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*Dialogue*

# Mobilizing IMF Gold for Multilateral Debt Cancellation

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ABSTRACT *Sony Kapoor examines how using IMF gold sales to fund multilateral debt cancellation could release much needed resources for meeting the millennium development goals (MDGs). He shows why multilateral debt cancellation is so critical and how the sale of IMF gold could finance it for the IMF as well as the World Bank. He addresses the concerns of the gold-producing poor countries by highlighting two distinct mechanisms by which the gold could be sold while eliminating or at least minimizing price impact. Finally, he underlines the fact that selling this gold and using its proceeds for debt cancellation would not in any way jeopardize the operations of the IMF.*

KEYWORDS *MDGs; multilateral debt; finance; developing countries; central banks*

## Multilateral debt cancellation and the MDGs

Debt relief is an integral part of the funding package needed to achieve the MDGs. While higher aid flows, a fairer tax and trade regime, and higher foreign investment all have the potential to generate the additional resources needed for achieving the MDGs, it is critical that these resources are not frittered away in servicing unpayable debt but are actually used for development-related expenditure.

Previous papers (Greenhill, 2003; Kapoor, 2004) have clearly established the link between the need for debt relief and achieving the MDGs. They have also established how debt relief and aid are complementary to each other and how the Heavily Indebted Group of Countries (HIPCs) would need both 100 per cent debt cancellation and a near doubling of aid flows in order to be able to achieve the MDGs.

Debt relief acts as de facto budgetary support and is a far more efficient funding mechanism than aid flows, up to 30 per cent of which can be 'tied' to services and goods from the donor country. Administratively too, debt relief is much cheaper than aid. Debt cancellation can help reduce the 'debt overhang' that discourages investment into the poorest and most indebted countries. Debt cancellation is also anti-inflationary, anti-cyclical and can stimulate growth in an economy. However, even a 100 per cent debt cancellation is not enough by itself to finance the achievement of the MDGs, which is why both debt cancellation and increased aid flows are needed.

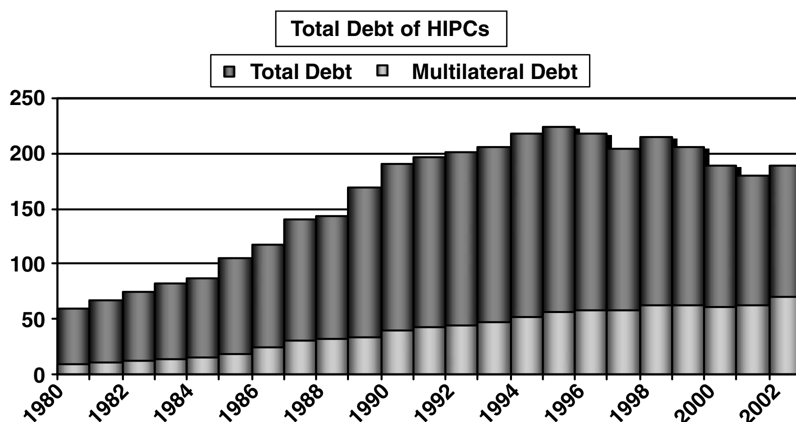


**Figure 1:**

Of all kinds of debt that is now owed by the HIPCs, multilateral debt is probably the most important. It is a big drain on poor country resources as it is almost always serviced. So, multilateral debt cancellation is perhaps the most efficient step in releasing more resources for achieving the MDGs.

## The growth of multilateral debt

For the HIPCs, external debt has gone up 320 per cent since 1980 to $US189 billion. Debt owed to multilateral institutions has increased 800 per cent to $US70 billion so it now constitutes a full 37 per cent of the total debt, up from 14 per cent in 1980 (Figure 1).

However, this number for the HIPC as a group understates the true share of multilateral debt as it includes countries that are not expected to reach completion point. In fact, for the first 27 countries that reached decision or completion point, the share of multilateral debt is expected to be a massive 65 per cent after the completion of the HIPC initiative, up from 42 per cent before.

## The efficiency of multilateral debt cancellation

The preferred creditor status of the multilateral institutions ensures that almost all debt owed to them is serviced regularly. This is different from the debt owed to bilateral and private sector creditors, significant proportions of which are in arrears – not serviced regularly by resource-poor countries.

So cancellation of bilateral and private sector debt may sometimes be just a paper transaction involving writing off debt that was not being repaid. For example, the following graph clearly shows that most HIPC debt stock reduction to date has come in the form of writing off debt in arrears – cancelling debt that was not being repaid. In fact, more than 80 per cent of the debt stock reduction has been eroded by a reduction in arrears (Figure 2).

The cancellation of multilateral debt, on the other hand, almost always frees up resources that would have gone into debt servicing and also reduces debt overhang at the same time. Thus, compared with the cancellation of other forms of debt, multilateral debt cancellation frees up more resources per dollar debt cancelled and hence is more efficient.

## Multilateral debt comes with strings attached

The multilateral institutions, when lending to developing countries, require them to meet certain conditions while running government policy. These conditionalities have grown more onerous over time and now encroach on all important aspects of governance including fiscal, monetary and social policy. These conditionalities have

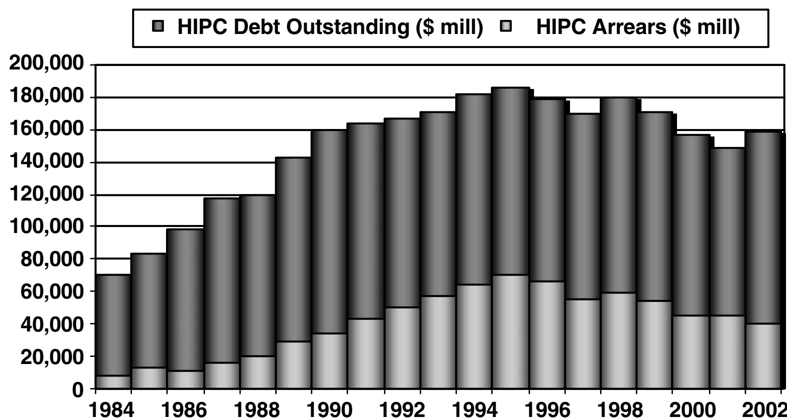


**Figure 2:**

limited policy space available to governments and have been instrumental in pushing a standardized model of development that has been largely discredited for its failure to achieve sustainable poverty reduction.

Multilateral debt gives the international financial institutions a large degree of leverage in driving policy in the poorest countries. A large part of the multilateral debt is rolled over – new debt is given by the multilaterals to repay the old debt owed to them – and a failure to meet conditionalities by the national governments can result in a refusal to roll over debt, leading to a default that cuts the country off from external financial markets. Cancelling multilateral debt will free up some policy space for the poorest countries to pursue policies that are best suited to achieving the MDGs.

## Financing multilateral debt cancellation with IMF gold

### *The IMF and its gold*

The IMF holds 103.4 million ounces, the third-largest reserves of gold in the world. The gold is valued at about $US8.5 billion in the IMF's books when the current[1] market value is close to $US46.5 billion. Hence there is about $US38 billion of latent value locked up in the IMF's gold reserves, which could be mobilized through the sale of this gold.

The IMF has no real use for this gold and it is not used in the general day-to-day operations of the Fund. Also, at the present book value, gold just constitutes 2 per cent of the total $US370 billion in resources http://www.imf.org/external/np/tre/liquid/2004/0304.htm ($US290 billion is in usable currencies). Even at the market value of $US46.5 billion, gold would only be 12.5 per cent of the Fund's available resources.

We suggest (Kapoor, 2003, 2004) that the IMF sell this gold in order to finance multilateral debt cancellation. At the current[2] market price of $US450 per ounce, this would generate more than $US38 billion. A more conservative estimate, using the 24-year historical average[3] for the price of gold, $US370 would still generate additional resources of over $US30 billion.

These can then be used to cancel the multilateral debt owed to the IMF by the HIPCs and the excess amount can be used to finance the cancellation of debt owed to other multilaterals, especially the International Development Association (IDA), the concessional lending arm of the World Bank.

## Gold sales or gold revaluation

The revaluation of gold, in the 1999–2000 transactions used to mobilize resources for debt cancellation, is a misnomer since it was little more than an accounting trick that had little, if anything, to do with gold. The transaction did not involve any

additional inflow of funds and comprised a simple transfer of resources from one account to another.

As a consequence of revaluation, the money that was allocated to HIPC debt cancellation came not from the use of gold, but from IMF borrower and creditor nations. The revaluation diverted funds from borrowers – in the form of a higher interest burden, and creditors – in the form of lower compensation for their contribution to the Fund and then used these funds to pay off HIPC debt. In fact, this transaction is still costing IMF members, about SDR 100 million every year.

Revaluing all IMF gold in a manner akin to that used in 1999 would in fact impose an additional annual cost on IMF members of as much as SDR 1.4 billion – an amount that will surely not allow the IMF to perform its job as the lender of last resort.

Gold sales, on the other hand, would actually use gold to generate resources required for debt cancellation. So the IMF would lose its gold and inturn, raise money for debt cancellation. This would involve the flow of real additional money and will not be just an accounting trick involving internal IMF accounts.

## The gold market and the sale of official gold

The second amendment of the Articles of Agreement of the International Monetary Fund, in April 1978, officially established the end of the gold standard and after this, no central bank provided for full convertibility of its currency into gold.

This was expected to drastically decrease the amount of gold reserves held by countries. However, that never happened, and gold continues to be an important asset in the reserve holdings of a number of countries. In fact, between 1978 and 2004 the total reserve holdings of gold in the world have only gone down by about 150 million ounces to 1,016 million ounces, a decrease of only about 13 per cent.

However, there is an increasing trend for central banks to get rid of their gold reserves. More than 75 per cent of the 150 million ounces sold have been brought to the market since 1992 and more than half the gold sales have occurred since 1997 (Figure 3).

In fact, most of the largest sales of central bank gold have taken place in recent years. The official sector sold 19.5 million ounces in 2003, 17.5 million ounces in 2002, 16.9 million ounces in 2001, 15.4 million ounces in 2000, 15.3 million ounces in 1999 and 19.8 million ounces in 1997.

There is a trend for ever-increasing gold sales by central banks. Despite this, gold price has generally followed a higher trend since 2000.

This is illustrated by the graph shown in Figure 4, which tracks the price of gold from 1998 right up to 2004.

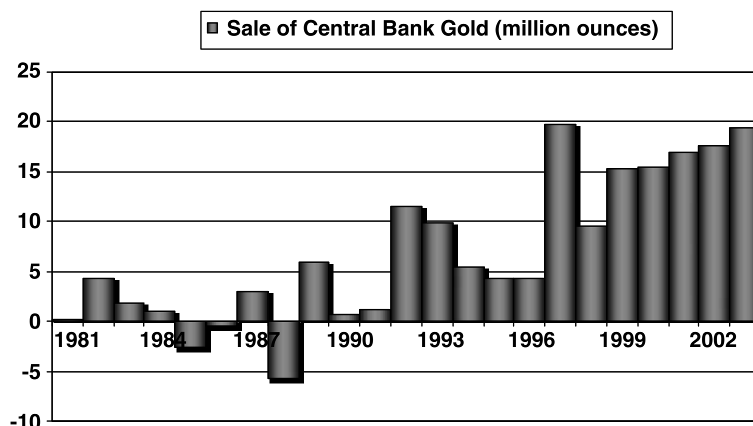


**Figure 3:**

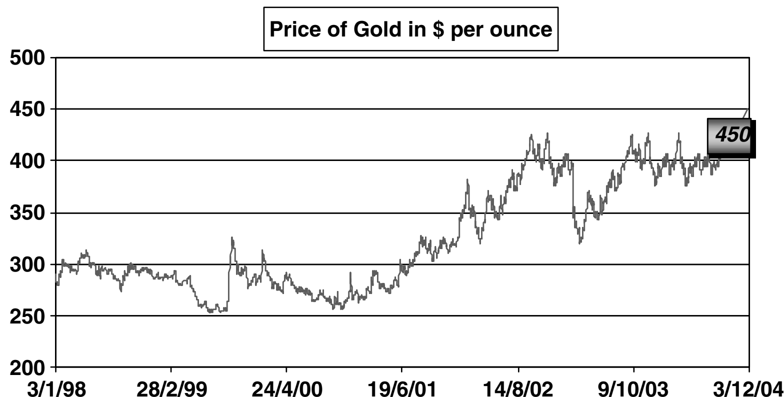


**Figure 4:**

Switzerland, The Netherlands, Belgium, UK, Australia, Canada and other OECD countries have been major sellers of gold in recent times and a decrease in the overall level of gold reserve holdings is now a fact of life in the gold market.

Large annual sales of central bank gold are now fairly common. For example,

- Switzerland sold 5.5 million ounces in 2000, 7.1 million ounces in 2001, 9.1 million ounces in 2002, 9.15 million ounces in 2003 and had already sold more than five million ounces by mid-2004.
- The Netherlands sold 12.9 million ounces in 1993, 9.7 million ounces in 1999 and is in the process of selling another 9.6 million ounces.
- Belgium sold 9.6 million ounces in 1998, 6.54 million ounces in 1996, 5.6 million ounces in 1995, 6.51 million ounces in 1992 and four million ounces in 1989.

## Central bank sales of gold and gold price

In general, the financial markets do not like uncertainty. This is because valuation of financial assets derives from the confidence in their value and uncertainty can dent confidence. One of the reasons why central bank gold sales became a contentious issue in the late 1990 s was that they were sporadic and unpredictable. There was no way of knowing when a central bank could suddenly announce the sale of significant stocks of gold. This could have had a negative impact on market confidence.

Moreover, central banks were leasing increasing amounts of gold to financial market participants. While no one really thought that central banks would sell a large chunk of their gold holdings, there were real fears that gold leasing could increase exponentially and depress gold prices.

It was in this environment that the first Central Bank Gold Agreement (http://www.usagold.com/NewGoldMarket.html) was announced on 26 September 1999. All major central banks that had been significant sellers of gold signed this agreement, which the declaration said was 'In the interest of clarifying their intentions with respect to their gold holdings...' or in other words, to reduce uncertainty surrounding gold sales and leasing by central banks.

The agreement did not reduce gold sales as is widely stated by those opposed to gold sales but in fact totalled up the gold sales that were planned by the signatories and disclosed the number to the market. This helped reduce uncertainty.

What the agreement did limit was the further leasing of gold to financial market participants. The growth in gold leasing was depressing gold prices and there was also concern about leased gold being used for speculative purposes. The CBGA sought to freeze gold leasing, futures and options at levels prevailing in 1999.

This helped alleviate market concerns of an exponential growth in gold leasing and there was

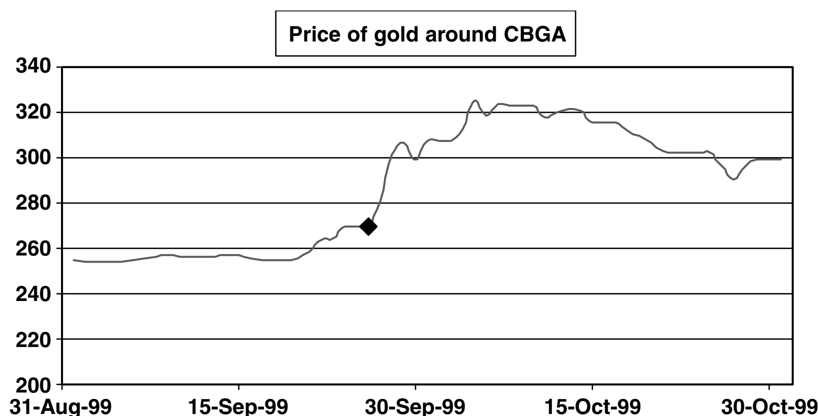


**Figure 5:**

an instant rise in gold price. It is interesting to note that this happened while the CBGA announced that the signatories would actually sell over 65 million ounces of gold over the next five years – about 13 million ounces every year.

The bounce in gold price was primarily a result of: (1) a more certain environment for gold sales, (2) a limit on further leasing of gold and (3) not because the planned sales of gold were cut down.

The following graph illustrates how the gold market reacted to the announcement. There was a clear positive price reaction around the date the CBGA was announced (marked in graph in Figure 5) before the price settled down again.

The recent renewal of the agreement (http://www.gold.org/value/reserve_asset/agreements/ecb_pressrelease2.html) did not have much of a market impact though it will expand the sales to about 80 million ounces over five years or about 16 million ounces every year. Importantly, it keeps the freeze on gold leasing, futures and options in place.

Hence, the gold market can absorb sales of significant amounts of gold as long as they are carried in an open and transparent manner with the planned sale time table released into the public domain. This helps curb speculation and uncertainty in the market. The conclusion is supported in another study[4] of previous IMF gold sales.

We have suggested that the IMF sell five million ounces of gold every year to fund debt cancellation.

## Precedents for the sale of IMF gold

The IMF has already engaged in several transactions[5] where it sold gold in the 1950s and 1960s. Then, between 1976 and 1980, the IMF sold approximately one-third (50 million ounces) of its then-existing gold holdings following an agreement by its members to reduce the role of gold in the international monetary system[6] and to finance concessional lending to poor countries. In 1999–2000, the IMF carried out off-market transactions involving 12.9 million ounces of gold in order to generate resources for HIPC debt cancellation.

In 1979–1980, discussions took place regarding the establishment of a substitution account in lieu of gold reserves, which included a proposal for the sale of a part of the gold to invest in income-generating assets.[7] Though IMF staff supported the idea, the issue was dropped because of the lack of political support. At that time, the sale of gold was seen as contentious because of its possible adverse impact on the gold price and the value of central bank gold reserves. The nascent gold market was fairly illiquid then.

Things have moved on since then and a sale now would just be belated recognition of the

relatively insignificant role that gold now plays in the monetary system. The gold market has become much bigger, is very liquid and diverse and central banks themselves have been off-loading their reserves in the market for many years now without much price impact (http://www.gold.org/value/reserve_asset/). The time is now right to revisit the sale of IMF gold.

## OECD central banks and gold sales

OECD central banks have been selling large quantities of gold in the open market. They have already sold about 100 million ounces of gold since 1999. Of this, more than 19 million ounces was sold in 2003 and 17 million ounces in 2002.

The new CBGA expands the sanctioned gold sales by its signatories from 65 million ounces to 80 million ounces. The countries selling gold under the CBGA are among the richest in the world. If central bank sale of gold impacts gold price as some critics say and has the kind of negative impact on gold producing poor countries, then this sale of central bank gold is directly harming poor countries.

None of the rich countries selling gold have any pressing needs that would require such a sale. Their decision to sell is strategic rather than urgent. The sale of IMF gold, on the other hand, is urgently needed to help cancel the debilitating debt of the poorest countries in the world.

Under the renewed CBGA, Switzerland is likely to continue to be a large seller. Statements coming out of France and Germany also indicate they are likely to be other major sellers.

Italy is likely to be another major seller. Significantly, Renato Brunetta, the economic advisor to the Italian Prime Minister has said that Italy could use its gold reserves to help slash its government debt.[8]

This is analogous to our suggestion for the sale of IMF gold to help reduce poor country debt. If Italy, one of the richest countries in the world, can contemplate the sale of its gold reserves for paying off national debt, surely our suggestion for the sale of IMF gold to cancel poor country debt needs to be considered seriously.

Also, the suggested sale of five million ounces of IMF gold every year pales in comparison to the 16 million ounces sales agreed to under the CBGA. If the OECD countries believe that IMF gold sale would damage the economy of poor gold-producing countries, then a simple way round this problem would be to revise the CBGA to limit central bank gold sales to 11 million ounces per year and let the IMF sell five million ounces every year.

## Developing county central banks and gold sales

Countries such as China, the Philippines and Russia are actually already increasing their gold reserve holdings. China, for instance, bought about 6.6 million ounces of gold in 2001–2002. This year, the Argentine government has been buying gold in the market in order to diversify its holdings of reserve assets.

Developing countries have record levels of foreign exchange reserves that are greater than $US1,500 billion. While OECD reserves have a larger proportion of gold in their reserves,[9] developing country reserves are mostly denominated in the US dollar though the proportion of the euro and yen is steadily on the rise.

Finance theory dictates that the diversification of risk adds to the long-term value of a portfolio. This would mean that it makes sense for developing countries to hold as many different assets as is reasonably possible. Gold is especially good for diversification as its price varies inversely to that of most other assets – when some of the major currencies fall gold mostly rises. The recent fall in the dollar has seen a simultaneous rise in the price of gold. Holding gold could mean that the reserve portfolio would be more likely to maintain its value in a volatile environment.

As the dollar has fallen, developing countries have booked real capital losses on their reserve portfolios. The effect of the more than 30 per cent fall in the dollar (in trade-weighted terms) has meant that developing countries have lost over $US100 billion by holding mostly dollar-denominated reserves. It is likely that they are seeking to diversify their portfolios by holding more gold

despite there being a significant opportunity cost associated with holding gold.

There is a real possibility that more developing countries would diversify their reserve holdings to include more gold. The IMF, on the other hand, already holds the most diversified portfolio of reserves even without its gold holdings. Since its portfolio consists of the currencies of over 170 members, it does not need gold to add to the diversification and hence can easily get rid of it without any adverse affects.

One possible way of selling IMF gold in order to minimize market impact would then include off-market direct sales to central banks that are looking to increase their gold holdings (Kapoor, 2004).

## IMF gold sales and IMF lending capacity

The IMF's ability to lend is determined by the capital it holds. There is an ongoing debate about whether the IMF has too much capital or too little. However, it is critical to note that the sale of IMF gold does not take sides in this debate.

Selling IMF gold is not an implicit recognition that the IMF is overcapitalized. In fact, the sale of gold will have no effect on the amount of capital that the IMF holds.

Gold, as it is currently held by the IMF, constitutes only about 2 per cent of the resources that the IMF has available to lend. In fact, the IMF's articles forbid it from lending the gold – so the Fund cannot use it normal lending operations and this means that this gold is of no practical use to the IMF for its lending operations.

The sale of gold would actually increase, not decrease, the IMF's capacity to lend by replacing gold that cannot be used for lending with its cash equivalent (of SDR 35 per ounce), which of course can be used for lending. This increase in the actual lending capacity of the IMF will be about SDR 3.2 billion or $US5 billion.

Some commentators have mentioned that holding undervalued gold lends fundamental strength to the balance sheet of the IMF. This premise is based on the notion that the IMF would be able to unlock the $US30 billion or more that lies locked up in latent value. It is critical to note that this can only be done through a sale of the gold.

In fact, members of staff at the IMF first proposed selling the gold in 1980, but were thwarted by the lack of political will. Calls for the sale of gold were revived in 1999 when it was suggested that the resources mobilized should be used for the cancellation of some of the HIPC debt owed to the Fund. However, even then, a lack of political will thwarted the sale of gold and instead, a compromise solution involving the off-market revaluation of gold – a mere accounting trick – was reached. It is clear that there is a significant amount of hesitation in the world political community to sell the IMF gold.

At least in the foreseeable future, the Fund would not be allowed to sell gold to mobilize additional resources for strengthening its balance sheet. Since there is no other way that gold could lend strength to the IMF's balance sheet, the Fund has no use for the gold, and hence selling it would have no impact on the fundamental strength of its balance sheet.

In fact, holding gold has a significant opportunity cost for the Fund and it has been estimated that if the Fund had started phased sales of gold in 1980 and invested the proceeds in income-generating assets, it would have had a balance sheet that would be stronger by about $US70 billion as compared to its current value (Kapoor, 2003). Of this, more than $US30 billion is the lost income and the rest is the cash value generated by gold sales.

The only politically feasible way that the Fund could sell gold is when it is linked to another objective, such as multilateral debt cancellation, which has large political capital behind it. This time around, when both the US and the UK have put their weight behind multilateral debt cancellation and other creditor nations are in favour, it is likely that enough political will could be mobilized to sell IMF gold.

This is even more likely since civil society and many governments are making the link between attaining the MDGs – behind which there is enormous political capital – and 100 per cent multilateral debt cancellation. The sale of gold is also made more likely by the fact that countries such as Germany, which are hesitant to commit any additional bilateral resources to debt cancellation

due to the domestic fiscal and political situation, would find funding the cancellation of debt through the sale of IMF gold a more palatable option.

There is also a notion that the Fund could somehow use the gold in the event of a financial emergency when many of its borrowing members cannot meet their obligations. Such a situation will no doubt be accompanied by stressed financial markets and all financial practitioners would agree that selling huge quantities of gold – an illiquid asset – into stressed financial markets can only exacerbate the financial crisis. So it is clear that, especially in the event of an emergency, the IMF would not be able to draw on its reserves of gold.

Thus, holding undervalued gold does not help the IMF tackle an emergency in any way whatsoever. In fact, selling gold as proposed by us will generate an additional $US5 billion in liquid resources for the Fund, which can be drawn on in the event of any emergency.

### Notes

1 28 November 2004.
2 28 November 2004.
3 From 1980, when Fund Staff suggested that gold be sold and the proceeds be invested in income-generating assets.
4 'Transparency in announcing and then sticking to an auction calendar gave reassurance to the markets' The IMF and Gold, World Gold Council, 2001.
5 'Financing the Fund's Operations – Review of Issues', 'in the late 1950s and in the 1960s, the IMF sold gold on several occasions to replenish its holdings of currencies', 'in order to generate income to offset operational deficits, some gold was sold to the United States and the proceeds invested in US government securities. A significant build-up of reserves through income from charges prompted the IMF to reacquire this gold from the US government in the early 1970s' (IMF, 2001).
6 'Auctions and restitution sales (1976–1980). The IMF sold approximately one-third (50 million ounces) of its then-existing gold holdings following an agreement by its members to reduce the role of gold in the international monetary system. Half of this amount was sold in restitution to members at the then-official price of SDR 35 per ounce; the other half was auctioned to the market to finance the Trust Fund, which supported concessional lending by the IMF to low-income countries' (IMF, 2001).
7 'In 1979–80, discussions took place regarding the establishment of a Substitution Account. Fund management supported the use of a (substantial) part of the Fund's gold holdings to ensure the viability of the Account, and also the sale of a small portion of the Fund's gold and use of the profits to create an investment fund and thereby strengthen the Fund's income position. The question of a Substitution Account was later dropped, as was the issue of gold sale for the purpose of deriving income for the Fund. This was done primarily because of the lack of a political consensus and concerns about the impact on the still nascent post gold standard international gold market' (IMF, 2001).
8 Interview with Rachel Sanderson, August 5 (Reuters).
9 Mostly due to historical reasons.

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