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OPEN-ENDED WORKING GROUP OF THE PARTIES TO
THE MONTREAL PROTOCOL ON SUBSTANCES THAT
DEplete THE OZONE LAYER

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Item 7 of the provisional agenda*

IMPLEMENTATION OF THE FIXED-EXCHANGE-RATE MECHANISM AND DETERMINATION
OF THE IMPACT OF THAT MECHANISM ON THE OPERATIONS OF THE MULTILATERAL
FUND FOR THE FUNDING OF THE PHASE-OUT OF OZONE-DEPLETING SUBSTANCES
IN ARTICLE 5 PARTIES FOR THE TRIENNIUM 2000-2002 (DECISION XIII/4)

Final report by the Treasurer and the secretariat of the Multilateral Fund

I. BACKGROUND

1. At their eleventh meeting, the Parties to the Montreal Protocol, by decision XI/6 (see UNEP/OzL.Pro.11/10), introduced the fixed-exchange-rate mechanism, with the purpose and objective (see paragraph 2) to ease some of the contributing Parties' administrative difficulties due to commitments in other than their national currencies; promote the timely payment of contributions; and ensure that there was no adverse impact on the level of available resources of the Multilateral Fund. In paragraph 3 of the same decision, the Parties directed the Treasurer to implement the fixed-exchange-rate mechanism on a trial basis for the replenishment period 2000-2002, so that payments by contributing Parties to the Fund for the triennium commencing in 2000, could be made in accordance with the mechanism. In paragraph 6 of the decision, the Parties called for a review of the implementation of the mechanism at the end of 2001 for consideration at the technical segment of the meeting of the Parties in that year, to determine the impact of the mechanism on the operation of the Multilateral Fund and on the funding of the phase-out of ozone-depleting substances (ODS) in article 5 countries during the triennium so that the ODS phase-out process was not adversely affected.

2. An interim review of the mechanism (UNEP/OzL.Pro.13/6) was submitted to the twenty-first meeting of the Open-ended Working Group, in July 2001, and subsequently to the thirteenth meeting of the Parties, in December 2001. The latter meeting, through its decision XIII/4 (see UNEP/OzL.Pro.13/10), requested the secretariat and the Treasurer to finalize the review, in accordance with decision XI/6, and

* UNEP/OzL.Pro/WG.1/22/1.

present a final report to the Parties at the twenty-second meeting of the Open-ended Working Group. In doing so, the Parties requested the secretariat to consult, as appropriate, other relevant multilateral funding institutions that use a fixed-exchange-rate mechanism, or similar mechanisms; and identify options on how a fixed-exchange-rate mechanism could be implemented so that the process of phasing out ODS was not adversely affected, and hire consultants for that purpose, as appropriate.

3. In reviewing the report, other views were expressed by the Parties including:

(a) An assessment of the success of the mechanism assumed a longer period of operation than that covered by the interim review rendering the conclusions drawn premature, and there could be other causes for the shortfall experienced;

(b) The loss to the Multilateral Fund was “numerical” and, though important, the interim review had not fully answered the question of whether the mechanism had had, or might have had, an adverse impact on the Fund’s operations;

(c) Other aspects to be taken into account included the purchasing power of the United States dollar, the effect of interest accumulation on funds not disbursed, hedging in order to enhance the return on the Fund’s investments, and using national currencies;

(d) An alternative scenario would be to have 50 per cent of contributions paid in national currency and 50 per cent in United States dollars.

II. ASSESSMENT OF THE IMPACT OF THE FIXED-EXCHANGE-RATE MECHANISM

4. Paragraph 4 of decision XI/6 which established the fixed-exchange-rate mechanism, stated that only Parties with inflation rate fluctuations of less than 10 per cent for the preceding triennium would be eligible to utilize the mechanism. Presumably, this was an attempt to ensure that only currencies that could be expected to move within narrow limits would participate in the scheme. A total of 22 contributing Parties were so eligible: 19 decided to participate, while Japan, the Netherlands and Spain, although eligible, opted not to join the mechanism and continued to contribute in United States dollars.

5. The initiation of the fixed-exchange-rate mechanism meant that the annual contributions agreed for the triennium 2000-2002 could be divided into two parts, which can be summarized as follows:

	<u>US dollars</u>	<u>Percentage</u>
Contributions in United States dollars	245,569,634	55.8
Contributions under the fixed-exchange-rate mechanism	194,430,366	44.2
Total assessed contributions	<u>440,000,000</u>	<u>100.0</u>

6. Countries eligible and opting to make contributions to the Fund in the triennium 2000- 2002 in their own national currencies at a fixed rate of exchange were due to make their initial contributions on 1 January 2000. Since the fixed rates of exchange were determined by the average United Nations rates over the six months prior to November 1999 when the United States dollar was rising in value, the market rates of exchange of all currencies under the fixed-exchange-rate mechanism except three (Australia, Canada and the United Kingdom of Great Britain and Northern Ireland) were lower in terms of the United States dollar on 1 January 2000 than the fixed rates of exchange previously determined. Thus, from day one, other things being equal, the Fund could as a result only expect to receive in United States dollar terms some 3.9 per cent less contributions under the fixed-exchange-rate mechanism in the new triennium than had been expected when the total and individual contributions for the triennium replenishment had been fixed.

7. It is debatable whether there are advantages for either the contributing countries or for the Fund in determining the fixed rate of exchange for its operation using the average rate of exchange for the six months immediately prior to the replenishment period for which the contributions are needed. The Fund had the problem of projecting the resources that would be available to it in the coming triennium. If the fixed-exchange-rate mechanism is to continue into a second triennium, this issue should be reconsidered, perhaps having regard to the experience of other funds such as the Global Environment Facility (GEF) discussed later in the present report.

8. Even so, at the beginning of 2000, it might have been expected that – in the nature of exchange markets – the exchange rate of the United States dollar in terms of other currencies might have reversed the upward trend of the previous half-year and decline, in part at least, by the amount it had then risen. In the event, this did not happen.

9. Indeed, rates of exchange of currencies under the fixed-exchange-rate mechanism in terms of the United States dollar continued to depreciate through to March 2002, and it was only in the second quarter of 2002 that there was a reversal of this trend. Currencies of 14 of the 19 Parties participating in the mechanism depreciated by more than 20 per cent. Overall, the currencies in the mechanism (fixed as calculated in 1999) depreciated in comparison with the United States dollar by an average of approximately 18 per cent. Clearly, the mechanism has been initiated in a period of substantial movement in the relative exchange rates of major currencies.

10. The monthly movement of rates of exchange over the 28 months from January 2000 to April 2002 compared to the United States dollar for all parties contributing by means of the fixed-exchange-rate mechanism are set out in annex I.

A. Impact of the fixed-exchange-rate mechanism on the United States dollar income of the Fund

11. In this triennium, where the fixed-exchange-rate mechanism was being implemented on an experimental basis, the United States dollar values of contributions of the Parties contributing under the new arrangement were depreciating as described above. The principal impact of this was that the total United States dollar value of contributions received by the Fund was lower than had been anticipated when the amounts of each Party's contributions to the replenishment were assessed and pledged. Further, contrary to earlier triennia, no mechanism was in place to compensate for this reduction in United States dollar income.

12. The value of contributions made in national currencies is determined and recorded by the Treasurer on the basis of the value in United States dollars received into the Fund's dollar bank account on the date the cash contributions are credited or the date that promissory notes are encashed and received into the same bank account. When a promissory note in national currency is deposited, the Treasurer records its United States dollar value using the prevalent United Nations exchange rate, and as encashments are made the realized United States dollar amount and the exchange rate are then revised to reflect the actual rates used. Any shortfall compared with the original assessment in United States dollars is calculated on the basis of this recording of receipts, taking into account the full dollar value of bilateral projects that have been approved by the Executive Committee. No bank accounts are maintained in the fixed-exchange-rate mechanism currencies and the currency risks and administrative problems of the Fund would be heightened if this were to be so.

13. From the calculations of the shortfall in the Fund resources due to the implementation of the fixed-exchange-rate mechanism (presented in detail in annex II and summarized in annex III), as a result of the fluctuating exchange rates of the currencies of Parties contributing under the fixed-exchange-rate mechanism arrangements, a shortfall in the United States dollar income of the Fund compared with the original assessment for the 2000-2002 replenishment, amounted on 30 April 2002 to:

<u>Year of contribution</u>	<u>Shortfall</u> (United States dollars)	<u>Percentage of pledges made by</u> <u>fixed-exchange-rate</u> <u>mechanism Parties</u>
2000	8,985,136	13.9
2001	9,298,286	14.3

14. At the time of writing it was not possible to anticipate further movements in rates of exchange and calculate the shortfall that may be recorded in 2002 after annual contributions have been effected in full and after all promissory notes will have been encashed. On the basis of rates of exchange in effect in April 2002 of currencies of Parties contributing under the fixed-exchange-rate mechanism, it is roughly estimated that the additional shortfall for the triennium may be in the order of \$7.1 million. If that estimate proves to be broadly correct, the total shortfall over the triennium as a whole would be approximately \$27.25 million, or some 14.02 per cent of the United States dollar value originally pledged by the fixed-exchange-rate mechanism Parties. This would be equivalent to a loss of some 6.19 per cent of total contributions of all Parties for the triennium.

15. The fact that these figures are estimates subject to change in the event of new movements in exchange rates of the fixed-exchange-rate mechanism currencies underlines the element of uncertainty that has been introduced into the projections of Fund income following the initiation of the mechanism in 2000. Even when promissory notes are deposited with the Fund, the precise United States dollar value of those notes is not known until they are encashed, which will most likely be up to three years after they are deposited.

B. Impact of the decline in the market values of fixed-exchange-rate mechanism currencies on the purchasing power of the Fund

16. It has been suggested that the international purchasing power value of the currencies participating in the fixed-exchange-rate mechanism would not decline equally with the decline in the rate of exchange in fixed-exchange-rate mechanism currencies relative to the United States dollar. At the same time, the purchasing power of the United States dollar internationally should rise in line with its appreciation in currency markets. In general, both these statements are broadly correct. But in the specific circumstances of the Multilateral Fund, they are only correct to a very limited degree. The Executive Committee allocates funds to the implementing agencies and the secretariat on the basis of budgets prepared in terms of United States dollars. Working within the United Nations financial regulations and rules, much of the expenditures of the Fund and its implementing agencies are incurred in United States dollars. Staff costs, consultancy costs, travel, training/workshop attendance allowances, and administrative support costs are all defined in United States dollar terms, which are not influenced, except very indirectly in the longer term, by changes in the rates of exchange of the currencies of the fixed-exchange-rate mechanism Parties vis-à-vis the United States dollar.

17. Equipment and machinery purchased in non-United States dollar countries should, however, be purchased for less dollars after a dollar appreciation, if the equipment and machinery prices are not increased in terms of national currencies during this period. In order to test this hypothesis, the extent that a drop in dollar prices of such equipment has occurred in practice has been the subject of an investigation conducted by the implementing agencies and the secretariat. The results of this investigation are inconclusive. Data on the proportion of equipment and machinery purchased in countries participating in the fixed-exchange-rate mechanism is sparse. However, implementing agencies advise that quotations for the purchase of such equipment are most often made in United States dollars at the insistence of the suppliers. Suppliers are

afraid of exchange-rate risks and do not change their prices in United States dollar terms when other currencies are fluctuating. Attempts by the secretariat to obtain details of the price variations over recent years of items of equipment most frequently purchased under the Fund programme have not been successful. Implementing agencies have reported that this information is not readily available in their computerized data systems and any attempt to find such data in paper files would, if maintained, be expensive, time-consuming and probably inconclusive because of price factors other than currency values.

18. As an example, the approach to procurement taken by the World Bank is that it should be undertaken at the country level. Therefore, World Bank managers at the country level were consulted by the Bank, but few meaningful responses were obtained. In one case, Thailand, the rate of exchange of the Thai baht depreciated between June 1999 to June 2000 by 6.0 per cent, while during the same period the price of high pressure foaming machines increased by only 1.5 per cent. However, between June 2000 and June 2001, the rate of exchange of the Thai baht against the United States dollar depreciated by 16.3 per cent, while the average price of high pressure foaming machines increased by 27.3 per cent. Even these comparisons cannot be regarded as definitive. The information available is insufficiently precise to be sure whether the high pressure foaming machines priced in different time periods represent, in practice, consistent and homogeneous technical specifications, or whether they include the same elements of freight, insurance, installation and commissioning, and training cost components.

19. The conclusion from this, admittedly limited and non-quantitative analysis, is that the purchasing value to the Fund of fixed national currency contributions does fall if those currencies depreciate against the United States dollar. At the same time, the purchasing power of the dollar does not appreciate to any significant extent in a United Nations purchasing context. These issues are determined by the fact that virtually all United Nations/Fund expenditures are set in United States dollars.

20. If these conclusions can be accepted, even if only broadly, it must also be accepted that payment of fixed-exchange-rate mechanism contributions when banked convert to a lower United States dollar value and will have the effect of distorting the agreed proportions of burden sharing of contributions between those that contribute a sum fixed in United States dollars and those that contribute in national currencies that provide a dollar total less than originally allocated. The share of fixed-exchange-rate mechanism contributors would, on the basis of estimates of loss included here, drop from 44 per cent of the total (as set out in paragraph 5 above) to 40 per cent, while the share of Parties contributing in United States dollars would rise from 56 per cent to 60 per cent of the lower United States dollar total of contributions collected during 2000-2002, as illustrated in the table below:

	<u>US dollars</u>	<u>Percentage</u>
Contributions in United States dollars	245,569,634	59.5
Contributions under the fixed-exchange-rate mechanism	167,180,366	40.5
Total projected contributions	<u>412,750,000</u>	<u>100.0</u>

C. Interest earnings of the Fund

21. It has been suggested that interest earned on the Fund cash holdings and other income in some way mitigates the loss of United States dollars derived from fixed-exchange-rate mechanism contributions. But the Fund has always earned interest on its cash holdings. These earnings will not have been influenced by the introduction of the mechanism, except to the extent that cash holdings may be lower than they would have been otherwise. Interest earnings will also have been influenced by the fact that no interest is paid on the Fund's holding of promissory notes. Actual interest earnings and other income are, and always have been, taken into account when calculating the cash flow needed for committing funds to projects approved by the Executive Committee.

D. Impact of fixed-exchange-rate mechanism and other income

22. Although the estimates of the real loss of projected real resources as a result of the fall in the value of fixed-exchange-rate mechanism currencies against the dollar in the current triennium are imprecise, any loss would normally represent a set back to the Fund's programme to reduce and eventually phase-out ODS. Given the time limitations imposed by the Protocol, any set back is regrettable. Indeed, if the loss of \$27.25 million, as projected in paragraph 14, had been deducted from the resources allocated to implementing agencies for the triennium, it could have represented a delay in the phase out of ODS equivalent to more than 5,000 tonnes on the basis of a broad estimate of \$5,362 for the cost of phasing out one tonne of ODS. However, for the 2000-2002 triennium, the loss in United States dollars may not affect the ability of the Executive Committee to commit the entire budget of the triennium approved by the eleventh meeting of the Parties by the end of 2002. The cash flow as a result of the loss, as well as the non-payment by some Parties of their contributions, has been made up by the interest receipts and savings derived from completed and cancelled projects.

III. ADMINISTRATIVE DIFFICULTIES IN CONTRIBUTING TO THE FUND UNDER FIXED-EXCHANGE-RATE MECHANISM ARRANGEMENTS

23. All but one country of those paying contributions in national currencies at fixed rates of exchange reported that the administrative difficulties involved in paying their contributions to the Fund were either "considerably reduced" or "reduced some[what]" as a result of the fact that, except in respect of funds required for bilateral projects, the amount of the contribution in local currency was more predictable under the fixed-exchange-rate mechanism arrangements. One Party noted that the administrative difficulties remaining would have been even less if bilateral projects had also been subject to the same fixed-exchange-rate mechanism. Interestingly, one or two non-fixed-exchange-rate mechanism Parties commented that it would make no difference in terms of administrative problems whether they paid their contribution in United States dollars or in local currency at a fixed rate of exchange.

24. It must be concluded that the advantages to contributing countries in the form of lower administrative burdens from the adoption of the fixed-exchange-rate mechanism would be lost if the Parties were to take up a suggestion made by some Parties that only a portion, such as 50 per cent of contributions, should be paid at the fixed rate of exchange, the remaining part being paid in United States dollars as previously. This would exacerbate the administrative problems of both the contributing Parties as well as the Treasurer and there seems little to be gained by pursuing the idea further, even though it might provide a proportionately greater degree of certainty in the level of funding for the Fund.

25. In this context, it should be noted that the introduction of the fixed-exchange-rate mechanism has involved the Treasurer in a significant additional administrative burden in handling and projecting contributions in order to monitor the flow of resources to the Fund. It may be recalled that at the outset of the Fund, the United Nations Environment Programme (UNEP) offered to undertake the role of Treasurer of the Fund for no administrative fee under an agreement between UNEP and the Executive Committee dated 21 November 1991. At that time, the services involved were those of any other trust fund managed by UNEP, administering the Fund in accordance with the financial regulations and rules of the United Nations, advising non-article 5 Parties of their contributions and requesting payment, acknowledging receipt of payments received and issuing reminders to those whose contributions were overdue, managing the bank account established to hold the contributions, investing the surplus sums held in the bank account not immediately required and crediting interest earned from the investments to the Fund, and disbursing funds for activities to the implementing agencies on the instructions of the Executive Committee.

26. However, in the course of the development of the Fund, the Executive Committee and the meeting of the Parties to the Montreal Protocol have adopted a number of innovative financial instruments aimed at enhancing programme delivery, the effectiveness of deploying the resources of the Fund towards programme implementation and easing the administrative problems of payment of contributions to the Fund. Crediting approved bilateral projects against the relevant countries' contributions was the first innovative element to be

introduced. Promissory notes were introduced in 1993 and the fixed-exchange-rate mechanism in 1999 which applied to both cash contributions and promissory notes of participants in the fixed-exchange-rate mechanism. These changes have significantly complicated the work of the Treasurer in administering the Fund, involving consultations with contributing Parties that were not required previously or by other funds managed by UNEP. The monitoring of contributions in different currencies and of the resources available for commitment has been made significantly more complicated. The studies and reporting requirements of what are in effect two separate contributing systems have involved UNEP in work significantly beyond the requirements of standard trust funds and beyond what was envisaged when the offer was made to undertake the work without charge.

27. An estimate of the cost to UNEP of the work as Treasurer of the Fund in the current triennium has been made and indicates that it now needs a full-time senior Professional staff member to coordinate effectively the management of the trust fund, fulfil the reporting requirements and undertake and/or lead the frequent studies for guiding the management and policy-making bodies of this financial mechanism. In these circumstances, UNEP now feels that it would be reasonable to ask for reimbursement of some part of the cost of the additional workload it has had to incur as a result of the introduction of this dynamically evolving financial mechanism. It proposes to pursue this matter with the Executive Committee.

IV. TIMELINESS OF CONTRIBUTION PAYMENTS

28. There is evidence from the record of contribution payments to the Treasurer that contributions were generally received more promptly in the years 2000 and 2001 compared with earlier years. Overall, outstanding contributions unpaid at the end of the year dropped from an average proportion of contributions due for the year of 42.1 per cent between 1994 and 1999 to an average of 16.5 per cent in 2000 and 2001. As far as fixed-exchange-rate mechanism Parties are concerned, the average proportion unpaid as at the end of December was 25.3 per cent in the period 1994-1999, compared with an average of 13.1 per cent in 2000-2001. Non-fixed-exchange-rate mechanism Parties recorded an average of unpaid contributions as at the end of December of 52.9 per cent in the period 1994-1999 and 22 per cent in 2000-2001. These figures are set out as percentages for each quarter in annex IV to the present report. Overall, the conclusion must be that although all Parties generally improved the timeliness of their contributions, the fact remains that fixed-exchange-rate mechanism Parties improved the timeliness of their contributions within the general improvement.

V. EXPERIENCE OF OTHER INSTITUTIONS IN IMPLEMENTING A FIXED-EXCHANGE-RATE MECHANISM

29. The following paragraphs set out the information obtained from other institutions accepting contributions in national currencies.

A. United Nations Development Programme

30. The main fund of the United Nations Development Programme (UNDP) is financed by voluntary contributions. UNDP receives pledges to this Fund from donors in both United States dollars and national currencies. Being a voluntary fund, a donor which pledges in a national currency is not required to cover any shortfall between the dollar value of the national currency pledge when made and the United States dollar value of the national currency when the contribution payment is received and converted into dollars. UNDP encourages donors to pay contributions early in the year to minimize such differences. However, UNDP uses hedging tools to protect the value of expected contributions in the current financial year. It does not hedge across years. UNDP considers that the use of hedging tools to protect the value of voluntary contributions is within the scope of the Administrator's mandate to manage UNDP's financial resources effectively and efficiently. Foreign exchange gains or losses, whether from spot or forward transactions, are treated as miscellaneous income when compiling the annual accounts.

B. United Nations Environment Programme (UNEP)

31. UNEP accepts contributions to the Environment Fund in national currencies. Such contributions are then immediately converted into United States dollars as the contributions are paid into UNEP's United States dollar bank account. However, when there is a shortfall compared with a pledge received earlier, UNEP looks to the contributor to make good the shortfall in that year. This principle of reimbursement has generally been accepted by contributors. This is, of course, how the Multilateral Fund operated up to the end of 1999. No hedging operations in the forward currency market have been undertaken by UNEP.

C. International Fund for Agricultural Development

32. Contributions to the International Fund for Agricultural Development (IFAD) are pledged for a three-year replenishment period and pledges may be made in national currencies at fixed rates of exchange determined in advance by taking an average over a six-month period. For the replenishment which runs from 20 February 2001 to 19 February 2004, the average was determined over the six-month period 1 July to 31 December 1999, that is, some 14 months before the first contribution was due. The currencies permitted to be used for the last replenishment were the Australian dollar, the British pound, the Canadian dollar, the Danish krone, the Euro, the Japanese yen, the New Zealand dollar, the Norwegian krone and the Swedish krona. No adjustments are made when there are subsequent changes in relative rates of exchange and IFAD bears any loss between the amounts pledged by donors and the actual receipts when converted into United States dollars.

33. Investment guidelines require IFAD to maintain the assets of its Fund (including in particular its loan portfolio which is held principally in special drawing rights (SDRs)) in such a way as to ensure that, to the extent possible, commitments for undisbursed loans and grants are denominated in the currencies representing the ratios of the SDR basket of currencies. The main part of the IFAD investment portfolio is managed by external fund managers who do use forward contracts to hedge currency and duration exposures.

D. Global Environment Facility

34. The reference currency for GEF is the SDR, but GEF accepts contributions in national currencies from all countries who wish do so, except countries with an average inflation rate exceeding 10 per cent over the three-year period prior to the replenishment discussions. The latter countries are required to denominate their pledges in the reference currency and pay their contribution equal to the pledge at the time it is paid. The reference period for fixing the rates of exchange for contributions in national currencies for the third GEF replenishment commencing 1 July 2002 was the six-month period 15 May to 15 November 2001. The reasons for these arrangements were that it was considered desirable to reach agreement at the GEF meeting on 7 May 2001 concerning a future period for setting reference exchange rates, with the reference period ending sufficiently before the expected conclusion of the third GEF replenishment discussions, so that the exchange rates to be used would be known to donors ahead of the final meeting. Although the replenishment negotiations were expected to conclude and donors would therefore confirm pledges, only by February 2002, a number of donors required specific reference exchange rates by the December 2001 meeting in order to reserve budgetary resources in advance (see GEF/R.3/5).

35. Gains and losses from movements in exchange rates are born by the GEF Trust Fund and there are no arrangements for donors to make good any shortfalls in United States dollars.

36. The SDR is only the reference currency for the denomination of contributions to the GEF Trust Fund. Grant commitments are made in United States dollars. Thus, the Trustee attempts to mitigate the risk of mismatched assets and liabilities by converting all cash payments and promissory note encashments to United States dollars immediately upon receipt. The GEF Trustee will shortly be reviewing the techniques of risk management available to him with particular reference to more sophisticated risk management models used by the International Development Association (IDA).

E. International Development Association

37. IDA follows essentially the same rules as used for GEF. The only differences relate to risk management where sophisticated risk management models are deemed appropriate. This is a very large fund and IDA operations are denominated in SDRs. Their objective is to mitigate the currency risks arising from a mismatch between the currency composition of its assets (donor receivables) and that of liabilities (project disbursement of IDA credits). They monitor and regularly rebalance the currency composition of their liquid assets to achieve a balance in line with the balance of the SDR basket of currencies. IDA is considering using currency derivatives (futures) to hedge further remaining currency exposure.

VI. OPTIONS AVAILABLE TO VARY THE RULES OF THE FIXED-EXCHANGE-RATE MECHANISM

38. The fixed-exchange-rate mechanism was established for the current triennium on a trial basis and the purpose of the present report has been to examine the impact of the new mechanism and, on the basis of that examination, suggest what options are available to the Parties to improve the mechanism so as to give greater certainty in projecting Fund resources for the implementation of the programme, greater equity between contributing Parties, and easier administration for contributors, the secretariat and the Treasurer.

39. There is no doubt that the fixed-exchange-rate mechanism has introduced an element of uncertainty in projecting Fund resources that was not present before the current triennium. Estimates of Fund resources available for commitment have to take into account that, on the basis of recent currency exchange movements, there may be a shortfall in resources for commitment. It is, however, true that if currency exchange rates had gone the other way there could have been a surplus of resources above the original expectations. Nevertheless, this does not remove the uncertainty.

40. Since the United States dollar did rise in foreign exchange markets against the currencies of Parties participating in the fixed-exchange-rate mechanism in the first two years of the current triennium, there was an overall loss as measured in United States dollars in the resources available to the Fund. How far this represented a loss in real purchasing power of the Fund cannot be estimated with precision. An increase in purchasing power on the part of the United States dollar may have mitigated the overall loss in United States dollar income, but it seems likely that in the particular spending circumstances of the Fund, this did not have a significant impact.

41. One impact of the introduction of the fixed-exchange-rate mechanism has been to create a two-tier structure of contributors and, because of the direction of exchange rates over the first two years of the current triennium, the relative proportions of burden sharing in the payment of contributions has been disturbed slightly from the original agreement on this issue. If some increase in the buying power of the United States dollar occurred, this would have further increased the real burden of those Parties contributing in United States dollars.

42. There is also no doubt, on the basis of replies received to a survey of fixed-exchange-rate mechanism participants, that those Parties who have taken advantage of the arrangements under the mechanism have found that the administrative problems involved in making the budgetary arrangements for their contribution to the Fund are less than formerly, since those parties, in general, know precisely, at least in the second and third years of the triennium, the amount of national currency that has to be provided for in the national budget. This certainty has been upset for some, in part, by the fact that bilateral projects approved by the Executive Committee are defined in United States dollar terms.

43. The administrative problems of the Treasurer have been increased quite significantly by the introduction of the fixed-exchange-rate mechanism.

44. Contributions to the Fund were, in general, paid earlier in years 2000 and 2001 than hitherto by most Parties, whether they were participating in the fixed-exchange-rate mechanism or not. However, Parties using the mechanism have paid their contributions earlier. It is not clear whether this was as a result of the introduction of the fixed-exchange-rate mechanism or because of the urging in decision X1/6, paragraph 7, for the Parties to the Montreal Protocol to pay more promptly.

45. Overall, the introduction of the fixed-exchange-rate mechanism has had advantages for those Parties participating in the scheme, but there have been some disadvantages for those outside it and for the Fund generally as well as for the Treasurer. Thus, although the mechanism has not yet been in operation for a full triennium, it is appropriate to examine whether there are options available to retain the advantages of the principle of contributions to the Fund being made in national currencies at pre-determined fixed exchange rates, while mitigating some of the more obvious disadvantages.

46. The option to scrap the whole idea does not seem realistic in the light of trends in other international financial institutions. The idea of paying 50 per cent in United States dollars and 50 per cent in national currencies also does not seem feasible, since it would encapsulate all of the disadvantages without providing the advantages.

47. Some of the disadvantages, in particular those derived from the creation of a two-tier system of contributions could be overcome by using the SDR as the reference currency for the Fund rather than the United States dollar. The SDR, valued on the basis of a basket of major currencies (the British pound, the Euro, the Japanese yen and the United States dollar), tends to move within narrower limits than individual currencies simply because when one currency in the SDR basket goes up, others tend to go down, and as a result currencies move less in relation to the SDR than they do in relation to other national currencies, including the United States dollar.

48. If the SDR were to be adopted as the reference currency, the value of the currencies of all non-article 5 Parties in terms of the SDR would be determined on the reference date to be agreed by the Parties, which would, by the same action, fix their contributions for the coming triennium in their national currencies at the same time. All Parties would pay their contributions in their national currencies in the amount fixed on the reference date or the equivalent to that sum in another freely exchangeable currency on the date of payment.

49. The sequence of actions would be:

(a) The Parties determine the total amount of the triennium replenishment in United States dollars as hitherto;

(b) Simultaneously, that is converted to SDRs;

(c) The Parties agree to the percentage shares of the replenishment to be paid by each contributor;

(d) The percentage shares are related to the total replenishment valued in SDRs to establish each individual contribution valued in SDRs;

(e) Each contribution in SDRs is revalued in the currency of the contributor on the reference date and is fixed on that date for the triennium.

50. All contributing Parties will contribute under the same mechanism and the two-tier system will be eliminated, but all Parties will be aware of the amount they are required to contribute from the outset. There will still be movement of currencies affecting the volume of resources for commitment by the Fund, but the use of the SDR as the reference currency is expected to dampen these movements overall.

51. The Fund bank account will continue to be held in United States dollars and commitments will be entered into in this currency. Whether bilateral projects should be valued in United States dollars or the national currency of the contributing Party may need to be reviewed.

52. Parties will have to agree a reference date on which contributions in national currencies will be fixed for the following triennium. This could be determined, as last time, by taking the average of currency values against the SDR in the last six months of the current triennium or by choosing a six-month period further back, as has been done by GEF and IFAD. However, no particular advantage seems to have been obtained by using such a six-month average in the current triennium and it is suggested that it would be just as appropriate and much easier in practice to fix the date as the last working day of the month immediately before the meeting of the Parties, that is 31 October 2002, so that all contributions in terms of national currencies can be known and made available in the meeting of the Parties which has to determine the amount of the replenishment and its distribution between individual Parties.

53. It will be appreciated from the recommendations above that, if contributions are fixed initially in relation to the SDR, there is still likely to be movement of currency exchange rates by the time contributions are paid in cash, and possibly even more movement by the time promissory notes are encashed. The element of uncertainty in the volume of resources available to the Fund will persist. This can only be overcome either by requiring Parties to contribute in the fixed sum of SDRs determined at the outset (which would not then represent a fixed-exchange-rate mechanism in national currencies) or by some system of reimbursement of shortfalls from the amount of contribution in SDRs either in the triennium to which they relate or, possibly, in the following triennium. Such reimbursement as compensation for adverse movements in exchange rates reducing the SDR or United States dollar contributions has tended to be dropped from international fund rules in recent years and is not therefore recommended for the Multilateral Fund in this document. The problem of potential shortfall in resources remains, however, and the only other option is to accept the possibility of this occurring and make an allowance for it at, say 5 per cent of the total replenishment when the replenishment is initially determined.

54. Some part of the inescapable risk of contributions fixed in terms of national currencies not providing the full amount of funds required to finance the approved programme could be offset by the use of the currency futures market, even though it is only recently that international funds have started to make use of these facilities. In the early part of the year, before the flow of contribution payments to the Fund has started, United States dollars requirements (or some part of those requirements) could be purchased on margin against a sale of dollars, say, six months forward. This would enable the Executive Committee to commit funds in advance of the receipt of contributions while hedging the risk of a fall in the United States dollar value of contributions pledged in national currencies. Such a hedging operation would provide that any fall in the value of the non-dollar currencies in the markets would be covered by the profit made on the sale of dollars at the end of the six-month period. Similarly, if the value of the United States dollar went down against other currencies, those currencies would buy an additional quantity of United States dollars. This type of currency hedging would be a way for the Fund to have cash in hand to commit early in the year. It carries dangers, however, and the edifice would collapse if contributions were to be paid later than the hedging operation anticipated. Inevitably also, there are costs involved in operating in the futures market. Further thought needs to be given to the advantages and disadvantages of such hedging operations in the light of the experience of similar international funds and the precise timing of the Multilateral Fund's needs before any decision is made to make use of these markets.