review*, except for credit outstanding following the advance repurchases by Argentina and Brazil.

3/ Initial Projections made at the beginning of FY 2006 are based on assumptions set out in *Review of the Fund's Income Position for FY 2005 and FY 2006*.

4/ The IAS 19 expense for FY 2006 was not available when the income projections for FY 2006 were prepared.