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FOR AGENDA

SM/10/306
Supplement 1

December 1, 2010

To: Members of the Executive Board

From: The Secretary

Subject: **Steady State Income Outlook—Updated Estimates**

The attached paper provides background information to the paper on asset allocation under a broadened investment mandate—preliminary considerations (SM/10/306, 12/1/10), which will be brought to the agenda for discussion on **a date to be announced**.

The staff does not propose the publication of this paper due to market-sensitive content.

Questions may be referred to Mr. Andrews (ext. 38318) and Mr. Kabwe (ext. 37828) in FIN.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

Steady State Income Outlook—Updated Estimates

Prepared by the Finance Department

In consultation with the Legal Department and the Office of Budget and Planning

Approved by Andrew Tweedie

November 30, 2010

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I. INTRODUCTION

1. **As background to the Executive Board discussion on a broadened investment mandate, this supplement updates earlier estimates of the Fund's steady state income outlook.**[1] A comprehensive update of the medium-term consolidated income and expenditure framework will be issued for discussion in January 2011 in the context of the FY 2012–14 medium-term budget (MTB) cycle. This paper focuses on the outlook beyond this horizon to a steady state, when crisis lending is assumed to have dissipated and compares this outlook with the estimates at the time of Board approval of the new income model in April 2008.[2]

2. **The global financial crisis has significantly changed the medium-term outlook for the Fund's income position.**[3] Lending income has risen sharply, and is expected to stay at elevated levels for at least the next three years. This temporary increase in lending income will support the accumulation of precautionary balances needed to address the heighted credit risks now facing the Fund.

3. **However, the outlook for the Fund's net income position in the steady state has not changed significantly.** After lending income declines, the Fund will depend on investment income to provide a sustainable revenue source. As envisaged under the new income model, in this steady state low-credit environment, returns from the investment of reserves and the gold-funded endowment will provide the bulk of the Fund's income, consistent with its important public good functions. Nonetheless, these estimates are inevitably subject to significant uncertainties.

II. STEADY STATE INCOME OUTLOOK IN APRIL 2008

4. **Projections presented in April 2008 illustrated the imperative of the new income model and spending restraint to restore balance.** At the time, Fund income from lending had fallen sharply and was projected to decline further, with the stock of Fund credit stabilizing at SDR 5–6 billion. The new income model was designed to provide an alternative sustainable source of income that could, in the steady state and after savings from the agreed restructuring program, cover the expenses of the Fund. Profits from sales of the Fund's post-Second Amendment gold, at an assumed price of US$850 per ounce, would fund an endowment, and income from this endowment and investment of the Fund's reserves were expected to account for about two-thirds of total income in the steady state, beginning around FY 2014. Despite expenditure savings from the restructuring program, deficits were projected to be eliminated only gradually as the new income model was put in place. During this interim period, the Fund's reserves would be drawn upon to cover losses, with precautionary balances declining to about SDR 6 ½ billion (Figure 1).

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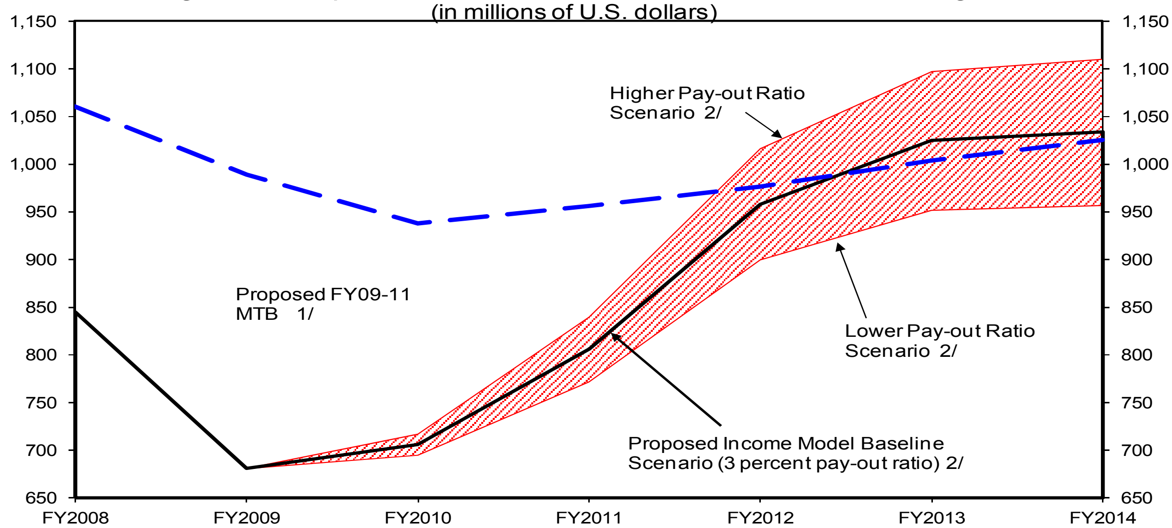
[1] See *Asset Allocation Under a Broadened Investment Mandate: Preliminary Considerations* (SM/10/306, 12/1/10).

[2] See *The Consolidated Medium-Term Income and Expenditure Framework* (EBAP/10/31, 4/8/10) and *Supplementary Material to (i) the FY2009-FY2011 Medium-Term Administrative, Restructuring, and Capital Budgets and (ii) Developing a New Income Model for the Fund—Proposed Decisions* (EBAP/08/27, 4/3/08).

[3] For the purposes of this paper, medium-term refers to the next three year period consistent with the budget cycle.

Figure 1. Proposed Income Model and Medium-Term Budget
(in millions of U.S. dollars)



1/ Includes restructuring expenses, capital budget items expensed, and depreciation.
2/ The scenarios assume a baseline 3 percent pay-out ratio and +/- 100 basis points from the baseline.

5. **The 2008 projections pointed to a finely balanced income position in the steady state.** It was recognized that the evolution of net income was subject to significant uncertainty, particularly with respect to interest rates, the US$/SDR exchange rate, and the impact of a broadened investment mandate. The SDR interest rate was expected to remain broadly around 3 percent. A payout ratio of 3 percent from the gold endowment was based on an assumed return of 5 percent under a broadened investment mandate, with 2 percent retained in the endowment to preserve the real value of the gold profits. As indicated below, with a lower payout ratio, steady state income was projected to be less than expenditures (Table 1).

Table 1. Projected Net Income Position in the Steady State (2008 Outlook) 1/

	Alternative Payout Ratio Scenarios		
Stock of credit (SDR billions)	5.5	5.5	5.5
Lending income (SDR millions)	65	65	65
Stock of precautionary balances (SDR billions)	6.5	6.5	6.5
Endowment payout ratio (percent)	2.0	3.0	4.0
SDR interest rate	3.5	3.5	3.5
US$/SDR	1.65	1.65	1.65
Net operational income (SDR millions)	**-41**	**6**	**52**

1/ Steady state assumed to be in FY 14 when Fund credit is stable at about SDR 5.5 billion, and the new income model is fully implemented.

III. Updated Steady State Income Outlook

6. **The global financial crisis has significantly changed the Fund's near-term income outlook**. Fund credit outstanding has increased to over SDR 50 billion; lending income has risen sharply, and is expected to stay at elevated levels for at least three years. The impact of this higher lending on the Fund's overall income position has been attenuated by the very low interest rates during the crisis which have, in the short term, reduced the Fund's actual and expected investment income to well below the levels projected in 2008. Nevertheless, instead of the annual losses that were expected to arise in the transition to the new income model, the latest projections point to significantly positive net income flows that will likely continue for several years.

7. **Looking further ahead to when lending income declines, the Fund will again depend heavily on investment income to provide a sustainable revenue source**. In the steady state, assumed to be FY 2020 when full drawings under current arrangements have been repurchased, the stock of credit outstanding is assumed to stabilize at about SDR 10 billion and provide only a modest contribution to total income.[4] In addition, commitments under contingent lending facilities are assumed to fall back from their current high levels and make a modest contribution to income from commitment fees in the steady state.[5] In the interim, the increase in lending and surcharge income from the Fund's support to members in the crisis is expected to bolster precautionary balances. While these reserves are needed primarily to address the heightened credit risks facing the Fund, they also provide the potential for higher investment income in the steady state. The assumed level of precautionary balances in the steady state is the recently agreed floor of SDR 10 billion.[6] The projections retain the original assumption that the endowment receives profits from gold sales at a price of US$850 per ounce.[7]

8. **Expenditures are assumed to be unchanged from the most recent medium-term scenario presented in April 2010.** Thus, the expenditure path assumes that the real spending in US dollar terms is maintained at the level of the current medium-term budget envelope. As

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[4] This represents almost a doubling of the steady state assumption of Fund credit of SDR 5.5 billion in the 2008 projections. The previous level reflected the outlook at the time, but in light of developments since then, the previous trough (SDR 10 billion) in Fund credit over the past 30 years seems a broadly appropriate assumption on which to build a steady state outlook.

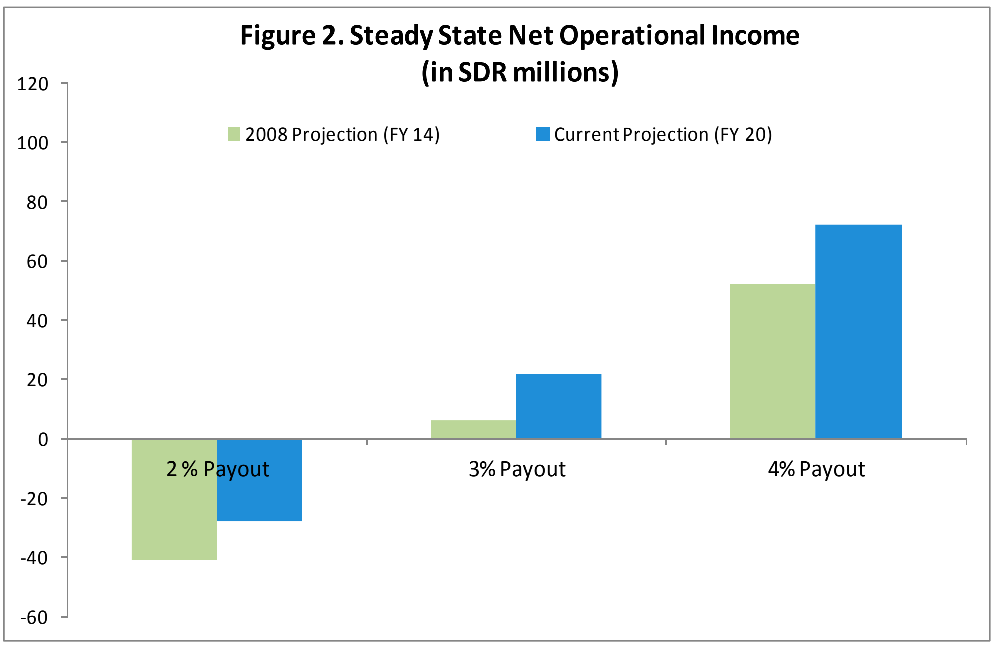
[5] Current commitments under precautionary Flexible Credit Lines (FCLs) amount to almost SDR 50 billion. The Fund's experience with FCLs is limited, and therefore considerable uncertainty remains about future demand.

[6] See *The Acting Chair's Summing Up, Review of the Adequacy of the Fund's Precautionary Balances* (BUFF/10/137, 9/22/10).

[7] In July 2009, the Executive Board endorsed the use of SDR 0.7 billion from gold sales to facilitate the financing of concessional lending to low-income countries. To date, the actual sales price has averaged more than the US$935 per ounce needed to cover this SDR 0.7 billion. The Board will need to consider separately the disposition, if any, of these additional profits from the gold sales when sales are concluded.

highlighted in Section I, these estimates will be updated in the context of the FY 2012–2014 MTB cycle.

9. **Overall, the income outlook in the steady state has not changed significantly from the 2008 outlook (see Figure 2).** As noted above, the updated estimates take into account the new floor for precautionary balances and include somewhat higher lending income in the steady state. However, these changes are broadly offset by the movement in the SDR/US dollar exchange rate since 2008 and its impact on expenditures (in SDR terms).[8] Thus, the projections show only a small positive income-expenditure position in the baseline scenario which assumes a gold endowment pay-out ratio of 3 percent. As was the case in the 2008 projections, a lower payout would result in steady state income below projected expenditures. That said, the projections are subject to significant uncertainties concerning the level of interest rates, investment returns and the US$/SDR exchange rate (see Figure 3). Table 2 provides a sensitivity analysis. Market factors and developments in the Fund's lending under current and potential new arrangements present both downside and upside risks from the baseline scenario.



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[8] In 2008, projected expenditures were converted at the prevailing rate of US$1.65 per SDR; the updated estimates use a rate of US$1.55 per SDR.

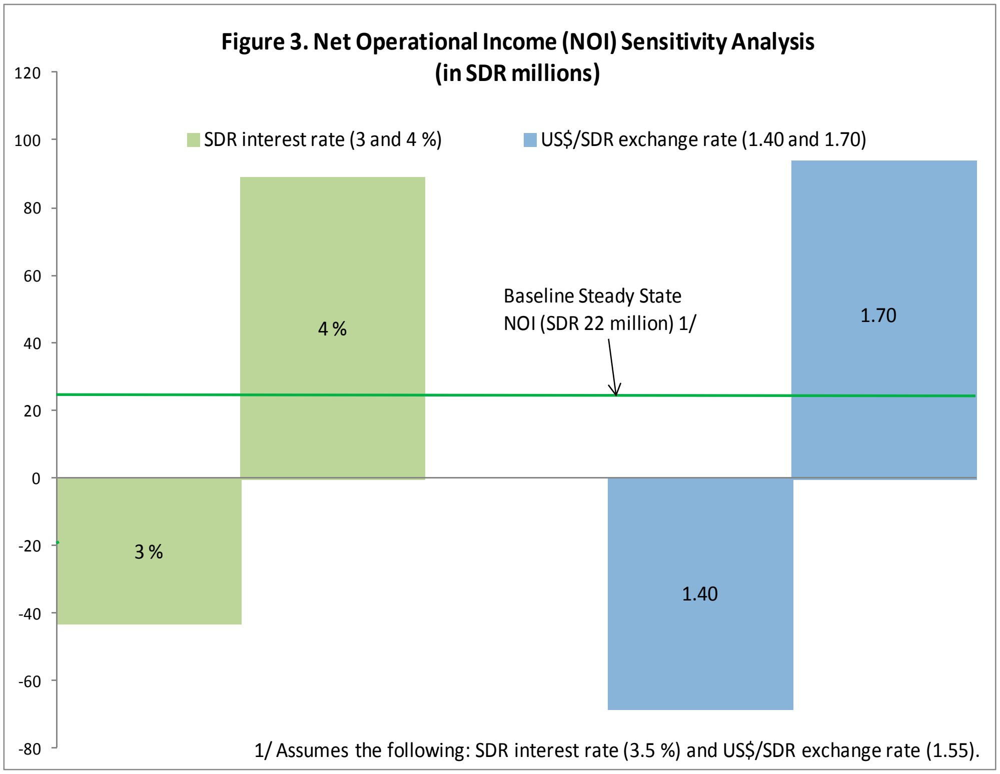

Table 2. Projected Net Income Position in the Steady State (Current Outlook) 1/

	Updated Projections						
	A	B	C	D	E	F	G
Stock of credit (SDR billions) 2/	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Lending income (SDR millions)	112	112	112	112	112	112	112
Stock of contingent lending (SDR billions)	10	10	10	10	10	10	10
Income from contingent lending (SDR millions)	27	27	27	27	27	27	27
Stock of precautionary balances (SDR billions)	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Endowment payout ratio (percent)	2.0	3.0	4.0	3.0	3.0	3.0	3.0
SDR interest rate	3.5	3.5	3.5	3.0	4.0	3.5	3.5
US$/SDR	1.55	1.55	1.55	1.55	1.55	1.40	1.70
Net operational income (SDR millions)	**-28**	**22**	**72**	**-43**	**89**	**-68**	**94**

1/ Steady state assumed to be reached in FY 2019-20 when the effects of the increase in lending have fully dissipated.

2/ Fund credit in the steady state is assumed to reflect upper bound of troughs in Fund credit in the past 30 years.

3/ Contingent lending assumed to fall from current levels of about SDR 50 billion to one-fifth (SDR 10 billion) in the steady state.