

# Financial operations and policies



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 (see Table 5.1). 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 at a very low interest rate and with long maturities to low-income member countries. These loans support programs designed to strengthen balance of payments positions, respond to unexpected shocks, foster durable growth, raise living standards, and reduce poverty. The Fund also makes grants available to eligible heavily indebted poor countries and certain other low-income countries to help them achieve sustainable external debt positions and achieve their poverty reduction goals. The principal for concessional loans is funded by member countries that make resources available to the IMF at market-based rates, with the Fund acting as a trustee. Resources used to subsidize the rate charged to borrowers and grants for debt relief are financed by separate contributions from some member countries and out of the IMF's own resources.

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

There were a number of significant financial developments in FY2006:

- Outstanding IMF credit declined to low levels as a favorable external financing environment for emerging market countries contributed to a sharp reduction in the demand for IMF credit and to the early repayment of outstanding IMF credit by a number of large borrowers.
- The decline in credit outstanding led to a corresponding drop in IMF income, the main source of which is the

interest charged on loans. In response, the Fund initiated steps to develop a stable and diversified income base that is less dependent on its lending operations. The Executive Board established an Investment Account to enable the IMF to invest its reserves, thereby broadening the sources and increasing the level of its income. Further steps to strengthen the IMF's financial structure and enhance its income-generating capacity are being considered in the context of an ongoing review of the Fund's finances.

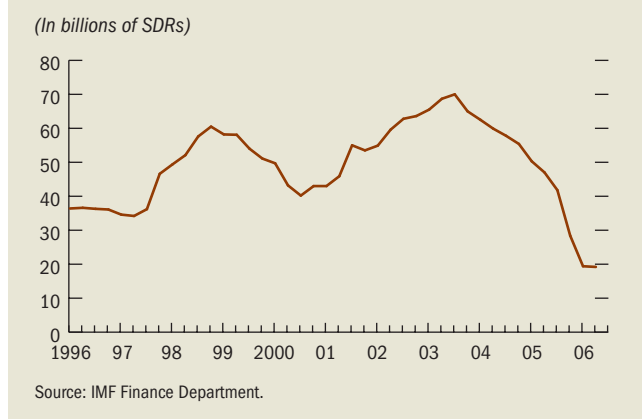
- Major initiatives were introduced that enhance the ways in which the IMF helps its low-income members achieve faster economic growth, reduce poverty, decrease their debt burdens, and address the impact of adverse shocks. These initiatives include the establishment of the Exogenous Shocks Facility and the Multilateral Debt Relief Initiative, which are described in detail in Chapter 6.

## Regular financing activities

The funds for the IMF's regular lending activity come from member countries' quota subscriptions, which are held in the General Resources Account (GRA) (Box 8.1). The bulk of IMF lending is provided under Stand-By Arrangements, which address members' short-term balance of payments difficulties, and the Extended Fund Facility (EFF), which focuses on external payments difficulties caused by longer-term structural problems. Loans under Stand-By and Extended Arrangements can be supplemented with short-term resources from the Supplemental Reserve Facility (SRF) for members experiencing a sudden and disruptive loss of access to capital markets. 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 (see Table 5.1).

## Lending

During FY2006, repayments on loans increased sharply, to SDR 32.8 billion. Many countries—Algeria, Argentina, Armenia, Brazil, the Republic of Congo, Georgia, Papua New Guinea, Uzbekistan, and Zimbabwe—repaid all of their GRA obligations to the IMF, some ahead of schedule. Advance repayments totaling SDR 21.9 billion were made by Algeria (SDR 246 million), Argentina (SDR 6.7 billion),

**Figure 8.1** Regular loans outstanding, 1996–April 30, 2006

Brazil (SDR 14.2 billion), Bulgaria (SDR 249 million), and Uruguay (SDR 519 million).

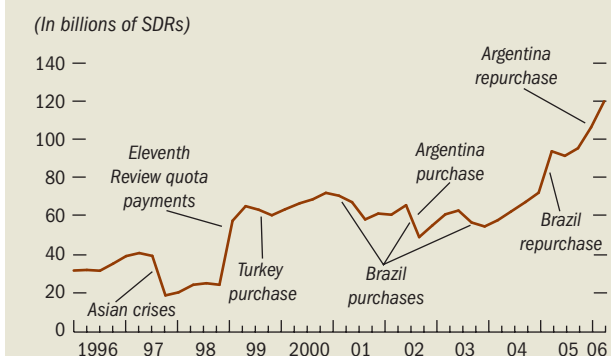
Disbursements during the financial year were relatively low—totaling SDR 2.2 billion—the bulk of which was disbursed to Turkey under its Stand-By Arrangement. In addition, Emergency Post-Conflict Assistance disbursements totaling SDR 17.2 million were made to the Central African Republic and Haiti.

Reflecting the high level of net repayments, IMF credit outstanding at the end of FY2006 stood at SDR 19.2 billion, a 25-year low, compared with SDR 49.9 billion in April 2005 (Figure 8.1).<sup>1</sup>

In addition to advance repayments, 18 members—Bolivia, Bosnia and Herzegovina, Brazil, Bulgaria, the Dominican Republic, Ecuador, Indonesia, Jordan, the former Yugoslav Republic of Macedonia, Pakistan, Papua New Guinea, Romania, Serbia and Montenegro, Sri Lanka, Turkey, Ukraine, Uruguay, and Yemen—made repayments on the expectation schedule in the amount of SDR 2.9 billion during the year. Five members requested and were granted extensions of repurchase expectations (Table 8.1). As of April 30, 2006, there was no outstanding credit subject to time-based repurchase expectations under the policies adopted in November 2000 (Box 8.2).

New IMF commitments rose sharply, from SDR 1.3 billion in FY2005 to SDR 8.4 billion in FY2006—largely reflecting the Stand-By Arrangement in the amount of SDR 6.7 billion approved for Turkey in May 2005 (Table 8.2). The IMF approved a total of five new Stand-By Arrangements and one augmentation of an existing Stand-By Arrangement. In addition, one Extended Arrangement was approved for Albania. Haiti and the Central African Republic made purchases under the policy on Emergency Post-Conflict Assistance (EPCA). No commitments were made under the

<sup>1</sup>As of April 30, 2006, SDR 1 = US\$1.47106.

**Figure 8.2** IMF one-year forward commitment capacity (FCC), 1996–April 2006

Source: IMF Finance Department.

Note: The IMF started publishing data for 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 note selected large financial commitments by the IMF to members and groups of members.

IMF's Supplemental Reserve Facility (SRF) and Compensatory Financing Facility (CFF) during the year.

Eleven Stand-By and Extended Arrangements were in effect as of the end of FY2006, 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. At the end of April 2006, undrawn balances under all arrangements still in effect amounted to SDR 7.5 billion.

## Resources and liquidity

The IMF's lending is financed primarily from the fully paid-in capital (quotas) subscribed by member countries in the form of reserve assets and currencies. 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, and the current Thirteenth General Quota review period will end in January 2008. A member's quota can also be adjusted separately from a general review to take account of major developments in the member's economy relative to the world economy. In addition, 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 as a result of the Fund policy of lending only in the currencies of members that are financially strong. The IMF's base of usable resources increased during FY2006 after Kazakhstan and the Slovak Republic were

added to the IMF's Financial Transactions Plan (Box 8.3).

The IMF's liquidity, as measured by the Forward Commitment Capacity (FCC; see Box 8.4), rose to an all-time high of SDR 120.1 billion at the end of April 2006, from SDR 94.3 billion at the end of April 2005 (Figure 8.2).

### Concessional financing activities

The IMF provides support to its low-income members through a variety of instruments. These include concessional lending through its Poverty Reduction and Growth Facility (PRGF), grants to eligible heavily indebted poor countries (HIPC) to help them achieve debt sustainability, and subsidized emergency assistance to post-conflict countries and to countries hit by natural disasters. During FY2006, the IMF launched two major initiatives to further strengthen its financial assistance to its low-income members—the Multilateral Debt Relief Initiative (MDRI) and the Exogenous Shocks Facility (ESF).

In July 2005, the Group of 8 (G-8) proposed that the IMF, the International Development Association, and the African Development Fund cancel 100 percent of their claims on countries having reached, or upon reaching, the completion point under the enhanced HIPC Initiative. In response, the IMF Executive Board adopted the MDRI in November 2005, which became effective on January 5, 2006. The MDRI provides debt relief to member countries with an annual per capita income at or below \$380, and to HIPC above that threshold, with respect to the stock of their debt to the IMF disbursed as of end-2004 that remains outstanding when the country qualifies for MDRI debt relief. The MDRI debt relief is intended to complement the HIPC Initiative by providing additional resources to help a group of low-income countries reach the Millennium Development Goals. The cost to the IMF is to be covered through the institution's own resources and those provided through bilateral contributions.

At its September 2005 meeting, the International Monetary and Financial Committee (IMFC) endorsed a proposal to establish a facility to provide concessional financing to low-income countries that experience exogenous shocks but do not have a PRGF arrangement in place. The IMF Executive Board subsequently approved on November 23, 2005,

the establishment of the ESF within the PRGF Trust (now known as the PRGF-ESF Trust).

The implementation of the MDRI and ESF decisions resulted in changes to the financial structure for providing concessional assistance to low-income members (Box 8.5).

See also Chapter 6.

### Poverty Reduction and Growth Facility

The IMF's concessional lending through the PRGF includes, as a key objective, an explicit focus on poverty reduction in the context of a growth-oriented economic strategy. PRGF loans support strategies elaborated by the borrowing country in a Poverty Reduction Strategy Paper (PRSP) prepared with the participation of civil society and development partners. These loans carry an annual interest rate of 0.5 percent, with semiannual repayments beginning 5½ years and ending 10 years after disbursement.

During FY2006, the Executive Board approved seven new PRGF arrangements (for Albania, Armenia, Benin, Cameroon, Grenada, Malawi, and São Tomé and Príncipe), with commitments totaling SDR 107.9 million (Table 8.3). In addition, the Board approved the augmentation of an existing arrangement for Niger in the amount of SDR 19.7 million to help the country recover from the economic impact of a severe drought and terms of trade deterioration. Total

**Table 8.1** Extension of repurchase expectations in FY2006

Member	Period covered by extension <sup>1</sup>	Approval date	Amount extended
<i>(In millions of SDRs)</i>			
Argentina	May 20, 2005–April 28, 2006	May 18, 2005	1,683.1
Dominica	December 22, 2005–December 22, 2006	October 14, 2005	1.3
Macedonia, FYR	November 4, 2005–September 29, 2006	August 31, 2005	5.4
Macedonia, FYR	September 30, 2006–December 31, 2007	April 20, 2006	13.4
Turkey	January 2, 2006–December 22, 2006	May 11, 2005	2,520.7
Uruguay	February 8, 2006–December 19, 2006	January 18, 2006	540.9
<b>Total<sup>2</sup></b>			<b>4,764.7</b>

Source: IMF Finance Department.

<sup>1</sup>The period in which extended repurchases were originally due.

<sup>2</sup>Figures may not add up to total because of rounding.

**Table 8.2** IMF regular loans approved in FY2006

Member	Type of arrangement	Effective date	Amount approved <sup>1</sup>
<i>(In millions of SDRs)</i>			
Albania	3-year Extended Arrangement	February 1, 2006	8.5
Colombia	18-month Stand-By	May 2, 2005	405.0
Croatia	Augmentation of Stand-By	March 29, 2006	2.0
Iraq	15-month Stand-By	December 23, 2005	475.4
Macedonia, FYR	3-year Stand-By	August 31, 2005	51.7
Turkey	3-year Stand-By	May 11, 2005	6,662.0
Uruguay	3-year Stand-By	June 8, 2005	766.3
<b>Total</b>			<b>8,370.9</b>

Source: IMF Finance Department.

<sup>1</sup>For augmentations, only the amount of the increase is shown.



**Box 8.1 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—based largely on the country's relative economic size and external trade volume—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 8.3).

A loan is disbursed by the IMF when a borrower "purchases" 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 8.9) 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 tranche 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, 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 (Box 8.4).

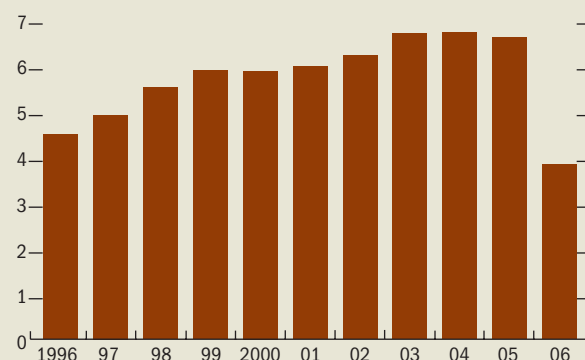
Detailed information on various aspects of the IMF's financial structure and regular updates of its financial activities are available on the IMF's website at [www.imf.org/external/fin.htm](http://www.imf.org/external/fin.htm).

PRGF disbursements amounted to SDR 0.4 billion during FY2006. As of April 30, 2006, 27 member countries' reform programs were supported by PRGF arrangements, with commitments totaling SDR 1.8 billion and undrawn balances of SDR 0.7 billion; total PRGF credit outstanding as of end-April 2006 stood at SDR 3.8 billion (Figure 8.3).

As described in Box 8.5, financing for the PRGF is provided through the PRGF-ESF and PRGF-HIPC Trusts. As of end-April 2006, total loan resources available for PRGF-ESF operations amounted to SDR 15.8 billion, of which SDR 12.9 billion had already been committed to borrowing members. The remaining uncommitted PRGF-ESF loan resources of SDR 2.9 billion are expected to be able to cover the projected demand for PRGF lend-

**Figure 8.3 PRGF credit outstanding<sup>1</sup>**

(In billions of SDRs; end of financial year)



Source: IMF Finance Department.

<sup>1</sup>Includes outstanding associated loans from the Saudi Fund for Development.

**Table 8.3 PRGF arrangements approved in FY2006**

Member	Effective date	Amount approved
(In millions of SDRs)		
Albania	February 1, 2006	8.5
Armenia	May 25, 2005	23.0
Benin	August 5, 2005	6.2
Cameroon	October 24, 2005	18.6
Grenada	April 17, 2006	10.5
Malawi	August 5, 2005	38.2
Niger <sup>1</sup>	November 14, 2005	19.7
São Tomé and Príncipe	August 1, 2005	3.0
<b>Total</b>		<b>127.7</b>

Source: IMF Finance Department.

<sup>1</sup>PRGF augmentation.

ing through 2008.<sup>2</sup> SDR 12.1 billion of the committed resources had been disbursed. Based on current assumptions, subsidy resources available for the PRGF, amounting to SDR 1.3 billion in end-2005 net present value (NPV) terms, would need to be supplemented by about SDR 0.1 billion to ensure full subsidization of existing and future PRGF lending through 2008.

**Exogenous Shocks Facility**

The IMF launched the ESF in FY2006 to provide concessional assistance to low-income members that are facing sudden exogenous shocks (such as a large terms of trade shock) but do not have a PRGF arrangement in place. The IMF's Executive Board adopted decisions to implement the ESF on November 23, 2005, and the decisions became effective on January 5, 2006. Loans under the ESF carry repayment terms identical to those of the PRGF.

<sup>2</sup>This excludes any potential need for concessional financing for the three protracted arrears cases—Liberia, Somalia, and Sudan—in the event of arrears clearance and a subsequent PRGF arrangement.

**Table 8.4** Subsidy contributions for the ESF

(FY2006; on a cash basis)

Contributors	Contribution pledged <sup>1</sup>	Date of pledge	SDR equivalent
<i>(In millions of currency units)</i>			
Canada	SDR 14.3	11/28/05	14.3
France <sup>2</sup>	US\$ 30	12/16/05	20.4 <sup>3</sup>
Japan	SDR 20	11/28/05	20.0
Oman	SDR 3	3/19/06	3.0
Norway	SDR 24.7	3/15/06	24.7
Russian Federation	SDR 30	1/30/06	30.0
Saudi Arabia <sup>4</sup>	SDR 40	3/7/06	40.0
Spain	SDR 5.3	4/24/06	5.3
United Kingdom <sup>5</sup>	£50	11/23/05	61.3 <sup>3</sup>
<b>Total</b>			<b>219.0</b>

Source: IMF Finance Department.

<sup>1</sup>Some contributions are still subject to parliamentary approval.<sup>2</sup>To be generated as an implicit subsidy through new loan resources of \$1 billion provided at a concessional rate.<sup>3</sup>Calculated using the end-April exchange rate for contributions to be disbursed.<sup>4</sup>In end-2005 NPV terms.<sup>5</sup>First installment (£10 million) was disbursed on March 21, 2006, equivalent to SDR 12.1 million.

To finance projected ESF lending over the next five years, it is estimated that loan resources totaling SDR 2 billion and subsidy resources of SDR 0.5 billion (in end-2005 NPV terms) will need to be mobilized. In November 2005, the IMF initiated efforts to mobilize resources for ESF subsidies and approached a broad spectrum of members, including the members of the Organization for Economic Cooperation and Development (OECD), oil exporters, and countries that have built up substantial foreign exchange reserves. As of end-April 2006, nine member countries have pledged bilateral subsidy contributions totaling SDR 219 million (Table 8.4). One member (France) has also pledged new loan resources of \$1 billion at a concessional rate so as to generate an implicit subsidy contribution.

### The Multilateral Debt Relief Initiative (MDRI) and the enhanced Heavily Indebted Poor Countries (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, 2006, 29 countries had reached their decision points under the enhanced HIPC Initiative,<sup>3</sup> of which 19 had reached their completion points.

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, 2006, the IMF had

<sup>3</sup>Excludes Côte d'Ivoire, which reached the decision point only under the original HIPC Initiative.

**Box 8.2** 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. The expectations schedule entails earlier repayments than the original obligations schedule, as shown in the table. 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

**Box 8.3** 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 Web site the outcome of the Financial Transactions Plan for the quarter ending three months before publication. As of April 30, 2006, with the addition of Kazakhstan in December 2005 and the Slovak Republic in March 2006, there were 48 participants in the Financial Transactions Plan.

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

**Box 8.4 The IMF's lending capacity**

The IMF's key measure of liquidity is the Forward Commitment Capacity (FCC), which is an indicator 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.

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 8.3). 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 Web site at [www.imf.org/external/fin.htm](http://www.imf.org/external/fin.htm).

**Box 8.5 The IMF's financial structure for concessional assistance and debt relief to low-income member countries**

The main changes to the structure for IMF concessional assistance resulting from the MDRI and ESF initiatives include the following:

- The PRGF Trust was renamed the PRGF-ESF Trust. The Trust consists of the Loan Account, the Reserve Account, and three Subsidy Accounts.
- The Trust borrows from central banks, governments, and official institutions through the Loan Account, largely at market-related interest rates, and lends these resources to PRGF-eligible countries under the PRGF and ESF.
- The Reserve Account provides security for both types of loans. Thus, the resources in the Reserve Account are available to protect the lenders to the Trust against risks arising from overdue principal and interest payments by borrowers.
- The original subsidy account was renamed the PRGF-ESF Subsidy Account to receive

and provide resources for subsidizing both PRGF and ESF loans (the resources in this account are used to subsidize the difference between the interest charged to PRGF-ESF borrowers and that owed to PRGF-ESF lenders). In addition, two new subsidy accounts were established under the Trust—the ESF Subsidy Account and the PRGF Subsidy Account—to receive and provide subsidy resources earmarked for ESF loans and PRGF loans, respectively.

- Two new MDRI Trusts were established to receive and provide resources for MDRI debt relief (see Box 8.6 for a more detailed discussion).
- The PRGF-HIPC Trust remains unchanged and continues to receive and provide resources for financing HIPC Initiative assistance and helps subsidize the PRGF. In addition, HIPC Umbrella Subaccounts have been maintained for channeling HIPC assistance to qualifying members.

committed SDR 1.9 billion in grants to the following countries: Benin, Bolivia, Burkina Faso, Burundi, Cameroon, Chad, Côte d'Ivoire, the Democratic Republic of the Congo, the Republic of Congo, 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. Cameroon reached its completion point and two members (Burundi and the Republic of Congo) reached their decision points under the enhanced

HIPC Initiative during FY2006. As of April 30, 2006, total disbursements of HIPC assistance by the IMF amounted to SDR 1.6 billion.

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 interim 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 FY2006, SDR 16 million of interim assistance was disbursed to five countries. As of April 30, 2006, a total of SDR 640 million had been disbursed as interim assistance.

On November 7, 2005, the Executive Board of the IMF reached agreement on the implementation modalities of the MDRI. The Board approved the associated decisions to implement the MDRI on November 23, 2005. The MDRI became effective on January 5, 2006, following receipt of the consents of the 43 members that have made contributions to the Subsidy Account of the PRGF Trust.

The IMF's MDRI relief covers the full stock of debt owed to the IMF at end-2004 that remains outstanding at the time of the provision of debt relief. All countries (both HIPCs and non-HIPCs) with per capita incomes of \$380 or less (on the basis of 2004 gross national income) would receive MDRI relief financed from the IMF's

own resources held in the Special Disbursement Account (SDA) subject to applicable requirements on eligibility, qualification, and availability of resources. HIPCs with per capita incomes above \$380 would receive MDRI relief financed from bilateral contributions in the original PRGF Trust Subsidy Account, subject to the consent of contributors and other applicable requirements (Box 8.6).

The IMF delivered debt relief totaling SDR 2.3 billion to 19 qualifying countries on January 6, 2006, immediately

after the MDRI decision took effect (Table 8.5). These countries included 17 HIPCs that had reached their completion points (Mauritania had reached its completion point but did not qualify as yet because it did not meet the criteria set by the Executive Board) and two non-HIPCs (Cambodia and Tajikistan). On April 28, 2006, one more country—Cameroon—reached its completion point and qualified for MDRI debt relief of SDR 0.2 billion. This initial phase of full debt relief under the MDRI—totaling SDR 2.5 billion—was financed from the HIPC Umbrella Subaccounts of 18 HIPC completion point countries (SDR 0.3 billion) and the newly established MDRI-I and MDRI-II Trusts (SDR 1.1 billion from each).

### Investments supporting concessional lending and debt relief

The IMF invests assets supporting PRGF lending and the HIPC Initiative in a diversified portfolio of fixed-income securities issued by governments and international financial institutions. As of April 30, 2006, the value of these assets declined from last year's total of SDR 9.6 billion to SDR 7.4 billion, primarily owing to the early repayment of PRGF-ESF Trust lenders in connection with MDRI debt relief.

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.<sup>4</sup> Under this investment strategy, about half the assets have been invested in fixed-income portfolios and are currently managed by the World Bank and two private external managers. Following

<sup>4</sup>Prior to this shift in investment strategy, these assets had been invested in short-term SDR-denominated deposits with the Bank for International Settlements.

**Table 8.5** Delivery of MDRI debt relief to 20 qualifying members

(In millions of SDRs; as of April 30, 2006)

Recipient country	Delivery date	Fund credit outstanding from disbursements made before January 1, 2005	Sources of financing		
			Balance in the HIPC Umbrella Subaccounts	MDRI-I Trust	MDRI-II Trust
Benin	January 6, 2006	36	2	—	34
Bolivia	January 6, 2006	161	6	—	155
Burkina Faso	January 6, 2006	62	5	57	—
Cambodia <sup>1</sup>	January 6, 2006	57	—	57	—
Ethiopia	January 6, 2006	112	32	80	—
Ghana	January 6, 2006	265	45	220	—
Guyana	January 6, 2006	45	13	—	32
Honduras	January 6, 2006	107	9	—	98
Madagascar	January 6, 2006	137	9	128	—
Mali	January 6, 2006	75	13	62	—
Mozambique	January 6, 2006	107	24	83	—
Nicaragua	January 6, 2006	140	49	—	92
Niger	January 6, 2006	78	18	60	—
Rwanda	January 6, 2006	53	33	20	—
Senegal	January 6, 2006	100	6	—	95
Tajikistan <sup>1</sup>	January 6, 2006	69	—	69	—
Tanzania	January 6, 2006	234	27	207	—
Uganda	January 6, 2006	88	12	76	—
Zambia	January 6, 2006	403	4	—	398
Cameroon	April 28, 2006	173	24	—	149
<b>Total<sup>2</sup></b>		<b>2,503</b>	<b>330</b>	<b>1,120</b>	<b>1,053</b>

Source: IMF Finance Department.

<sup>1</sup>Not eligible for assistance under HIPC.

<sup>2</sup>Figures may not add up to totals because of rounding.

### Box 8.6 Financing of the MDRI

The current estimate of the cost to the IMF of full MDRI debt relief is around SDR 3.4 billion in end-2005 NPV terms, excluding four newly identified HIPCs and the three protracted arrears cases (see below). Financing of the debt relief is expected to come from the MDRI-I Trust, the MDRI-II Trust, and resources already earmarked under the HIPC Initiative. Two separate Trusts were established to maintain the principle of uniformity of treatment with respect to the use of the Fund's own resources.

- The MDRI-I Trust, financed with the IMF's own resources of SDR 1.5 billion transferred from the Special Disbursement Account (SDA), was designed to provide MDRI debt relief to low-income countries, both HIPCs and non-HIPCs, with per capita incomes at or below \$380.
- The MDRI-II Trust was designed to receive and provide resources for MDRI debt relief to HIPCs with per capita incomes above \$380. It was financed with bilateral resources of SDR 1.12 billion, transferred from the renamed PRGF-ESF Trust.

- The remainder of about SDR 0.8 billion is to be financed from earmarked HIPC Initiative resources in the PRGF-HIPC Trust.

Additional contributions will be needed to cover the cost of HIPC Initiative and MDRI debt relief for the three protracted arrears cases (Liberia, Somalia, and Sudan) and the four newly identified countries that meet the HIPC Initiative's income and indebtedness criteria at end-2004 and might wish to be considered for debt relief. The total cost to the IMF for these countries is estimated at SDR 1.9 billion in end-2005 NPV terms. Financial resources needed to meet these additional costs have not yet been mobilized. In this context, the G-8 has committed to cover, on a fair burden-sharing basis, the cost of debt relief for countries that may become eligible for the HIPC Initiative under the extended sunset clause; donors would provide the extra resources necessary for full debt relief at completion point for the three protracted arrears cases.



**Table 8.6** Subsidy contributions for emergency assistance

(In millions; as of April 30, 2006)

Contributor	Contribution pledge	Date of pledge	SDR equivalent <sup>1</sup>	Contribution received	Subsidy disbursed <sup>2</sup>
<b>Subaccount 1:</b>					
<b>EPCA subsidization only</b>					
Belgium	SDR 0.63	March 2002	0.6 <sup>3</sup>	0.6	0.3
Canada	Can\$ 3.25	October 2002	1.7	1.7	—
Norway	SDR 3.0	June 2002	3.0	3.0	—
Sweden	SDR 0.8	January 2002	0.8	0.8	0.8
Switzerland	US\$ 1.0	March 2002	0.8	0.8	—
United Kingdom	£ 2.5	October 2001	2.9	2.9	1.8
<b>Subtotal</b>			<b>9.7</b>	<b>9.7</b>	<b>2.9</b>
<b>Subaccount 2:</b>					
<b>ENDA subsidization only</b>					
Australia	Aus\$ 2.0	June 2005	1.0	0.4	—
Austria <sup>4</sup>	SDR 1.2	April 2005	1.2	—	—
Canada	Can\$ 5.0	February 2005	3.1	1.1	0.5
China	US\$ 2.0	May 2005	1.4	1.4	—
Germany <sup>5</sup>	Euro 1.65	November 2005	1.4	1.4	—
India	SDR 1.5	February 2005	1.5	—	—
Japan	US\$ 2.5	April 2005	1.7	1.7	1.5
Luxembourg	Euro 1.25	February 2005	1.0	0.2	0.2
Russia	US\$ 1.5	February 2005	1.0	0.2	0.2
Saudi Arabia	US\$ 4.0	April 2005	2.8	—	—
Switzerland	US\$ 2.0	February 2005	1.4	1.4	1.4
<b>Subtotal</b>			<b>17.6</b>	<b>7.8</b>	<b>3.8</b>
<b>Subaccount 3:</b>					
<b>Subsidization of EPCA and ENDA</b>					
France	Euro 1.5	January 2005	1.2	1.2	—
Netherlands <sup>6</sup>	US\$ 2.0	March 2002	1.5	1.5	—
Netherlands	US\$ 2.0	March 2005	1.4	1.4	—
Norway	NKr 10.0	February 2005	1.1	1.1	—
Sweden	US\$ 10.0	February 2005	6.6	6.6	—
United Kingdom	£ 1.0	February 2005	1.2	1.2	0.2
<b>Subtotal</b>			<b>13.0</b>	<b>13.0</b>	<b>0.2</b>
<b>Total</b>			<b>40.3</b>	<b>30.5</b>	<b>6.9</b>
<i>Memorandum item:</i>					
Pledges made since 2005			<b>29.1</b>	<b>19.2</b>	<b>4.0</b>

Source: IMF Finance Department.

Note: Figures may not add up to subtotals because of rounding.

<sup>1</sup>For contributions that have been fully received, the SDR equivalent is the actual SDR amount received using the exchange rate on the value date. For contributions that are not yet disbursed, the SDR equivalent is calculated using the exchange rate at end-April 2006.<sup>2</sup>Donors can earmark their subsidy contributions for specific ENDA/EPCA users.<sup>3</sup>Belgium has fulfilled its pledge to subsidize Burundi's emergency post-conflict assistance in full, as Burundi made an early repurchase in February 2004.<sup>4</sup>Reflecting investment income to be generated on a deposit agreement.<sup>5</sup>To subsidize the rate of charge on purchases by Sri Lanka and Maldives under ENDA following the 2004 tsunami.<sup>6</sup>Existing contribution, previously earmarked for EPCA.

a shortening of the average duration of the fixed-income portfolio in January 2002, the benchmark was changed to a customized index based on three-month Libor rates and 0-to-1 year government bonds. The remaining assets have been invested in short-term deposits with the Bank for International Settlements (BIS) to provide liquidity 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, 2006, the annual return on the portfolio was 2.8 percent, up from 2.1 percent a year earlier. In the six years that the investment strategy has been in place, the annual portfolio return has been 3.3 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 normal rate of charge. In May 2001, a decision was taken to provide emergency post-conflict assistance (EPCA) to PRGF-eligible countries at a subsidized rate of 0.5 percent a year, and an administered account was established at that time for contributions 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 are available—and requested new bilateral contributions from member countries. Three subaccounts were created under the existing administered account, 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 end-April 2006, 17 member countries had pledged bilateral contributions totaling SDR 40.3 mil-

lion for the subsidization of emergency assistance (Table 8.6). New pledges received after the January 2005 decision accounted for SDR 29.1 million of this amount. Of the overall total, SDR 9.7 million is available for the subsidization of EPCA only, SDR 17.6 million for the subsidization of ENDA only, and SDR 13.0 million can be used for the subsidization of either kind of emergency assistance.

During FY2006, two countries made purchases under emergency assistance. Both purchases were made under EPCA—SDR 10.2 million for Haiti in October 2005, and SDR 7.0 million for the Central African Republic in January 2006.

### Box 8.7 Medium-term income outlook and options

Under its current financing framework, the IMF earns the bulk of its income on the interest margin associated with its GRA loans to member countries. The income from lending is used to finance all of the IMF's principal activities that promote global economic stability, including multilateral and country surveillance, technical assistance, and administration and oversight of program arrangements. However, this framework is not sustainable in an environment of low IMF lending. Thus there is some urgency to developing options for a new framework that broadens the long-term sources of steady income.

To this end, the Executive Board and the Fund's management and staff are investigating such options. Indeed, some important measures have already been implemented. First, for FY2007 the Board agreed to a temporary pause in the accumulation of reserves, reflecting a shift in the current environment to a greater emphasis on income risk than on credit risk. Second, an Investment Account (IA) was established, as authorized by the IMF's Articles of Agreement, to generate income and protect the capital of the IMF. The IA also helps diversify the sources of IMF

income. The IA may invest an amount up to the level of the IMF's balances in the General and Special Reserves—currently nearly SDR 6 billion—in eligible marketable obligations denominated in SDRs or in the securities of members whose currencies are included in the SDR basket. Eligible investments include the domestic government bonds of countries in the euro area, Japan, the United Kingdom, and the United States; the bonds of eligible national agencies; and the obligations of international financial organizations. The IA is expected to earn returns above the SDR interest rate, while seeking to minimize the risk of large fluctuations in annual investment income. The earnings of the IA may be used to meet the expenses of conducting the IMF's business. Action has also been taken on the expenditure side, where real reductions are proposed in the medium-term administrative budget.

Other, more far-reaching changes to broaden the Fund's income base are also under consideration. Some options include charging user fees for technical assistance, raising income from new financing instruments, mobilizing greater external financing, and

lowering the rate of remuneration. However, to ensure medium-term income sustainability, structural changes in the IMF's finances will be needed. In May 2006, the Managing Director announced the appointment of an eight-member committee of eminent persons to provide the Fund with an independent view of the available options for ensuring that it has a sustainable and durable income base to finance its running costs over the long term.<sup>1</sup> The committee is expected to make specific recommendations to the Managing Director in the first quarter of 2007. Structural options include an amended authority in the Articles of Agreement to allow the IMF to use its quota-based resources for purposes other than adjustment lending, more effective management of gold resources, and annual membership fees. Structural changes will take time to develop and require the broad support of the membership. In the meantime, the IMF has the security of being able to meet immediate operating income shortfalls by drawing, if necessary, on its accumulated reserves.

<sup>1</sup>See Press Release No. 06/100 at [www.imf.org/external/np/sec/pr/2006/pr06100.htm](http://www.imf.org/external/np/sec/pr/2006/pr06100.htm).

Thus far, disbursements from the administered account have totaled SDR 2.9 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 two countries—the Central African Republic and Haiti—still have purchases outstanding under EPCA. A total of SDR 3.8 million has been disbursed to date to subsidize interest on ENDA for four countries (Grenada, Malawi, Maldives, and Sri Lanka). All four countries became eligible for subsidization with the Executive Board's decision in January 2005, and, as of end-April 2006, all four still had outstanding purchases under ENDA.

### Income, charges, remuneration, and burden sharing

The IMF, like other financial institutions, earns income from the 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. While the current framework relies heavily on income from lending, a priority for the IMF in the period ahead will be to establish a new framework that generates other steady and reliable long-term sources of income (Box 8.7).

The basic rate of charge on regular lending is determined at the beginning of the financial year as a margin in basis points above the SDR interest rate (see "SDR developments," below) to achieve an agreed net income target for the year. Under the current framework, this rate is set to cover the cost of funds and administrative expenses as well as to add to the IMF's reserves. The IMF's reliance on quota subscriptions and internally generated resources provides it with some flexibility in setting the basic rate of charge. At the same time, the IMF needs to ensure that it provides creditors with a competitive rate of interest on their IMF claims. The specific margin above the SDR interest rate 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 any shortfalls can be made up in the following year if the Executive Board decides to do so.

The IMF has imposed 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 and to preserve the revolving nature of IMF

financial resources. The IMF also imposes surcharges on shorter-term loans under the SRF that vary according to the length of time credit is outstanding. Income derived from surcharges can be placed in the IMF's reserves or used for other purposes as decided by the Executive Board.

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 Fund pays interest (remuneration) to creditors on their IMF claims (reserve tranche 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. The burden-sharing mechanism has also been used in recent years to make annual contributions to the SCA-1 in order to mitigate the income impact of the off-market gold transactions in 1999–2000. In FY2006, the combined adjustment for unpaid interest charges and the allocation to the SCA-1 resulted in an increase in the basic rate of charge of 18 basis points and a reduction in the rate of remuneration of 23 basis points. The adjusted rates of charge and remuneration averaged 4.18 percent and 2.68 percent, respectively, for the financial year.

In FY2006, the margin for the basic rate of charge was set at 108 basis points above the SDR interest rate, and no adjustments were made at midyear. Net income for FY2006 amounted to SDR 128 million, which fell short of the target by SDR 60 million, owing mainly to lower income from

lending after the voluntary advance repurchases (repayments) by Argentina and Brazil of their entire outstanding obligations to the IMF, as well as to sizable net repayments by Indonesia, Turkey, and other members. The Executive Board has decided not to make up this shortfall in FY2007, given the expectation of further income pressures associated with the low level of IMF credit outstanding. Income derived from SRF and level-based surcharges amounted to SDR 294 million in FY2006. Adjusted for expenses associated with administering the PRGF Trust (SDR 51 million)<sup>5</sup> and the cost of pension and other post-retirement provisions (SDR 136 million), total net income for the year amounted to SDR 235 million. This amount was added to the IMF's reserves. For FY2007, given the expected pressures on the IMF's income, the Executive Board has agreed to a temporary pause in the accumulation of reserves, and surcharge income will be used to cover a portion of the cost of the IMF's administrative expenses.

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

The IMF faces credit risk from its existing loan portfolio. In addition, it must be ready to address the additional credit risk that would arise from a large unexpected demand for IMF credit. The Fund mitigates credit risk by rigorously implementing the policies governing the use of its resources and carefully managing its liquidity while accumulating adequate precautionary balances.<sup>6</sup> Precautionary balances also contribute to the IMF's net income and help mitigate the risk of net income shortfalls.

#### 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 2006, three countries (Indonesia, Turkey, and Uruguay) accounted for some 80 percent of all GRA credit outstanding, and these three plus Serbia and Montenegro and Ukraine accounted for 87 percent, or some SDR 16.7 billion.

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

<sup>5</sup>As 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 help meet concessional financing needs.

<sup>6</sup>For more details, see [www.imf.org/external/np/sec/pn/2004/pn0416.htm](http://www.imf.org/external/np/sec/pn/2004/pn0416.htm).

nature of the IMF and the Fund'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. This is because the Fund relies on a multilayered structure to safeguard against credit risk. This risk-mitigating structure includes its lending policies (conditionality, access limits and the exceptional access framework, its policies on charges and maturities, and safeguards assessments), its arrears strategy and burden-sharing mechanism, and maintenance of an adequate level of precautionary balances. IMF conditionality, together with its preferred creditor status, can mitigate credit risk to a considerable extent but does not eliminate it. Risks remain because successful balance of payments adjustment depends ultimately on borrowers' ownership and effective implementation of appropriate policies, because member countries may be subject to further shocks, and because renewed timely access to other sources of financing is not assured.

### 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 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). 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 6.0 billion as of April 30, 2006, from SDR 5.7 billion a year earlier. The balance in the SCA-1 amounted to SDR 1.7 billion, compared with overdue principal of SDR 0.6 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, are kept under close review.

### Box 8.8 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. Of the twelve general reviews that have been conducted so far, five have concluded that no increase in quotas was needed. 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. The ongoing Thirteenth General Review of Quotas will need to be completed by January 2008.

In addition to general reviews of quotas, ad hoc quota increases are possible to address cases in which quotas are not representative of a country's weight in the global economy. Ad hoc quota increases outside general reviews have been rare in recent decades, although China was granted a higher quota in 2001 following its resumption of sovereignty over Hong Kong SAR.

### Quota developments

In September 2005, Executive Directors considered three broad options for adjustments in quotas and voting power in the absence of a general increase: ad hoc increases for selected countries whose quotas are much lower than their weight in the global economy; voluntary adjustments among country groups or individual members; and an increase in basic votes. Executive Directors agreed to continue to explore ways to achieve a redistribution of quotas in the absence of a general quota increase.

The Managing Director has identified quota and voice issues as a priority in the Fund's Medium-Term Strategy (MTS). In his April 2006 report to the IMFC on implementing the MTS, the Managing Director underscored the need to make concrete progress on this issue by the time of the September 2006 Annual Meetings. In April 2006, the International Monetary and Financial Committee (IMFC) underscored the role an ad hoc increase in quotas would play in improving the distribution of quotas to reflect important changes in the weight and role of countries in the world economy. The committee called on the Managing Director to work with the IMFC and the Executive Board to come forward with concrete proposals for agreement at the 2006 Annual Meetings.

As of April 30, 2006, 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 (see Box 8.8 on general reviews of quotas). 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 August 24, 2005, the Executive Board approved an



**Box 8.9** Review of 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 November 2005, the Executive Board decided to change the weights of the currencies in the SDR basket based on the value of the exports of goods and services and the amount of reserves denominated in the currencies held by other members of the IMF. The new weights became effective on January 1, 2006. 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 2006–10 continued to be the euro, the Japanese yen, the pound sterling, and the U.S. dollar (see table). The next review by the Executive Board is scheduled to be completed in 2010 and the new basket to be in effect on January 1, 2011.

**Interest rate**

The weekly SDR interest rate is 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 Euro rate,<sup>1</sup> Japanese government 13-week financing bills, 3-month U.K. treasury bills, and 3-month U.S. treasury bills. During FY2006, the SDR interest rate evolved in line with developments in the major money markets, rising gradually from 2.49 percent at the beginning of May 2005 to peak at 3.51 percent in the last week of April 2006. Over the course of FY2006, the SDR interest rate averaged 2.9 percent (see figure).

**SDR valuation, as of April 30, 2006**

Currency	Amount of currency	Exchange rate <sup>2</sup>	U.S. dollar equivalent <sup>3</sup>
Euro	0.4100	1.25510	0.514591
Japanese yen	18.4000	114.17000	0.161163
Pound sterling	0.0903	1.80850	0.163308
U.S. dollar	0.6320	1.00000	0.632000
			1.471062

*Memorandum:*

SDR 1 = US\$1.47106

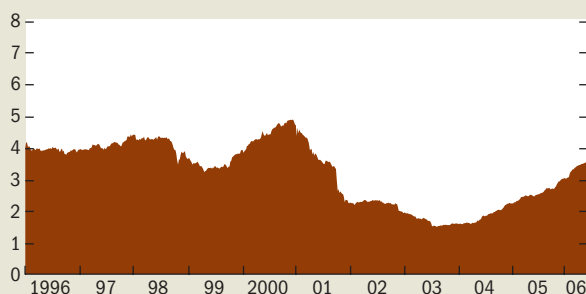
US\$1 = SDR 0.679781

Note: Valuation as of April 28, 2006, which was the last business day of the IMF's financial year.

<sup>1</sup>Prior to January 1, 2006, the euro area interest rate was represented by the three-month Euro Interbank Offered Rate (Euribor).

<sup>2</sup>Exchange rates in terms of U.S. dollars per currency unit, except for the Japanese yen, which is in currency units per U.S. dollar.

<sup>3</sup>Rounded to six digits.

**SDR interest rate, 1996–April 2006***(In percent)*

extension of the period for consent to the Eleventh Review quota increases to September 29, 2006. 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 to make payments to the IMF. Such use does not constitute a loan; members are allocated SDRs unconditionally and may use them to meet a balance of payments financing need without undertaking economic policy measures or repayment obligations. However, 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. The method of valuation is reviewed every five years. The latest review was completed in November 2005, and the IMF Executive Board decided on changes in the valuation basket, effective January 1, 2006 (see Box 8.9). 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.* 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, had never received an SDR allocation. 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 it has been accepted by three-fifths of the IMF membership (111 members) having 85 percent of

the total voting power. As of April 30, 2006, 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 to hold SDRs. 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.<sup>7</sup> These arrangements have helped ensure the liquidity of the SDR system.<sup>8</sup>

The total level of transfers of SDRs increased in FY2006 to SDR 13.0 billion, from SDR 10.6 billion in FY2005. 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 April 30, 2006, the IMF's own holdings of SDRs had increased to SDR 3.6 billion from SDR 0.6 billion at end-FY2005, as a result of advance repayments of financial obligations from several members. SDRs held by prescribed holders amounted to SDR 0.3 billion. SDR holdings by participants decreased to SDR 17.5 billion from SDR 20.6 billion in FY2005.

### Safeguards assessments

Since FY2000, the IMF has conducted safeguards assessments of member countries' central banks in connection with IMF lending operations. The assessments aim to provide reasonable assurance to the IMF that a central bank's framework of financial reporting, audit, and controls is adequate to manage its resources, including IMF disbursements (see Box 8.10). In FY2006, 12 safeguards assessments

of member countries' central banks were conducted, bringing the total number of completed assessments as of April 30, 2006, to 124.<sup>9</sup>

The findings of safeguards assessments to date have indicated that significant, but avoidable, risks to IMF resources may have existed in certain cases, although identified vulnerabilities have declined in significance and frequency over time. Experience has shown that central banks are progressively implementing the measures recommended to mitigate identified vulnerabilities.

Typical recommendations include (1) independent external audits in accordance with international audit standards; (2) reconciliation of the economic data reported to the IMF for program-monitoring purposes with the underlying accounting records of the central bank; and (3) enhancement of the transparency and consistency of financial reporting, through the adoption of International Financial Reporting Standards (IFRS) and publication of the audited financial statements. 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.

As in previous years, in FY2006, IMF staff continued to conduct seminars on safeguards assessments. The seminars cover the safeguards methodology and the relevance of the framework to central banks. Such seminars were held at the Joint Africa Institute (Tunis) in May 2005 and at the IMF Institute (Washington, D.C.) in December 2005. As of April 30, 2006, some 236 officials from 104 countries had attended these seminars.

### Arrears to the IMF

Overdue financial obligations to the IMF totaled SDR 1.9 billion at end-April 2006, a slight decline from SDR 2.0 billion at the beginning of the financial year (Table 8.7). The main reason for the decline was Zimbabwe's clearance of its arrears to the IMF's General Resources Account (GRA) in February 2006 (Zimbabwe still has arrears to the PRGF-ESF Trust). Sudan's arrears to the IMF also declined as a result of its regular monthly payments in excess of obligations falling due. At end-April 2006, virtually all arrears to the IMF were protracted (outstanding for more than six months), 41 percent of which represented overdue principal, with the remainder consisting of overdue charges and interest. More than four-

<sup>7</sup>These include 12 IMF members and one prescribed holder. In addition, one member has established a one-way (selling only) arrangement with the Fund.

<sup>8</sup>Under 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 set-up of the voluntary arrangements starting in 1986.

<sup>9</sup>This 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.

**Box 8.10 Safeguards assessment policy**

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

In FY2005, the Executive Board's review of the safeguards policy concluded that the framework for assessing operations of central banks continued to be broadly appropriate.

**Objective of safeguards assessments**

- To provide *reasonable* assurance to the IMF that a central bank's controls, financial reporting, auditing systems, and legal framework are adequate to ensure the integrity of financial operations and reporting to the IMF.

**Applicability of safeguards assessments**

- Central banks of (1) member countries with new arrangements for use of IMF resources approved after June 30, 2000, or existing arrangements that are augmented, (2) member countries following a Rights Accumulation Program (RAP) under which resources are being committed, and

(3) member countries receiving Emergency Post-Conflict Assistance (determined on a case-by-case basis);

- Central banks of member countries with a Policy Support Instrument (PSI) are encouraged to undertake a safeguards assessment, which would become a requirement in the event of a need for access to IMF resources;
- Voluntary for central banks of members with staff-monitored programs; and
- Not applicable to first-credit-tranche purchases, stand-alone CFFs, or Emergency Natural Disaster Assistance (ENDA).

**Scope of policy—ELRIC**

- The **E**xternal audit mechanism;
- The **L**egal structure and independence;
- The financial **R**eporting framework;
- The **I**nternal audit mechanism; and
- The internal **C**ontrols 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.

- The outcome of a safeguards assessment is a confidential report that identifies vulnerabilities and makes recommendations to mitigate the identified risk. Central bank 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 continuously monitored by IMF staff.

**Publication references**

The staff's papers and other background information concerning the safeguards policy are available at [www.imf.org/external/fin.htm](http://www.imf.org/external/fin.htm).

fifths of arrears were to the GRA and the remainder to the SDR Department and the PRGF-ESF Trust.

The two countries with the largest protracted arrears to the IMF—Sudan and Liberia—account for 83 percent of the overdue financial obligations; 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 to the IMF.<sup>10</sup>

The IMF's Executive Board reviewed the overall arrears strategy in August 2005 and extended the rights approach for one more year.<sup>11</sup> The Board also conducted several reviews of individual member countries' overdue financial obligations to the IMF during FY2006:

- The Board reviewed Liberia's overdue financial obligations to the IMF on April 26, 2006. The Board commended the authorities' resolve to work closely with their international partners in addressing the daunting challenges of rebuilding Liberia's economy and reducing pervasive poverty. As a first key step, they welcomed the agreement that had been reached on an ambitious macroeconomic program to be monitored by the IMF during February–September 2006. Directors concurred that satisfactory implementation of the staff-monitored program (SMP), along with continued repayments to the IMF, would be important for providing a basis for considering the timely de-escalation of the IMF's remedial measures. Prompt and sufficient indications of support from donors and strong performance under the SMP would be important steps toward the clearance of arrears to the IMF and a formal IMF arrangement. Satisfactory performance under such an arrangement would help pave the way to Liberia's timely participation in the HIPC Initiative and the MDRI, and would lead, in turn, to a resolution of Liberia's debt overhang.
- The Board reviewed Sudan's overdue financial obligations to the IMF on December 2, 2005. The Board noted

<sup>10</sup>In the case of Somalia, the application of remedial measures has been delayed because of the absence of a functioning central government.

<sup>11</sup>Established in 1990, the rights approach permits an eligible 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.

**Table 8.7** Arrears to the IMF of countries with obligations overdue by six months or more*(In millions of SDRs; as of April 30, 2006)*

	By type				
	Total	General Department (incl. SAF) <sup>1</sup>	SDR Department	Trust Fund	PRGF-ESF
Liberia	519.1	462.3	26.3	30.5	—
Somalia	227.5	208.1	11.4	8.0	—
Sudan	1,050.7	971.1	0.1	79.5	—
Zimbabwe	83.1	—	—	—	83.1
<b>Total</b>	<b>1,880.4</b>	<b>1,641.5</b>	<b>37.8</b>	<b>118.0</b>	<b>83.1</b>

Source: IMF Finance Department.

<sup>1</sup>Structural Adjustment Facility.

that Sudan had continued to make regular payments to the IMF in 2005, in line with its commitment. Many Directors observed that Sudan's rapid export growth and reserve accumulation should permit an increase in its payments to the IMF in 2006, and urged the authorities to increase the level of payments. The Board agreed that Sudan's external debt remains unsustainable, and that debt relief beyond traditional mechanisms would be needed to achieve sustainability. However, they noted that while the situation in Darfur remains unresolved, serious discussion of arrears clearance options would be premature. Sudan has committed to increasing its annual payments to \$45 million in 2006.

- The Board discussed the complaint by the Managing Director regarding Zimbabwe's compulsory withdrawal from the IMF on September 9, 2005.<sup>12</sup> The Board urged the authorities to 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 welcomed Zimbabwe's payments of \$131 million to the IMF since the previous review. To provide the authorities with a further opportunity to improve cooperation with the IMF, the Board decided to further consider the complaint before March 9, 2006. At its meeting on March 8, 2006, the Board noted that, as a result of Zimbabwe's full settlement of its arrears to the GRA, the Managing Director had withdrawn his complaint with respect to compulsory withdrawal. The Board decided not to restore Zimbabwe's voting and related rights and not to terminate its ineligibility to use the general resources of the IMF at that juncture. The Board called for urgent implementation of a comprehensive policy package comprising several mutually reinforcing actions in the areas of macroeconomic stabilization and structural reforms. The Board urged Zimbabwe to continue its efforts to resolve

the remaining overdue financial obligations to the PRGF-ESF Trust and agreed that the IMF would consider further Zimbabwe's overdue financial obligations to the PRGF-ESF Trust within six months.

As of end-April 2006, 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 the voting and related rights of those two countries in the IMF were suspended.

### 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, D.C., and is available for consultation throughout the year.

The 2006 External Audit Committee members are Mr. Pentti Hakkarainen (Chair), Board Member, Bank of Finland; Dr. Len Konar, Board Member, South African Reserve Bank; and Mr. Satoshi Itoh, Professor, Chuo University, Japan.

The responsibility for performing the external audit and issuing the opinion rests with the external audit firm, which is selected by the Executive Board in consultation with the External Audit Committee and 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 and Touche LLP is the IMF's present external auditor.

The IMF's financial statements for FY2006 form Appendix VII of this *Annual Report*.

<sup>12</sup> The 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.