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Economics

A US$100 Billion Supra-Sovereign Wealth Fund?

Bottom line. 'SWFs' are far from a four-letter word. They are an inevitable and rational consequence of some of the most powerful structural trends in the global economy. Demographics, excess savings and artificially depressed sovereign long-term interest rates are all factors that have altered the ability and the willingness of sovereign funds to modify their investment portfolios. In this note, we argue that the IMF itself confronts similar pressures, and that, in our view, it should seriously contemplate setting up a supra-sovereign wealth fund, out of the gold holdings it has. Fully financing the operating expenses of the IMF, this prospective fund could be launched at around US$92 billion and grow to US$130 billion in 10 years' time.

The IMF is rich, if it wants to be. Contrary to popular belief, the IMF is rich. It holds 103.4 million ounces of gold. At the current market price, this is worth US$92 billion, up from US$23 billion just five years ago. This is arguably a good time to consider selling some of these gold holdings and investing the proceeds in financial securities with positive yields.

We should not downsize the 'fire station' of the global economy. Just because there haven't been any forest fires doesn't mean we should downsize or close down fire stations. In many ways, the global economy needs the IMF's intellectual and policy leadership more than ever, even though demand for traditional IMF programme lending may have dwindled. Investing some of the IMF's assets in the financial markets could go a long way to resolving much of the pressures impinging on the IMF, by making the IMF more financially autonomous, without compromising its ability to provide financial help.

Ultimately a political decision, by the US. Ultimately, this will be a political decision to be made by the US, given that it has the largest voting share and, more importantly, it gave the IMF most of the gold holdings in the first place. But the economic and financial argument, in our view, is compelling.

Recent Reports

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Celebrating the Birth of Russia's SWF Stephen Jen & Oliver Weeks	January 31 2008

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A US$100 Billion Supra-Sovereign Wealth Fund?

Summary and conclusions

The IMF has been asked by the G7 to come up with a set of best-practice guidelines for the sovereign wealth funds (SWFs). The irony here is that we believe the IMF itself should invest its capital more like a SWF (and more like a central bank). The IMF has one of the largest gold holdings in the world. At today's gold prices, the 103.4 million ounces of gold that the IMF holds is worth close to US$92 billion. Arguably, this is a good time to convert its gold holdings into paper assets, for not only are gold prices high, but the IMF now also has a genuine need to generate investment income.

Our argument

At the G7 meeting in October 2007, the IMF (International Monetary Fund) and the OECD (Organisation for Economic Cooperation and Development) were asked to come up with a set of best practices for the SWFs and the recipient countries, respectively. These two institutions were chosen because of expertise in dealing with balance of payments (BoP) and exchange rate-related issues (in the case of the IMF) and institutional knowledge on foreign direct investment (FDI) (in the case of the OECD). Being multilateral institutions, these two entities are thought to also have the credibility and (relative) political neutrality needed to render a set of guidelines on a controversial issue that a wide range of countries would accept. The irony, however, is that the IMF itself has ample reasons to consider forming a SWF of its own. It now has both the *ability* and possibly greater *willingness* to do so. Such a fund could easily reach US$100 billion in size in the not-too-distant future. Even if invested in the most traditional 'safe' assets held by the most conservative central banks, the annual investment returns could be substantial and could go a long way towards helping the IMF to be better equipped to face the new global environment.

The case for the IMF having its own SWF

The IMF now has both the ability and possibly greater willingness to contemplate forming a SWF of its own.

The IMF is more *able* to do so mainly because gold prices have more than tripled since 2002. The IMF's gold holding – at 103.4 million ounces – is only surpassed by the US (261.5m) and Germany (109.9m). The sharp rise in gold prices in recent months (see Exhibit 1) has pushed up the value of one of the IMF's assets from US$23 billion in 2002 to US$92 billion now. This is arguably a good time for the IMF to consider selling its gold holdings.

At the same time, the IMF is more *willing* to consider a different investment style. The new Managing Director of the IMF, Mr Dominique Strauss-Klahn, announced on December 6 the need to rationalise the 64-year-old institution, including a drastic 15% cut in staff.[1] The main reason for this is that, with the balance of payments (BoP) outlook of the developing world being much better than at any time since WWII, the demand for IMF resources has dwindled. For example, outstanding IMF credit to the world declined from an average of US$30.6 billion during 1996-2000 to US$4.3 billion at end-2007 (see Exhibit 2).[2] This decline in lending has translated into a sharp fall in the IMF's operating income, compromising the ability of this institution to pay for its staff and to run the institution in general: the IMF's annual operating costs were around US$715 million in 2007. Further, the more modest revenue path has also restrained its ability to finance the HIPC (Highly Indebted Poor Countries) Initiative.[3]

Exhibit 1

A Sharp Rise in Gold Prices

Source: Haver

In our view, the IMF possesses one of the most talented pools of economists in the world, produces top research on both developed and developing economies and still enjoys great credibility in the world. While sensible rationalisation from time to time is always welcome and justified, the ability of the IMF to operate at its full potential should never be compromised, in our view. Retrenching now is tantamount to downsizing a fire department when there is a low incidence of fire. Further,

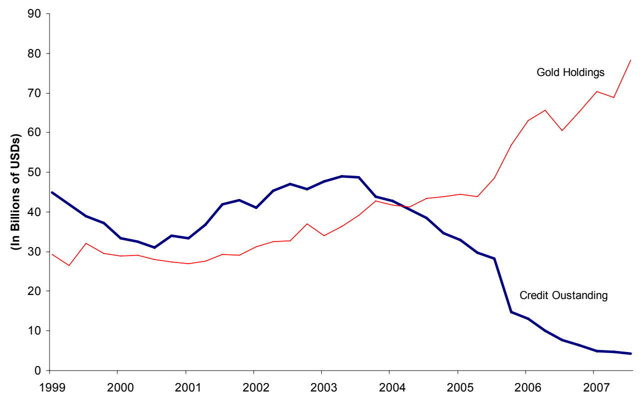
[1]There are at present 2,700 employees working for the IMF.

[2]The IMF's credit to the world peaked at US$49 billion in 2003.

[3]The HIPC Initiative is a project to reschedule or write off some of the debt owed to the IMF by selected poor countries. The issue has always been where the needed financing would come from.

downsizing now when the global economy is down-shifting and with new and daunting policy challenges (lingering inflation, financial regulation, cross-border investment, etc.) confronting both developed and developing countries means that the timing may not be ideal.

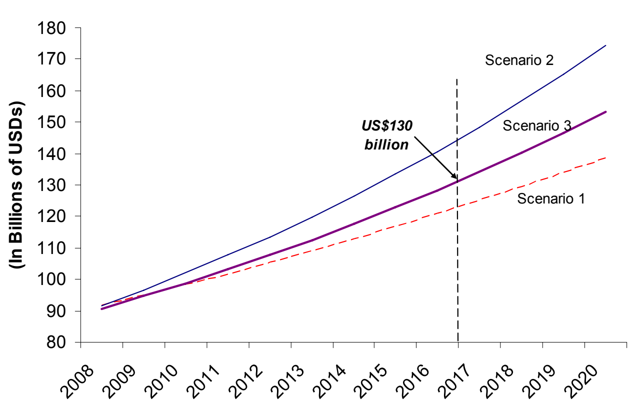
Exhibit 2
The IMF's Gold Holdings and Credit Outstanding



Source: International Monetary Fund

Convert the IMF's gold holdings into paper assets
We ran some simple back-of-the-envelope simulations to calculate the possible earnings streams if the IMF were to sell some or all of its gold holdings and invest the proceeds in bonds and equities. Please see Exhibit 3 for details.

Exhibit 3
Simulated Investment Earnings for the IMF



Source: Morgan Stanley Research

Scenario 1 shows how the 103.4 million ounces of gold, if completely sold now, would grow over time, assuming a conservative annual nominal investment return of 3.5%. Scenario 2 assumes a 5.5% nominal return.

Scenario 3 shows how this latter profile would be altered if the annual operating expenses of US$1 billion were taken out from the investment returns in 2008. With the operating expenses assumed to rise at an inflation rate of 2.5% beyond 2008, this 'supra-SWF' could reach US$130 billion in 10 years' time. Spending out of this fund would strictly be limited to the investment returns, and the principal would be protected in nominal and/or real terms.

The 3.5% nominal return is a most conservative assumption. Depending on the IMF's investment strategy, higher investment returns would, of course, be possible, even if investments were limited to AAA rated bonds. Asking the Fund to hold equities may be unreasonable, given the associated market risk, liquidity concerns and reputational considerations. But the point is that the IMF has a great deal of scope to enhance its investment returns without exposing itself to undue market risk. Having most of the assets yielding no investment return does not seem to make a lot of sense. Even if the IMF only sells off a portion of its gold holdings, it would be helpful, from a financial perspective.

Ultimately a political decision
The economic and financial argument in favour of the IMF altering its investment style seems compelling to us. The key impediment to this proposal is mainly political. The US government, in particular, will need to reconsider its thus far firm position on gold being a good, prudent asset for the IMF to hold. But with the financial proposition being so different now than a decade ago, when the idea of gold sales to finance the HIPC Initiative was first proposed – and rejected, perhaps the IMF may be allowed to sell its gold holdings this time around.

Bottom line
'SWFs' are far from a four-letter word. They are an inevitable and rational consequence of some of the most powerful structural trends in the global economy. Demographics, excess savings and artificially depressed sovereign long-term interest rates are all factors that have altered the ability and the willingness of sovereign funds to modify their investment portfolios. In this note, we argue that the IMF itself confronts similar pressures, and that, in our view, it should seriously contemplate setting up a supra-sovereign wealth fund, out of the gold holdings it has. Fully financing the operating expenses of the IMF, this prospective fund could be launched at US$92 billion and grow to US$130 billion in 10 years' time.

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USD to Reassert; Non-G4 Currencies to Shine	14 June 07
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* = Co-Authored.

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