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McNamara's: Finance Committee Feb. 1980 to March. 1980 Vol. 3

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The World Bank

Mr. McNamara

Bob:

I asked that the attached memorandum be prepared as backup for the paper on Cost of IBRD Borrowings.

As you may recall, that paper assumes a linear, i.e. equal yearly appreciation of various currencies against the dollar. The attached note assumes, instead, a rate of depreciation of the dollar which is implied by the interest rate differentials at various maturities. The paper then asks what it would cost to repay right now all of our non-dollar borrowings by borrowing dollars, converting those dollars at current exchange rates and repaying our non-dollar debt.

Gene Rotberg
Feb. 11, 1980

cc: Mr. Qureshi

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara

DATE: February 11, 1980

FROM: Eugene H. Rotberg

SUBJECT: Cost of IBRD Borrowings: A Market-Oriented Analysis

The sensitivity analyses on the Bank's non-dollar borrowing costs in the memorandum "Cost of IBRD Borrowings" of February 8, 1980 were conducted based on a useful but somewhat arbitrary assumption that the dollar would depreciate linearly over the life of the borrowings to reach a range of levels in 1999 against each of the non-dollar currencies. Questions about the acceptability of this assumption could be raised on theoretical as well as practical grounds since exchange rate adjustments do not normally follow smooth linear patterns over either short or long term periods. The linear depreciation assumption was used in the memorandum "Cost of IBRD Borrowings" since it provided intuitively simple future exchange rate scenarios, and allowed us to reach quantitative results that span a wide range of possibilities.

In the present memorandum it will be shown that the assumption of a linear decline of the dollar against the non-dollar currencies is a reasonably good one based on a more fundamental analysis of capital market rates on I/28/80. Here we approach the question of exchange risk from a market-oriented perspective in order to develop a methodology for determining, at any given point in time, the dollar-based cost of outstanding non-dollar borrowings, without having to make any particular assumptions about future exchange rates. This methodology is then applied to the Bank's borrowings of Swiss franc, German mark, and yen since FY78, using capital market rates of 1/28/80. It should be noted that this methodology should be applied to these borrowings on a continuing basis to determine the volatility of the cost results to major swings in interest rates and exchange rates. It should also be noted that the specific results obtained for 1/28/80 probably represent the upper range of the dollar costs of the non-dollar borrowings for reasons to be discussed.

The Bank's overall balance sheet is not subject to foreign exchange risk since the Bank does not take a net foreign exchange position - total assets and liabilities are matched by national currencies. However, if we consider the debts of the Bank in isolation of its investment and loan portfolios, and if we take the dollar as the standard of value, the Bank faces a market-related exchange risk on the liability side of its balance sheet any time it borrows a currency other than dollars.

The Bank could in principle resolve this uncertainty at any point during the life of the non-dollar borrowings if it were allowed to convert dollars to foreign currencies in the spot exchange markets (then taking a net foreign exchange position on the overall balance sheet). The Bank would simply borrow a sufficient amount of dollars at that given point in time to retire fully the outstanding non-dollar debts.* In order to maintain the maturity structure

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* If it were not possible for the Bank to retire its debts, the Bank could still hedge its exchange risk on its non-dollar debts equally by buying the corresponding amount of non-dollar bonds in its investment portfolio with the proceeds of the dollar borrowings.

of its debt, the Bank would borrow dollars in the maturities corresponding to those of the total non-dollar debts that are retired. If the Bank were to retire all of its non-dollar debts by borrowing a sufficient amount of dollars at fixed and known costs today, we would be able to determine exactly the total dollar-based cost of the Bank's original non-dollar borrowings. This dollar-based cost on non-dollar borrowings could then be compared to the cost that would have resulted if the Bank had originally borrowed dollars instead of the non-dollar currencies.

We consider that we can mark to market the value of the Bank's exchange position on its liabilities at any point in time over the life of the non-dollar borrowings. Then we have, in principle, a simple way to determine exactly how the Bank's past non-dollar borrowing program has fared up to now, as reflected in the current capital and exchange markets, without having to make any assumptions about future exchange rates. The Bank could in principle fully realize the net gain or loss implied at this point in time by the markets due to its outstanding non-dollar debts, and would then bear no further exchange risks on its liabilities. The Bank could also maintain its exchange exposure on its liabilities by not retiring (or hedging) its non-dollar debts today, thus taking the view that additional gains or a lower net loss will accrue in due course over the remaining life of the non-dollar borrowings. The above market analysis is of course purely hypothetical since in practice the Bank, once it borrows non-dollar currencies, cannot cover its exchange exposure on the non-dollar borrowings until these borrowings mature. However it may still be of interest to determine the market-implied current unrealized gain or loss due to the Bank's outstanding past non-dollar borrowings and to track this gain or loss as interest rates and exchange rates fluctuate.

The market value of the Bank's debt in the non-dollar currencies simply depends on the current term structure of interest rates in the various currencies, and the specific coupons and maturities of the outstanding debts. The equivalent total dollar amount of the non-dollar debt is obtained using the current spot exchange rates. Thus the only information used for this methodology is:

a) The current term structure of interest rates (yield curves) in the various currencies.

b) The spot exchange rates

From this information available from capital and exchange markets, a market-implied pattern of forward exchange rates can be derived by equating the present value of cash flows of future periods in the various currencies. It can be shown that using these forward exchange rates to convert the non-dollar cash flows to dollars, and then determining the dollar cost of the resultant dollar stream, is mathematically equivalent to finding the overall dollar cost that would be realized from the non-dollar borrowings if the Bank were to borrow dollars today to pay off the outstanding non-dollar debts. It must be noted that the forward exchange rates derived here are purely mathematical transformations that allow us to calculate the market value of the Bank's debt based on current interest rates, and no predictive power should or need be ascribed to these forward rates according to this methodology. In fact, such patterns of forward exchange rates have had very little, if any, predictive power in the past. These forward rates

simply allow us to perform the hypothetical exercise of retiring outstanding non-dollar debts today by borrowing a sufficient amount of dollars in the corresponding maturities.

We now illustrate the methodology by presenting results for an analysis based on the capital and exchange market rates of 1/28/80. The term structure of interest rates (capital yields using semi-annual compounding) that prevailed on 1/28/80 on domestic government bonds in the different currencies is given in Table 1. *

Table 1
Term Structure of Interest Rates on 1/28/80

Currency	1 Year	2 Year	5 Year	19 Year
Sw. Franc	5.55%	5.55%	5.55%	5.40%
D. Mark	8.50%	8.40%	8.25%	8.25%
Yen	8.50%	8.50%	8.50%	8.50%
Dollar	12.25%	11.80%	11.05%	11.00%

The market-implied forward exchange rates based on the interest rate structures of Table 1 and the spot exchange rates of 1/28/80 are given on Table 2.

Table 2
Market-Implied Forward Exchange Rates on 1/28/80

Rate	Spot	1 Year	2 Year	5 Year	19 Year
Sw.F./$	1.617	1.517	1.434	1.242	0.582
D.M./$	1.737	1.676	1.628	1.520	1.055
Yen/$	240	231.6	225.4	212.5	152.6

Instead of assuming a constant linear depreciation of the dollar until 1999, as we have done in the memorandum "Cost of IBRD Borrowings" of February 8, 1980, we can now use the pattern of decline dictated by our hypothetical exercise of retiring the non-dollar debts today by borrowing dollars. These patterns of forward exchange rates are shown in the attached graphs. Visually the patterns appear in fact very linear from 1980 to 1999. The actual numbers however imply somewhat faster than linear depreciation of the dollar for the first few years. This is essentially due to the fact that the term structure of interest rates is sharply more negative for the dollar than for the other currencies, resulting in larger interest rate differentials in the early years.

A calculation of the market-implied dollar cost as of 1/28/80 has been carried out for each of the non-dollar currencies and for the aggregate non-dollar borrowing program since FY78. The results are presented in Table 3. The difference between the market-implied dollar cost of the Bank's non-dollar borrowing program and the cost of the hypothetical all-dollar borrowings is the

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* In order to carry out a more precise analysis, yields on IBRD bonds should be used instead of domestic government bonds. In general IBRD - treasury yield spreads will vary from time to time and across currencies and maturities, distorting the shape of the relevant term structure of rates.

net unrealized gain or loss as of 1/28/80, in yield terms, due to the non-dollar borrowing program. This unrealized net gain or loss on 1/28/80 is also given in Table 3. The unrealized gain or loss will naturally fluctuate over the life of the borrowings as spot exchange rates and current interest rates vary.

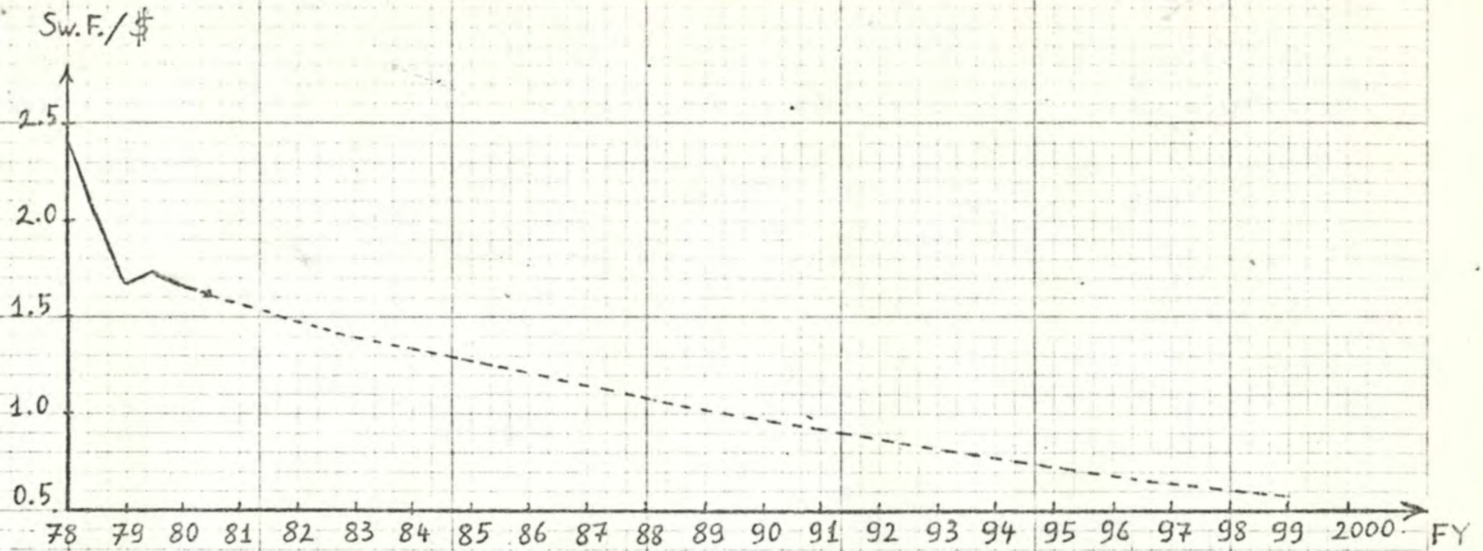
Table 3
Bank's Exchange Exposure Due to Non-Dollar Borrowings since FY78
on 1/28/80

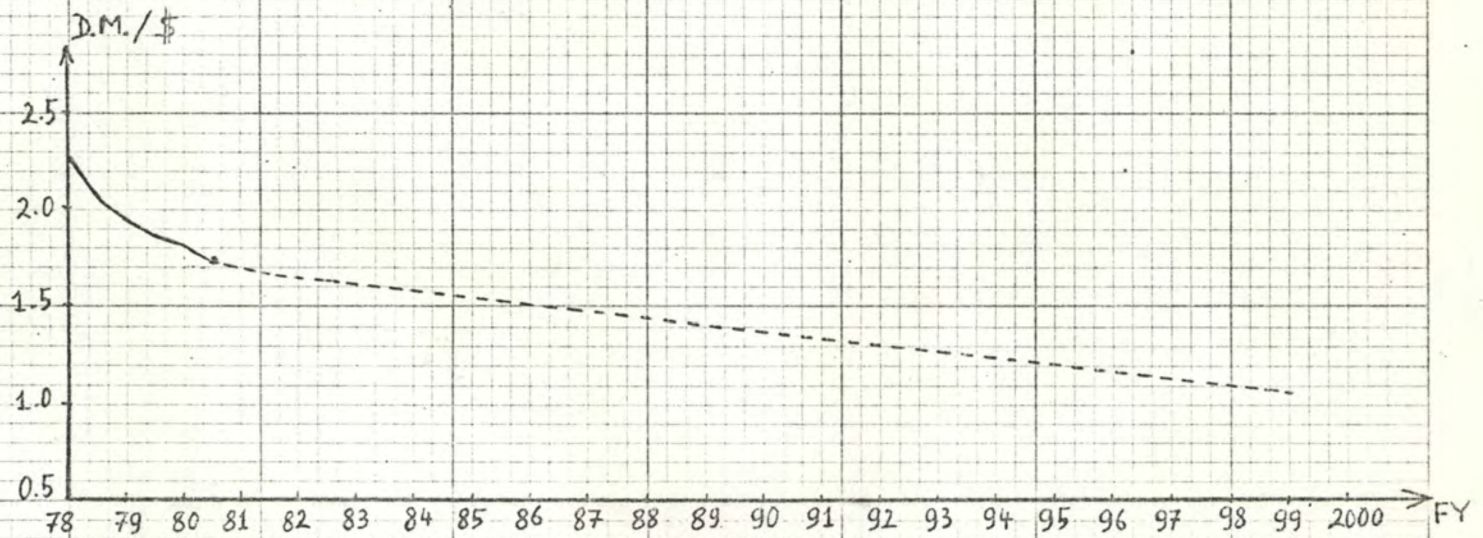
Borrowing Program	Overall $ Cost if Non-dollar debts were to be paid off now	Hypothetical all-$ Borrowing Cost	Unrealized Market Gain or Loss in yield terms on $ cost
Swiss Franc	10.04%	9.28%	-0.76%
Deutsche Mark	11.27%	9.49%	-1.78%
Yen	9.01%	9.46%	+0.45%
Aggregate	10.12%	9.42%	-0.70%

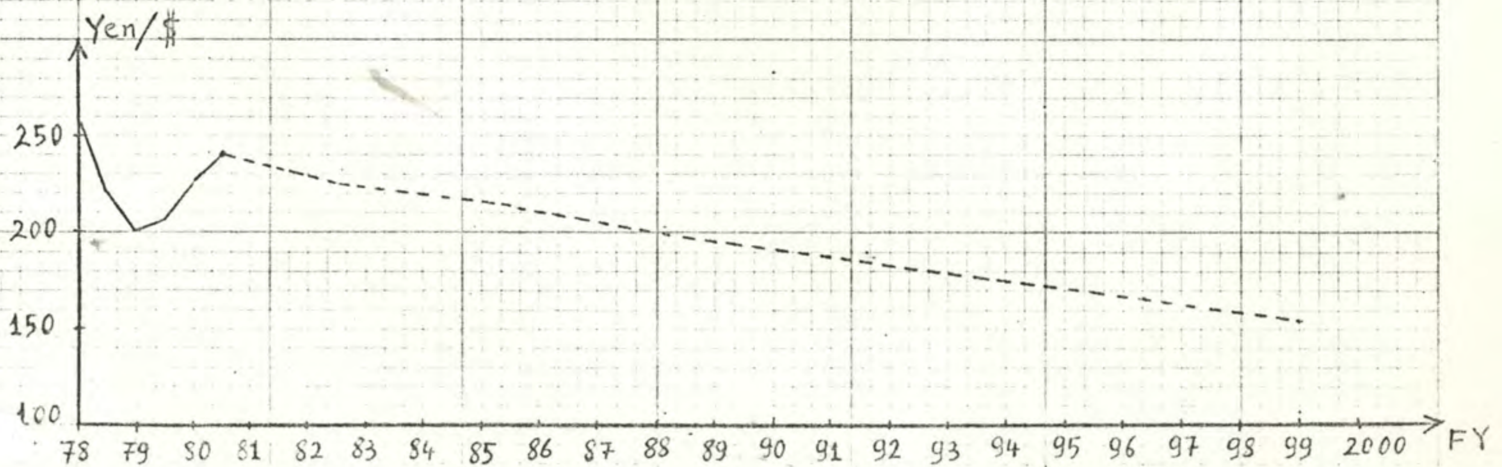
It would be misleading to assign too much importance to the actual dollar-cost results obtained above or on any particular day. Both interest rates and exchange rates have been highly volatile, even on a day-to-day basis, particularly over the last few months. It would therefore be important to track these market-implied cost results as rates vary, to determine the range and frequency of fluctuations. Also, IBRD rather than Treasury yields should really be used to describe the relevant term structure of interest rates in each currency. There is also reason to believe that these market-implied cost results represent the higher range of the dollar-based costs of the non-dollar borrowings. We are currently at historical interest rate levels in the U.S. and it is a very costly proposition to borrow dollars at these rates to pay off non-dollar debts. It is not so much the weakness of the dollar as the extraordinary level of interest rates in the U.S. that causes the distortions. If interest rates in the U.S. were to decline from these levels, even by modest amounts, and everything else were to remain roughly at current levels, the results would quickly shift to favor the past non-dollar borrowings on an aggregate basis. Many economists predict a recession accompanied by a drop in interest rates in the U.S. in the next few months. It would be interesting to evaluate the Bank's same non-dollar borrowings when the U.S. interest rates start declining. Meanwhile, even with a much weaker dollar compared to 1978 levels, and completely unforeseen peak interest rate levels in the U.S., the net unrealized loss in dollar yield terms on the aggregate non-dollar borrowings was 70 basis points on 1/28/80. As a comparison, similar maturity U.S. Treasury securities have had an increase of about 200 basis points in yield since the Federal Reserve System changed its monetary policy on October 6, 1979.

Adnan Akant, Investment Division, TRE

MARKET-IMPLIED FORWARD EXCHANGE RATES ON 1/28/80







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FORM NO. 75
(9-78)

THE WORLD BANK

ROUTING SLIP	DATE: March 3, 1980

NAME	ROOM NO.
Members of the Finance Committee	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		URGENT

REMARKS:

Attached please find Minutes of the February 12, 1980 Finance Committee Meeting.

FROM: JM for Paul V. Applegarth	ROOM NO.: C-1204	EXTENSION: 75765/6

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FINANCE COMMITTEE MEETING

February 12, 1980

MINUTES

Present: Members: Messrs. McNamara, Qureshi, Damry, Nurick, Rotberg

Others: Messrs. S. Husain, Applegarth, Koch-Weser,

Chenery (for discussion of Brandt Commission and agenda items 1 through 4);
W. Clark and Haq (for discussion of Brandt Commission);
Hattori (for Currency Pooling discussion);
Baneth, Hornstein (for Co-Financing discussion);
Vergin (for Research Budget discussion);
Akant (for IBRD Borrowing Costs discussion).

1. Brandt Commission Proposals Work Program

The Committee reviewed the draft work program and modified it for forwarding to the President Council. The importance of having several papers considered by the Board and ready for review by the Development Committee in October 1980 was stressed. The subjects and parties responsible for each paper were agreed; the timing of papers was tentatively identified subject to modification after consultation by the responsible Vice Presidents with their staffs. Mr. McNamara indicated that outlines of each paper should be prepared for Finance Committee review.

2. Co-Financing

Mr. McNamara requested that paragraph 16 and the conclusion of the paper be redrafted to increase the discussion of Co-Financing in the private sector. The redraft should make three points:

(i) to date, commercial banks have shown little interest in co-financing because they have been very liquid, seeking direct lending opportunities, and competing with each other in developing new markets;

(ii) it is not clear how much of the Bank's existing co-financing has been additional;

(iii) the situation in the next five years may be different, as the current account deficits of LDC's will triple. Co-financing with private sources may stimulate additional lending in the future and may become more important in non-concessional flows.

Mr. Husain noted that co-financing by other official institutions was limited; that future co-financing with commercial banks is crucial, and that it would be important to review what steps could be taken to make co-financing additional. Mr. Nurick added that substantially increasing co-financing with private banks would raise a number of potentially difficult legal and policy issues. Mr. Qureshi indicated that any references in the paper which created difficulties for the

Legal Department would be deleted. He also stated that a paper would be available by February 14 for review by the operating Vice Presidents, and requested that the operating Vice Presidents complete their review by February 19. Distribution to the Board would be on February 20, for consideration on March 11.

3. Currency Pooling

The Committee agreed to distribute the paper to the Board for information (without Annex II), with the offer to hold a seminar for Board members if they wished. Mr. Husain expressed doubt that operating staff and borrowers would be able to understand the system without considerable education. Mr. McNamara added that the accounted cost of loans for borrowers would increase under the system, increasing their difficulty in understanding the system. The Committee decided that to permit a full education effort the system would take effect for loans negotiated after July 1, 1980, and that the Controller's Department would prepare and review with the operating Vice Presidents a program for disseminating information to borrowers and operating staff. Mr. McNamara noted that the bulk of the cost of developing and implementing the pooling system had been budgeted in FY80. He asked that efforts be made to fully utilize these FY80 funds. To the extent reconciliable with general accounting principles, provision may have to be made to accrue part of these funds to cover payments coming due in FY81.

4. Guidelines for the Bank Research Program

The Committee noted that the original Budget Guideline called for 9% growth in the research budget, and that Mr. Chenery's proposal for a budget of $12,860,000 would result in 17% growth. Mr. Qureshi indicated he had reviewed the proposal and was in agreement that the amounts needed to finance the UN study, which had been included within the original guidelines, should be additional. He therefore recommended a budget of $12,420,000. Mr. McNamara asked Mr. Chenery to prepare an alternative program, for the budget amount recommended by Mr. Qureshi. Mr. Qureshi noted that approval of the higher program would cause the total IBRD budget to grow more than 5% in real terms, that operating departments had been severely constrained in the recent budget review and that the substantial increase in the research budget recommended by Mr. Chenery would be difficult to justify in the general context of the constrained FY81 budget. Mr. McNamara agreed that budgetary growth equal to or exceeding 5% in real terms would be undesirable. Mr. Vergin noted that the proposed research budget made as yet no provision for the cost of publishing the growing research output. He suggested that the cost of publishing these documents should be included within the proposed research budget.

5. Board Budget Committee & Role of Board in Formulating Bank Policy

Discussions of these items was deferred until the next Finance Committee meeting. Mr. McNamara noted that a Board Budget Committee was likely to be dominated by developed countries and would not benefit developing countries.

6. Cost of IBRD Borrowing

Mr. Qureshi indicated the paper would be redrafted to explain why the period of 2 1/2 years was being examined and to expand the sensitivity analysis. A new concluding section would note that the Bank's experience to date was limited, and that considerable dollar devaluation had already occurred, but that it was unlikely that future devaluations would be so great as to exceed the break-even for present borrowings. Mr. McNamara said that the analysis focussing on borrowing francs in 1978 and converting them to dollars in 1980 was irrelevant and should be deleted from the paper. The relevant issue was whether borrowing francs in 1978 or dollars in FY78 was appropriate. Mr. McNamara requested a redraft for the paper on a line-in, line-out basis by February 15, to be distributed to the Board for information (without the supplementary analysis). A Board seminar could be held if Board members were interested, but the paper would not be discussed at a formal Board meeting.

7. Capital Flows Paper

Mr. McNamara suggested that it might be desirable to ask Mr. Polak and Mr. Irving Friedman to review the paper. He also asked Messrs. Qureshi and Chenery to consider the organization of a seminar of private parties and possibly central bankers, to review and discuss the paper. This should be done as soon as possible, preferably by the end of April. The group should consist of people such as Messrs. Costanzo, de Vries and Guth, but Messrs. Qureshi and Chenery should agree on a list of names to be invited.

8. IDA4 Exchange Gains

Mr. Nurick raised the question of the Bank's policy regarding commitments of exchange gains on IDA replenishments after the close of a repleishment period. Mr. McNamara asked Mr. Qureshi to prepare a paper for review at the next Finance Committee meeting, but indicated he would be reluctant to commit the funds because the gains could easily be reversed through future foreign exchange movements. He would also be opposed to committing the available IDA4 funds now for IDA5 and reconstituting the reserve from IDA5 third tranche funds when they became available.

Mr. Robert S. McNamara March 5, 1980

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Moeen A. Qureshi

Criteria for Selective Capital Increases

There are two points that I would like to flag in connection with this paper. We have liberalized the criteria in comparison to the earlier draft and incorporated proposals for selective increases in individual countries. Nevertheless, Kuwait is one of the countries that does not meet the criteria. Kuwait's present quota is over 90% of its calculated quota in the Fund, and therefore the only case for increasing its quota in the Bank would be the fact that it has made a relatively high contribution to IDA. Second, the proposed 25% increase recommended for Korea is on the generous side and we are stretching the argument somewhat, mainly because of Korea's desire to increase its quota and our continuing dialogue with that country for some time on this issue.

If this paper is approved after the Finance Committee review then I would like to take up this subject informally with the Directors before circulating it.

MAQureshi:gmb

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Mr. Robert S. McNamara
DATE: March 4, 1980
Through: Mr. Moeen A. Qureshi, Vice President, Finance

FROM: K. Georg Gabriel, Director, PAB

SUBJECT: Criteria for Selective Capital Increases

1. Attached please find a revised draft of the Board memorandum on Criteria for Selective Capital Increases. The draft incorporates the comments made in the Finance Committee on the earlier version, and also makes specific recommendations for selective increases to 21 member countries from whom requests have been received.

2. If you agree, we would propose to distribute the new draft to the Finance Committee for the meeting on March 11.

Attachment

JMurli:sl

DISCUSSION DRAFT
March 4, 1980

CRITERIA FOR SELECTIVE CAPITAL INCREASES

Introduction

1. At the time the Executive Directors approved the proposals for selective increases in Bank capital subscriptions for Japan and France in 1979, 1/ several Directors expressed the view that it would be desirable to agree on the criteria for determining such increases before considering any new proposals. This memorandum suggests certain general criteria that the Bank might use in considering requests for special capital subscriptions. Specifically, it recommends that selective increases in the Bank should be based essentially on the principle of parallel action to the Fund, with some flexibility for the Bank to grant selective increases independent of the Fund when it would be in the Bank's interest to do so. Such action may be justified in recognition of special actions of member countries that further the objectives of the Bank Group, or when there is a significant change in the economic circumstances of member countries that enables them to play a larger role in the Bank. The memorandum recommends the grant of selective increases to [21] member

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1/ Japan - Increase in Subscription (R79-29, dated February 22, 1979) and France - Increase in Subscription (R79-44, dated March 8, 1979).

countries, [18] based on existing principles and [3] applying the new criteria.

Bank Policy in the Past

2. At the Bretton Woods Conference in 1944, it was intended that the initial subscriptions of the original members of the Bank be equal to the members' Fund quotas. However, twenty-three developing countries requested lower subscriptions to the Bank's capital, and the shortfall was taken up by three countries -- Canada, China and the United States -- that subscribed more than their Fund quotas indicated (Appendix 1). 1/

3. Since then, members' quotas in the Fund and subscriptions in the Bank have been increased on several occasions. Following the Bretton Woods precedent, the Bank has adopted a policy of maintaining proportionality between IMF quotas and Bank capital subscriptions, and has authorized increases in capital subscriptions whenever there was a selective increase in Fund quotas.

4. The quota increases in the Fund have been the end result of

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1/ In 1956 (Brazil) and 1979 (Yugoslavia), two of the original twenty-three obtained special capital increases which brought their Bank subscriptions into line with their Fund quotas (cf. R-976, dated June 22, 1956 and R79-23, dated February 14, 1979). These increases, which permitted the two countries to make up the initial shortfall in their subscriptions, were granted in recognition of their growing economic strength that enabled them to assume a greater share of the burden of financing the Bank.

a process that commences with the preparation by Fund staff of sets of quota calculations based on recent economic data, using various formulae used in the past. The results of several of these formulae are then combined to determine a "calculated" quota for each member. The Fund staff also prepares tables indicating the divergence between calculated quotas and the actual quotas as a result of previous increases. These tables and calculations then form the basis of the quota negotiations that end with a set of "agreed" quotas approved by the Fund's Governors. Although the principal purpose of special increases in Fund quotas is to adjust the relative positions of individual member countries to reflect changes in their positions in the world economy, it is important to recognize that the "agreed" quotas are arrived at on the basis of a number of considerations which include, but are not confined to, the relative financial and economic standing of countries indicated by the quota formulae. 1/ Quota reviews are required at intervals of not more than five years, 2/ and the "agreed" quotas become the actual quotas when countries subscribe

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1/ In the past, these considerations have included:

(1) to give certain developing countries access to more conditional liquidity in the Fund (prior to Fifth General Review of Quotas, 1970);

(2) to meet the needs of the Fund for additional resources through special increases granted to industrial countries (Fourth Review of Quotas, 1965).

2/ The Seventh Review of Quotas took place in 1978, only three years after the previous review.

to them.

5. In the Bank, the general policy that has emerged with regard to capital increases has been the following:

- General increases in the capital of the Bank are determined by the objectives and specific needs of the Bank. For example, the General Capital Increase under consideration at present is primarily necessitated by the need to sustain current and projected higher levels of lending in the future.

- Selective increases are granted to further the policy of parallelism with the Fund. Thus, whenever the Fund has granted a selective increase in quotas, whether to individual countries or to a group of countries, the Bank has taken parallel action so that the increases authorized in Bank subscriptions are in the same proportion as the selective increases in the Fund. For purposes of parallel action in the Bank, the common component (percentage), if any, of quota increases for all countries is regarded as a general increase, and the balance is regarded as a selective increase for the countries concerned.

6. Separating Bank increases in this manner into general

increases independent of the Fund and selective increases parallel to selective increases in the Fund has helped to ensure that the relative positions of countries in the two institutions were similar even though the sizes of the institutions may have changed because of general increases. 1/

Criteria for the Future

7. Over the years, the principle of parallelism has served the Bank well. It has generally ensured that increases in the Bank's capital come from the richer and faster-growing countries. It is a simple and practical system, which has avoided duplication of time-consuming negotiations. It is consistent with the precedents of Bretton Woods, which have been reviewed and endorsed by the Executive Directors on several subsequent occasions. 2/

1/ Parallel action has not achieved perfect parallelism, although relative positions of member countries in the Bank and the Fund are quite close (Appendix 2). Differences can be traced to the smaller initial subscription to Bank shares by 23 developing countries (paragraph 2), and converse action by three other members; to occasional decisions by members not to take up their authorized Fund quotas, while taking up their authorized additional Bank shares, or vice versa; to the occasional exercise of preemptive rights by some member countries (Article II, Section 3(c) of the Bank's Articles of Agreement gives each member country the right to purchase shares in the new capital increase in proportion to their existing holdings.); to the two selective capital increases of 1979 referred to in paragraph 1; and to the decision to grant each IBRD member 250 "membership" shares as part of the General Capital Increase.

2/ See, for example, Draft Report of the Executive Directors, attached to Special Increases in Certain Subscriptions to Capital Stock, dated February 14, 1979, (M79-24). See, similarly, M70-4, dated January 7, 1970 and R69-221, dated November 24, 1969.

8. The various reasons that have justified the use of parallelism in the past continue to be valid. It is therefore desirable from the point of view of the Bank as well as its members to retain parallelism as a cornerstone of Bank policy, and it is recommended that the Bank do so. However, parallelism should not be so strictly applied as to prevent the Bank from authorizing in exceptional circumstances special increases beyond those agreed in the Fund even when there is a consensus among Bank members that such increases would be justified.

9. The idea that, in granting special increases, the Bank ought to take note of other factors is of course not new. It was recognized in the recent increases for Japan and France, as well as in earlier Board documents. 1/ The reason why the Bank stayed with strict parallel action until recently was simply that an agreed alternative was not available.

10. Selective increases which have not been preceded by action in the Fund seem most justified when there is a wide disparity between the concerned member's economic strength and support it provides to the Bank Group, and its capital participation. It is recommended that such circumstances be considered in future selective increases. It is

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1/ See, for example, Review of IBRD Capital Structure (R75-215, dated November 5, 1975), paragraph 49.

impossible to establish any sort of mechanical link between a country's economic situation, the support provided by it to the Bank Group, and the amount of the selective capital increase justified by it. One cannot list in advance all the criteria that might be relevant, although some illustrative examples of specific support can be provided. Exceptional contributions to IDA would figure prominently among them. Official long-term lending to the Bank could also constitute a valid consideration. Other types of support might also be relevant. The merits of eligible requests would have to be considered on a case by case basis; and in accordance with the Articles, all capital increases would be subject to approval by the Bank's Board of Governors.

Technical Aspects

11. Selective increases granted on these considerations should not be allowed to compromise, over the long-term, the principle of parallelism with the Fund. This could best be accomplished by restricting selective increases independent from the Fund to cases where a member country's authorized participation in the Bank's capital fell exceptionally short of its calculated subscription, derived from its calculated quotas in the Fund. 1/ In the past, when

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1/ Calculated subscriptions in the Bank can be derived by multiplying the Bank's total authorized capital by the ratio of each country's calculated quota in the Fund to the total of calculated quotas.

extreme divergence developed in the Fund between actual and calculated quotas, special increases authorized by the Fund have been granted to reduce them. It is therefore reasonable to expect that, provided independent action by the Bank is limited to cases of extreme divergence, such independent action will often just anticipate Fund action and will therefore constitute only a limited departure from the principle of parallelism over the long-run. While any definition of extreme divergence will be to some extent arbitrary, applying a standard that a member country's actual participation in the Bank's capital must be less than three-fourths (75%) of its calculated share seems reasonable. Out of the Bank's 135 member countries, only 16 1/ are in this position now, which serves both to indicate that a three-fourths standard is a useful measure of extreme divergence and to allay concerns that departures from parallelism with the Fund would be large.

12. The scope of the exception to the rule of strict parallelism with the Fund can be further reduced by restricting the frequency of selective increases. It would be reasonable to arrange the timing of such increases so that they are taken up immediately after quota reviews in the Fund, which would normally be once every five years,

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1/ Of these sixteen members, two would qualify for increases under the Brazil and Yugoslavia precedents (see footnote to para. 2). If shares were granted under these precedents, one member would move above the three-fourths cut-off point.

and in addition once approximately midway through the five year period. Considering all requests for increases together at those times would be administratively convenient and would enable the requests to be evaluated in light of one another and against the same standards. It also seems desirable that member countries should be eligible for extraordinary selective capital increases, i.e. those not determined by parallelism with the Fund, only if they have taken up any shares still available to them under earlier capital increase resolutions.1/ Finally, additional shares attributed to any member in such exceptional capital increases might be limited to no more than 25% of the shares already authorized for it at the time of the increase.

Selective Increases for Individual Member Countries

13. The criteria developed above can be employed in evaluating the requests for selective capital increases currently pending with the Bank.

14. The first group of requests involves [eighteen] countries that have followed the Brazil and Yugoslavia precedents 2/ in

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1/ Since procedural formalities relating to subscription take time to be completed, it might be provided that for a request for a special increase to be processed, the member concerned must have applied formally for any shares available under previous resolutions and must be actively pursuing its application. The special increase, if any, authorized would be subject to satisfactory completion of action on the earlier application.

2/ See footnote to paragraph 2.

requesting selective increases to bring their Bank subscriptions in line with their Fund quotas. The new criteria for selective increases proposed in paragraphs 10-12 are not applicable to these requests, since they are based solely on a existing precedent. Many of the requests were in fact received prior to the formulation of the General Capital Increase proposals last year, and a block of about 25,000 shares had been set aside in the GCI for meeting these requests as well as other requests that were expected. The table below shows the names of the countries concerned, the number of additional shares (pre-GCI) that would be required in each case to eliminate the disparity between Bank subscriptions and Fund quotas, and the further increases that would be appropriate under the principles adopted for the GCI:

Member	Required Increase in Shares		
	Pre-GCI	Increase under GCI	Total
1. Bolivia	104	97	201
2. Brazil	31	29	60
3. Chile	533	499	1032
4. Colombia	402	376	778
5. Costa Rica	204	191	395
6. Dominican Republic	274	256	530
7. Ecuador	204	191	395
8. El Salvador	210	197	407
9. Guatemala	250	234	484
10. Haiti	14	13	27
11. Honduras	169	158	327
12. Mexico	1214	1136	2350
13. Panama	152	142	294
14. Paraguay	118	110	228
15. Peru	402	376	778
16. Suriname	42	39	81
17. Uruguay	168	157	325
18. Venezuela	1616	1513	3129
	6107	5714	11821

15. Since these requests follow precedent and are in consonance with the principle of parallelism with the Fund, it is recommended that the additional shares be allocated as requested. The increases corresponding to the GCI would be subject to the same "scaling down" condition as the other increases under the GCI. 1/

16. From 1959 (when Bank capital subscriptions were doubled with no additional paid-in capital) until the GCI, all new or increased subscriptions to the Bank contained a 10% paid-in portion. Under the GCI, the paid-in portion of the increased subscriptions has been fixed at 7.5%. In order to maintain parity of treatment, the proportion to be paid in of the increases proposed in paragraph 14-15 above would be so fixed as to be equivalent to a 10% paid-in portion on the pre-GCI increase (6107 shares) and a 7.5% paid-in portion on the component corresponding to the GCI (5714 shares).

17. The proposed new criteria would apply to a second group of requests for selective increases. These requests are not based on parallelism with the Fund but rely on considerations relating to economic performance in general as well as specific support for the Bank Group. Such requests have been received from Saudi Arabia, the United Arab Emirates, [Kuwait] and Korea. [As far as Kuwait is

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1/ See "IBRD General Capital Increase" (R79-57/2, dated June 20, 1979), Attachment I, paras. 6-8.

concerned, its actual subscription in the Bank, assuming that it takes up all the shares allocated to it under the various capital increase resolutions already approved, will amount to over 90% of its calculated subscription. Consequently, Kuwait would not be eligible for a selective increase under the technical criterion proposed in paragraph 11 above.] The [other] three cases are discussed individually below:

(i) Saudi Arabia: If Saudi Arabia takes up its entire allotment under the GCI, its actual subscription would be 46.7% of its calculated subscription, implying a condition of extreme divergence in terms of the definition in paragraph 12. Saudi Arabia has subscribed to all the shares available to it under previous resolutions. It would therefore be entitled to a maximum increase of 25% of its post-GCI subscription, or 2803 shares, provided it meets the criterion relating to support for the Bank Group. As against its projected share of [1.66%] in the Bank's capital after the GCI, and a share of [2.20%] in the capital contributed by IDA6 donors alone, Saudi Arabia contributed 3.25% of both the Fifth and Sixth IDA Replenishments, and an additional $100 million to the Fifth Replenishment. Further, the Saudi Arabian Monetary Agency has directly purchased Bank bond issues

in both FY79 and FY80, and additional borrowing from it is contemplated in coming years. Under these circumstances, and in view of Saudi Arabia's growing economic strength as a capital exporting country, we believe that it would be a appropriate to grant a selective increase of 2803 shares to Saudi Arabia, amounting to 25% of its post-GCI subscription.

(ii) United Arab Emirates: This again is a case of extreme divergence, since the UAE 's post-GCI share of Bank capital would be 47.2% of its calculated share. UAE meets the other technical criteria of eligibility for a selective increase, and would be entitled to a maximum increase of 596 shares. It has contributed 0.66% to both the Fifth and Sixth Replenishments of IDA, significantly in excess of its post-GCI share of [0.35%] in total Bank capital and [0.47%] in capital contributed by IDA6 donors alone. It is recommended that a selective increase of 596 shares be granted to UAE.

(iii) Korea: Assuming that Korea takes up the shares allocated to it under the GCI, its actual subscription would be [67.8%] of its calculated subscription. Since Korea also fulfil the other technical criteria for selective increases, it would be eligible for a maximum

increase of 737 shares. Korea was one of four Part II donors in the IDA Fifth Replenishment, and has increased its contribution in the Sixth Replenishment. Korea's example has encouraged other middle- and high-income developing countries to participate in the IDA replenishment exercises. In view of Korea's growing economic strength, it is hoped that opportunities for official Bank borrowing from it may also arise in the future. Korea has expressed a very strong desire to increase its share in the Bank's capital. Since it fulfils the technical criteria proposed for selective increases, it is recommended that a special increase of 737 shares be granted to Korea.

18. The proportion of capital to be paid-in may be fixed at 7.5% for the capital increases recommended in the preceding paragraph, in line with the arrangements agreed upon for the GCI.

19. An adequate number of unallocated shares is available to cover the special increases recommended in paras. 16 and 18 above. The increases would as before be subject to adjustment if the allocations under the GCI are scaled down.

Summary and Recommendations

20. As a general rule the Bank should continue to allocate selective increases of its capital in parallel with selective

increases of quotas in the International Monetary Fund. However, it is desirable for the Bank to have some flexibility in recognizing actions by member countries that are specially supportive of the Bank Group, as well as significant changes in their economic circumstances, particularly when those changes are not fully translated into higher quotas due to the length of the period over which the Fund reviews its quotas. Such flexibility could enable the Bank to respond positively to strong support received from its members, and to encourage and elicit further support from members for the Bank Group in the future. It would also enable the Bank to recognize changes in country positions and grant selective increases during the intervals between adjustments of Fund quotas, when there was a consensus to do so. Therefore, I recommend that requests for selective capital increases independent of action by the Fund should be eligible for consideration in the exceptional circumstances described above. Eligibility to be considered for such increases, their magnitude and their frequency should be restricted according to the criteria defined in paragraphs 11 and 12 above. I also recommend that selective increases be granted to individual countries as recommended in paragraphs 14 to 18.

[Financial Analysis Division
Programming and Budgeting Department]

Appendix 1

ORIGINAL BANK MEMBERS WHOSE SUBSCRIPTIONS DIVERGED FROM THEIR FUND QUOTAS

(See Paragraph 2)

Initial Bank Subscription higher than Fund Quota:

Canada
China
United States

Initial Bank Subscription lower than Fund Quota:

Bolivia
Brazil
Chile
Colombia
Costa Rica
Dominican Republic
Ecuador
Egypt
El Salvador
Ethiopia
Greece
Guatemala
Honduras
Iran
Iraq
Mexico
Nicaragua
Panama
Paraguay
Peru
Uruguay
Venezuela
Yugoslavia

MEMBERS' RELATIVE SHARES IN THE IBRD AND IMF

Country	Members' Relative Shares		
	Post GCI	Post 7th Review	IBRD/IMF
AFGHANISTAN	.137	.115	1.1880
ALGERIA	.703	.730	.9632
ARGENTINA	1.382	1.370	1.0091
AUSTRALIA	1.883	2.023	.9308
AUSTRIA	.809	.845	.9568
BAHAMAS	.114	.085	1.3524
BAHRAIN	.084	.051	1.6339
BANGLADESH	.393	.389	1.0084
BARBADOS	.077	.044	1.7626
BELGIUM	2.117	2.279	.9290
BENIN	.071	.041	1.7248
BOLIVIA	.113	.115	.9763
BOTSWANA	.058	.023	2.5211
BRAZIL	1.583	1.703	.9295
BURMA	.206	.187	1.1025
BURUNDI	.087	.059	1.4735
CAMEROON	.107	.115	.9314
CANADA	3.220	3.475	.9267
CAPE VERDE	.042	.003	12.1675
CENTRAL AFRICAN EMP	.071	.041	1.7248
CHAD	.071	.041	1.7248
CHILE	.392	.556	.7053
CHINA	1.146	.939	1.2203
COLOMBIA	.373	.494	.7553
COMOROS	.042	.006	6.9528
CONGO	.073	.044	1.6709
COSTA RICA	.075	.105	.7097
CYPRUS	.117	.087	1.3381
DENMARK	.759	.794	.9565
DOMINICAN REPUBLIC	.087	.141	.6183
ECUADOR	.142	.179	.7934
EGYPT	.509	.584	.8721
EL SALVADOR	.077	.110	.7022
EQUATORIAL GUINEA	.059	.026	2.3036
ETHIOPIA	.079	.092	.8548
FIJI	.079	.046	1.7160
FINLAND	.649	.671	.9680
FRANCE	5.065	4.914	1.0307
GABON	.103	.077	1.3375
GAMBIA, THE	.056	.023	2.4120
GERMANY	5.078	5.521	.9198
GHANA	.282	.271	1.0387
GREECE	.308	.474	.6491
GRENADA	.044	.008	5.6964
GUATEMALA	.085	.131	.6487
GUINEA	.105	.077	1.3721
GUINEA-BISSAU	.045	.010	4.4328
GUYANA	.096	.064	1.4942
HAITI	.087	.059	1.4735
HONDURAS	.068	.087	.7828
ICELAND	.101	.074	1.3538

Country	Post GCI	Post 7th Review	IBRD/IMF
INDIA	3.281	2.932	1.1189
INDONESIA	1.150	1.229	.9354
IRAN	1.653	1.835	.9006
IRAQ	.311	.400	.7772
IRELAND	.399	.397	1.0061
ISRAEL	.516	.525	.9826
ITALY	2.934	3.175	.9238
IVORY COAST	.183	.195	.9412
JAMAICA	.208	.189	1.0954
JAPAN	5.057	4.248	1.1904
JORDAN	.104	.077	1.3491
KAMPUCHEA, DEMOCRAT	.110	.043	2.5703
KENYA	.194	.177	1.1003
KOREA, REPUBLIC OF	.436	.437	.9973
KUWAIT	.954	.671	1.4205
LAOS	.071	.041	1.7248
LEBANON	.088	.048	1.8469
LESOTHO	.054	.018	2.9857
LIBERIA	.111	.095	1.1750
LIBYAN ARAB REPUBLI	.491	.509	.9641
LUXEMBOURG	.122	.079	1.5365
MADAGASCAR	.115	.087	1.3245
MALAWI	.089	.049	1.8293
MALAYSIA	.628	.648	.9698
MALDIVES	.039	.002	16.2068
MALI	.095	.069	1.3749
MAURITANIA	.073	.044	1.6777
MAURITIUS	.100	.069	1.4498
MEXICO	.940	1.370	.6863
MOROCCO	.386	.384	1.0053
NEPAL	.079	.049	1.6196
NETHERLANDS	2.235	2.428	.9206
NEW ZEALAND	.577	.594	.9713
NICARAGUA	.068	.087	.7862
NIGER	.071	.041	1.7248
NIGERIA	.879	.922	.9533
NORWAY	.727	.755	.9621
OMAN	.092	.060	1.5346
PAKISTAN	.758	.730	1.0386
PANAMA	.099	.115	.8570
PAPUA NEW GUINEA	.107	.077	1.3972
PARAGUAY	.057	.059	.9689
PERU	.305	.420	.7273
PHILIPPINES	.528	.538	.9815
PORTUGAL	.416	.440	.9442
QATAR	.140	.113	1.2415
ROMANIA	.610	.627	.9718
RWANDA	.087	.059	1.4735
SAO TOME & PRINCIPE	.041	.005	7.9962
SAUDI ARABIA	1.658	1.776	.9335
SENEGAL	.165	.108	1.5355
SIERRA LEONE	.088	.079	1.1081
SINGAPORE	.152	.158	.9635
SOLOMON ISLANDS	.042	.005	7.6588
SOMALIA	.091	.059	1.5463
SOUTH AFRICA	1.028	1.086	.9469

Country	Members' Relative Shares		
	Post GCI	Post 7th Review	IBRD/IMF
SPAIN	1.340	1.426	.9392
SRI LANKA	.312	.305	1.0237
SUDAN	.238	.225	1.0556
SURINAME	.083	.064	1.3025
SWAZILAND	.065	.031	2.1169
SWEDEN	1.089	1.152	.9452
SYRIAN ARAB REPUBLI	.182	.161	1.1299
TANZANIA	.163	.141	1.1547
THAILAND	.460	.464	.9923
TOGO	.089	.049	1.8293
TRINIDAD & TOBAGO	.228	.210	1.0850
TUNISIA	.171	.161	1.0612
TURKEY	.504	.512	.9838
UGANDA	.151	.128	1.1789
UNITED ARAB EMIRATE	.353	.346	1.0195
UNITED KINGDOM	7.479	7.490	.9985
UNITED STATES	22.287	21.523	1.0355
UPPER VOLTA	.071	.041	1.7248
URUGUAY	.185	.215	.8612
VENEZUELA	1.118	1.690	.6613
VIETNAM	.253	.230	1.0982
WESTERN SAMOA	.044	.008	5.6964
YEMEN ARAB REPUBLIC	.067	.033	2.0207
YEMEN, PDR	.133	.105	1.2673
YUGOSLAVIA	.685	.709	.9652
ZAIRE	.391	.389	1.0039
ZAMBIA	.366	.361	1.0146

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WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Members of the Finance Committee DATE: March 6, 1980

FROM: for JM Paul V. Applegarth, Chief, Financial Analysis, PAB

SUBJECT: Finance Committee Meeting

The attached papers are scheduled for discussion at the Finance Committee meeting on March 11, 1980. A full agenda for this meeting will be distributed shortly.

Attachments

JMurli:sl

DISCUSSION DRAFT
March 4, 1980

CRITERIA FOR SELECTIVE CAPITAL INCREASES

Introduction

1. At the time the Executive Directors approved the proposals for selective increases in Bank capital subscriptions for Japan and France in 1979, 1/ several Directors expressed the view that it would be desirable to agree on the criteria for determining such increases before considering any new proposals. This memorandum suggests certain general criteria that the Bank might use in considering requests for special capital subscriptions. Specifically, it recommends that selective increases in the Bank should be based essentially on the principle of parallel action to the Fund, with some flexibility for the Bank to grant selective increases independent of the Fund when it would be in the Bank's interest to do so. Such action may be justified in recognition of special actions of member countries that further the objectives of the Bank Group, or when there is a significant change in the economic circumstances of member countries that enables them to play a larger role in the Bank. The memorandum recommends the grant of selective increases to [21] member

1/ Japan - Increase in Subscription (R79-29, dated February 22, 1979) and France - Increase in Subscription (R79-44, dated March 8, 1979).

countries, [18] based on existing principles and [3] applying the new criteria.

Bank Policy in the Past

2. At the Bretton Woods Conference in 1944, it was intended that the initial subscriptions of the original members of the Bank be equal to the members' Fund quotas. However, twenty-three developing countries requested lower subscriptions to the Bank's capital, and the shortfall was taken up by three countries -- Canada, China and the United States -- that subscribed more than their Fund quotas indicated (Appendix 1). 1/

3. Since then, members' quotas in the Fund and subscriptions in the Bank have been increased on several occasions. Following the Bretton Woods precedent, the Bank has adopted a policy of maintaining proportionality between IMF quotas and Bank capital subscriptions, and has authorized increases in capital subscriptions whenever there was a selective increase in Fund quotas.

4. The quota increases in the Fund have been the end result of

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1/ In 1956 (Brazil) and 1979 (Yugoslavia), two of the original twenty-three obtained special capital increases which brought their Bank subscriptions into line with their Fund quotas (cf. R-976, dated June 22, 1956 and R79-23, dated February 14, 1979). These increases, which permitted the two countries to make up the initial shortfall in their subscriptions, were granted in recognition of their growing economic strength that enabled them to assume a greater share of the burden of financing the Bank.

a process that commences with the preparation by Fund staff of sets of quota calculations based on recent economic data, using various formulae used in the past. The results of several of these formulae are then combined to determine a "calculated" quota for each member. The Fund staff also prepares tables indicating the divergence between calculated quotas and the actual quotas as a result of previous increases. These tables and calculations then form the basis of the quota negotiations that end with a set of "agreed" quotas approved by the Fund's Governors. Although the principal purpose of special increases in Fund quotas is to adjust the relative positions of individual member countries to reflect changes in their positions in the world economy, it is important to recognize that the "agreed" quotas are arrived at on the basis of a number of considerations which include, but are not confined to, the relative financial and economic standing of countries indicated by the quota formulae. 1/ Quota reviews are required at intervals of not more than five years, 2/ and the "agreed" quotas become the actual quotas when countries subscribe

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1/ In the past, these considerations have included:

(1) to give certain developing countries access to more conditional liquidity in the Fund (prior to Fifth General Review of Quotas, 1970);

(2) to meet the needs of the Fund for additional resources through special increases granted to industrial countries (Fourth Review of Quotas, 1965).

2/ The Seventh Review of Quotas took place in 1978, only three years after the previous review.

to them.

5. In the Bank, the general policy that has emerged with regard to capital increases has been the following:

- General increases in the capital of the Bank are determined by the objectives and specific needs of the Bank. For example, the General Capital Increase under consideration at present is primarily necessitated by the need to sustain current and projected higher levels of lending in the future.

- Selective increases are granted to further the policy of parallelism with the Fund. Thus, whenever the Fund has granted a selective increase in quotas, whether to individual countries or to a group of countries, the Bank has taken parallel action so that the increases authorized in Bank subscriptions are in the same proportion as the selective increases in the Fund. For purposes of parallel action in the Bank, the common component (percentage), if any, of quota increases for all countries is regarded as a general increase, and the balance is regarded as a selective increase for the countries concerned.

6. Separating Bank increases in this manner into general

increases independent of the Fund and selective increases parallel to selective increases in the Fund has helped to ensure that the relative positions of countries in the two institutions were similar even though the sizes of the institutions may have changed because of general increases. 1/

Criteria for the Future

7. Over the years, the principle of parallelism has served the Bank well. It has generally ensured that increases in the Bank's capital come from the richer and faster-growing countries. It is a simple and practical system, which has avoided duplication of time-consuming negotiations. It is consistent with the precedents of Bretton Woods, which have been reviewed and endorsed by the Executive Directors on several subsequent occasions. 2/

1/ Parallel action has not achieved perfect parallelism, although relative positions of member countries in the Bank and the Fund are quite close (Appendix 2). Differences can be traced to the smaller initial subscription to Bank shares by 23 developing countries (paragraph 2), and converse action by three other members; to occasional decisions by members not to take up their authorized Fund quotas, while taking up their authorized additional Bank shares, or vice versa; to the occasional exercise of preemptive rights by some member countries (Article II, Section 3(c) of the Bank's Articles of Agreement gives each member country the right to purchase shares in the new capital increase in proportion to their existing holdings.); to the two selective capital increases of 1979 referred to in paragraph 1; and to the decision to grant each IBRD member 250 "membership" shares as part of the General Capital Increase.

2/ See, for example, Draft Report of the Executive Directors, attached to Special Increases in Certain Subscriptions to Capital Stock, dated February 14, 1979, (M79-24). See, similarly, M70-4, dated January 7, 1970 and R69-221, dated November 24, 1969.

8. The various reasons that have justified the use of parallelism in the past continue to be valid. It is therefore desirable from the point of view of the Bank as well as its members to retain parallelism as a cornerstone of Bank policy, and it is recommended that the Bank do so. However, parallelism should not be so strictly applied as to prevent the Bank from authorizing in exceptional circumstances special increases beyond those agreed in the Fund even when there is a consensus among Bank members that such increases would be justified.

9. The idea that, in granting special increases, the Bank ought to take note of other factors is of course not new. It was recognized in the recent increases for Japan and France, as well as in earlier Board documents. 1/ The reason why the Bank stayed with strict parallel action until recently was simply that an agreed alternative was not available.

10. Selective increases which have not been preceded by action in the Fund seem most justified when there is a wide disparity between the concerned member's economic strength and support it provides to the Bank Group, and its capital participation. It is recommended that such circumstances be considered in future selective increases. It is

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1/ See, for example, Review of IBRD Capital Structure (R75-215, dated November 5, 1975), paragraph 49.

impossible to establish any sort of mechanical link between a country's economic situation, the support provided by it to the Bank Group, and the amount of the selective capital increase justified by it. One cannot list in advance all the criteria that might be relevant, although some illustrative examples of specific support can be provided. Exceptional contributions to IDA would figure prominently among them. Official long-term lending to the Bank could also constitute a valid consideration. Other types of support might also be relevant. The merits of eligible requests would have to be considered on a case by case basis; and in accordance with the Articles, all capital increases would be subject to approval by the Bank's Board of Governors.

Technical Aspects

11. Selective increases granted on these considerations should not be allowed to compromise, over the long-term, the principle of parallelism with the Fund. This could best be accomplished by restricting selective increases independent from the Fund to cases where a member country's authorized participation in the Bank's capital fell exceptionally short of its calculated subscription, derived from its calculated quotas in the Fund. 1/ In the past, when

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1/ Calculated subscriptions in the Bank can be derived by multiplying the Bank's total authorized capital by the ratio of each country's calculated quota in the Fund to the total of calculated quotas.

extreme divergence developed in the Fund between actual and calculated quotas, special increases authorized by the Fund have been granted to reduce them. It is therefore reasonable to expect that, provided independent action by the Bank is limited to cases of extreme divergence, such independent action will often just anticipate Fund action and will therefore constitute only a limited departure from the principle of parallelism over the long-run. While any definition of extreme divergence will be to some extent arbitrary, applying a standard that a member country's actual participation in the Bank's capital must be less than three-fourths (75%) of its calculated share seems reasonable. Out of the Bank's 135 member countries, only 16 1/ are in this position now, which serves both to indicate that a three-fourths standard is a useful measure of extreme divergence and to allay concerns that departures from parallelism with the Fund would be large.

12. The scope of the exception to the rule of strict parallelism with the Fund can be further reduced by restricting the frequency of selective increases. It would be reasonable to arrange the timing of such increases so that they are taken up immediately after quota reviews in the Fund, which would normally be once every five years,

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1/ Of these sixteen members, two would qualify for increases under the Brazil and Yugoslavia precedents (see footnote to para. 2). If shares were granted under these precedents, one member would move above the three-fourths cut-off point.

and in addition once approximately midway through the five year period. Considering all requests for increases together at those times would be administratively convenient and would enable the requests to be evaluated in light of one another and against the same standards. It also seems desirable that member countries should be eligible for extraordinary selective capital increases, i.e. those not determined by parallelism with the Fund, only if they have taken up any shares still available to them under earlier capital increase resolutions.1/ Finally, additional shares attributed to any member in such exceptional capital increases might be limited to no more than 25% of the shares already authorized for it at the time of the increase.

Selective Increases for Individual Member Countries

13. The criteria developed above can be employed in evaluating the requests for selective capital increases currently pending with the Bank.

14. The first group of requests involves [eighteen] countries that have followed the Brazil and Yugoslavia precedents 2/ in

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1/ Since procedural formalities relating to subscription take time to be completed, it might be provided that for a request for a special increase to be processed, the member concerned must have applied formally for any shares available under previous resolutions and must be actively pursuing its application. The special increase, if any, authorized would be subject to satisfactory completion of action on the earlier application.

2/ See footnote to paragraph 2.

requesting selective increases to bring their Bank subscriptions in line with their Fund quotas. The new criteria for selective increases proposed in paragraphs 10-12 are not applicable to these requests, since they are based solely on a existing precedent. Many of the requests were in fact received prior to the formulation of the General Capital Increase proposals last year, and a block of about 25,000 shares had been set aside in the GCI for meeting these requests as well as other requests that were expected. The table below shows the names of the countries concerned, the number of additional shares (pre-GCI) that would be required in each case to eliminate the disparity between Bank subscriptions and Fund quotas, and the further increases that would be appropriate under the principles adopted for the GCI:

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5.	Costa Rica	204	191	395
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8.	El Salvador	210	197	407
9.	Guatemala	250	234	484
10.	Haiti	14	13	27
11.	Honduras	169	158	327
12.	Mexico	1214	1136	2350
13.	Panama	152	142	294
14.	Paraguay	118	110	228
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17.	Uruguay	168	157	325
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		6107	5714	11821

15. Since these requests follow precedent and are in consonance with the principle of parallelism with the Fund, it is recommended that the additional shares be allocated as requested. The increases corresponding to the GCI would be subject to the same "scaling down" condition as the other increases under the GCI. 1/

16. From 1959 (when Bank capital subscriptions were doubled with no additional paid-in capital) until the GCI, all new or increased subscriptions to the Bank contained a 10% paid-in portion. Under the GCI, the paid-in portion of the increased subscriptions has been fixed at 7.5%. In order to maintain parity of treatment, the proportion to be paid in of the increases proposed in paragraph 14-15 above would be so fixed as to be equivalent to a 10% paid-in portion on the pre-GCI increase (6107 shares) and a 7.5% paid-in portion on the component corresponding to the GCI (5714 shares).

17. The proposed new criteria would apply to a second group of requests for selective increases. These requests are not based on parallelism with the Fund but rely on considerations relating to economic performance in general as well as specific support for the Bank Group. Such requests have been received from Saudi Arabia, the United Arab Emirates, [Kuwait] and Korea. [As far as Kuwait is

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1/ See "IBRD General Capital Increase" (R79-57/2, dated June 20, 1979), Attachment I, paras. 6-8.

concerned, its actual subscription in the Bank, assuming that it takes up all the shares allocated to it under the various capital increase resolutions already approved, will amount to over 90% of its calculated subscription. Consequently, Kuwait would not be eligible for a selective increase under the technical criterion proposed in paragraph 11 above.] The [other] three cases are discussed individually below:

(i) Saudi Arabia: If Saudi Arabia takes up its entire allotment under the GCI, its actual subscription would be 46.7% of its calculated subscription, implying a condition of extreme divergence in terms of the definition in paragraph 12. Saudi Arabia has subscribed to all the shares available to it under previous resolutions. It would therefore be entitled to a maximum increase of 25% of its post-GCI subscription, or 2803 shares, provided it meets the criterion relating to support for the Bank Group. As against its projected share of [1.66%] in the Bank's capital after the GCI, and a share of [2.20%] in the capital contributed by IDA6 donors alone, Saudi Arabia contributed 3.25% of both the Fifth and Sixth IDA Replenishments, and an additional $100 million to the Fifth Replenishment. Further, the Saudi Arabian Monetary Agency has directly purchased Bank bond issues

in both FY79 and FY80, and additional borrowing from it is contemplated in coming years. Under these circumstances, and in view of Saudi Arabia's growing economic strength as a capital exporting country, we believe that it would be a appropriate to grant a selective increase of 2803 shares to Saudi Arabia, amounting to 25% of its post-GCI subscription.

(ii) United Arab Emirates: This again is a case of extreme divergence, since the UAE 's post-GCI share of Bank capital would be 47.2% of its calculated share. UAE meets the other technical criteria of eligibility for a selective increase, and would be entitled to a maximum increase of 596 shares. It has contributed 0.66% to both the Fifth and Sixth Replenishments of IDA, significantly in excess of its post-GCI share of [0.35%] in total Bank capital and [0.47%] in capital contributed by IDA6 donors alone. It is recommended that a selective increase of 596 shares be granted to UAE.

(iii) Korea: Assuming that Korea takes up the shares allocated to it under the GCI, its actual subscription would be [67.8%] of its calculated subscription. Since Korea also fulfil the other technical criteria for selective increases, it would be eligible for a maximum

increase of 737 shares. Korea was one of four Part II donors in the IDA Fifth Replenishment, and has increased its contribution in the Sixth Replenishment. Korea's example has encouraged other middle- and high-income developing countries to participate in the IDA replenishment exercises. In view of Korea's growing economic strength, it is hoped that opportunities for official Bank borrowing from it may also arise in the future. Korea has expressed a very strong desire to increase its share in the Bank's capital. Since it fulfils the technical criteria proposed for selective increases, it is recommended that a special increase of 737 shares be granted to Korea.

18. The proportion of capital to be paid-in may be fixed at 7.5% for the capital increases recommended in the preceding paragraph, in line with the arrangements agreed upon for the GCI.

19. An adequate number of unallocated shares is available to cover the special increases recommended in paras. 16 and 18 above. The increases would as before be subject to adjustment if the allocations under the GCI are scaled down.

Summary and Recommendations

20. As a general rule the Bank should continue to allocate selective increases of its capital in parallel with selective

increases of quotas in the International Monetary Fund. However, it is desirable for the Bank to have some flexibility in recognizing actions by member countries that are specially supportive of the Bank Group, as well as significant changes in their economic circumstances; particularly when those changes are not fully translated into higher quotas due to the length of the period over which the Fund reviews its quotas. Such flexibility could enable the Bank to respond positively to strong support received from its members, and to encourage and elicit further support from members for the Bank Group in the future. It would also enable the Bank to recognize changes in country positions and grant selective increases during the intervals between adjustments of Fund quotas, when there was a consensus to do so. Therefore, I recommend that requests for selective capital increases independent of action by the Fund should be eligible for consideration in the exceptional circumstances described above. Eligibility to be considered for such increases, their magnitude and their frequency should be restricted according to the criteria defined in paragraphs 11 and 12 above. I also recommend that selective increases be granted to individual countries as recommended in paragraphs 14 to 18.

[Financial Analysis Division
Programming and Budgeting Department]

ORIGINAL BANK MEMBERS WHOSE SUBSCRIPTIONS
DIVERGED FROM THEIR FUND QUOTAS
(See Paragraph 2)

Initial Bank Subscription higher than Fund Quota:

Canada
China
United States

Initial Bank Subscription lower than Fund Quota:

Bolivia
Brazil
Chile
Colombia
Costa Rica
Dominican Republic
Ecuador
Egypt
El Salvador
Ethiopia
Greece
Guatemala
Honduras
Iran
Iraq
Mexico
Nicaragua
Panama
Paraguay
Peru
Uruguay
Venezuela
Yugoslavia

MEMBERS' RELATIVE SHARES IN THE IBRD AND IMF

Country	Members' Relative Shares		
	Post GCI	Post 7th Review	IBRD/IMF
AFGHANISTAN	.137	.115	1.1880
ALGERIA	.703	.730	.9632
ARGENTINA	1.382	1.370	1.0091
AUSTRALIA	1.883	2.023	.9308
AUSTRIA	.809	.845	.9568
BAHAMAS	.114	.085	1.3524
BAHRAIN	.084	.051	1.6339
BANGLADESH	.393	.389	1.0084
BARBADOS	.077	.044	1.7626
BELGIUM	2.117	2.279	.9290
BENIN	.071	.041	1.7248
BOLIVIA	.113	.115	.9763
BOTSWANA	.058	.023	2.5211
BRAZIL	1.583	1.703	.9295
BURMA	.206	.187	1.1025
BURUNDI	.087	.059	1.4735
CAMEROON	.107	.115	.9314
CANADA	3.220	3.475	.9267
CAPE VERDE	.042	.003	12.1675
CENTRAL AFRICAN EMP	.071	.041	1.7248
CHAD	.071	.041	1.7248
CHILE	.392	.556	.7053
CHINA	1.146	.939	1.2203
COLOMBIA	.373	.494	.7553
COMOROS	.042	.006	6.9528
CONGO	.073	.044	1.6709
COSTA RICA	.075	.105	.7097
CYPRUS	.117	.087	1.3381
DENMARK	.759	.794	.9565
DOMINICAN REPUBLIC	.087	.141	.6183
ECUADOR	.142	.179	.7934
EGYPT	.509	.584	.8721
EL SALVADOR	.077	.110	.7022
EQUATORIAL GUINEA	.059	.026	2.3036
ETHIOPIA	.079	.092	.8548
FIJI	.079	.046	1.7160
FINLAND	.649	.671	.9680
FRANCE	5.065	4.914	1.0307
GABON	.103	.077	1.3375
GAMBIA, THE	.056	.023	2.4120
GERMANY	5.078	5.521	.9198
GHANA	.282	.271	1.0387
GREECE	.308	.474	.6491
GRENADA	.044	.008	5.6964
GUATEMALA	.085	.131	.6487
GUINEA	.105	.077	1.3721
GUINEA-BISSAU	.045	.010	4.4328
GUYANA	.096	.064	1.4942
HAITI	.087	.059	1.4735
HONDURAS	.068	.087	.7828
ICELAND	.101	.074	1.3538

Country	Post GCI	Post 7th Review	IBRD/IMF
INDIA	3.281	2.932	1.1189
INDONESIA	1.150	1.229	.9354
IRAN	1.653	1.835	.9006
IRAQ	.311	.400	.7772
IRELAND	.399	.397	1.0061
ISRAEL	.516	.525	.9826
ITALY	2.934	3.175	.9238
IVORY COAST	.183	.195	.9412
JAMAICA	.208	.189	1.0954
JAPAN	5.057	4.248	1.1904
JORDAN	.104	.077	1.3491
KAMPUCHEA, DEMOCRAT	.110	.043	2.5703
KENYA	.194	.177	1.1003
KOREA, REPUBLIC OF	.436	.437	.9973
KUWAIT	.954	.671	1.4205
LAOS	.071	.041	1.7248
LEBANON	.088	.048	1.8469
LESOTHO	.054	.018	2.9857
LIBERIA	.111	.095	1.1750
LIBYAN ARAB REPUBLI	.491	.509	.9641
LUXEMBOURG	.122	.079	1.5365
MADAGASCAR	.115	.087	1.3245
MALAWI	.089	.049	1.8293
MALAYSIA	.628	.648	.9698
MALDIVES	.039	.002	16.2068
MALI	.095	.069	1.3749
MAURITANIA	.073	.044	1.6777
MAURITIUS	.100	.069	1.4498
MEXICO	.940	1.370	.6863
MOROCCO	.386	.384	1.0053
NEPAL	.079	.049	1.6196
NETHERLANDS	2.235	2.428	.9206
NEW ZEALAND	.577	.594	.9713
NICARAGUA	.068	.087	.7862
NIGER	.071	.041	1.7248
NIGERIA	.879	.922	.9533
NORWAY	.727	.755	.9621
OMAN	.092	.060	1.5346
PAKISTAN	.758	.730	1.0386
PANAMA	.099	.115	.8570
PAPUA NEW GUINEA	.107	.077	1.3972
PARAGUAY	.057	.059	.9689
PERU	.305	.420	.7273
PHILIPPINES	.528	.538	.9815
PORTUGAL	.416	.440	.9442
QATAR	.140	.113	1.2415
ROMANIA	.610	.627	.9718
RWANDA	.087	.059	1.4735
SAO TOME & PRINCIPE	.041	.005	7.9962
SAUDI ARABIA	1.658	1.776	.9335
SENEGAL	.165	.108	1.5355
SIERRA LEONE	.088	.079	1.1081
SINGAPORE	.152	.158	.9635
SOLOMON ISLANDS	.042	.005	7.6588
SOMALIA	.091	.059	1.5463
SOUTH AFRICA	1.028	1.086	.9469

Country	Members' Relative Shares		
	Post GCI	Post 7th Review	IBRD/IMF
SPAIN	1.340	1.426	.9392
SRI LANKA	.312	.305	1.0237
SUDAN	.238	.225	1.0556
SURINAME	.083	.064	1.3025
SWAZILAND	.065	.031	2.1169
SWEDEN	1.089	1.152	.9452
SYRIAN ARAB REPUBLI	.182	.161	1.1299
TANZANIA	.163	.141	1.1547
THAILAND	.460	.464	.9923
TOGO	.089	.049	1.8293
TRINIDAD & TOBAGO	.228	.210	1.0850
TUNISIA	.171	.161	1.0612
TURKEY	.504	.512	.9838
UGANDA	.151	.128	1.1789
UNITED ARAB EMIRATE	.353	.346	1.0195
UNITED KINGDOM	7.479	7.490	.9985
UNITED STATES	22.287	21.523	1.0355
UPPER VOLTA	.071	.041	1.7248
URUGUAY	.185	.215	.8612
VENEZUELA	1.118	1.690	.6613
VIETNAM	.253	.230	1.0982
WESTERN SAMOA	.044	.008	5.6964
YEMEN ARAB REPUBLIC	.067	.033	2.0207
YEMEN, PDR	.133	.105	1.2673
YUGOSLAVIA	.685	.709	.9652
ZAIRE	.391	.389	1.0039
ZAMBIA	.366	.361	1.0146

DRAFT
March 6, 1980

COMMITMENT OF EXCHANGE GAINS ACCRUED ON IDA CONTRIBUTIONS AFTER THE CLOSE OF A REPLENISHMENT PERIOD

Introduction

1. This note examines whether IDA should adopt a policy of committing exchange gains on member contributions that may accrue after the close of the pertinent replenishment period. The issue immediately facing the Association relates to exchange gains on non-dollar contributions to IDA4, and the note therefore focuses on the situation obtaining with respect to IDA4 resources. After examining the potential benefits and risks associated with the commitment of post-replenishment period exchange gains, the note concludes that on balance it would be prudent not to commit the available funds under IDA4. Many of the arguments developed in the note are however of general validity, and the conclusion would be applicable to future replenishments as well.

Availability of IDA4 Resources

2. At the time of the Fourth Replenishment Agreement in Nairobi (September 27, 1973), the total value of members' contributions was $4,435 million, computed at the then prevailing market rates of exchange. It was agreed to commit these contributions in three equal amounts, that is about $1,500 million annually, in the FY75-77 period. In the two years subsequent to the Nairobi Agreement, exchange rate changes did not alter the total IDA4 value significantly. As a result, the Association committed $1,576 million and $1,655 million in

FY75 and FY76 respectively, taking into account further resources available from Bank transfers and other sources. By June 1976, however, the value of member contributions had dropped by about $350 million to $4,083 million.1/ Consequently, commitments in FY77 were limited to $1,308 million. The remaining balance available for commitment at the end of the IDA4 commitment period (June 30, 1977) amounted to only about $5 million, as shown below:

US $ Equivalent of IDA4 Resources
at the End of the Commitment Period

	$ million
IDA4 Contributions a/	4151.5
Part II Releases	13.7
Transfers from IBRD b/	290.1
Cancellations	18.6
Repayments	40.4
Grant Participations	22.4
Balance Available 7/1/74	1.0
Net Income c/	6.5
Total IDA4 Resources	4544.2
Less: Commitments FY75-77	4538.9
Balance Available	5.3

a/ Valued at exchange rates prevailing on June 30, 1977; includes adjustments for amounts disbursed till that date.
b/ Net of grants for agricultural research and for onchocerciasis control.
c/ Excludes devaluation losses on Swiss loans, which do not affect commitment authority.

1/ The decline in the dollar equivalent of Fourth Replenishment contributions was caused by the depreciation of all member currencies against the dollar. A significant portion of the loss, representing about 87% of the decline, was attributed to the change in the value of contributions from France, Germany, Italy, Japan and the United Kingdom.

3. After June 30, 1977, the value of member contributions underwent a small further decline of about $7 million, reaching a level of $4,144 million at the end of December 1977. The trend was sharply reversed thereafter, and significant exchange rate gains were registered on the undisbursed portions of non-dollar contributions (Attachment I). As of January 31, 1980, the available IDA4 resources amounted to $378 million (Attachment II).

4. The principal benefit from committing these resources is that it would help to ease the present constraint on commitment authority in the IDA Fifth Replenishment. As a result of delay in the receipt of the third installment of the US contribution to IDA5, the third tranche of member contributions is not yet effective. Consequently, after the available commitment authority was exhausted late in 1979, all IDA credits have been approved on a conditional basis, subject to the availability of additional commitment authority. As of this date, there have been 21 such conditional credits, for a total of $680 million. Use of the additional resources from IDA4 would enable several of these credits to be made effective.

5. This benefit is offset, however, by several significant risks. Legislative action is still to be completed on the delayed US contribution of $292 million, so that the timing of its receipt must be regarded as uncertain. If the US funds have still not been received when IDA4 nears full disbursement (FY85 approximately) and the IDA4 exchange gains were not committed, the gains, assuming they

still exist, would be available to make up some or all of the shortfall. If this amount is excluded from consideration for the present, the balance available gets reduced to the much smaller figure of $86 million.

6. More importantly, committing the exchange gains involves the risk that funds will not be available when needed for disbursements. This can happen if the dollar strengthens against the other replenishment currencies, with a consequent exchange loss for IDA, during the period between commitment and disbursement. In such a case, IDA has the legal right to transfer resources from one replenishment to meet obligations arising under any other replenishment (except for IDA2, for which special arrangements were made). Language to this effect was in fact included in the IDA5 Agreement at the request of the United States and in the original drafts of the IDA6 Agreement. It was subsequently deleted from IDA6, again at the request of the United States who objected that the possibility of such switching would circumvent the carefully negotiated conditions of payment under each replenishment, as well as understandings reached with Congress on the use of funds in each replenishment. Notwithstanding this deletion, the General Counsel has given an opinion that as a legal matter the resources available under one replenishment (except for the Second Replenishment) are available if necessary to meet obligations arising under any other replenishment. Thus the problem of a shortfall is less a legal one

than one of whether it is in IDA's interest to incur the risk of violating donors' wishes in what is an essentially voluntary association.1/ If it is decided that donor contributions of one replenishment would not be used, or used only as a last resort, to meet obligations arising from commitments under another replenishment, then such obligations can be funded, at least for IDA4, only through the temporary diversion of repayments from past credits. These repayments will be relatively small for the next several years, 2/ and in any one year might well be insufficient to cover a funds gap arising from exchange losses. The other important source of free funds, namely net income, would not be available since IDA is not expected to earn any surplus from current operations till FY87. The use of repayments for disbursement could result in serious cash flow problems for IDA because of the deficits.

1/ There is also a real financial risk to be considered. If there is a delay in reaching agreement on a future replenishment, there would in fact be no additional member contributions that could be diverted to meet the shortfall, and other resources may be insufficient. Moreover, even if there is an agreement, diversion of member contributions may still not be possible, either because of a stipulation against it in the agreement itself, or because the agreement fails to become effective as a result of members falling behind in their payments (as has happened in IDA5).

2/ Repayments in FY81-85 are likely to be as follows: FY81-$33 million; FY82-$44 million; FY83-$58 million; FY84-$78 million; FY85-$96 million. These repayments would normally be included in the determination of the commitment authority for the replenishment periods in which they fall due. If the Swiss loans to IDA2 and IDA3 are converted into grants, an additional $1 million on average will be available annually through FY85.

7. Committing to the limit against exchange gains in IDA4 may not be prudent for another reason. These gains provide some protection for the Association's policy of fully committing exchange gains on IDA5 contributions during the IDA5 commitment period. Use of the IDA4 resources would eliminate this safeguard for IDA5. Furthermore, making additional commitments to utilize exchange gains that have accrued after the end of a replenishment period, without providing for a corresponding reduction in commitments when there are exchange losses, introduces an asymmetry in policy that increases the risk of a future shortfall of funds. 1/

8. The potential costs of committing the IDA4 exchange gains are thus considerable. The benefit, though real, is not substantial when viewed against the extent of the present shortfall in IDA5 commitment authority. 2/ The conditional credits already made ($680 million) exceed the $378 million available from IDA4, so commitment of the latter will not gain additional time for the Association. On balance, therefore, it appears financially prudent to hold the IDA4

1/ It should be noted that after the dollar devaluations of 1972 and 1973, the increases in commitment authority (reckoned in current dollars) arising from exchange gains were fully committed, including the portions pertaining to previous replenishments. However, these exchange gains arose from a change in par values that was expected to be maintained, and thus the risks of committing them were substantially less than the ones arising under a system of floating exchange rates as at present.

2/ Planned credits during the rest of the current fiscal year call for the commitment of an additional $2,310 million.

resources in reserve and not to commit them until disbursements already committed under IDA4 are completed. A decision could be taken at that time on the utilization of the balance, if any, of IDA4 resources still available. 1/

9. The risks discussed above will for the most part apply also to future IDA replenishments. It would be prudent, therefore, to follow a similar policy for them as well.

Attachments

Financial Analysis Division
Programming and Budgeting Department

1/ If large exchange gains build up towards the close of the disbursement period, the Association could plan for their commitment even before disbursements on previous commitments are actually completed.

Attachment I

VALUE OF MEMBER CONTRIBUTIONS TO IDA4

	($ million equivalent)
September 27, 1973 a/	4435
June 30, 1977 b/	4151
September 30, 1977	4148
December 31, 1977	4144
March 31, 1978	4305
June 30, 1978	4322
September 30, 1978	4423
December 31, 1978	4424
March 31, 1979	4393
June 30, 1979	4597
September 30, 1979	4533
December 31, 1979	4526
January 31, 1980	4526

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a/ Date of Agreement.
b/ End of replenishment period.

Attachment II

IDA4 RESOURCES AS OF 1/31/80

		$ million
Total Contributions from Members a/		4526
Part II Releases		14
Net Income b/		6
Repayments to IDA		40
Bank Transfers c/		290
Cancellations		19
Grant Participations		22
Total Sources		4917
Less Commitments:	FY75	1576
	FY76	1655
	FY77	1308
		4539
IDA4 Balance as of 1/31/80		378

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a/ Contributions from members to IDA4 valued at exchange rates prevailing on January 31, 1980; includes adjustments for amounts disbursed till that date.

b/ Excludes devaluation losses on Swiss loans which do not affect commitment authority.

c/ Net of allocations for grants to agricultural research and for onchocerciasis control.

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Members of the Finance Committee

DATE: March 7, 1980

FROM: JM for Paul V. Applegarth, Chief, Financial Analysis, PAB

SUBJECT: Meeting of the Finance Committee

The Finance Committee will meet on Tuesday, March 11, 1980 at 2:00 p.m. in Mr. McNamara's office to discuss the following items:

1. Criteria for Selective Capital Increases, prepared by PAB, (distributed March 6, 1980).

2. Currency Pooling - Remaining Issues - paper prepared by PAB, (to be distributed separately).

3. Commitment of Exchange Gains Accrued on IDA Contributions after the Close of a Replenishment Period, prepared by PAB, (distributed March 6, 1980).

4. Table I in SDR's prepared by the Controller's Department, (to be distributed separately).

5. Board Budget Committee - please refer to minutes of January 8 and February 12, 1980 Finance Committee meetings.

6. Role of Board in Formulating Bank Policy - please refer to minutes of January 8, 1980 Finance Committee meeting.

7. Fund Financing and the Increasing Payment Imbalances, prepared by and discussed at IMF Board, (attached).

Cheap, subsidized resources for rich c's.

PVApplegarth:mm

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

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March 5, 1980

To: Members of the Executive Board

From: The Secretary

Subject: Fund Financing and the Increasing Payments Imbalances

Attached for consideration by the Executive Directors is a staff paper dealing with the role of the Fund in the recycling process.

This subject has been scheduled for discussion on Monday, March 17, 1980.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Fund Financing and the Increasing Payments Imbalances

Prepared by the Staff

March 5, 1980

I. Introduction

The purpose of this paper is to provide a brief introduction for a discussion of the issues that have been raised by the resurgence of large imbalances in members' international payments in order to obtain Board guidance on the direction which further staff work should take. It is now evident that the strains caused in particular by high and rising energy prices are not to be short-lived. In this context, the paper inquires about the appropriate actions that might be expected of the Fund to help its members.

The plan of the paper is as follows: the second section describes the current setting on the basis of the most recent World Economic Outlook discussion, supplemented by material gathered on the prospects for some of the larger and more affected countries, and by the findings of a recent study of international capital markets. 1/ The third section assesses the medium-term outlook and its implications for the international payments system. The fourth section discusses the role of the Fund, addressing the potential need for an enlarged use of resources and the relationship with other sources of external assistance, in particular with the World Bank. Finally, the concluding section contains a few major issues on which the Board may wish to focus attention.

II. Imbalances and Their Financing in 1980

In ID/80/1: "World Economic Outlook--The Current Picture," the emergence of new strains on the payments mechanism was summarized in the projection--on a working hypothesis that the real price of oil would remain unchanged after the beginning of 1980--of a current account surplus of some US$100 billion in 1980 for the major oil exporting countries and of a current account deficit of around US$70 billion for the non-oil developing countries as a group. The scale of pressure put by these imbalances on the international payments mechanism was shown to be broadly similar to that which, six years ago, led to the establishment of the first Oil Facility in the Fund.

1/ See SM/80/55: "International Capital Markets - The Current Outlook" (2/25/80).

There are aspects of the present situation, however, which are even more worrisome than in the earlier period. One of them is the concentration of prospective deficits in the developing countries which are not oil exporters. This is particularly the case with respect to those countries in the developing world which have already borrowed extensively and are thus in a weaker position to attract the capital necessary to continue to finance large deficits. Such countries account for more than one half of the aggregate current account deficit of the non-oil developing countries. Despite the relatively large capital inflows envisaged at present, these countries could need substantial amounts of additional borrowing to finance the current account deficits presently in prospect. For a few of the countries the problems are extraordinary. The strain on their payments has already caused such concern that not only have capital inflows from private external sources virtually ceased, but sizeable capital outflows from domestic sources have emerged. The reduction in the flow of imports associated with the more limited availability of capital has led to shortages of raw materials and spare parts, which contribute to reduce or slow down domestic production and increase the rate of inflation, thus heightening the social and political difficulties involved in the process of adjusting the imbalances. In addition, there is an important group of countries which are mainly dependent on aid and official development assistance and which face severe financial difficulties, unless there is a quick and large expansion of these concessional aid flows.

Private financial institutions will continue to play the major role in financing the deficits of most developing countries. However, the recent staff visit to several banking centers found some unease leading to a temporary slowdown in the making of new commitments. In large part, the slowdown reflects the lenders' view that the current returns (e.g., lending spreads and fees) from such lending are not commensurate with the risks involved; these risks are perceived to have heightened substantially as a result of the rise in oil prices and certain developments of a noneconomic nature. At the moment, however, there is a large pipeline of undisbursed commitments, 1/ many developing countries have a healthy reserve position and a substantial volume of bank financing is likely to be available in the form of short-term trade credits. These factors suggest that a temporary cutback in the volume of new medium-term commitments will not render the difficulties of developing countries, as a whole, unmanageable in the near future. Moreover, the immediate issue appears to relate to the size of the spreads; these will either widen or prove to be adequate and the slowdown should end in either event. Assuming no further major shocks to the international economy in the next few months, new commitments should be forthcoming in the remainder of the year in amounts sufficient to cope with most of the foreseeable problems.

1/ The level of undisbursed credit commitments to non-oil developing countries from banks in the BIS reporting area increased by US$20 billion in the 12-month period ending June 1979, to a level of US$58 billion.

On the whole, it would seem that the immediate outlook is one of increased strain in the international payments situation but one in which the prospective capital flows are likely to prove adequate for most countries. However, this is by no means true for all countries. For those which already are in difficulties, the problems will intensify and for countries which are perceived to be nearing such difficulties, there is a great danger that they too could find their circumstances deteriorating abruptly. As pointed out earlier, there are also a number of countries with limited or no access to private capital markets that face severe financing problems because of inadequate official flows. So far, these are the countries that have tended to turn to the Fund for assistance and it is likely that this trend will continue.

The Fund's liquidity position--i.e., the volume of currently usable assets, including approximately SDR 6 billion of usable lines of credit under the SFF--is judged to be broadly adequate to cope with the needs for the remainder of 1980. For some time after its inception, the supplementary financing facility had not been strongly used, partly because of the ample availability of funds in international financial markets. Recently, however, use of the facility has begun to intensify and commitments outstanding or underway are equivalent to 28 per cent of currently usable resources. There are signs that this trend can be expected to continue in the remainder of the year. Negotiations with members in balance of payments difficulties are in progress and it is expected that they will add substantially to the current level of commitments by the Fund. Under the present guideline related to the use of supplementary resources of up to 300 per cent of quota, it is quite possible to envisage new commitments in the remainder of the year absorbing a very high proportion of the usable lines of credit under the supplementary financing facility. Furthermore, a possible relaxation of the present guideline, in cases where the Board believed this to be warranted, could lead to an even more rapid use of these funds.

III. Imbalances and Their Financing After 1980

As the previous section has suggested, the principal focus of concern must be on the years beyond 1980. It seems virtually certain that the strain currently developing in the international economy will not moderate in the near future. Compared to the situation following the first round of large oil price increases, at this time there seems to be less prospect for a decline in deficits either from increases in absorption by surplus oil countries or from a decline in the real oil price on the scale that took place after 1974. In addition, given the low rates of investment in the main industrial countries in the past, there is also a very strong presumption that the world economy will grow in the coming years at lower rates than in earlier periods; this will occur at a time when inflationary

pressures prevail in many countries--now leading to rapidly rising interest rates--thus compounding the adjustment problem. The ability of countries to cope with these strains will vary widely, but on present trends, the non-oil developing countries, as well as some of the relatively small industrial countries, will have the greatest need for balance of payments financing, despite substantially lower growth rates. 1/

The continuation of large current account surpluses of the major oil exporting countries entails that the resources necessary to finance the counterpart deficits will be available. However, there is a need to ensure that the financing is channeled toward the countries that need it most and that are willing to undertake the adjustment necessary to warrant the resource transfer. In present circumstances, this involves a discussion of the role of commercial banks, which have become the major source of balance of payments financing. Banks financed about half of the collective current account deficit and reserve accumulation of the non-oil developing countries in the five-year period 1974-78. However, in several aspects, the current situation differs significantly from the earlier period. Banks are more exposed now than they were six years ago. In 1974, medium-term international bank loans outstanding (particularly to developing countries) were relatively small for most banks, so that large increases could occur without giving rise to concerns on prudential grounds. From 1974 to 1978, the annual growth rate of domestic bank credit in five major industrial countries 2/ averaged less than 11 per cent, but international lending grew at an annual rate close to 25 per cent; and exposure to non-oil developing countries rose even faster. 3/ In addition, the capital of some major banks, for example those in the United States, rose less rapidly than total assets so that the ratios of capital to assets, and particularly to their claims on non-oil developing countries, declined. 4/

1/ In the forthcoming discussion of the World Economic Outlook, the Executive Board will have an occasion to review in depth the prospects for the international economy on the basis of forecasts currently being prepared.

2/ France, Germany, Japan, the United Kingdom, the United States.

3/ At the end of 1973 total international bank loans of all maturities by banks in the BIS reporting area (net of redepositing among the banks) was on the order of US$160 billion, of which developing countries accounted for less than 20 per cent. By September 1979 the global figure had quadrupled and the developing country share was approaching 30 per cent of total international claims.

4/ Data on banks' capital positions, particularly on an internationally comparable basis, are sketchy. For large U.S. banks, which have voiced the most concern about their capital positions, it has been reported that the ratio of capital to assets has declined in the last several years from 5.5 per cent to less than 4.5 per cent.

For these reasons, banks may be reluctant to continue expanding their exposure to non-oil developing countries at the pace of recent years. If so, there will be an increased need to provide a larger amount of financing from other sources to countries with favorable growth prospects and willing to undertake the necessary adjustments. This seems particularly urgent, since already in 1980 it is expected that the available financial flows will only allow for an increase of about 3 per cent in the volume of imports of non-oil developing countries as a group, compared to rises of around 6 per cent in earlier periods. Such a limited expansion of imports can only suggest that growth rates in these countries will be disappointing and even negative in per capita terms. Alternative sources of finance include foreign aid, both in the form of grants and capital transfers. There are prospects for increases in aid to certain low-income countries, but, in most cases, it seems doubtful, under present assumptions, that the increases will be on a scale commensurate with their overall problem. Consequently, unless there is a new commitment by donors for a substantially higher level of assistance, the ability of many developing countries to generate growth will be increasingly dependent on resources provided by international sources. This dependence will, of course, not be limited to countries in the early stages of development. A number of countries, especially the smaller ones, where industry is important and growing rapidly, will be in serious need of supplemental resources to permit them to adapt to the changed circumstances without undue restraint on their short-term growth rates.

IV. Implications for Fund Policies

1. The role of the Fund in recycling

Compared to other lenders, the value of the Fund as a mechanism to transfer resources on the required large scale lies particularly in its ability to ensure that the transfer is related to the adoption of the policies which provide the necessary confidence that adjustment will be achieved and that flows of external funds from other sources will be available on a continuing basis. The immediate task faced by members with unsustainable current account deficits is to adjust quickly to the situation created by the high real level of energy prices. To delay by attempting simply to finance the resulting gaps--in the way some members did six years ago--would be to waste scarce capital resources in countries which need them most. Therefore, the role of the Fund would seem to be best discharged by providing resources on a large enough scale and for sufficiently long periods to members that are able and ready to carry through the needed adjustments.

For many members, the commercial banks will, of course, continue to be the major source of financing for their increased payments deficits. This is not to be regretted but rather to be welcomed, as it allows the banks to retain their major role as intermediaries of available financing among countries. However, the degree of uncertainty is large and it will frequently be helpful that the member has a program agreed with the Fund. It is to be hoped that such a program will encourage banks to maintain the flow of resources at adequate levels and at reasonable spreads. For this purpose, it is likely to be important that Fund assistance to members is associated with the adoption and implementation of adjustment policies that give confidence that the prevailing problems will be solved. The current and prospective environment imposes serious constraints to countries' economic performance. It is, therefore, important that members--particularly those with a relatively large potential for growth--adopt policies that do not reduce or limit their growth rates unnecessarily, in order to ensure that they are able to service their external debt. The ability of Fund programs to foster efficient use of resources and resumption of growth in member countries should assist in ensuring greater parallel financing from the commercial banks.

It is to be recognized, however, that for some members currently assisted by the Fund, the payments situation has already become--and it is likely to remain--so serious that commercial banks will not be ready for prudential reasons to provide parallel support. In such cases, most would feel that it would be inappropriate for Fund resources to be used to repay the commercial banks--"to bail out the banks." As in the past, efforts can be made to ensure that, in these cases, Fund support is used to assist members in maintaining output through encouraging negotiations and, where appropriate, reschedulings with the commercial banks in order to avoid a net drain of resources.

With respect to members that are dependent on aid and concessional loans, the Fund may also play a more constructive role. Assistance from the Fund and other multilateral agencies frequently needs to be supplemented by aid flows granted by donor countries. While such flows can be obtained in the framework of existing Consultative Groups and, when debt relief is required, in the framework of creditor clubs, there seems likely to be an increasing number of cases when Fund assistance to organize ad hoc aid groups may be desirable. This assistance need not be limited to those cases where upper credit tranche resources are being provided. As on a few occasions in the past, Fund technical assistance could be provided to group meetings prior to the adoption of comprehensive adjustment programs.

2. The orientation of Fund programs in present circumstances

The Fund's conditionality practices have been reviewed recently and formalized in the guidelines adopted by the Executive Board on March 2, 1979, in a way which allows for a reasonable degree of flexibility. Therefore, the aim at this time is to focus directly on the type of policies which should be encouraged within these existing conditionality practices.

In the context of the continuing surpluses of some members, notably the major oil exporting countries, adjustment does not mean that members will be expected simply to reduce aggregate demand. On the contrary, the larger resources provided by the Fund, and by other lenders on the basis of the adjustment policies adopted, would appropriately permit members to sustain a higher level of demand than would be possible otherwise. The thrust of the adjustment effort, at this time, would be to make sure that resources are directed to productive investment in order to make the new situation manageable. Fund resources could, therefore, be directed in large measure to support adjustment programs which, besides ensuring financial balance, enable members to attain their growth potential and to surmount the difficulties caused by the change in relative prices. Consequently, in this period, instruments addressed to eliciting supply responses--e.g., the structure of relative prices (including the exchange rate), of taxes and of public investment--could carry more weight in Fund-supported programs.

In view of the overriding importance of energy costs in the recent payments imbalances, special attention will have to be paid to energy policy in any program to be supported by enlarged Fund resources. While some aspects of energy policy are immediately apparent--notably the adoption of full cost pricing--there are more technical aspects connected, in particular, with investment programs. Given the limited expertise of the Fund, effective attention to this area would seem to call for a close collaboration with the World Bank. Indeed, the present concern with adjustments required on the supply side of the economy involves a range of areas, particularly related to investment, that fall within the Bank's expertise. The specific modalities of this association will need to be developed actively. A clear demarcation of the responsibilities of the two institutions already exists in the understanding reached ten years ago ["Fund/Bank Collaboration," (EBD/70/38, 2/19/70)], which also discussed the modalities of collaboration both at headquarters and in missions. However, there is a need to develop further understandings on the precise association of Fund assistance with Bank programs and of the Bank's assistance with Fund programs.

Some aspects of this issue have arisen in connection with the proposal before the Bank Board for lending for structural adjustment. But equally important aspects can be raised in the Fund on whether--when the Fund extends longer-term assistance, notably under the extended Fund facility--there should be an expectation that the Bank has concluded that the basic objectives of the country's development strategy are both feasible and desirable. To make this expectation a firm requirement might unduly delay reaching initial understandings on Fund assistance; it may be desirable, nevertheless, to consider that, within a reasonable period of time, Fund assistance should be continued in parallel with Bank financial support of the country's development strategy.

3. Possible adaptation of Fund practices

Turning now to the operational aspects of the Fund's lending, it would seem important, given the nature of the adjustments required in the period ahead, that a relatively liberal attitude be taken with respect to the amount of Fund assistance in relation to quota. A major step in this direction has already been taken by the understanding, reached before the 1979 Annual Meeting, that resources from the supplementary financing facility could be used up to 300 per cent of quota, for the time being, thus raising the potential use of conditional resources as far as 465 per cent of quota in the context of an extended arrangement. But, it may prove necessary to go further in reducing the importance of quota limits, in view of the warranted needs foreseen at present. Furthermore, if the Fund is to raise the scale of assistance to the amounts that now seem required, it will have to show that it directs resources to members which have the ability to invest them appropriately to achieve economic growth and balance of payments viability.

In view of the scale of adjustment problems faced by many members, and the structural orientation of the policies required, it will be necessary to understand that the adjustment will take place over a longer period than was typical in the past. This too has been recognized since the inception of the extended Fund facility and, later on, in the supplementary financing facility. However, subsequent developments suggest that there are two aspects of this issue which bear further attention. First, some problems have arisen with respect to the adoption of longer-period programs. Several members have found that, even though the need for a medium-term frame was acknowledged, in their circumstances, it was difficult to define in advance policies for periods longer than one year. Sometimes, there were political reasons--for example, a forthcoming election--which made such commitments

inappropriate or unrealistic. On other occasions, economic developments and prospects were sufficiently uncertain to make future policy commitments and intentions a matter of conjecture. Consequently, it may be appropriate to recognize that actual programs adopted in the future may have to cover periods of one year or a little more, accompanied by broad indications of how the adjustment is to be completed over the medium term. While the programs may be of short duration, they need to be conceived in the context of a longer-term adjustment strategy. Second, it is becoming increasingly evident that, for a number of members, there will need to be a sequence of consecutive programs for a number of years; in these cases, Fund resources may in practice remain outstanding for quite long periods through the conclusion of successive arrangements. No formal recognition of this possibility may be necessary at this time, but it may be appropriate to note that more permanent financing--already a feature of private market financing--is not to be taken as evidence of inadequate adjustment in an international context where structural surpluses continue to prevail.

4. Potential demand for Fund resources

As noted earlier, the Fund's liquidity position at present seems broadly adequate to meet foreseeable needs during 1980. However, a deterioration in members' balance of payments and reserve positions, which could result in a reduction in the volume of currently usable assets, and growth in demand for the Fund's resources would suggest that some strengthening of the Fund's liquidity may be needed in 1981 and afterwards. This would especially be true if it were decided as a result of the current review of the external adjustment process that the Fund should play a greater role in the recycling process. It seems reasonable to plan for this eventuality even after taking into account the increase in quotas that were approved under the Seventh General Review and which it may be expected will come into effect before the end of 1980. Enlarged quotas provide the Fund with increased usable resources but also permit members to use larger amounts of those resources.

Therefore, it seems important to prepare for the possibility of further borrowing by the Fund. An important issue in this context is the willingness of countries in a strong balance of payments and reserve position to lend to the Fund in appropriate amounts over the medium term and at interest rates that would permit the Fund to continue to make its resources available at a cost that is below market rates of interest. In view of the pressing needs of the developing countries, it would seem to be desirable, if not necessary, for the Fund to try to secure new resources by borrowing on relatively concessional terms or by seeking some assurance that means would be found to permit the

resources of the Fund to be made available on concessional terms. This borrowing might be effected through a grouping of lenders or through a set of bilateral agreements. The ready availability of resources at concessional rates would help the international adjustment process and would also provide an important form of reserve diversification for the surplus countries. These developments would impart a stabilizing element in the international economy.

V. Concluding Remarks

As indicated at the outset, this paper provides a brief background for a discussion of the issues raised by the resurgence of large payments imbalances. It is hoped that the views expressed at the Executive Board will provide guidance to enable the staff to return with more specific proposals for consideration at a later stage.

Several issues arise in the context of this paper to which Directors may wish to devote their attention. An important issue which needs to be kept in sight is the adjustment needs facing the international economy. A main responsibility of the Fund is to ensure that member countries undertake adjustment efforts commensurate with their needs. In support of these efforts, the Fund makes available the use of its resources, thus contributing to the smooth functioning of the adjustment of process.

Given the size of the imbalances in prospect for an important number of countries, there is a need to examine the appropriate scale--in relation to quota--of use of Fund resources by members over the next two to three years. With the permanence of a relatively high cost of energy, a reasonable assumption to make in assessing prospects for the international economy is that the financing needs of a growing number of members are likely to become increasingly costly and difficult to arrange outside international organizations. While adjustment to the change in the terms of trade should begin quickly, provision of resources to a wide range of members through the Fund seems to be warranted to support programs which, besides providing financial balance to members' economies, aim at stimulating supply and fostering growth. In developing this role, with its implicit acceptance of assistance in amounts larger in relation to quota than has been the practice so far, an important issue would seem to be the establishment of appropriate guidelines governing the scale of use.

Another issue that calls for consideration relates to the modalities of an increasingly close relationship between the Fund and the World Bank in the complex task of assisting developing and other countries to maintain a reasonable degree of financial balance while making the

structural adjustments that are necessary to set their economies on a sound growth path. In this context, the difficult situation of members, which depend mainly on aid and concessional flows, needs to be kept in mind with a view to encourage a rapid expansion of these flows to ease the problems they face.

Finally, there are issues related to the ways and means for the Fund to obtain additional resources on appropriate terms from members in a strong balance of payments and reserve position.

#25

FORM NO. 75
(9-78)

THE WORLD BANK

ROUTING SLIP	DATE: March 10, 1980

NAME	ROOM NO.
Members of the Finance	
Committee	

	APPROPRIATE DISPOSITION		NOTE AND RETURN
	APPROVAL		NOTE AND SEND ON
	CLEARANCE		PER OUR CONVERSATION
	COMMENT		PER YOUR REQUEST
	FOR ACTION		PREPARE REPLY
	INFORMATION		RECOMMENDATION
	INITIAL		SIGNATURE
	NOTE AND FILE		URGENT

REMARKS:

The attached paper, Currency Pooling - Remaining Issues, is for discussion at tomorrow's Finance Committee meeting (Agenda #2).

PVA

FROM: Paul V. Applegarth	ROOM NO.: C1204	EXTENSION: 75765

WORLD BANK / INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

TO: Members of the Finance Committee DATE: March 10, 1980
Through: Mr. Moeen A. Qureshi, Vice President, Finance

FROM: K. Georg Gabriel, Director, PAB

SUBJECT: Currency Pooling -- Remaining Issues

1. Attached for discussion on March 11 is a draft Board paper on Currency Pooling -- Remaining Issues. The paper includes discussion and recommendations on the future of the DFC Currency Basket Scheme.

2. The original DFC Currency Basket Scheme, which was approved in mid-March 1979, applied only to DFCs not covered against foreign exchange risk by their governments and was intended to be an interim scheme lasting until the Currency Pooling System began operations on July 1, 1980. The Board agreed to review experience with the Scheme prior to July 1, 1980 and to decide its future. There was no presumption that the Scheme would end for new loans and for future disbursements on existing commitments, but neither was there a presumption that the Scheme would continue for either. However various DFCs asked whether once loans were included in the Scheme, they would remain in it until completely disbursed; they needed this assurance to be able to explain to sub-borrowers what the disbursement practice on subloans would be. Although the Board did not explicitly decide that loans to "uncovered" DFCs once included in the Scheme should continue on the same basis until completely disbursed, this was not inconsistent with the Board's decision and the Bank did give uncovered DFCs this assurance. If future disbursements after July 1, 1980 on loans to uncovered DFCs had been excluded, the annual cost of the Scheme in terms of Bank income foregone would have been about $10 million. With future disbursements on existing commitments to uncovered DFCs included the cost is about $20 million per year.

3. The Board extended the DFC Basket Scheme in October 1979 to include DFCs covered against exchange risk. The rationale was that covered DFCs should be given the same treatment as uncovered DFCs. In order to limit the cost of extending the Scheme, the Bank proposed that only disbursements to covered DFCs made before July 1, 1980 be included and that the Scheme be terminated completely for covered DFCs at that time. Limiting the extended Scheme in this way would still raise the estimated cost of the Scheme to $30-35 million annually.

4. The Board did not decide whether future disbursements after July 1, 1980 on existing commitments to covered DFCs should or should not continue under the Scheme and it may not have been aware that uncovered DFCs had already been assured that future disbursements on existing commitments could continue in the Scheme until completely

disbursed. The paper recommends that future disbursements after July 1, 1980 be continued under the Scheme only for uncovered DFCs. However, if the Board again insists on identical treatment of uncovered and covered DFCs, the cost of the Scheme will rise to $45-50 million per year.

Attachment
THoopengardner/mjw

DRAFT
THoopengardner/mjw
March 10, 1980

From: The President

MEMORANDUM TO THE EXECUTIVE DIRECTORS

Subject: CURRENCY POOLING: REMAINING ISSUES

1. When the Executive Directors considered the Currency Pooling System and later the DFC Currency Basket Scheme,1/ it was agreed that two topics would be left for later discussion: I) treatment of loans committed before the Currency Pool begins operation and II) loans to DFCs.

2. The present memorandum reviews these issues and makes the following recommendations:

A) The undisbursed portions of existing loans should be eligible for inclusion in the Currency Pool at the borrower's option.

B) The disbursed portions of existing loans should be excluded [except for loans with less than $1 million disbursed].

1/ "The Distribution of Exchange Rate Risks Among Borrowers" (R78-259); "A Currency Scheme for Disbursement of Loans to Certain DFCs and Other Intermediaries" (R79-28). The Currency Pooling System is described in detail in "Currency Pooling System" (R80-33).

C) Split loans, i.e. loans that are only partly in the Pool, should have the pooled portion recalled last in order to phase out the old system more rapidly.

D) Existing DFC loans should be eligible for the Currency Pooling System on exactly the same basis as other loans.

E) After the Currency Pooling System begins, new DFC loans, like other new loans, should enter the Pool.

I. Treatment of Previously Committed Loans

3. In the memorandum on the Currency Pooling System cited earlier (R78-259), reference was made to the possibility of transferring undisbursed portions of previously committed loans to the Currency Pool. During discussion of that memorandum on February 6, 1979, I reported that the Bank would also study the desirability of including disbursed portions with a view toward bringing specific proposals to the Board.

Undisbursed Portions

4. Inclusion of the undisbursed portions of previously committed loans in the Currency Pool would be highly desirable. From the borrowers' perspective, the inclusion of the undisbursed portions extends the risk-spreading feature of Currency Pooling more quickly to cover a greater volume of loans. A country would benefit from including the undisbursed portion of a previously committed loan in exactly the same way that it would benefit from including a new loan.

5. Including the undisbursed portions of previously committed loans would also be of modest benefit from the Bank's perspective. First, it would lead to a more rapid phase-out of the old system. Second, the Pool would grow more rapidly. At present, the Bank must sometimes make small recalls of a seldom used currency from many loans, or cash management of small amounts of the currency may be required between the time it must be recalled and the time it is needed. A large pool would ameliorate these problems.

6. Transferring the undisbursed portion of a previously committed loan into the Pool requires the consent of both the borrower and the Bank because the loan agreement must be amended. We recommend that the Bank approve the transfer in all cases, leaving the choice entirely to the borrower. It seems likely that borrowers will choose to transfer the undisbursed portions of most loans into

the Pool. However, a borrower might wish to keep a loan out of the Pool if the administrative costs of the transfer were significant relative to the size of the undisbursed balance. For example, in some cases a loan may involve several different agencies, each of which would participate in an amendment of the loan, and amendments may require formal ratification. On a previously committed loan with a very low undisbursed balance or short maturity, the potential benefit to the borrower of including the loan in the Pool might not justify the administrative costs of making the conversion.

7. The Bank will also incur added costs. It will be necessary for Bank staff to explain currency pooling to borrowers, to adapt standard language to fit specific loans, and to negotiate the actual loan amendment and monitor ratification procedures. It is difficult to estimate what these costs will be, and most can be regarded as start-up costs of the Pooling System itself. It does not seem worthwhile to make a specific administrative charge for each loan amended.

8. It would be desirable from the standpoint of both Bank and borrowers to allow time for the Bank to explain borrower options and to develop administrative arrangements. We envisage that this process would take about 6 months after pooling begins for new loans and that between now and January 1, 1981, most borrowers would notify the Bank which loans they wish to amend and negotiate amendments with

the Bank. The Bank will report semi-monthly to the Board on the requests received and their status. Most amendments would become effective after January 1, 1981.

9. In the past the Bank has circulated all loan amendments to the Board for approval. This seems neither necessary nor desirable for the pooling amendments. The amendments will typically be in substantial accord with the text of the form letter attached. We propose that the pooling amendments not be circulated to the Board for its approval, but that instead their status be summarized in the semi-monthly report.

Disbursed Portions 1/

10. Excluding the disbursed and outstanding portions of existing loans from the Pool would avoid complex problems of equity. In addition, inclusion of disbursed balances does not appear necessary to attain sufficient currency diversification fairly quickly, since the Pool would grow rapidly on the basis of undisbursed portions of past commitments.

11. However, inequities will arise if disbursed currencies are included. The problem with including the disbursed portion of existing loans arises out of the possibility of "negative selection"

1/ Includes completely disbursed loans.

by borrowers. The currency mix of past disbursements is known. This mix can be expected to influence strongly the borrowers' expectations of whether or not they would gain from pooling the currencies already disbursed. If borrowers were given an unconstrained, loan-by-loan choice, it seems likely that only those loans would be placed in the Pool which borrowers perceived as having a "harder than average" currency mix -- a mix expected to appreciate relative to the Pool mix. The potential burden of negative selection would fall on new loans and the undisbursed portions of existing loans also in the Pool, which would have to carry a larger amount of exchange adjustment than would have been the case if the "harder than average" disbursed portions had not been transferred and expectations are realized.

12. [Paragraph 6 discussed loans with undisbursed balances so small that the benefit of including them in the Pool would not justify the cost of amending the loan agreements. Similarly there may be loans with disbursed balances so small that the gain in equity from excluding them does not justify the costs of splitting the loan. We therefore recommend that borrowers be permitted to transfer a disbursed balance of less than $1 million equivalent on the date of effectiveness of this option to the Pool at current value if the borrower also transfers the undisbursed portion. About one hundred loans are likely to be eligible under this exception with disbursed balances totalling less than $75 million.]

Currency Recalls

13. If the undisbursed portion of a previously committed loan is included in the Pool but the disbursed portion is excluded, the borrower will be servicing the same loan under both the present and Pooling Systems until the present system expires. This presents only minor problems for the Bank, and borrowers which find it administratively burdensome will not opt for the Pool. However, since the borrower will be servicing a loan under two systems, a decision must be reached on the order in which the the pooled currencies are to be recalled relative to the various currencies outstanding under the present arrangements.

14. One alternative is to treat each loan as two, and make recalls on a pro rata basis between the two portions. However, this would extend the life of the old system and reduce the initial rate of growth of the Pool, thus reducing the Pool's benefits to borrowers. We therefore recommend that the pooled portion be

recalled last.[1/] This would simplify accounting procedures and provide borrowers more time to adjust to the new system in addition to phasing out the present system more rapidly.

II. Treatment of DFCs

15. Development Finance Companies (DFCs) are financial intermediaries which raise capital and relend it to sub-borrowers for investment. In most cases, they bear no foreign exchange risk themselves. Rather, it is either passed along to sub-borrowers or covered by the government.

16. Individual loans to sub-borrowers tend to be small and to disburse quickly. The range of currencies used by the Bank to finance an individual subloan is therefore narrower than most loans. Borrowers which receive many disbursements over a long period are likely to receive a mix of currencies which is not too different than the Bank average in the long run, but "uncovered" DFC sub-borrowers are not protected by this "natural pooling." Consequently they risk getting a high concentration of the harder currencies on which they

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[1/ If exchange rates cease to change and the Pool mix has an higher average yield than the old system average, repaying the single currencies first places an additional burden on borrowers because it accelerates the payment of the exchange adjustment. But if exchange rates continue to move as they have, postponing the recall of the single currencies only magnifies the exchange adjustment which must eventually be paid.]

must nevertheless pay interest rates based on average yields for several currencies. This risk has slowed disbursements on DFC loans.

17. When this problem was discussed in FY79, it was believed that the Currency Pooling System would not become effective rapidly enough to deal with the immediate problems of the DFCs. The Bank therefore proposed and the Board approved a Currency Basket Scheme for DFCs.1/ The DFC Currency Basket Scheme, which now includes both "covered" and "uncovered" DFCs, 2/ provides that until the Currency Pooling System begins, disbursements on DFC loans will be half in dollars and half in either German marks, Swiss francs, or yen. The future of the DFC Basket Scheme was to be reviewed prior to the start of the Currency Pooling System.

18. At the end of CY1979 there were one hundred active DFC loans under the Currency Basket Scheme. During the last nine months of the year (the Scheme was initiated in mid-March) total disbursements on DFC loans came to US$515 million. A quarter-by-quarter analysis of those disbursements, before and after

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1/ "A Currency Scheme for Disbursement of Loans to Certain DFCs and Other Intermediaries" (R79-28, February 16, 1979).

2/ "Extension of the Currency Scheme for Disbursement of Loans to DFCs Not Covered Against Exchange Risk (the Scheme)" (R79-248), September 26, 1979. "Proposed Extension of the Currency Scheme for Disbursement of Loans to DFCs not Covered against Exchange Risk" (R79-85), April 24, 1979.

introduction of the Scheme, does not reveal any significant trend. This is not surprising, in view of the short time period involved and the fact that many forces influence the pace of disbursement on DFC credit lines. In a few specific cases where the currency problem was known to be very serious, there is evidence that subloan approvals and commitments rose strongly during the latter part of the year. Yet even in these cases it would be inappropriate to attribute the gains entirely to the Currency Basket Scheme, in view of the multiple forces at work.

19. While the Scheme does facilitate DFC operations, there is a significant cost involved in the form of a subsidy to DFCs from other borrowers. The cost of the currencies loaned to DFCs in the Basket Scheme is greater than the cost of the currencies loaned to other borrowers, yet all borrowers are charged the same lending rate. The cost of funds is different because of the larger weight (one-half) of the dollar in the Basket Scheme and its low weight in the borrowing formula and in the overall basket of currencies the Bank lends. The cost to the Bank of lending dollars is great at present whether the dollars are borrowed or whether they are diverted from high-yield investments. Because the DFCs are receiving what amounts to a below-cost lending rate, this loss must be made up by other borrowing governments.

20. The loss will continue as long as the average yield on the

currencies in the Basket Scheme remains higher than the average for all currencies the Bank lends and as long as Basket Scheme balances remain outstanding. The size of the loss may be estimated in terms of Bank income foregone. Assuming (a) that a 500 basis point differential persists between dollar investments and investments denominated in the other currencies, and (b) that the Bank would disburse 5% dollars in the absence of the Scheme, the revenue loss attributable to the Scheme as presently constituted would grow rapidly to $30-35 million until the late 1980s when repayments began overtaking disbursements. Including loans committed after July 1, 1980 in the DFC Scheme would increase the annual losses and extend them indefinitely. Because of the availability of the Currency Pooling System and the substantial revenue loss involved in continuing the Scheme in parallel with the Pool, we recommend that disbursements on new commitments to DFCs made after July 1, 1980 be treated exactly as disbursements on all other new loans.

21. DFCs should have the same opportunity to transfer the undisbursed portion of previous commitments to the Pooling System as other borrowers. After the original DFC Basket Scheme was approved for uncovered DFCs, several asked that loans in the Scheme continue until completely disbursed. Otherwise it would be impossible for them to explain to sub-borrowers the system of disbursements which would prevail on sub-loans. Continuing the Scheme for disbursements after June 30, 1980 on commitments made before that time was

consistent with the Board's decision so the Bank gave assurances to the uncovered DFCs then included in the Scheme that once in the Scheme loans could continue until completely disbursed unless they were eligible for the Pooling System and elected to transfer undisbursed portions to it.

22. The same argument did not apply to covered DFCs when they entered the Scheme -- the system of disbursements to sub-borrowers is the same whether disbursements are under the Basket Scheme, the Currency Pool, or present practice for non-DFC loans. We recommend that the DFC Scheme for covered DFCs terminate when the Currency Pooling System begins; these DFCs would choose between transferring to the Pool and reverting to pre-Scheme practice.

* * * * * * *

23. In summary, we recommend that all new loans, including new loans to DFCs, enter the Currency Pooling System and that the Bank offer all borrowers the loan-by-loan option of transferring to the Pool undisbursed portions of previously committed loans, [as well as the disbursed portions of loans outstanding if less than $1 million] six months after the Pool begins operations. For loans with portions both in and out of the Pool, we recommend that the pooled portion be recalled after all single currencies. We recommend that DFCs be given the same opportunity to transfer undisbursed balances to the Currency Pool as other borrowers. Existing loans to DFCs not covered against exchange risk would continue disbursing under DFC Currency Basket Scheme arrangements until completely disbursed if they were not transferred to the Pool. Existing loans to covered DFCs would revert to pre-scheme practice if not transferred to the Pool.

Model form of
Letter Agreement
DRAFT/TMCAsser
Legal Department
February 28, 1980

THE WORLD BANK

[date]

[Name and
address of borrower]

Gentlemen:

Re: Loan No. ________

(__________________________ Project)
Currency Pooling System -
Amendment of Loan Agreement

1. We refer to the loan agreement (________________ Project) of ____________________ (hereinafter called the Loan Agreement) between [name of borrower](hereinafter called the Borrower) and the Bank [, to the guarantee agreement (________________ Project) of ____________________ (hereinafter called the Guarantee Agreement) between [name of guarantor](hereinafter called the Guarantor)] and to your notice of __________________ to the Bank by which you indicated that the amounts in various currencies withdrawn pursuant to the Loan Agreement after the date on which this amendment shall become effective in accordance with the provisions hereof, shall be covered by the currency pooling system of the Bank, as such system shall be defined by the provisions of, or referred to in, the Loan Agreement as hereby or hereafter amended.

ALTERNATIVE A - Pool transfer of Undisbursed Currencies only

2. The Loan Agreement [and the Guarantee Agreement] is [are] hereby amended by adding to Section 1.01 thereof the following proviso:

> "; provided, however, that, notwithstanding the foregoing, Section 2.01 (12) and Articles III and IV of the General Conditions Applicable to Loan and Guarantee Agreements of the Bank, dated __________________(*), shall apply in respect of the amounts in various currencies withdrawn from the Loan Account after the date agreed upon for the purpose between the Bank [, the Guarantor] and the Borrower, with the same force and effect as if they were fully set forth herein."

The Bank [, the Guarantor] and the Borrower hereby agree that the date after which withdrawals shall be covered by provisions of the new General Conditions of the Bank shall be the date upon which the Bank dispatches the effectiveness notice referred to in paragraph 3 of this letter agreement.

(*) The date of the new General Conditions incorporating the provisions governing the currency pooling system.

ALTERNATIVE B - Pool transfer of Disbursed and Undisbursed Currencies

2. Section 1.01 of the Loan Agreement [and of the Guarantee Agreement] is [are] hereby amended by substituting therein the date ________________(*) for the date of March 15, 1974.

3. This amendment [These amendments] shall not become effective until evidence satisfactory to the Bank shall have been furnished to the Bank that the execution and delivery of this letter agreement on behalf of the Borrower [and the Guarantor] have been duly authorized or ratified by all necessary governmental and corporate action. As part of such evidence, there shall be furnished to the Bank an opinion or opinions satisfactory to the Bank of counsel acceptable to the Bank, showing [:

(a)] on behalf of the Borrower that this letter agreement has been duly authorized or ratified by, and executed and delivered on behalf of, the Borrower and that the Loan Agreement as amended by this letter agreement is legally binding upon the Borrower in accordance with its terms [; and

(*) The date of the new General Conditions incorporating the provisions governing the currency pooling system.

(b) on behalf of the Guarantor that this letter agreement has been duly authorized or ratified by, and executed and delivered on behalf of, the Guarantor and that the Guarantee Agreement as amended by this letter agreement is legally binding upon the Guarantor in accordance with its terms].

4. The amendment[s] specified in the preceding paragraph 2 shall come into force and effect on the date upon which the Bank dispatches to the Borrower [and the Guarantor] notice of its acceptance of such evidence.

Please confirm your agreement with the foregoing by signing the form of confirmation below.

Very truly yours,

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

By ______________________________
Authorized Representative

CONFIRMED:

[Borrower]

By ______________________________
Authorized Representative

[Guarantor]

By ______________________________
Authorized Representative