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REPORT OF THE TREASURER OF THE MULTILATERAL FUND FOR THE IMPLEMENTATION OF THE MONTREAL PROTOCOL TO THE ELEVENTH MEETING OF THE PARTIES ON THE USE OF A FIXED CURRENCY RATE MECHANISM FOR THE REPLENISHMENT OF THE MULTILATERAL FUND

EXECUTIVE SUMMARY

1. The present document has been prepared in response to the request of the Tenth Meeting of the Parties that the Treasurer of the Multilateral Fund prepare a discussion paper on the implementation of a fixed currency exchange rate mechanism for the next replenishment of the Fund.

2. In preparing the discussion paper, the Treasurer reviewed the mechanism applied to the replenishment of the Global Environment Facility (GEF), where a fixed exchange rate mechanism is used. The fundamental difference between the contribution mechanisms of GEF and of the Multilateral Fund is that, while both approve projects and programmes in United States dollars, the agreed contributions to GEF are denominated in special drawing rights (SDRs) or, more significantly, in the national currency of the contributing Government in question. Accordingly, the exchange rate risk against the United States dollar is borne by the GEF Trust Fund, not by the contributing Parties, as is the case for the Multilateral Fund.

3. A mock desk study was conducted for a fictitious Fund replenishment period of 1996-1998, to evaluate the possible impact of a GEF-like fixed exchange rate mechanism for the Multilateral Fund. This

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study indicated that the total loss to the Fund over the three-year period would have been $43 million, or 9 per cent of the total assumed agreed contribution of $474 million. Almost all of this exchange rate loss would have been due to the depreciation of the yen ($22 million) and of the currencies of the eleven countries now using the Euro ($18 million). It may be assumed, however, that the trend of steady depreciation of most major currencies against the United Sates dollar will not continue indefinitely and that the reverse might also occur, resulting instead in exchange gains for the Fund in the future.

4. The latter part of the present document describes a possible procedure to be adopted by the Multilateral Fund along the lines of a simplified GEF model, whereby contributing countries could be given the option of either agreeing to denominate and pay their contributions in United States dollars, or to denominate and pay their contributions using their national currency. Criteria for determining which Parties should continue to pay their contributions in United States dollars are also suggested, as well as some measures to contain the currency exchange rate risk to the Multilateral Fund within reasonable limits. These procedures are outlined in paragraphs 31-40 below.

INTRODUCTION

5. The present report is submitted in response to decision X/32 of the Tenth Meeting of the Parties, by which the Parties requested the Treasurer of the Multilateral Fund to prepare a discussion paper on the possible implementation of a fixed currency exchange rate mechanism for the next replenishment of the Fund. The text of decision X/32, entitled "Proposal to study a fixed currency exchange rate mechanism for the replenishment of the Multilateral Fund", is reproduced below in full for ease of reference:

> "*Noting* that some donor countries make payments to the Multilateral Fund in their national currencies, and that minor discrepancies often arise from the different exchange rates used to issue and encash their payments,
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> *"Further noting* that some financial procedures have been utilized by other multilateral funding mechanisms to simplify the administration of these contributions and limit these discrepancies,
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> "1. To request the Treasurer of the Multilateral Fund to prepare, in consultation with relevant institutions and Parties and in time for the nineteenth meeting of the Open-ended Working Group, a discussion paper which describes how a mechanism using fixed currency exchange rates could be implemented for the replenishment of the Multilateral Fund for the triennium 2000-2002. The paper should examine the administrative framework, the potential impact and any risks for the operation of the Fund that are associated with the adoption of such a mechanism. The paper should also include criteria for determining if a particular currency's fluctuations had been of such a magnitude that a fixed exchange rate mechanism would not be practical, in which case that country would continue to make its commitments and payments in United States dollars;
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> "2. To request the Treasurer of the Multilateral Fund to monitor exchange rates of donor country currencies, including the Euro, between 1 March 1999 and 30 September 1999, and to submit in time for the Eleventh Meeting of the Parties a table showing the average exchange rate for each donor country currency with the United States dollar and Special Drawing Rights (SDRs) for this period".

I. BACKGROUND

6. As implied in the preambular paragraphs of decision X/32, a number of Parties contributing to the Multilateral Fund for the Implementation of the Montreal Protocol have expressed some concern *vis-à-vis* the current practice for determining the contribution amounts due to the Fund and on the modalities for the acceptance of payments of contributions to the Fund.

7. Contributions to the Fund, denominated in United States dollars, are agreed in advance for a three-year replenishment period, through a decision of the Parties taken at the meeting of the Parties held in the year preceding the first year of that triennium. Some countries experience a modicum of difficulty in programming United States dollar-denominated amounts three years in advance, instead of amounts denominated in their local currencies. This is one of the basic underlying reasons for the discussion on a possible fixed exchange rate mechanism.

8. The Fund accepts contributions paid either in cash or in the form of promissory notes. Payment in cash is accepted in United States dollar or in any convertible currency; in the latter case the amount is acknowledged and receipted at its actual United States dollars equivalent after conversion and deposit into the United States dollar bank account of the Fund. When payments of contributions are made in promissory notes, these may be denominated either in United States dollars or the convertible national currency of the contributing Government. Payments in non-United States dollar-denominated notes are acknowledged at their United States dollar equivalent at the time of deposit of the note. According to the decisions of the Parties and of the Executive Committee of the Fund, however, contributions to the Fund are agreed in United States dollars, and therefore the exchange rate risk for non-United States dollar-denominated promissory note contributions is borne by the contributing Government, not by the Fund.

9. The ultimate United States dollar value of contributions made to the Fund in non-United States dollar-denominated promissory notes will be known only after full encashment of such notes, which may occur up to three years after deposit. Consequently, Parties contributing through such notes may, in some cases be, obliged to pay significant additional contributions years later owing to the differences in exchange rates used at issue and encashment of notes. Conversely, any exchange gain realized in the process would be credited to the contributing Party, not to the Fund.

10. It may be noted in this connection that promissory notes issued as contributions to the Fund are non-interest bearing, and thus the contributing Party gains the interest income which would otherwise benefit the Fund in the case of cash contributions. This is of course true both for contributing Parties using non-United States dollar-denominated notes as well as for those using promissory notes denominated in United States dollars.

11. As a result of the budgetary difficulties caused by the modalities described above, both for cash and promissory note contributions, some contributing Parties would prefer the use of a fixed exchange rate mechanism for contributions to the Fund, making possible the accurate and final programming of contributions in the national currency of the contributing Party concerned. Although not explicitly indicated in decision X/32, a system of contributions that a number of Parties might prefer would be something similar to that used in the replenishment of the Global Environment Facility (GEF), where a fixed exchange rate mechanism is used.

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II. CHARACTERISTICS AND IMPLICATIONS OF THE GEF CONTRIBUTIONS MECHANISM AS COMPARED TO THAT OF THE MULTILATERAL FUND

12. The fundamental difference between the contribution mechanisms of GEF and of the Multilateral Fund is that, while both financial mechanisms approve and implement (through their implementing organizations) projects and programmes committed and accounted for in United States dollars, the agreed contributions to GEF are denominated in special drawing rights (SDRs) or, more significantly, in any convertible currency, in practice the national currency of the contributing Government in question.

13. The latest (second) replenishment of the GEF Trust Fund was agreed upon in February 1998 and payments would normally be in four equal instalments, the first by 30 November 1998 and the last by 30 November 2001. The Trustee of the GEF Trust Fund is authorized to accept contributions for the period from 1 July 1998 to 30 June 2002. This may be considered to be the current four year replenishment period of GEF. The fixed exchange rate applicable for a contribution to GEF which is denominated in a national currency is calculated using average historical exchange rates for an agreed six-month period ending about one year before the first payments are due for the replenishment. The fixed rate applies for the total contribution and therefore the four instalments are equal in the national currency in question, while their United States dollar value depends on the exchange rate applicable at the time of cash payment or encashment of a note contribution. Contributing Participants to GEF whose economies have experienced an inflation rate in excess of 10 per cent for an agreed historical three-year period shall, however, denominate their contributions in SDRs[1].

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1. The special drawing right (SDR) is an international reserve asset created by the International Monetary Fund (IMF) to supplement existing reserves. It is valued on the basis of a basket of five currencies, those of France (French franc), Germany (deutsche mark), Japan (yen), the United Kingdom (pound sterling) and the United States (United States dollar). The currency amounts are revised every five years, with the next revision due no later than 1 January 2000. The current basket came into effect 1 January 1996, with the following initial weights:

US dollar	39
deutsche mark	21
yen	19
French franc	11
pound sterling	11
Total	100

After the introduction of the Euro on 1 January 1999, the German and the French currencies were substituted by their equivalents in Euros. Consequently, the SDR is currently defined by a basket of four currencies only. The currency amounts for each basket currency are fixed. The exchange rate of the SDR varies daily against the United States dollar and other currencies as a function of the exchange rates of the four basket currencies. The currency amounts, derived from the revision of the basket which came into effect 1 January 1996, and the corresponding United States dollar values and currency weights (in per cent) as at 27 April 1999 were as follows:

Currency	Currency amount	US dollar equivalent	%
US dollar	0.5821	0.582100	43.0
Euro	0.3519	0.374175	27.7
yen	27.2000	0.227634	16.8

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14. It follows from the above that any amounts expressed in United States dollars with respect to GEF, such as the target size of the replenishment, or the resources available for commitment in the GEF Trust Fund at any given time, are only constantly fluctuating estimates which depend on the exchange rates of national currencies and SDRs against the United States dollar.

15. In the Multilateral Fund, the contribution amounts are agreed in United States dollars, which is the accounting currency of the Fund and of its implementing organizations. This allows for, *inter alia*, more exact planning and programming of resources (in United States dollar terms), and for full commitment (in United States dollars) of all available resources at any given time, as the exact amount of actual United States dollars available is always known, even for resources held in the form of promissory notes denominated in currencies other than the United States dollar. Thus the principal effect on the operations of the Multilateral Fund, should a fixed exchange rate mechanism for contributions be adopted, would be the need to put in place provisions and procedures to manage the potential exchange rate risk, which would now be transferred from the contributing Parties to the Fund.

16. For the medium-term planning of the operations of the Fund (e.g., three-year business plans), provision would need to be made for a broader fluctuation of resources actually becoming available as compared to the nominal indicative figures determined by the replenishment decisions at the Eleventh Meeting of the Parties, and/or later assumptions regarding the size of the replenishment for the triennium 2003-2005 and beyond. In calculating the approval (commitment) authority available for the Executive Committee of the Fund at any given time, adequate provision would need to be made for possible future exchange rate losses in respect of resources held in non-United States dollar-denominated promissory notes. In order for these provisions to be quantifiable, one possibility might be to cap the exchange rate risk taken by the Fund to some reasonable figure, with exchange rate losses beyond this still being ultimately borne by the contributing Party concerned.

III. IMPLICATIONS FOR THE MULTILATERAL FUND A MOCK STUDY

17. While it is impossible to forecast exchange rate fluctuations for the next three-year replenishment period of the Fund (2000-2002), some insight into the possible financial implications of a GEF-like fixed exchange rate mechanism may be gained by reviewing the results of a mock desk study conducted at the United Nations Office at Nairobi for a fictitious Fund replenishment period of 1996-1998, otherwise using criteria very similar to that used by the GEF mechanism, as explained in the following paragraphs.

18. The triennium chosen for the study was 1996-1998, these being the most recent full years, although they do not correspond to the Fund replenishment periods of 1994-1996 or 1997-1999. The latter period is still in progress while the previous one was felt no longer to be current enough to provide the necessary insight for the next replenishment.

19. The list of contributing Parties and the annual contribution levels were taken from the current table of contributions for the year 1999 in order to include actual contribution data which would be as relevant as possible both for the chosen mock triennium 1996-1998, as well as for the next replenishment period, without engaging in any speculation regarding the level of the next replenishment.

pound sterling	0.1050	0.169323	12.5
Total		1.353232	100.0

20. In line with GEF practice, a six-month period before the first year of the replenishment triennium (1996) was chosen to determine the fixed United States dollar exchange rates to be used for contributing Parties in their national currencies. These fixed rates were calculated as an average of the operational United Nations rates for the period May-October 1995.

21. To be able to estimate the actual United States dollar values of contributions received, it was necessary to make assumptions about when payments would have been received. In the study, it was assumed that all payments of contributions would be due and also paid in equal instalments in June and in December each year. The corresponding United Nations operative exchange rates, which closely follow actual mean rates, were used to calculate actual United States dollar amounts received.

22. Also in line with GEF practice, countries whose national currency values had deteriorated rapidly against the United States dollar were assumed to pay their contributions in United States dollars, while all others were assumed to choose their national currencies as the vehicle of payment, using the fixed rates as determined above. By setting a criteria of 13 per cent or less average annual deterioration of its national currency rate against the United States dollar from 1994 to 1998 (using December United Nations rates), seven Parties were excluded from using their national currencies and assumed to contribute using the United States dollar, in addition to the United States of America.

23. The mock study indicated that the total amounts received, using the fixed exchange rate mechanism, would have been significantly less than the United States dollar amounts originally agreed. This result is without distinction to whether payment was made in cash or in promissory notes. For the total mock replenishment triennium (1996-1998), the loss would have been $43 million, or 9 per cent of the total assumed agreed contribution of $474 million, and 13 per cent of the contributions of $280 million which were assumed to be paid in national currencies, using the agreed fixed exchange rates. Annual losses would have been as follows: 1996 $7 million (5 per cent), 1997 $16 million (10 per cent) and 1998 $19 million (12 per cent). With respect to the national currencies assumed to be used, these figures correspond to a weighted average depreciation against the United States dollar of some 20 per cent over the total period, averaging about 5.2 per cent annually.

24. It could be assumed that approximately $127 million, about 29 per cent of all contributions received, would have been paid in non-United States dollar-denominated promissory notes. As these would normally be encashed in equal instalments during the three years following deposit, this would introduce a further element of uncertainty, since the final United States dollar amounts received into the Fund would not be known for some years. It could also be expected that, at the end of the three-year replenishment period, some $84 million would still be held in un-encashed non-United States dollar-denominated notes, corresponding to about 53 per cent of contributions due for the last year of the replenishment period, or about 18 per cent of the contributions due for the total triennium period.

25. It might be argued that the period chosen for the mock study paints an unduly dismal picture of the potential losses to the Fund, should a fixed rate exchange mechanism be introduced. Indeed, the United States dollar did experience a very significant appreciation against most other major currencies during the time in question, and it could be well expected that the reverse might also occur in the future, resulting in considerable exchange gains to the Fund. At the same time, the often expressed view that in the long term currency fluctuations will tend to cancel each other out cannot be considered very valid for the Multilateral Fund, which has a finite lifetime, with no more than perhaps three additional replenishment periods expected.

26. In this connection, it may be appropriate to recall that the Montreal Protocol (Article 10, paragraph 6) mentions that the contributions to the Fund are based on the United Nations scale of

assessments. It would seem implicit that it was the intention of the Parties for one common currency to be used in determining contributions, and within the United Nations system this would normally be the United States dollar.

27. The agreed contributions from the 11 countries using the Euro amounted to approximately 32 per cent of originally agreed contributions, or about $152 million for the mock replenishment triennium. As a result of exchange rate losses, these contributions declined by about $18 million or by about 12 per cent from the agreed total amount. This loss of $18 million constituted about 42 per cent of the total exchange rate loss of $43 million.

28. The corresponding total exchange depreciation against the United States dollar for the 11 Euro-using Parties for the period ending in December 1998 varied between 3 and 22 per cent, with nine Parties out of eleven experiencing losses against the United States dollar of 17 per cent or more over the total period. The weighted average loss was about 17 per cent, corresponding to an annual average depreciation of about 5 per cent.

29. The analysis of the Euro-using Parties indicates that the fluctuations between the national currencies of the Euro-using countries themselves have been relatively minor in recent years. This is particularly true of those Euro-using countries who are among the major contributors to the Fund, with the possible exception of one country (Italy). It could be tentatively concluded from this observation that it is not likely that the introduction of the Euro would result in significantly more exchange rate volatility between the Euro and the United States dollar than was the case for the combined contribution-weighted national currencies of the Euro-using contributors prior to 1 January 1999, the date when the Euro was introduced.

30. The agreed contributions of Japan amounted to $85 million for the mock three-year replenishment period, about 18 per cent of all originally agreed contributions. The Japanese yen fell very significantly against the United States dollar already in 1996, as compared to the level prevailing during the period (May-October 1995) used in the mock study to determine the fixed rates for national currencies. Hence the exchange loss encountered for the Japanese contribution was absolutely and relatively even greater than that for the Euro-using countries, $22 million in total, a drop of 25 per cent from the original agreed contribution. This loss of $22 million represents 52 per cent of the total exchange loss encountered of $43 million.

31. The corresponding total exchange depreciation of the yen against the United States dollar for the period ending in December 1998 was a considerably high 36 per cent, which works out as a theoretical annual average decline of about 9.2 percent for this period. Of the total exchange rate loss of $43 million, $40 million or about 95 per cent would have been due to the combined reductions in the United States dollar value of the contributions by the 11 Euro-using countries and Japan.

32. Using the United Nations exchange rates for December for the three-year period December 1995-December 1998, it was noted that there were nine contributing Parties whose national currencies had experienced a drop against the United States dollar averaging more than 10 per cent annually and, of these nine Parties, the national currencies of seven had fallen by more than an average of 15 per cent annually during the three-year period reviewed, while the other two had fallen less than 13 per cent. It was also noted that these seven Parties represented about 7 per cent of the agreed contributions to the Fund, while all of the nine Parties mentioned in total represented about 8 per cent of agreed contributions. The majority of Parties included in the group of nine are countries with economies in transition who have historically experienced great difficulties in paying their agreed contributions to the Fund.

33. It was also noted that, during the same three-year period of December 1995 to December 1998, the total depreciation against the United States dollar, over the three-year period, of any individual Party, excluding the nine Parties mentioned in the previous paragraph, did not exceed 26 per cent, and of these, only eight were above 20 per cent, with the remaining 22 being below the 20 per cent figure.

34. The annex to the present report presents the main statistics and figures providing the basis for the calculations used for the mock study and the results indicated above.

IV. POSSIBLE PROCEDURE FOR THE IMPLEMENTATION OF A FIXED EXCHANGE RATE MECHANISM FOR THE REPLENISHMENT OF THE MULTILATERAL FUND FOR THE TRIENNIUM 2000-2002

35. The following paragraphs describe one possible procedure for the implementation of a fixed exchange rate mechanism for the next replenishment of the Fund. It is based on a simplified "GEF-like" concept, which endeavours fully to address the concerns of some of the principal contributing Parties, while simultaneously maintaining the operations of the Fund as efficient, practical and uncomplicated as possible. The potential impact and risks associated with the adoption of such a mechanism are examined simultaneously, as well as the criteria for determining whether a particular currency's fluctuations had been of such a magnitude that a fixed exchange rate mechanism would not be practical. Questions related to the administrative framework are examined in chapter V below.

36. Following the GEF model, contributing countries could be given the option of either agreeing to denominate and pay their contributions in United States dollars, or to denominate and pay their contributions using their national currency, provided that it is accepted that actual payments into the bank account of the Fund would always be in United States dollars even if originating in another currency.

37. For those countries wishing to denominate their contributions in their national currency, fixed rates against the United States dollar would be provided by the Treasurer of the Fund to the Meeting of the Parties deciding on the replenishment of the Fund. These fixed rates would be calculated using the average monthly United Nations operational rates of exchange for the six-month period immediately preceding the month during which the Meeting of the Parties is held. In 1999, the months in question would be May-October. As United Nations rates are based on average mean rates against the United States dollar, this method would lead to almost the same results as using daily average mean rates for the period, while being less laborious to implement.

38. Contributing Parties having experienced an average annual deterioration of the value of their national currency against the United States dollar of 13 per cent or more, as determined by the Treasurer of the Fund, during the three-year period immediately preceding the Meeting of the Parties (which, for 1999, would be from October 1996 to October 1999) would continue to denominate and pay their contributions in United States dollars. In calculating the average exchange rate fluctuations, the Treasurer would compare the United Nations operational rates of exchange effective for all contributing Parties during the month immediately preceding the Meeting of the Parties (October 1999) with the operational rate of exchange rate effective three years previously (October 1996). It is likely that there would not be more than about 10 Parties falling into this category, representing no more than about 10 per cent of the total agreed contributions to the Fund.

39. For those contributing Parties opting to denominate and pay their contributions in their national currencies, it would be agreed that these contributions so denominated would remain unchanged for the whole replenishment period, provided that the annual fully paid contributions of any such Party would

equal at least 80 per cent of the original United States dollar amount agreed for that year, as determined by the Treasurer of the Fund. A contributing Party wishing to denominate its contributions in its national currency would agree to pay to the Fund, in United States dollars, the amount required, as determined by the Treasurer, to bring its annual fully paid contribution up to 80 per cent of the United States dollar amount agreed for that year. Such incremental contributions could be deemed to be due on 31 March the following year.

40. In the case of Parties denominating their contributions in their national currencies and simultaneously opting to pay their contributions in promissory notes, the procedure for determining whether the 80 per cent United States dollar threshold for any annual contribution had been met would be effected (by the Treasurer) on the basis of the actual United States dollar amount received after encashment of all the notes pertaining to the annual contribution in question.

41. Adopting this 20 per cent margin of fluctuation or, in effect, capping the maximum exchange rate risk for the Fund to 20 per cent on non-United States dollar-denominated contributions, would simultaneously address the concerns of some of the major contributing Parties in that, in all likely scenarios, the 20 per cent margin would be adequate to ensure that no additional contributions would be required due to exchange rate fluctuations, while at the same time it would effectively safeguard the Fund from any excessive exchange losses, and allow for exact quantification of the maximum potential losses to the Fund.

42. Assuming that the burden-sharing structure of the Fund would not significantly change for the 2000-2002 replenishment as compared to the previous triennium, the 20 per cent exchange rate fluctuation gap would result in no more than a total additional risk of about 13 per cent in the forecasting of contributions for the whole triennium. For shorter term planning and operations such as approvals of programmes and projects at any given Executive Committee meeting, a precisely quantifiable 20 per cent provision for exchange rate losses in respect of available resources in the form of non-United States dollar promissory notes would need to be applied, to provide for maximum potential exchange rate risk.

43. To safeguard further the integrity of the Fund by ensuring more timely contribution payments and to discourage any possibility of speculation, it might be advisable for the Parties to consider reviewing the decisions and agreements in force for the dates on which contributions are due and on which promissory notes are to be encashed. One suggestion might be to consider a decision whereby contributions are to be paid on 31 March and 31 October each year in equal instalments, and a further decision on possible sanctions for defaulters, such as additional contributions for potential exchange losses when contributions were not paid on the due dates.

44. In the case of promissory note contributions, it may be beneficial for the operations of the Fund if a specific decision were taken to the effect that encashments of promissory notes are always due in six equal instalments during the three years following the year for which the note contribution is made, say on 31 March and 30 September each year, with no requirement for the Treasurer to show disbursement need. The right of the Treasurer to request accelerated disbursement on demand at any time on an as-needed basis would and should remain in force regardless.

V. ADMINISTRATIVE CONSIDERATIONS

45. It is well within the professional competence and capacity of the United Nations Office at Nairobi as Treasurer of the Fund (on behalf of UNEP) to deal with a contributions mechanism such as that described above, in addition to the duties already performed in exercising this function. No particular new

arrangements or framework would be required. Consistent with the existing agreement between the Executive Committee of the Fund and UNEP, neither UNEP nor the United Nations Office at Nairobi would endeavour to seek compensation from the Fund for the costs incurred in carrying out the functions of the Treasurer, despite the increase in the workload that would result from the adoption of a fixed exchange rate mechanism such as that described above.

46. Some concern has, however, been expressed by the Advisory Committee on Administrative and Budgetary Questions (ACABQ) in respect of the cost incurred, as neither UNEP nor the United Nations Office at Nairobi currently receive any payment from the Fund for carrying out the functions of the Treasurer. The United Nations Office at Nairobi is required to report to ACABQ later this year on this matter and, depending on the views of ACABQ, the Office may have subsequently to bring the issue to the notice of the Executive Committee and the Parties.

47. The estimated cost at the United Nations Office at Nairobi and UNEP for managing the functions of the Treasurer is currently in the region of $150,000 per year. Putting in place a fixed exchange rate mechanism for contributions would again increase the workload somewhat, both in terms of professional and general service staff time, although an exact figure would be difficult to estimate at the current time.

Annex

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